Value Creation: Theory and Practice

By David N. Fuller, CFA

Introduction

The essence of investing is putting funds at risk with the hopes of receiving a greater amount in return. If this is accomplished, it can be said that one has created value. The purpose of this article is to explore the theoretical basis of value creation as well as its practical application in the context of a going business.

Accounting Versus Economic Earnings

From an accounting perspective, profit can be defined as the amount by which revenues exceed costs. In the simplest cases, this profit definition may be good enough to define value creation as well. For instance, one purchases a product and resells it the same day for more than was paid.

Economic earnings are defined as the amount by which cash inflows exceed the costs associated with all of the factors of production. This includes not only the expenses incurred in operating the business, but also includes the cost of capital invested in the business.

As the business enterprise becomes more complex, factors like time differences, depreciation and amortization of assets, book versus tax accounting policies, and investments such as inventories and accounts receivable cause profits to become more difficult to measure. At the same time, the disparity between accounting profits and economic profits becomes wider and wider.

In order for value to be created, the business must return economic profits. If the business is profitable from an accounting perspective but not profitable enough to provide economic profits, the business will be worth less that the amount invested in it and value will have been destroyed. Similarly, if the business is profitable and provides a fair return on the amount invested but nothing more, the business will be worth an amount equal to that invested and value will not have been created. Instead, the owners will have simply swapped assets of one type for different assets with the same value.

Another complexity in measurement of economic earnings is the treatment of time. Profit measured over a single period cannot capture whether value has been created because investments in businesses typically provide returns over a longer time period. This period, know as the economic life of the investment is the relevant period for value measurement.

Theory of Value Creation

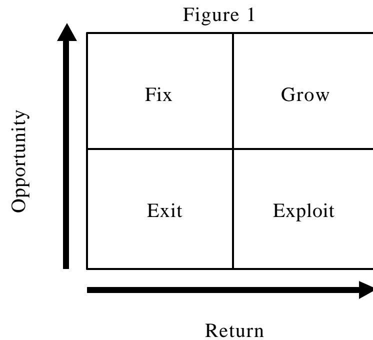
Most corporations have some sort of capital budgeting process in place to evaluate their opportunities for investment. While the metrics used vary widely, they typically revolve around calculations of the net present value of the future benefits associated with the investment. They may also include measures of internal rate of return or payback period. Investments that clear the hurdles established by management can then be pursued based on their future benefits and strategic importance. These investments are pursued because they are expected to deliver economic profits and create value.

While capital budgeting is a routine activity at most corporations, most do not have a similar process in place to evaluate the performance of their existing operations. Take a company with a market capitalization of $200 million that is considering how to spend its $20 million capital budget. Wouldn't the company benefit far more from evaluating the value contribution of each aspect of its operations and the opportunities for value improvement than

focusing its financial inspection on the deployment of additional capital.

When evaluating a capital project, the decision point is basically binary, to invest or not to invest. When evaluating existing businesses, the decision point is more complex. Essentially, four courses of action may be indicated by this sort of analysis. These are displayed in Figure 1.

Figure 1



When allocating capital and resources, first priority should be given to business activities that show significant return on investment and have significant opportunity for growth. These activities hold the greatest potential for value creation. Activities that have high returns but limited growth opportunities should be managed and exploited. Cash flow from these activities can be distributed to owners or used to fund more attractive investments. Activities which produce poor returns but have significant promise should be fixed. Perhaps the most difficult decisions are faced when it is demonstrated that an activity produces low returns and has limited promise. Companies should exit these activities and re-invest proceeds in other areas.

As you can see, value creation analysis is instrumental in assessing the merits of existing corporate strategy and forming optimal strategies for the future.

Practical Application

Step 1: Model. The first step in applying value creation concepts within a going concern is to investigate the company's operations and construct financial models that mirror the company's operations in each area. At this stage, care must be taken to capture the relationships between factors of production within the business. Linkages such as the attribution or allocation of various assets to various operations are often not apparent from a review of financial statements. The company model must capture these linkages to produce accurate conclusions.

Take the example of a distribution company that sells both equipment and service parts. If the same fleet of trucks is used to make the deliveries, how is the use of vehicles captured for each line of business. Often times, the delivery vehicles show up on division income statements only as depreciation allocated based on revenue. In this example, if the equipment sales and parts sales businesses use the fleet in equal proportions, the equipment sales business may be bearing too much of the cost. Likewise, the parts business may not be charged its fair share of the accounting department if these charges are allocated by revenue due to the fact that it would have a larger number of transactions in the same amount of revenue.

Step 2: Prioritize. The next step in the process is to identify the company's key value drivers based on testing the model to determine the sensitivity of the company's performance, and hence its value, to changes in each area of its operations. Each business is different in terms of which value drivers have the greatest impact. In our practice, we have identified over 125 distinct value drivers which may be relevant to each company. Managers should identify the areas of greatest sensitivity and set these as the highest priority for focus on improvement. Figure 2 illustrates a value driver sensitivity chart, at a summary level. In this particular situation, the first priority of executives should be placed on initiatives that may improve profit margin. Conversely, the graph indicates that if executives are spending an inordinate amount of time with tax planning they are not

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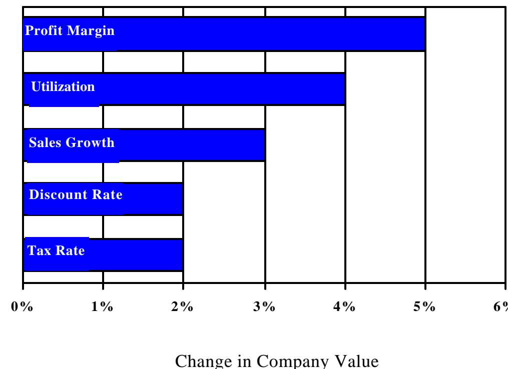
focused on the highest and best use of their time.

Step 3: Evaluate Opportunities. After setting priorities based on the measured impact of success in each area, we proceed to analyze and investigate any opportunities for improvement which may exist. For a manufacturing concern with a focus on margin improvement, this may mean a review of manufacturing processes and application of "lean manufacturing" principles or a focus on sourcing and purchasing materials at a more favorable cost.

Figure 2
Value Driver Relative Sensitivity



Change in Company Value

For another firm, utilization of its manufacturing capacity may be identified as its primary opportunity and it may take on private label manufacturing jobs to increase the base over which fixed costs are spread.

In our practice, we have developed a user interface called OVE (Optimal Value Equation). This interface allows us, and our clients, to test the importance of value drivers and measure the per share increase in stock price which will result from exploitation of an opportunity.

Step 4: Implement. After specific opportunities are identified, management goals must be defined. In order to ensure these goals are met, two final steps are required. First, a system must be developed for measuring progress towards the goal. Second, the reward system must be altered to incent managers to achieve the goal.

Step 5: Measure and Revise. Finally, managers must recognize that the value creation process never ends. Changing dynamics of companies and markets cause the decisions required of management to change constantly. By making this process continual, companies assure their shareholders that they will not accept poor performance from their investments, whether made this year or years ago.

Conclusion

The path to value creation requires that economic profits be earned. In order to ensure that economic profits are being earned, the same type of capital budgeting analysis used to evaluate new investments must be applied to the existing assets and operations of the going concern business. This process is vital not only to forming a coherent strategy for the future, but to prioritizing management resources as well.

Value creation is a never-ending cycle. It begins with modeling business operations, prioritizing areas for more detailed investigation, identifying opportunities for improvement, implementing the changes required to maximize success and the measurement and revision that starts the process over again and allows management to stay abreast of company and market changes.

Value creation analysis is a critical but often overlooked component in the financial management of every company. Without this type of inspection, value will not be created at the maximum pace.

David N. Fuller, CFA is the Managing Principal of VALUE Incorporated, a premier firm in the practical application of valuation and economic theory. VALUE Incorporated provides value creation services to companies to fill the needs illuminated and discussed in this article. He can be contacted in the Dallas office at dfuller@valueinc.com The firm can be visited online at www.valueinc.com