The Three Jobs of Management

By David N. Fuller, CFA

Introduction

As executives and managers, our ultimate goal is to create the most value possible given the resources available to us. This goal is often obscured by the various and sundry issues, projects, meetings, and crises that consume our daily schedule. In order to avoid losing focus on this primary objective, managers should routinely step back and review their company's performance and status in terms of the value drivers that are most critical to the performance of their company and, hence, its valuation. Our experience is that many executives perform this type of a review all too infrequently given the demands of daily operations and management. Consequently, they almost certainly lack a precise understanding of the manner and magnitude in which each value driver impacts the value of their firm. Likewise, the manager must understand the expectations placed upon the company by its investors. In order to maximize value, it is first necessary to have a crystal-clear perspective on the company's current position.

The Three Jobs of Management

To maximize value, managers have to successfully accomplish three tasks. *First*, managers must protect and maintain the company's existing cash flow base. *Second*, managers must deliver on the growth expectations already embedded in its value or, if publicly traded, its stock price. *Third*, managers must generate additional growth in excess of that which is already embedded in its company value to fuel additional value appreciation.

In the public market, there are frequent examples of failures in one or more of these areas. Consider for a moment the typical impact on companies' stock prices from failure to meet analysts' earnings expectations. The drop in stock price that corresponds to this type of announcement shows the market's reaction to management's failure to deliver on embedded growth expectations. In severe cases, it may also reflect a failure to protect the company's base of business. Companies that routinely meet expectations but fail to appreciate markedly may be failing to deliver sufficient growth above and beyond that which is already embedded in its stock price.

Financial Theory

Stepping back for a moment, the value of a company and its securities is based on the present value of the cash flow investors expect the company to generate in the future. Financial theory provides a number of methods for calculating the present value of this future cash flow. The most straightforward calculation of the present value of future cash flow divides the annual cash flow expectation by the required return.

$$\text{Value} = \text{Cash Flow} \div \text{Discount Rate}$$

For example, a company expected to generate $10 million in cash flow and that has a 12% discount rate is worth $83 million. However, this calculation fails to address growth the company is expected to generate in the future. To incorporate future growth in the formula, simply subtract the growth rate from the discount rate before dividing it into cash flow.

$$\text{Value} = \text{Cash Flow} \div (\text{Discount Rate} - \text{Growth Rate})$$

For example, if the same company were expected to grow at a constant annual rate of 5%, its value would be $143 million ($10 million ÷ (12% - 5%)).

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Conversely, if the company is valued at $143 million, management has to ensure that the core business generating $10 million is maintained and protected and that the company delivers 5% growth just to prevent the value of the company from falling. To create value above the $143 million mark, growth over 5% is required.

Simplistic Models

The two formulas applied above are often referred to as the Dividend Discount Model and the Constant Growth Dividend Discount Model. A further refinement of the model is the Two-Stage Dividend Discount Model.

The table below demonstrates that a company selling at a 20x P/E has to grow income at 10% for 10 years to justify its price, while it only has to grow at 50% for one year. (Note that these figures assume 5% growth in the second stage and a 12% discount rate.) It should be noted that, when using this formula, value can be increased in three ways. *First*, value increases as cash flow increases. *Second*, value increases as risk (and, hence the discount rate) decreases. *Third*, value increases when future growth rates increase.

The first step in delivering on market expectations is to understand them. With this type of analysis, you can estimate the market's growth expectations for your firm.

TABLE 1: P/E Ratios By Growth Rate and Duration

		Short-Term Growth Rate					
		0%	10%	20%	30%	40%	50%
Duration	1	13.6	14.9	16.2	17.5	18.8	20.0
	2	13.1	15.5	18.2	21.2	24.3	27.7
	3	12.6	16.2	20.4	25.5	31.3	38.0
	5	11.7	17.4	25.3	36.2	50.9	70.3
	7	11.0	18.5	30.9	50.8	81.6	128.1
	10	10.2	20.2	40.9	82.5	162.7	311.5
	15	9.4	22.7	62.9	180.0	504.0	1,350.8
	20	9.0	25.1	94.0	385.4	1,545.3	5,829.1

The two-stage model allows for use of one growth rate for a certain time period and a second growth rate thereafter. This is much more consistent with the way companies actually grow. It becomes increasingly difficult to maintain high annual growth as products and services mature over time and offer declining growth rates. The primary determinants needed to apply a two-stage model are assumptions as to the discount rate, initial growth rate, growth duration, and second-stage growth rate.

A two-stage model can even be used to calculate the growth required to support a given P/E ratio, and therefore, stock price. We applied the two-stage model to calculate P/E ratios for a variety of short-term growth rates and growth durations.

A Value Creation Plan

The simplistic models discussed above are useful for developing a general understanding of the growth required to support a stock price. In order to truly understand the expectations related to the current value of your business and the potential for value creation, a detailed analysis of its financial and economic operations is called for.

Once built, robust financial models can indicate much more than the level of future profits. Models can assist in identifying the key drivers that affect the company's value and quantifying the relative importance of each. Outperforming firms know which

value drivers most affect performance and allocate their resources accordingly.

Based on this knowledge, a value creation plan can be prepared. The plan identifies the optimal mix of value drivers and the plan for their exploitation to maximize firm performance and value. With full support and buy-in from management at all levels, the value creation plan becomes a key element in the culture of the firm.

Value Drivers

Every business has a unique set of value drivers, and it takes a keen analysis to correctly identify them. Once they are identified, they must be evaluated and measured to determine which are critical to success and which are not. Only then can a workable value creation plan can be put in place.

Value drivers can be divided into two main categories: internal and external. Internal value drivers are factors within the firm that can be managed or altered based on the decisions of management. Examples of internal value drivers include staffing levels, compensation programs, and manufacturing processes. External value drivers reside outside of the company and its direct influence. Some examples are raw materials prices, competition or events such as market interruptions and natural disasters. While not as controllable as internal drivers, many of these external value drivers can be managed or at least monitored.

As an example, a key value driver for an oil field firefighting business may be the rate at which field fires occur. The number of fires varies each year and management can't (or at least shouldn't) create more fires to improve its business. The company's value creation plan should address additional applications for its equipment and technology in order to utilize intermittent excess capacity. In another example, a key value driver for an insurance underwriter may be customer retention, which can be more important than new customer generation. A plan to create maximum value would therefore address initiatives designed to maximize policy renewal rates. Finally, a transportation firm may find that its value is very sensitive to fuel prices. Any value creation plan created for this company should include hedging strategies to fix prices for a portion of its future fuel requirements.

Conclusion

The primary objective of management is to create maximum value with available resources and opportunities. The three jobs of management in achieving this objective are to:

- Protect and maintain the company's cash flow base;
- Deliver on the growth expectations embedded in company's current value; and
- Generate additional growth to fuel additional appreciation.

To be successful in each area, executives must create and maintain a comprehensive value creation plan that begins with an understanding of investors' expectations and results in a plan to exceed them. Otherwise, management may continue to allocate resources sub-optimally and the company's value potential will never be reached.

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