Abstract: All companies have significant unrealized value potential. Causes of the existence of this potential is uncovered, and guidance is provided to identify and realize the potential.

This publication has been prepared in order to provoke, and to help you generate ideas as to how you may create value in your company. It is based on real-life experiences of our consultants on assignments, and on research.

Academics have greatly enriched us through the research they have shared with us, and they have undoubtedly enabled us to deliver higher value on our assignments. The many executives that we have had the privilege to work with have been a constant source of ideas and challenges to our thinking.

Most of the credit for what we may have got right is due to these people, any remaining errors or omissions are our sole responsibility.
The small business owner often has a better understanding of the imperative of value creation than many highly paid executives of large corporations.

The separation of ownership from operations, often with a widely spread shareholding of passive investors, has left the destiny of many large companies largely in the hands of the executives in charge. Employees, unions, customers, suppliers, politicians, all have interests in the large company and a legitimate right to try to influence the executives of the company in their favor. Additionally the executives often have an incentive system that does not align their interest too closely with shareholders.

The result has been the widely acclaimed stakeholder model of business, especially prominent in Europe. Company objectives are often developed, with the help of outside consultants, through models such as the Balanced Scorecard, Mission Statements, etc. that try to balance the interests of all stakeholders and set objectives in a wide range of aspects such as market share, employee development, environmental impact, competitiveness of the local economy, quality, customer satisfaction, earnings, geographic reach, etc.

The stakeholder model may seem appropriate with its explicit consideration for all parties with interest in the company. However, in attempting to satisfy all in the short term, it is most likely to be detrimental to the long-term viability of the system. The pursuit of multiple unrelated objectives will naturally cause additional costs for the company with negative results for some stakeholders: higher prices for clients, lower pay for employees or lower return for shareholders.

Additionally, companies are not ideal vehicles for determining and achieving what are essentially social objectives. The democratic system with elected governments and the independent judicial system already have this mission.

In the end, the stakeholder model may simply end up being a shield for the executives in the face of poor results.

How much simpler is the situation for the small business owner, who has in general a single objective: personal enrichment, or to put it differently: Create value for the shareholder!

Long term, the orientation towards value creation benefits all stakeholders as it naturally improves the health of the economic system of which the company forms part. Value creation is based on generating free cash-flow for the company which is necessary to satisfy the needs of all stakeholders: Better benefits for employees, better quality and lower prices for clients, payments assured for suppliers and creditors, and finally a return provided for the shareholders’ investment. Additionally, the creation of value is no more than a result of improvements in productivity and competitiveness that benefits the economy and the society at large. Even the politicians stand to gain more money for their causes through increased tax revenue.

In consequence, all objectives other than value creation are secondary, to be subordinated to the main objective of any business: Create value. This does not imply disregard for the importance of the other objectives such as employee and client satisfaction. These objectives are often crucial means to reach the ultimate objective of value creation, but they remain only means to achieve the goal of value creation.
The key issue is how one goes about the business of creating value in a company.

The Value Pyramid provides a simple overview of how value is built on the competitiveness of the products and services of the company. The competitiveness in turn is based on the processes that produce the products and services of the company. Finally the processes depend on the capabilities that the company has developed.

Value creation depends fundamentally on the value drivers. That is, how well the company is able to convert capabilities into processes, processes into competitiveness and competitiveness into value.

Of course, most top executives recognize that this is how value is created, even if this is the first time that they see this model. What is likely to be of more interest is a closer look at each of the levels of the model and how opportunities of value creation may be found at each level.
Value creation is measured quite easily by the shareholders of quoted companies by simply following the evolution of the share-price. The shareholders can evaluate the performance of the CEO by how the company fares compared to an index or similar companies. However this is not a very useful instrument for the CEO in managing the company given the volatility of the stock-market and the difficulty of relating the share-price with the underlying business. Hence most companies rely on earnings numbers produced by accountants to manage the company.

Unfortunately, neither earnings, nor earnings growth seem to bear any relation with the creation of value for shareholders.

It is fairly simple to obtain whatever accounting result is desired (within certain limits) depending on the accounting treatment that is afforded to the business transactions carried out. Furthermore, the accounting results do not contemplate investment needs, nor consider adequately the time-value of money. (For example, any investment with a positive return will improve earnings, whereas the shareholder should not be satisfied with anything below the average cost of capital (WACC)).

It should be noted that the accounting numbers do have their purpose in life:

1. To determine taxes.
2. Serve as support for the financial institutions in evaluating the creditworthiness of the company (Liquidation value).

While accounting results tend to be misleading, and of little use for management controls, it is worth noting that the accounting inputs are very valuable as they reflect the business transactions carried out by the company.
To understand the basis for creating value for the shareholder it is necessary to clarify how financial instruments are valued. A bond is a financial instrument whose value is clearly determined by the expected future cashflows to the bondholder and the cost of the capital invested.

A share is also a financial instrument. The main difference, as compared to a bond, is that the share introduces more uncertainty (timing and value of dividends are uncertain, the lifespan of the company is unknown, cost of capital is more difficult to estimate). However this does not change the basic method that one should use\(^1\) to value the instrument; it just increases the difficulty of determining the value.

In consequence, if we wish to create value we should base our management controls on cash-flows and the cost of capital employed, not accounting earnings. Fortunately, most executives are very familiar with tools based on cash-flows, as most companies evaluate new investment using Net Present Value (NPV). Unfortunately, these concepts are not used to evaluate the results after the investment decision is made, as companies revert to reliance on the accounting results to evaluate progress.

As a result companies end up making some investments that destroy value and avoid others that would create value. On one hand, companies invest in projects that provide positive earnings, but do not cover the cost of the capital employed, hence destroying value. On the other hand, there is a tendency to avoid investments that are treated accounting-wise as expenses such as training, R&D, restructuring, etc, even if these have a positive NPV.

A way to measure the results of each period that is consistent with the creation of value is required. That is, the measure of results in each period should be consistent with the approach used to evaluate investments (NPV).

\(^1\) It should be noted that some companies do have real options incorporated that require special consideration.
The NPV evaluation of investment projects discounts future cash-flows by the cost of capital to determine the present value of those cash-flows and then deducts the initial investment.

Net Present Value vs Cash Value Added

An alternative approach would be to determine a capital charge to each of the individual cash-flows according to the investment used to generate those cash-flows. The cash-flow minus the capital charge (capital employed*cost of capital (WACC)) would indicate if the operations have created value in the period by generating sufficient cash to cover the cost of the capital that is used in the operations. The result is the Cash Value Added\(^2\) (CVA) in the period. The Present Value of the CVAs of each period is identical to the Net Present Value. Hence the CVA is a measure of the performance in the period that is consistent with the NPV approach.

When determining the CVA for the entire company or divisions, one should use the net operating cash-flow after taxes, but before interest payment\(^3\). Expenses such as R&D, training, marketing, etc. that are made with the objective of generating future cash-flow should be considered as investments. Operating leases and similar off-balance sheet financing should be considered as debt. The capital employed can be more difficult to value. There are three alternative approaches: Market value of assets (ideal, but difficult to determine), Book value (with some adjustments), or replacement value.

It is important to note that value is created for the shareholder, not by producing a positive CVA, but by consistently improving the CVA from period to period. Its use in performance incentives will help align management interest better with shareholders and help avoid accounting-induced errors.

\(^2\) Similar measures are Economic Profit and Economic Value Added. All take into account the cost of capital, though there are differences in the way each one is determined.

\(^3\) Debt is considered in the cost of capital, hence the interest payment should not be considered a cash cost.
Competitiveness is often confused with market-share. This is natural as market leaders are perceived as competitive, and competitive firms tend to grow into market leaders. Many companies chase market-share on the presumption that economies of scale will materialize to make the venture profitable. Whereas this seems to hold true in the early stages of development of a new industry or segment, it is not so clear in the more mature industries.

The true measure of competitiveness is the ability to deliver the highest value to the client at the lowest cost, so that maximum value (CVA) is created for the shareholder.

When considering the competitiveness of a company it is very important to take into consideration the different dimensions of the business, and not limit oneself to a simplified view, or only consider the company at an aggregate level.

Of course the most relevant dimensions may differ from company to company. In order to get a better understanding of the competitiveness, it is important to consider the relevant dimensions particular to each company.
Upon taking a detailed look at the contribution to the company’s overall CVA along the different dimensions, it quickly becomes clear where the company is competitive as well as where it is at a serious disadvantage.

This analysis tends to bring several surprising situations to light. Some of the “best” clients of the company turn out to be destroying value. The company’s star product (often determined by volume of sales) is actually neutral in value terms, while some of the “less exciting” products are producing 100% of the value created.

These examples are quite common insights, that become visible if top management are willing to leave aside the numbers produced by the accountants to determine the taxes to pay and take a hard, honest look at the real situation of the company.

To improve the situation, one needs to make changes in the way the business is operating: Redirect the sales effort from the “star” product towards promoting the “less exciting” products that produce value. Stop applying those generous discounts to the “best” clients, and so forth.

It is important to reach an understanding of why products (clients/regions) are adding or destroying value. Let’s for a moment assume that we have our costs correctly determined (including the cost of capital employed), and concentrate on the price our clients are paying.
The most frequently used pricing mechanism is cost-plus pricing (10-30% depending on sector), normally considering a single estimate of demand volume. This has evident advantages in being simple, and should ensure that one does not lose money if the costs are correctly determined and the volume guess is right.

Unfortunately this method of pricing may leave a lot of money on the table, as some customers may be quite willing to pay considerably more. The critical aspect is the total CVA produced, and this depends critically on customers’ behavior, as well as the costs of delivering the product or service.

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\text{Total CVA margin} = \text{Unit CVA margin} \times \text{Units sold}
\]

Hence it is critical to determine both cost (at different volumes) and demand curves (at different prices) before making pricing (and launch decisions) in order to maximize the total CVA margin. The demand curve may be modeled using historical data, controlled market tests or conjoint analysis depending on each situation.

The modeling of the demand curve must always take into account the competitors. That is, if you are considering new product launch and find that there is a strong unmet demand for your product, you are likely to be proven wrong quickly if you base your demand volume on this. Your estimate may correctly assess the total market size, but what is relevant to you is your slice of the pie, which is likely to be quite a lot lower as your competitors launch copy-cat products, normally at a lower price.

Additional care should be awarded to evaluating the response of the sales channels, as these are often key to the success or failure of new product launches.

Of course, new product/service launches are difficult to get right (as is demonstrated by the large number of failures). Luckily a lot of value can be discovered within the current product/service portfolio, as modeling the demand curve is likely to yield additional insights into what is driving the customers’ willingness to pay. This depends fundamentally on the value delivered to the client, which will vary for each combination of different product features, and may vary between target segments, and even geographically.
A thorough look at the key products/services in each group (Value Destroyers, Neutrals, and Value Creators) is likely to identify the key features of each product/service that may be changed in order to increase the value delivered to the client.

The analysis is likely to demonstrate that some features are more valuable to some clients than to others, and different products may be tailored to meet these needs. In the above example the continuity of service is a lot more valuable to clients with a continuous process that depends on electricity to operate (such as a telecoms operator), than to the average domestic customer.

Adapting to customers’ preferences may actually enable some features to be provided at lower cost upon closer investigation. In the above example, the outsourcing of the call centre could bring improvement in quality and reduction in cost. Some of the more costly features may prove to not be very relevant to the client purchasing behavior, and may be eliminated altogether.

At this stage it is necessary to start exploring the costs of providing the product/service in order to make meaningful trade-offs between the customers’ willingness to pay and the cost of providing the product/service with a given configuration of features. This takes us on to the internal processes of the company.
 Processes (made up of individual activities), internal to the company and its suppliers (and complementors), determine both the features and the cost of delivery of each product/service. Most accounting systems do not aid in the understanding of how the company operates at this level. These fundamentally describe the resources that the company consumes, but add rather little in the way of how these resources are used, and what results they bring. The cost of the different activities the company carries out is brought about by applying Activity Based Costing (ABC). ABC determines unit costs, so one can more easily evaluate alternatives for carrying out activities.

### Accounting vs. ABC: Illustrative

<table>
<thead>
<tr>
<th>Traditional Accounting View</th>
<th>ABC View</th>
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<tbody>
<tr>
<td><strong>Concept</strong></td>
<td><strong>Concept</strong></td>
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<tr>
<td>Salaries</td>
<td>Answer calls</td>
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<tr>
<td>Social Security</td>
<td>Visit clients</td>
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<td>Rent</td>
<td>Search for Info.</td>
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<td>Utilities</td>
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<td>Telecoms.</td>
<td>Total: 8 000 000,-</td>
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<td>Supplies</td>
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<td>Etc.</td>
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The ABC method distributes the costs from the resource information provided by accounting to the key business dimensions mentioned earlier (these are referred to as cost objects in ABC parlance) by determining the rate of consumption of the resources by the activities, and how the activities carried out by the company serve the different cost objects (products, clients, regions).

Illustration: ABC cost distribution
The difference between the product cost estimation provided by the traditional method of allocating overhead costs according to sales volume, and as determined by activity based costing is often large. Furthermore, taking into account the cost of capital, the difference frequently exceeds the margin previously thought to exist, giving rise to the hidden value destruction previously illustrated.

The company cost is not the only issue here. The same processes that causes the costs, determine features of the delivered products/services.

As anyone that has spent half an hour listening to music, interspersed with “your call is important to us” while trying to reach customer support can attest, while the cost to the company drops by maintaining all support agents fully occupied, the customer’s perception of the service/product purchased, and of the company in general drops even faster, making repeat business less likely (and refund claims more likely).

Hence, company costs may not be considered in isolation, but must be considered in combination with the value delivered to the client, taking special care with those aspects of high importance to the client since they affect the willingness to pay.

One should evaluate both cost and performance as indicated below, taking care to measure the output of the processes. In the example of the customer service this would mean understanding the cost of attending each call, and the trade-off with respect to the time the client has to wait listening to music. The technical support of a computer manufacturer may increase the waiting time from 60sec to 180 sec in order to reduce the cost per call by 25cents without causing a major shift in the value perceived by the client. A courier company attempting the same is likely to see a marked drop in business as clients turn to competitors that pick up the phone when they want to place an order.

The key inputs to the above model are the cost drivers and resources. Cost-drivers are essentially a description of the causes of the consumption of resources by activities, and how the activities serve the cost objects. Accounting reflects the costs related to the resources of the company but these are far more important and more flexible than generic resources such as money. The resource costs represents in monetary terms the way in which the company has applied its capabilities.
Capabilities are best thought of as what provides the company with the portfolio of opportunities that the company may pursue if it so chooses. These capabilities are a result of the assets (financial, physical and intangible), the human resources and the collective know-how available to the company.

As these capabilities are applied in the pursuit of certain opportunities, the company is committing resources to the development of these opportunities. The application of the capabilities should be realized through the structure (organization and management systems) that provides the best way of exploiting the business opportunity being pursued. The business structure is what channels the resources into the business processes of the company.

The commitment of resources influences the capabilities that the company will develop in the future, as the processes, competitiveness and value created not only depend critically on this, but all levels feed back into developing the future capabilities of the firm (as learning occurs and adjustments are made). Similarly the current capabilities of the firm depend on history and are unlikely to be identical to their competitors. It should be noted that the capabilities that the firm has available are perishable goods (depreciation of assets, turnover of personnel, and dissipation of know-how) that require maintenance and improvement continuously. Building the capabilities of the firm is carried out through daily operations, hiring, investments and pursuing new opportunities.

A key issue is identifying which capabilities to maintain and build. The critical capabilities are those that generate abnormally high returns for the company. One should take a close look at that 20-30% of sales that produces 100% of the CVA, and determine which capabilities are at work here, and how these differ from those applied for the sales that are value neutral or destructive.

The critical capabilities are likely to be specialized and difficult to imitate by competitors (due to historical path dependency, or simply due to the inherent difficulty in their identification). They are extremely unlikely to be found to be capabilities readily available in the marketplace (such as money, key suppliers, manpower, call centers, professional services, etc). They may however lie in the combination and coordination of such capabilities.

The identification of the critical capabilities will allow management to guide the company’s operations to reinforce and build upon these strengths. This insight may be formalized through guiding principles, vision statements, etc. or alternatively not be formalized and end up working through the normal way of doing things that the firm adopts (otherwise known as culture).

Unfortunately, gaining understanding of one’s critical capabilities makes it more likely that over time the competitors will identify these and attempt to neutralize them. The improvements in capabilities that the company should have achieved in the meantime and the path-dependency effect will make it difficult for the competitors to successfully neutralize the competitive advantage derived. In any case, a temporary advantage is preferable to none at all.

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4 Includes employees, suppliers and complementary firms.
5 Often the best structure is the current structure, though, due to inertia, the current structure is sometimes used when superior alternatives exists.
6 It may be in the best interest of the firm to eliminate capabilities by pulling out of certain business lines.
7 It is difficult for competitors to identify your critical capabilities before you do.
Culture and guiding principles are useful for helping the firm make daily operational decisions in a manner consistent with reinforcing the critical capabilities. However, occasionally the company is faced with some alternatives that may have a high impact on the company value and where significant uncertainty or ambiguity are present. Examples are large irreversible capital investments; organizational restructuring; new market entry; etc.

These are decisions that require in-depth evaluation of each alternative on each of the levels (value, competitiveness, processes and capabilities) considering different scenarios with respect to both external and internal factors such as competitive response, client acceptance, workforce reaction, etc.

The decisions on applying the capabilities and committing the resources of the firm in the pursuit of certain opportunities are key decisions that a firm makes given that the capacity of current capabilities may be limited and that new capabilities will be built (or capacity increased). In fact, this is how competitive advantage is created, sustained or destroyed.

However, after having decided to apply the capabilities and commit the resources of the firm in the pursuit of certain objectives companies frequently run into problems rapidly. These difficulties are often structural in that most companies are organized by functions, such as marketing, sales, production, accounting, etc., whereas most meaningful changes in strategy require an interdisciplinary approach with participation of most functions.

Project management is critical to the success of implementation. This can be divided in two parts: planning and tracking.

In the project planning stage two related deficiencies are endemic: Insufficient resources are dedicated to the execution of the project, and the time allotted to carry out the required tasks is vastly underestimated. The time allotted to the individual tasks and the overall project often tend to be based on how fast it could conceivably be done by having excellent people dedicated full-time. The result is a discredited project that produces nothing but distraction for the organization. The dedication of the time of key executives is particularly critical, often it is simply assumed that these key people will execute the project tasks in addition to their normal duties. This is not realistic, these people must free up time by off-loading part (or all) of their regular duties to others.

The project tracking should account for the resources and time expended for each task relative to the plan, but must also evaluate the results produced at each level (capabilities, processes, competitiveness, and value) as the project progresses to ensure that value will be created. There should be milestones to be met in the project plan that, if missed, trigger a complete review of the viability of the venture.

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8 Understood as superior return on invested capital.
In conclusion, an outline has been provided of how value is created.

Opportunities for value creation abound in all companies. Any executive that is willing to challenge conventional thinking is likely to identify these opportunities rapidly.

Unfortunately, turning these opportunities into reality often require the investment of much effort and personal prestige in changing the status quo. Additionally, any attempt at significant change does entail risk of failure, especially if unrealistic expectations are held with respect to the time and resources required for implementation.

To mitigate the risks involved it can be useful to create an “unbalanced” scorecard” that provides information as to how the company is doing at each level in the quest to create value. This should include the key performance indicators at each level, as well as for the value drivers that connect one level with the next. These performance indicators may be usefully integrated in the company incentive system.

Understandably, many prefer not to face up to the situation, decide not to rock the boat, and leave things in the hands of the accountants. This option is definitely “safer”, though it’s unlikely to deliver much in the way of value.

For those who are willing to assume and manage the risks, there is a world of reward out there, waiting for executives that can bring about a significant increase in the value of their companies.

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9 Unbalanced in the sense that all indicators should be aligned with value creation as the final objective.