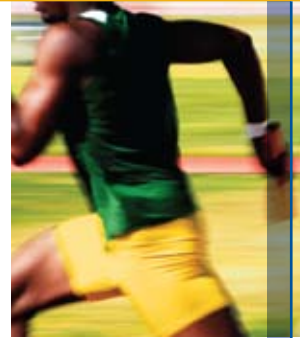


September 2007

Enhancing Business Performance – a value-based approach



A common business error is to measure and manage performance based on short-term earnings. A better approach is to manage performance by linking it to value creation. A well-designed and executed performance-improvement program would spin off discrete business initiatives aligned to a key corporate goal – enhancing the value of the enterprise.

Earnings can vary depending on the type of accounting practice adopted. For example, depreciation depends on capitalisation policy and valuation of inventory can differ depending on the method used. More importantly, managing performance based on earnings alone has two major shortcomings. Firstly, investments made in working capital and fixed assets to generate the earnings are not considered. Secondly, the time value of cash flows is ignored – it is well known that the present value of future cash flows is dependent not only on the magnitude of cash flow but on its timing as well.

The value of an enterprise depends on cash flow performance (adjusted for risk) as opposed to short-term earnings. This is supported by empirical evidence that shows a strong correlation between the share price of listed companies and free cash flow (and little correlation with earnings) over time.

In the current predatory environment, if the potential value of the company exceeds market value, it becomes a target for acquisition. Therefore managers must constantly focus on business improvement initiatives that create value. The design and implementation of such a program consists of the following key steps (*Figure 1*):

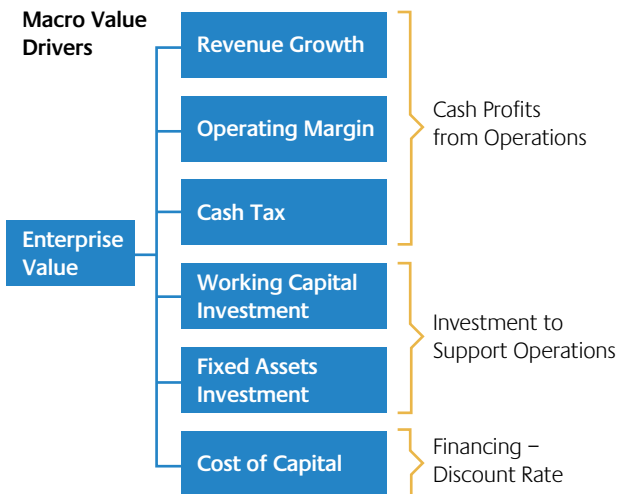
Figure 1 – Staged approach to business performance improvement



Step 1 – Understanding key value drivers

The term ‘value driver’ is commonly used to describe those variables that have a significant effect on the value of an enterprise. At a macro level, all variables that affect free cash flow or reduce the cost of funding (used to discount future cash flows) are value drivers (*Figure 2*).

Figure 2 – Understand macro drivers



Sales revenue growth, operating margin and cash tax paid are used to determine the net cash inflow of an enterprise. Investments in working capital and fixed assets reduce the cash flow, and the net effect gives the ‘free’ cash flow. The relative mix of debt and equity determines the optimum capital structure and cost of funding.

For example, increasing operating margin (say, by reducing indirect overhead costs) or decreasing cash tax paid (by having a tax-effective corporate structure) would both increase free cash flow and consequently increase value of the enterprise. Thus, key variables on both the P&L and balance sheet are considered simultaneously in defining the first stage (macro) value drivers.

Step 2 – Break down drivers to operating level

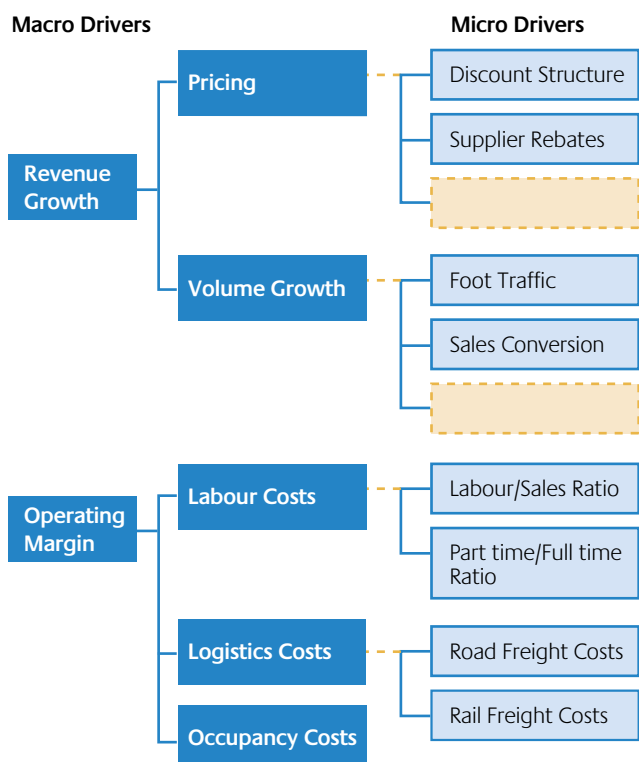
While the above concepts are expected to be well understood at the executive management level, it is harder to make it relevant to the operating managers unless the link between enterprise value and operating variables is clearly defined. Line managers can only impact variables under their control, hence the link between operating decisions and value should be clearly demonstrated.

Let’s take an example of a shop floor manager who is in charge of safety in a manufacturing company. The safety manager’s role is to improve manufacturing practices on the shop floor and a relevant performance measure might be the number of accidents over a period of time. Reducing the accident rate would reduce safety costs and possibly insurance costs as well. This can be directly related to improvements in operating margin. By spelling out this link, the connection between operating-level metrics and drivers of value can be made more meaningful to the shop floor manager.

As a starting point, it is necessary to break down the ‘macro’ drivers into relevant ‘micro’ drivers that operating managers can influence. Next, it is important to identify which drivers are relatively more important to the overall value of the enterprise so that managers can focus their efforts on improving them.

Figure 3 breaks down two macro drivers – revenue growth and operating margin (macro) – into their component operating (micro) drivers for a hypothetical retail company selling consumer electronics.

Figure 3 – Operating (micro) drivers



In the retail example, the supply chain manager's role is to optimise distribution and logistics cost and control inventory holding costs through appropriate purchasing methods. Product costs can be influenced by the merchandising manager by sourcing from established suppliers and also designing the appropriate rebate terms. The advertising manager's role is to create marketing programs that increase foot traffic through the stores. The store manager's role is to convert foot traffic into sales.

Similarly, other macro drivers can be broken down to micro drivers. It should be noted that these micro drivers are industry (and sometimes) company specific.

Step 3 – Select the most important value drivers

It is not practical to design improvement initiatives around every value (macro or micro) driver and neither is it necessary to do so. Therefore, it is important to determine which driver has the most positive impact on value. A sensitivity analysis can be constructed using company-specific financial data and business forecasts to identify which micro drivers have the biggest impact on the business. Figure 4 shows what a sensitivity analysis may look like – the relative impact of changing micro drivers (say 10%) on value is examined.

Figure 4 – Sensitivity analysis

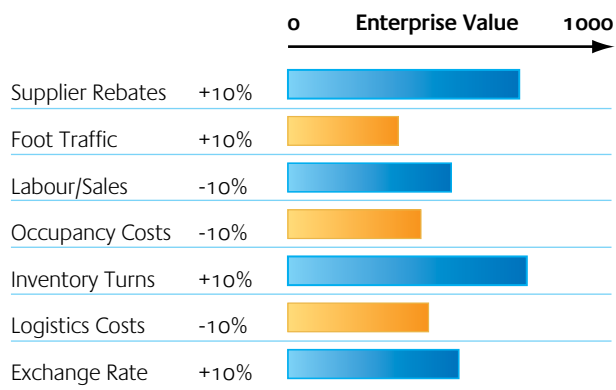
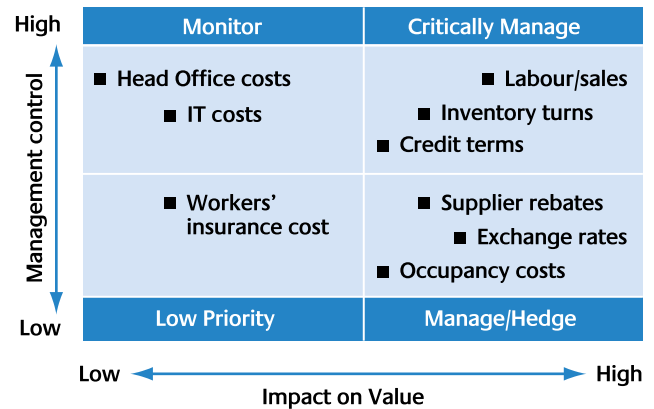


Figure 5 – Prioritise drivers



Results from micro driver sensitivity analysis can sometimes surprise top managers – for example, an incremental reduction in inventory or reduction in operating costs for manufacturing companies could have a higher impact on value than sales growth. Companies focusing on growth for growth's sake would be advised to do a sensitivity analysis first. Results may indicate that profit growth may be more important than revenue growth.

Further, it is also not possible to influence all key drivers of value as management might not have control over some of the variables. In the example of the electronics retailer, if the bulk of the products are imported, the currency exchange rate (which determines the product costs in local currency) might have a significant impact on value. However, exchange rates depend on several economic factors beyond the control of managers.

A simple matrix (Figure 5) can help determine the appropriate strategy for that particular driver. The X axis shows impact on value and the Y axis shows level of management control - obviously, those variables that have a high impact on value and can be controlled by management need to be critically managed and improved.

Step 4 – Design & implement a program

Once key drivers are identified for improvement, performance targets need to be set. For this, current performance needs to be measured and realistic targets need to be set within appropriate time frames (*Figure 6*). Each driver improvement initiative might spin off several performance improvement projects.

Figure 6 – Develop program and implement

Macro Driver	Micro Driver	Current State	Target State	Timing	Project
Revenue Growth	Foot Traffic	750/day	1200/day	6 months	Advertising Effectiveness
Operating Margin	Labour/Sales	15%	12%	3 months	Rostering Project
Working Capital	Inventory Days	100 days	75 days	12 months	Auto Replenishment System

It should be noted that a value-based business improvement program requires constant commitment from management and works best if remuneration incentives are aligned with value creation.

In summary, the following are critical factors in developing and implementing a value-creating business improvement program:

- Executive management needs to focus on value creation rather than earnings ‘quick fixes’
- There needs to be a clear understanding throughout the organisation of how key value drivers relate to operating decisions
- Operating managers need to address and improve those drivers that have the maximum impact on value

About us

Ferrier Hodgson Corporate Advisory partners with its clients to improve value. We work with you to enhance operational performance and drive strategies that deliver growth.



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