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Driving Long-Term Value: What are the Next Steps?

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Before you can *build* value, you need to find out what *drives* value in your company.

Ed. Note: Shepherd G. Pryor and William J. Hass are the authors of *Board Perspectives: Building Value Through Strategy, Risk Assessment, and Renewal,* featured in the Year-End Book Roundup on page 20.

As the custodians of corporate value, directors must seek out clear definitions and methods of measuring value-oriented targets. Many directors rightly lament the pressure to focus on short-term results, often at the expense of developing sustainable, long-term value. There is also a growing concern that hedge funds, wielding a great deal of power through ownership concentration, might demand changes for short-term results and then take their profits, leaving the company in worse shape.

At this point, much has been done to articulate the problem, along with a number of ideas for directors and management to work on, and a number of traps to avoid. The purpose of this article is to set forth a coherent framework that directors can use to help identify what builds value in their companies, and what destroys it.

Stock Market Myths

Myth 1. *Earnings per share (EPS) growth, accounting profits, and other shortcut measures like EBITDA (earnings before interest, taxes, depreciation, and amortization) provide a clear path toward corporate value for boards and management to follow,*

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removing the need to understand the stock market.

While these measures typically provide the desired level of simplicity, they rarely track value for an individual company in a statistically meaningful way. Directors and management are left open to manipulation either by those who stand to gain from "hitting the numbers," or by the outcome of "shooting at the wrong target." In particular, companies that have settled on one such measure to the exclusion of all others have frequently veered off course, sometimes disastrously.

Myth 2. *The market is swayed by the short-term thinking of some of its participants and by the belief that "the bottom line" is all that counts.*

While a particular investor class, such as hedge funds, may be thought to only value short-term results, the market will ultimately penalize any company that sacrifices sustainable, long-term results on the altar of short-term, bottom line performance. Consider this: A trader has to sell his stock to another participant in the market to realize any gain. Unless the market is populated by "greater fools" or is temporarily following false signals, the trader will not be benefited by pressuring a company to focus on short-term results at the expense of sustainable long-term results.

Boards and management should be wary of pressure from any investor to take actions to produce short-term results at the expense of long-term value. The outcome could undermine valuable long-term strategies or could result in hasty announcement of strategic initiatives that the company will never be able to fulfill. Either way, the market will ultimately see through the misguided actions, and the market value of the company will decline.

Myth 3. *The market is irrational and doesn't understand companies or value.*

The researchers of the market clearly report otherwise. However, while the market seems to understand companies very well on average, companies have widespread difficulties understanding what the market really expects or wants from them.

In an ideal world, information flows from the company's operations to the investors. Armed with a clear understanding of the ability of the company to produce economic value, the investors will value the company properly. A feedback loop, from investors back to the operations of the company, sends signals about where capital should be allocated more aggressively or withdrawn.

However, in the real world, what occurs most often is that the stock analysts communicate with the CEO and the CFO through the quarterly conference calls. The management discussion and analysis (MD&A) from the 10K and 10Q reports provides the framework, and the communicators focus on the recent changes and explanations for those numbers. Limited strategic commentary is also provided, and the analysts use the data to populate their valuation models. Feedback from the analysts goes to the CEO, in the form of more questions and analyst estimates. In recent years, a great deal of this feedback has related to EPS "guidance" and whether the company will meet it the next quarter. This dynamic has contributed to the short-term, bottom line focus that concerns all board members. Recently, many companies have stopped giving EPS guidance, recognizing that the process may not have been providing any new value to the companies involved.

The Current State of Financial Theory

The good news is that financial theory does link the price of the stock to management actions. According to financial theory, the value of a corporation (as expressed in its stock price over time) should be equal to the net present value of all of the expected free cash flows produced by the company, discounted at an appropriate rate that takes into account the risk of the investment and the returns available on alternative investments available to the investors.

Growing numbers of investors, particularly large sophisticated investors, do use financial theory to value their investments. Meeting the next quarterly EPS target plays only a tiny direct role in valuation under financial theory. The clamor for meeting short-term targets is for two main purposes:

- Trust: testing the reliability of information provided by management.
- Prediction: developing a feel for long-term expectable cash flow performance.

After a session of being peppered with questions by financial experts, it is not surprising that a CEO would be loath to return to the same forum without "meeting the guidance." Hence, the CEO may be strongly prompted to turn the focus to quarterly targets and to fashion internal compensation programs to push in the same direction.

Director Summary: The authors believe directors spend a disproportionate amount of time examining narrowly focused, potentially misleading accounting measures. They suggest directors turn their attention to measuring corporate value and discuss how directors can maintain proper oversight for the creation of a better value-building process.

Directors do not need to be experts in the computations, but they need the insight to ask the right questions.

However, these quarterly targets often provide the wrong signals. Why? Because they do not satisfy the analysts. What satisfies the analysts is an uptrend in expectable long-term cash flow and value, not a one-time increase in quarterly GAAP accounting results.

Finance and accounting differ in one fundamental way that is crucial to the issue of valuation. GAAP accounting is inherently focused on past performance, rules, and history, while finance is focused on future cash flow and risk. The best example is the flaw in using price/earnings (P/E) ratios as a performance measure. "Earnings" is an accounting measure, arising from historic results of past actions. "Price" is based entirely on investor expectations and projections about the future cash flow and risk.

There are various useful financial valuation methodologies (provided by or championed by various consultants and academics). They all incorporate some form of discounting future expected cash flows. They are all based on numerous assumptions about risk, and the value of alternative investments. While these methods are available to virtually all public companies, directors and management frequently despair at the seeming complexity of the models and choose instead to use simplistic rules of thumb and shortcut measurements to approximate value (e.g., P/E and EBITDA multiples.) Unfortunately, most of the popular rules of thumb and shortcut measures do not adequately track value, and "value" is lost.

Determining Whether Value is Added

Using internal data and value-oriented analysis, a company can analyze its operations by product, division, or geography. The results can be presented in a way that highlights which sectors are adding to corporate value and which are reducing it. The painful part of the exercise is that the analysis must follow financial theory closely enough so that the important judgments are made correctly. Directors do not need to be experts in the computations, but they need the insight to ask the right questions and provide oversight.

Value analysis is not subject to the major flaw that can be found in the type of accounting variance analysis that is usually shown to the board. Accounting variance analysis is dependent on a unit's business plans. Unfortunately, these business plans often are not linked to corporate value, but are based on improving performance from previous years, or other benchmarks. This means business units that are destroying corporate value may be shown to be "performing above plan" in the variance analysis. When this happens, the analysis shown to the board may seem favorable, and the managers of the units may inappropriately be awarded incentive pay.

Thus, variance analysis, a historic mainstay of board reporting, is an inadequate guide for directors who seek to enhance corporate value. It is critical to find a way to focus on the key performance measures that drive corporate value. Directors do not need to be GAAP accounting experts. They currently rely heavily on management for the calculations of measures such as EPS and EBITDA. Similarly, directors can rely on management's cash flow models for estimates of business unit value

A complete value analysis is the best approach, and one that is feasible for large sophisticated companies that have the resources. However, even in the absence of the heavy artillery, we should be able to do a better job than chasing P/E ratios or EPS guidance numbers.

Building value basically requires that, over time, a unit provide returns to its investors in excess of the cost of capital. When such a unit grows, the value increases even further.

Our simple performance measures must take these factors into account. The performance measures must answer the questions:

- Is the unit expected to return free cash flow above its cost of capital over the long term?
- Is the unit growing?
- Is the free cash flow stream sustainable?

Thinking about these questions in the context of one of your business units should quickly convince you that these answers do not pop out of your accounting system, and that they cannot just be put on autopilot as simple formulas. However, cash flow and asset growth can be quantified and tracked. The more elusive question about future cash flows can be discussed and business judgment can be applied. Estimates can be made as to whether the business unit will sustainably provide the necessary cash margins over time.

The internal financial staff can provide inputs on these questions for senior management and the board. The typical financial staff of a public company has the skill to work with basic cash flow models. If more refined calculations are needed, outside consultants and investment bankers are prepared to provide them.

Steps Directors Can Take to Focus Management on Value Creation

There are five key elements involved in establishing

an effective oversight process. The following discussion will look at each in terms of questions directors should ask and actions they can take in order to create a better value-building process:

Element 1: Setting Standards and Directions

Questions to Ask:

- Are both management and the board committed to long-term value?
- Are management or the board threatened by some investor or other force that is pushing for short-term, illusory increases in value?
- Can we state what our goal is for investor returns and stock value?

Actions to Take:

- Set a common goal with management to build value, rather than react to analysts' outcries for more guidance.
- Bring the compensation committee in on the discussion early, in recognition of the fact that incentives must be aligned with the new focus on long-term value.
- Determine the level of complexity and sophistication that is compatible with the organization. Start with easy-to-understand, line-of-sight measures like free cash flow.

Element 2: Developing Trackable Performance Measures

Questions to Ask:

- What is management's view of how the market values the company?
- How does management value the company?
- Which operating units have the greatest potential for value improvement, and which are at risk?
- If we rank-order our business units by value, do they add up to something like our current stock price?

Actions to Take:

- Task management with the development of and explanation of a set of value-oriented measures.
- Task management with providing value analyses of separate business units.

Element 3: Monitoring and Providing Feedback From Performance Measures

Questions to Ask:

- Is every unit "carrying its load?"
- If a low-performing unit's explanation is that it supports another, more successful unit, should the units be consolidated for reporting purposes?
- What are we doing to rectify situations where a unit cannot earn its cost of capital over the long term, and is decreasing the value of the overall enterprise?

Actions to Take:

- Quarterly, track the key measures at the full board level.
- Quarterly, have unit-level management explain the underlying changes to the board.
- Ensure that the CEO is communicating value-building measures throughout the organization.

Element 4: Adjusting Behavior Based on the Performance Measures

Questions to Ask:

- What changes are planned to respond to the problems that have surfaced in the past quarter?
- What changes are planned to respond to the opportunities that have surfaced in the past quarter?

Actions to Take:

- Require near-term turnaround action plans on value-destroying or underperforming units.
- Align compensation plans with increases in unit value.

Element 5: Adjusting Standards and Directions

Questions to Ask:

- Are we beginning to make important decisions with a focus on building corporate value?
- Are we disposing of business units that are destroying value and that cannot be "fixed?"
- Are we looking for ways of improving our insights on value creation?

Actions to Take:

- Experiment with value-based measures.
- Revisit the standards and directions annually at the board level.
- Make incremental improvements to reflect new insights.

The most courageous steps will be altering the compensation plans and pushing back on analysts who clamor for guidance in micromanaging detail. If the process is carefully applied, management will be focused on producing long-term value and the board will be comfortable that the company is not being pressured by short-term shareholders to hurt long-term value. The strategy will be communicated and upgraded continually by the new value-building process, and the process will pay off in higher stock prices over time. ■

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