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# Strategy and Structure – Non-Negotiables!

## Does your strategy maximize long-term value and do you have the organization to deliver?

by Patrick Furtaw, Sarah Essex and Konstantin Wrona

It's earnings season and each day brings multiple new press releases. Is your company among the many companies that are announcing revised strategies for creating shareholder value in 2010 and beyond? If so, how does the new strategy differ from the past? Are you targeting new markets, revising your approach to existing markets or optimizing processes? Have you realigned your organization or modified your incentive compensation plans to execute the new approach?

We believe a renewed focus on value is good news and we applaud companies on this list. What is troubling, however, is that despite all the shareholder rhetoric, both past and present, so many companies come up short and fail to create sustainable value. How is your strategy going to avoid the pitfalls of those that have gone before you as well as your own past mistakes?

In our work with clients across all industries, we find that the most common failings toward this goal are along two dimensions: first, corporate or business unit strategy is not aligned with maximizing value; second, companies lack the organizational capabilities required to execute and deliver long-term value. Without a shared belief that maximizing value is paramount and a clear understanding of what drives value, success will be difficult to achieve no matter how good the strategy or how strong the organization.

Here are four questions to ask yourself in order to gauge your company's value awareness and to determine whether your strategy is truly on the path to long-term value creation and whether you have the necessary capabilities to deliver:

1. How well does your leadership team and organization truly understand value?
2. Does the company as a whole and each of the businesses have a strategic roadmap that is expressed in value terms and determined to be value accretive?
3. Are your management processes aligned with long-term value and are they consistent with the strategy?
4. Does your incentive system encourage and reward value creation?

Creating value is an ongoing process that begins with very manageable steps. For those companies that are deliberate and resolute in their pursuit of value, dramatic gains can be achieved.

## 1. How well does your leadership team and organization truly understand value?

Even if their strategy is well conceived, many companies neglect to develop the understanding and organizational capabilities required to deliver upon the strategy. Such capabilities begin with a leadership team that has a strong understanding and awareness of value. To gauge your team's value awareness, how would you answer the following questions?

- Has your executive team defined what "value" means for your organization?
- Does your team understand what your position is relative to your peers in terms of value creation?
- Do they understand what level of returns investors expect from your company and how that translates to operating and financial performance?
- How well does your executive team understand where value is being created or destroyed across your business portfolios? (Said differently, do they have an understanding of both return on capital and the cost of capital as they relate to your portfolio of businesses?)
- Is the wider organization focused on value creation and does it know how to maximize value?

## Adopting an external focus: what is our position relative to our peers?

Depending on how you answered these questions, you may be asking what you can do to increase your team's value awareness. One powerful approach is to start by developing a competitive analysis of your industry and company in terms of value and by making it the centerpiece of a leadership forum. Surprisingly, while most companies look externally to research new products and understand customer demands, few employ the same outward focus when it comes to understanding value.

This kind of external benchmarking engages the leadership team in a discussion of the organization's strategy and capabilities relative to the industry. Further, sharing an external market perspective introduces an objective basis for highlighting the firm's current position and engaging your management team for the mission ahead.

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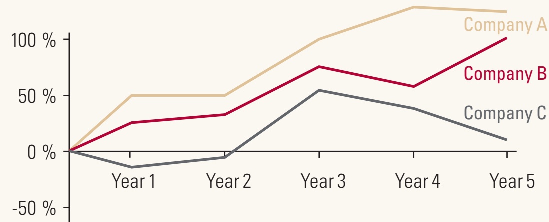
MEASURING VALUE CREATION – 5-YEAR SHARE-PRICE PERFORMANCE




- Externally, shareholder value is measured in terms of share-price appreciation plus dividends
- The graph illustrates total shareholder return – TSR (share-price growth plus dividends) relative to peer companies for a five-year period
- TSR can be calculated for private companies by developing a valuation methodology and applying it at the end of each period to determine the change in value that, together with paid-out dividends, determines overall return

## Looking internally: how is value dispersed within our company?

The benchmarking exercise is a starting point to create understanding and awareness at the total company, or consolidated, level. The natural extension is to turn the focus internally to begin to understand where value is created or destroyed across the business units, and the product and customer segments, below the consolidated level.

With insights from the competitive benchmarking as context, managers are better equipped to evaluate their own day-to-day decisions and business portfolios. Which businesses are earning returns in excess of the cost of capital? What combination of profit margins and capital efficiency underlies these returns? This type of analysis can be carried into lower levels of your organization to gain more insight around product and customer value contributions.

Having a clear picture of current and past performance is a critical starting point to formulating meaningful business strategies.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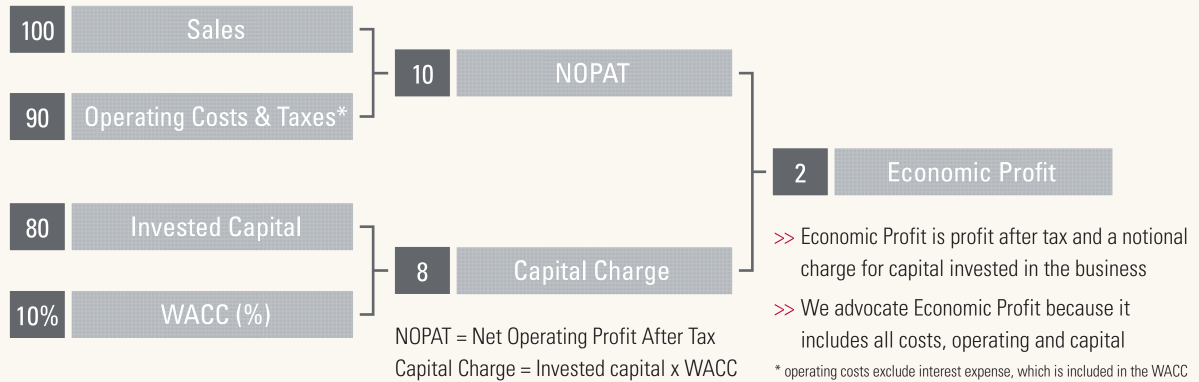
CALCULATION OF ECONOMIC PROFIT

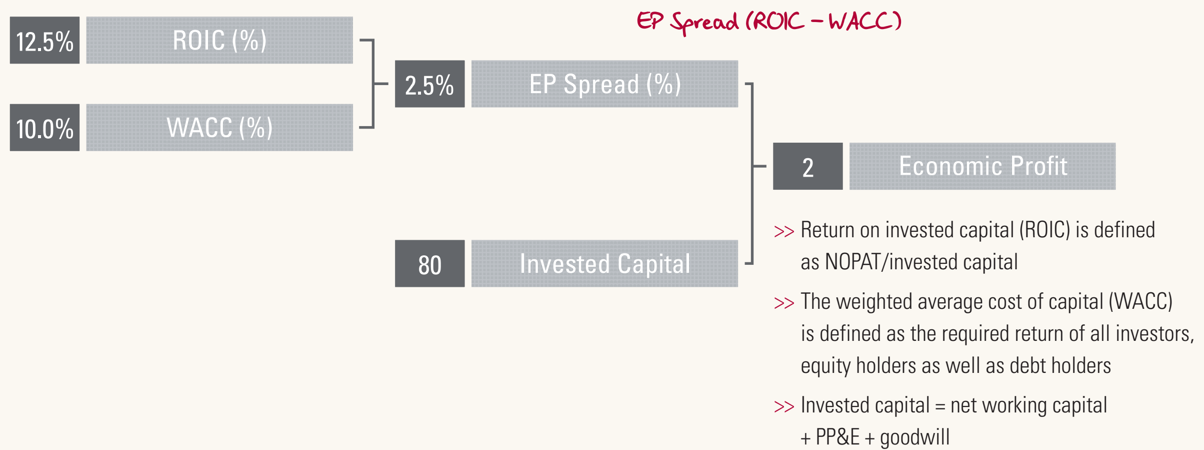



- >> Economic Profit is profit after tax and a notional charge for capital invested in the business
- >> We advocate Economic Profit because it includes all costs, operating and capital

NOPAT = Net Operating Profit After Tax
Capital Charge = Invested capital x WACC

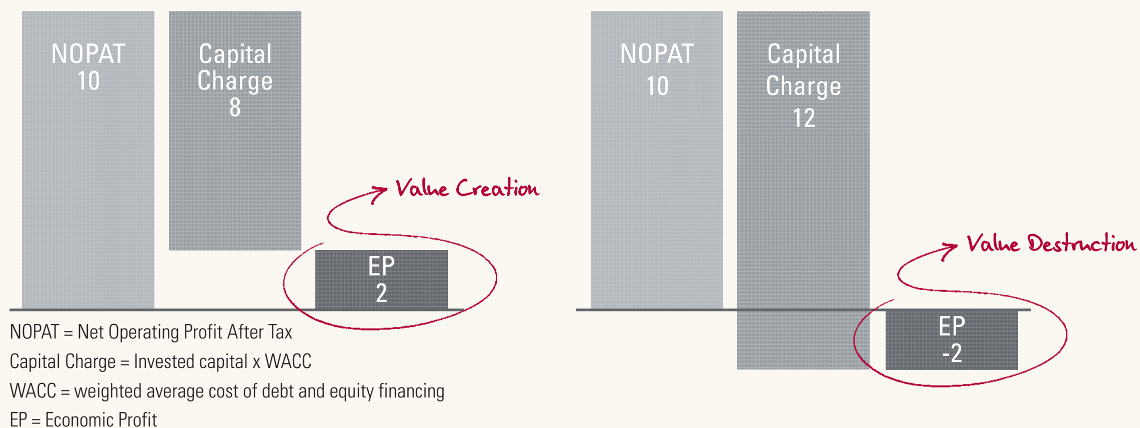
* operating costs exclude interest expense, which is included in the WACC

ALTERNATIVE CALCULATION OF ECONOMIC PROFIT – SPREAD METHOD




- >> Return on invested capital (ROIC) is defined as NOPAT/invested capital
- >> The weighted average cost of capital (WACC) is defined as the required return of all investors, equity holders as well as debt holders
- >> Invested capital = net working capital + PP&E + goodwill

DEFINING VALUE CREATION




NOPAT = Net Operating Profit After Tax
Capital Charge = Invested capital x WACC
WACC = weighted average cost of debt and equity financing
EP = Economic Profit

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## 2. Does the company as a whole and each of your businesses have a strategic roadmap that is expressed in value terms and determined to be value accretive?

Too often we see strategies and roadmaps that are conceived without value in mind. To gauge whether the concept of creating value is really an integral part of your strategy process, how would you answer the following questions?

- Does your strategy process prioritize investment opportunities in two dimensions: first, the value available in each market and, second, competitive advantages or disadvantages your company has relative to the competition?
- Does your strategic planning process include explicit measures of value, such as return on capital or Economic Profit, over the forecast horizon?

## Use value to determine market attractiveness and your own competitive positioning

With an understanding of the current value contributions of the businesses in your portfolio, you can begin to consider the broader industry and competitive dynamics. Each business needs to be evaluated in light of changing trends in the relevant market and industry. In addition to overall market attractiveness, an assessment of internal capabilities must be considered.

How easy or difficult will it be for industry participants to create value over the long run? Understanding market attractiveness in terms of value potential is a key perspective in establishing strategic priorities. A few of the factors that should be considered are the size and projected long-term growth rate of the industry as well as the current return on capital or Economic Profit performance across the industry.

Analyzing your competitive positioning within the industry is the other critical dimension to consider in formulating your strategic priorities and non-priorities. Competitive positioning can be proxied by current return on capital or Economic Profit performance levels relative to your competitors. Excess returns can be an indication of superior brand strength, which allows a price premium to be charged, or of possessing more efficient and low-cost manufacturing processes. You must ask how strong and sustainable (i.e., not replicable by competitors) any identified advantages may be. The company's relative strength in new product innovation, quality of management, market share and capital efficiency are other examples of factors to consider in determining competitive position.


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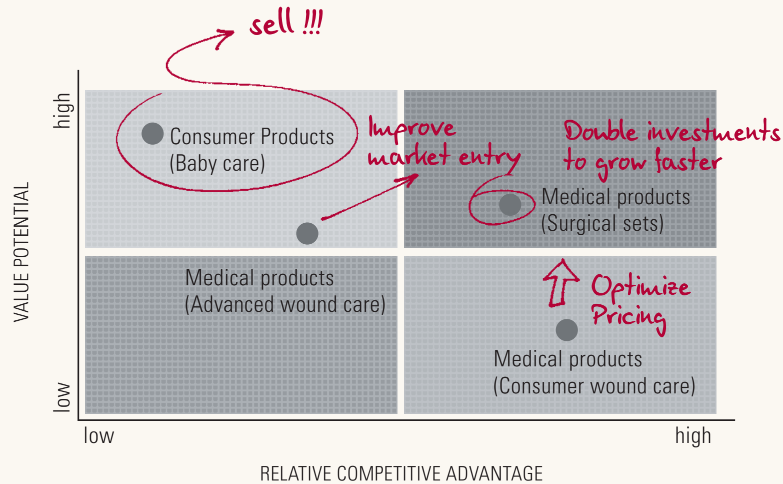
MARKET STRATEGY MATRIX




>> The picture above reflects the relative positions of four segments of a healthcare company. The Baby Care segment is attractive in terms of value potential; however, it is not well positioned from a competitive standpoint. Therefore, one consideration is to sell at a premium to a competitor who is better positioned to take advantage of the opportunity. Conversely, the Consumer Wound Care segment in the lower right quadrant is highly competitive in a less attractive market. By focusing on strategies that leverage its advantaged position, this segment may have value potential.

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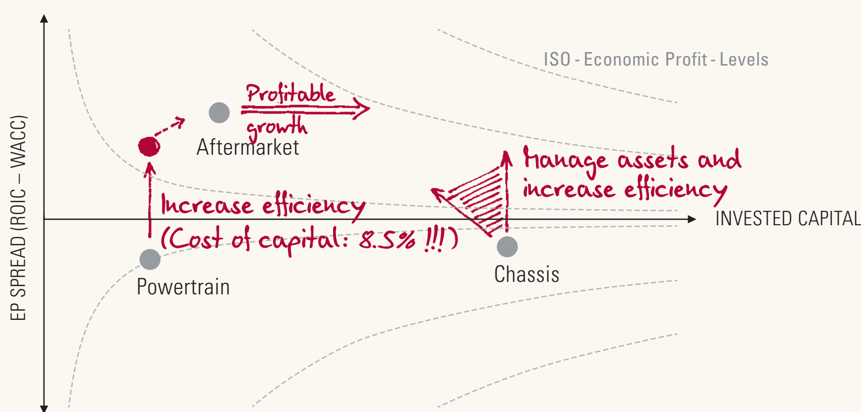
## Making sure your strategic compass points to value

Once you consider the industry and competitive perspectives you can begin to tailor strategic roadmaps for each business unit. It is important to use both revenue growth and Economic Profit which combines both returns and size in one number, as the measures for this analysis. While revenue growth, volume and market share can be important drivers of value, alone they do not distinguish between good and bad growth. Only businesses that can deliver returns in excess of their cost of capital should be allowed to grow. Investors don't reward companies for growing earnings below their minimum required rate of return.

Keep in mind that there are three primary ways value can be increased and these should be considered as you evaluate each business.

- Invest and grow: Invest where increased profits will more than cover the cost of capital
- Gain efficiencies: Improve operating profits without tying up more capital in the business
- Rationalize: Divest operations that do not and cannot cover the cost of capital

ECONOMIC PROFIT PERFORMANCE PROFILES




>> The picture highlights how three business units of an automotive OEM are currently performing relative to their cost of capital, which is shown to be 8.5% as represented by the horizontal axis. The Aftermarket business, depicted above the cost of capital line, is exceeding its cost of capital and therefore represents a profitable growth opportunity. However, the Powertrain business is earning returns below the cost of capital and therefore requires an increase in efficiency and returns before growth could be perceived as good growth. The Chassis business is also earning returns below the cost of capital and has a large amount of capital invested. Therefore, the strategy may be to focus on increases in efficiency as well as to consider managing assets through divestitures and redeployment.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## 3. Are your management processes aligned with long-term value and are they consistent with the strategy?

Even if you have put forward a strategy aimed at creating long-term value, its impact is diminished if your underlying management systems are not aligned with value. It is not uncommon to see companies publicly announce strategies based on value but simultaneously have day-to-day operating processes that are driven by other measures that potentially conflict with value. Even when these conflicts are well understood, ingrained metrics and long-established processes can be hard habits to break.

To gauge whether the concept of creating value is truly integral to your management processes, how would you answer the following questions regarding your key processes?

- How far down in the organization is your company able to measure value?
- How are performance targets linked with the strategy?
- Is capital allocated to the highest value opportunities in a systematic process?
- How well is value understood across all levels of the organization?

Ensuring that value is embedded in the day-to-day operational processes of the business is vital to value creation.

## Measuring value: progress, not perfection

Being able to execute a value strategy begins with management having the information and insight as to where value is being created or destroyed in the portfolio. This need translates into being able to measure return on invested capital and Economic Profit at meaningful levels throughout the company. Without this basic information it is difficult to know in which direction to head.

The good news is that most companies are able to measure profitability at quite granular levels in the organization, sometimes even at the product or customer level. The bigger challenge for most organizations is being able to allocate capital at the same levels of granularity. This is a process that takes some work, but typically most companies are able to generate this information for their major businesses, products and customers.

Once the measurements have been developed, they should be integrated with other management processes related to executing the strategy.

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## Set targets with the market in mind

With an enhanced understanding of your company's and industry's range of value creation, you are in a much stronger position to set targets that are aligned with value. The insights gathered in your external benchmarking serve as the link between company performance and market expectations and provide an objective basis for target setting.

If you have evaluated your roadmap strategies over the strategic horizon, then you already know what is implied in terms of returns and Economic Profit. You also understand how these implied targets relate to the range of historical industry performance. Specific targets can then be established by targeting a given level of industry performance, e.g., 90th percentile growth in Economic Profit improvement. This is also a defensible mechanism when speaking with external constituents such as investors. Naturally, no one would want to set targets that equate to below-average industry performance; but without completing external analysis you would not know how your targets compare.

## Make capital allocation a core component of your value strategy

Once strategies, targets and measurements are aligned with value, the process of capital allocation becomes naturally more streamlined for you and your leadership team. Allocating capital becomes a critical step in achieving the strategy. One CEO explained that after implementing a value framework, when he was approached by businesses requesting capital, he would simply ask what the implied value was from the proposed investment and how it related to the strategic priorities and roadmap. We recommend maintaining formal processes for capital allocation while ensuring they have strong linkage to the value targets.

Most companies have formal processes and procedures around capital allocation that appropriately consider some form of cash flow analysis. The disadvantage with such systems is that once capital is approved for investment there is no means of tracking performance against original projections. Understanding this, managers are often encouraged to request as much capital as possible to grow revenues and earnings even if they know the project may not truly be value enhancing. This problem is addressed by measuring performance in terms of Economic Profit, which explicitly charges managers for all capital invested in their business. With this understanding, managers are unlikely to request capital that they don't believe can generate acceptable returns.


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## Go beyond training and communication to create demand and supply for value

The first step toward creating awareness around value is directed at the senior leadership team. It is critical they understand and become the champions around value. The second step and way to embed value creation as a sustainable capability requires that the organization create both "demand" and "supply" for the change.

Processes that create value "demand" begin with senior management communicating in terms of value, whether talking about strategies, analyzing investment opportunities or reviewing operating results. Insisting that business units assess investment opportunities in terms of Economic Profit and approving only the requests that are expressed accordingly also will drive demand. Monetary incentives, such as incentive compensation, must be aligned to drive value and non-monetary incentives; for example, promotion of awards and events to showcase businesses and individuals that demonstrate extraordinary efforts toward value creation can also be used to reinforce the message.

Processes that create value "supply" include comprehensive training to integrate the value perspective in day-to-day decision-making. Training efforts should be facilitated by a tool kit that includes presentations, software systems, how-to guides, analytical tools, worked examples and actual case examples. In addition, building value into the corporate and business unit strategy development processes as well as budgeting and financial reporting processes is a prerequisite. The concept of value creation takes on an added dimension when managers begin to see their own business unit performance expressed in terms of Economic Profit.

Finally, talent is perhaps the most critical asset in establishing value, and hiring, coaching and people-development efforts should be designed with this priority in mind. By disseminating value concepts to employees across the entire company through both demand and supply approaches, value will become a sustainable capability rather than a passing initiative.

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## 4. Does your incentive system encourage and reward value creation?

In conjunction with renewing their focus on value creation, many companies are also adjusting their incentive compensation plans to be aligned with their revised strategies. In designing or revising incentive compensation plans, the two most important objectives to keep in mind are alignment and motivation. Alignment refers to whether the behavior being encouraged is consistent with sustainable value creation, and motivation refers to the degree to which the plan actually affects the participants' behavior. To gauge how effective your incentive systems are along these two dimensions, how would you answer the following questions?

- Are incentives that are based on performance also based on measures that relate to value?
- Are the measures consistent across the enterprise, e.g., manufacturing, sales, finance, etc.?
- How effective are incentives at driving long-term results? What is the time horizon for determining incentive results?
- Does your incentive plan drive behavior? Is it the right kind of behavior?

Once you have defined value as paramount, ensuring strong alignment and motivation are the next vital ingredients to executing the strategy.

## Alignment paves the way

Most of the recent controversy over banker bonuses had to do with the issue of alignment. Did it make sense to pay gargantuan bonuses on revenue and profits without consideration of the risk that was taken to achieve them? Did it make sense to pay such bonuses based on single-year results? Most would agree that it did not. So how can companies ensure that corporate strategic objectives and individual compensation schemes are aligned?

Alignment can be thought of from both an external perspective (alignment with shareholders and other external stakeholders such as governments and NGOs) and from an internal perspective (alignment across businesses). The elements required to align executive and shareholder interests refer to the performance measures and the time horizons incorporated into the plan. The elements required to provide internal alignment are generally an issue of consistency across businesses and processes.

We have already discussed the importance of using value measures but it bears repeating. Once you have integrated value into your strategy, key processes and communications, it only makes sense to reward people on a consistent basis. Investors, politicans and regulators are also increasingly focused on monitoring incentive systems to ensure management's interests are aligned with their own. They are not only interested in aligning the incentive measures but also the incentive horizons.


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It is generally accepted that investors value companies based on expectations of future cash flows, which implies a longer-term horizon than a single year. Yet, many companies pay bonuses based on single-year performance. We have seen the trouble with this approach in the recent crisis as extraordinary bonuses were paid out in one year only to have companies completely fail in the next. There are alternative mechanisms for extending the horizon, such as paying bonuses on multi-year performance targets or paying out a single year's award over several years (using a bonus bank) to ensure only sustainable performance is rewarded. The key is to choose one and ensure that the incentive plan is effective in extending the horizon to be in line with that of long-term investors and other external stakeholders. Once you have the right measures and horizons designed into your plan, the next step is making sure the plan actually impacts behavior.

## Opportunity drives motivation

CEOs, senior executives and middle managers alike struggle to find ways to motivate employees to act in ways that increase value. Incentive plans focused on encouraging financial performance should be designed to enhance the value of the company by providing managers with a strong incentive to do so. What defines a strong incentive is the size of the opportunity or amount of the bonus available for achieving a pre-determined target.

Defining the size of the opportunity is first a matter of setting the target bonus amount, which is usually defined as a percent of base salary and varies according to the level of the position and industry standards. Just as investors seek the highest returns in the capital markets, so too in a competitive labor market employees will gravitate toward companies that provide the greatest opportunities.

A second element in defining the size of the opportunity is determined by how much the bonus amount received increases or decreases for exceeding or falling short of the target. Many companies employ caps and floors to keep the bonus within a range, e.g., 0 – 2x target payout. We find that this demotivates managers once the upper limit of compensation is reached.

To address this issue, we recommend uncapped incentive plans, meaning that there is no upper limit on the amount of bonus that can be earned. However, in order to remove the limits, it is necessary to architect a structure that aligns the interests of managers to avoid short-term performance spikes and related payouts for performance that is not sustainable. This can be addressed by the bonus bank concept mentioned earlier.

By aligning compensation with the principles of value-based management, managers can be effectively incentivized to change their behaviours to maximize long-term value creation.

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## Summary and Conclusion

Many companies have realized that their pre-crisis approaches to product and customer markets may no longer apply and are re-aligning their strategies as a result. A word of caution may apply. Many companies aim to create long-term shareholder value but fail to take the necessary actions to realize the goal. However, for those companies that do take the necessary steps to align their strategies with value and invest in developing organizational capabilities to deliver, dramatic gains can be achieved.

While tangible results can be achieved early, the best performers continue to evolve their strategies and organizations over time. The reason for this is that to grow and sustain value it is critical to develop and spread the necessary understanding and knowledge across the entire organization. There are four key steps to include in your company's roadmap to creating long-term value:

- Make sure your leadership team has a shared understanding of what constitutes value and what drives it in your business.
- Develop your company and business unit strategic roadmaps in terms of value creation.
- Ensure that your key management processes are aligned with the strategies and are based on value.
- Make sure your incentive plans are designed to provide both alignment with value and motivation to change behavior.

As we said at the beginning, for those companies that are deliberate and resolute in their pursuit of value, dramatic gains can be achieved.


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Stern Stewart & Co. is an independent partnership that stands for a simple yet far reaching concept: consistent value management. Our credibility on the capital markets and our clear focus have been admired by senior managers at leading international companies – particularly when it comes to increasing a company's long-term value.

We support companies primarily in setting and achieving their key management agenda: strategy and valuation as well as corporate steering and organization. The key to our success are our consultants and our approach to consulting. We think and act like an entrepreneur whose decisions are motivated by long-term goals and whose focus is on economic value. And we apply these principles in our consultancy services consistently, regardless of whatever the current vogue may be.

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