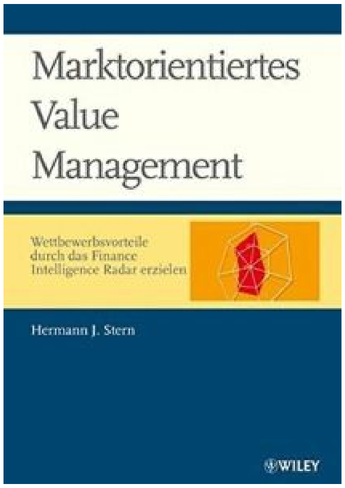


# Book Competitive Value Management

## Achieving competitive advantages using a Finance Intelligence Radar

Hermann J. Stern
Wiley-VCH, 2007

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## Recommendation

In his book, Hermann J. Stern identifies the weaknesses of traditional market analysis, and financial and strategic planning. He drafts a convincing alternative to budget-based management. His analysis and planning processes are largely well-known but the author subordinates them to one goal: increasing the value of the company. Alongside his explanations, he throws in guest contributions and interviews with renowned finance experts to add insight into the practice of value-based management. He includes case studies in every single chapter to provide – much needed – illustration of the theories and models. *BooksInShort* finds this demanding yet information-laden book extremely useful for CEOs and directors, and especially for decision makers in the finance and strategy sectors. Why? Simply because it can help you increase the value of your company considerably.

## Take-Aways

- Budget-based planning does not motivate employees toward great performance.
- You should replace absolute objectives with relative ones. To achieve this, management must reorient itself.
- Derive forward-looking objectives from the expectations of the financial market.
- Think like an investor: Compare your company to similar organizations.
- Incorporate all capital costs when evaluating your company.
- Closely examining "value added" best reveals the development of market values.
- The market-value model acts as an acquisition radar: You can identify takeover targets and also assess your own company's risk of takeover.
- With the "Stern radar," you can depict an abundance of figures, and easily compare your company's performance with that of competitors.
- This radar makes it possible for you to identify weak points early on – even in highly profitable divisions.
- The Balanced Scorecard can help implement the findings from the Stern radar.

## Summary

### Moving from Budgets to Value Management

Today's companies should heed this motto: "Don't beat the budget; beat the competition." However, more than likely, your company also takes part in the yearly ritual of tedious budget negotiations. After all, budgets do not only determine objectives, they often serve as the basis for employee assessment and the incentive system. Nevertheless, with budgets you lose valuable time and inspire employees to only mediocre performance. Furthermore, budgets are not a suitable criterion for performance: What counts is market performance. To increase the market value of your company, you must break the vicious circle of budgeting and look toward the future.

### Orientation toward the Market: Observing the Competition

Your main question should be that of any potential investor: Is your company better or worse than comparable companies? Answer this question irrespective of how large your company is or whether it can really finance itself above the equity market. The long-term capital gain matters. Unlike in benchmarking, where you only look at a few competitors, you should compare yourself with a large number of similar companies (peers). Peer companies are those in similar industries or sectors, with comparable business cycles, business models, target markets, suppliers, or purchasing, production and sales processes.

> "What is nice about the Stern radar is that it functions with relative benchmarks. We're not evaluating the absolute change, as the traditional evaluation process does; we're looking at change relative to peers."

The "peer universe" marks alternative investment possibilities from an investors' point of view. Identification requires instinct and intimate industry knowledge. Ideally, the peer universe comprises 60 to 80 companies.

To track down your peers, search electronic databanks, for example those of industry federations, big banks, data providers, market-research institutes or rating companies. Look for test subscriptions before signing up to any services, as the scope and features of each provider differ. For financial analysis, divide your peers into groups and investigate each one individually. For direct competitors, use categorization systems such as Standardized Industrial Classification (SIC) or Global Industry Classification Standard (GICS).

> "Every company has peers or competitors with whom they can compare themselves. That sounds obvious but it is denied by most companies."

Carry out statistical evaluations and trend analyses for all peer companies. When gathering data, focus on the value drivers for growth, margins and resource efficiency. Pay particular attention to these factors:

- Pretax margin.
- Growth in turnover.
- Earnings before interest and taxes (EBIT).
- Earnings before interest, taxes, depreciation and amortization (EBITDA).
- Net operating profit after tax (NOPAT).
- Turnover of invested assets.
- Net working capital.

## Calculating the Value Added

To ascertain the performance of your company or its divisions, don't compare just your profit-and-loss account with the competition, incorporate all asset costs, too. But watch out: Asset costs are often misinterpreted, and it is easy to overlook the interest on borrowed capital or on net assets. This is dangerous: If investors do not receive an appropriate interest yield, they will take their money elsewhere. Use the widely accepted and easily applicable Capital Asset Pricing Model (CAPM) to determine the capital costs. It allows you to calculate investors' expected average return, the weighted average costs of capital (WACC).

> "From the investors' point of view only one thing counts: What peer company can earn what return? Because of that, growth rates, margins and the use of the invested capital are just as relevant as trademarks, future products or scale effects."

Find out how the market might develop by taking a realistic look at the value added (the profit after deduction of capital costs), as opposed to EBIT or EBITDA. At a glance you will learn whether an increasing EBIT is sufficient to cover the capital costs, and intuitively recognize trends as well as changes in the relationship of different variables. Keep the calculation simple:

> "The value-added calculation is frequently misunderstood and, hence, done in an overly complicated way. The following rule of thumb is sufficient: value added = profit after deduction of the capital costs."

Value Added = NOPAT – Capital Costs (invested capital x WACC).

You need to make only a few adjustments to find the true value added: Balance the research and development (R&D) costs around periodic fluctuations, neutralize the marketing expenditure around the build-up of patents or markets, or evaluate one-off costs. Before you carry out these adjustments, check whether the corrections could better represent the actual added value.

## Defining Objectives from an Investor's Perspective

Value-based performance figures such as value added or return on investment (ROI) can help define goals from an investor's point of view. To do this, determine the market value of your company, which is composed of the operating value and the strategic value (also called future growth value). The strategic value captures investors' future value expectations derived from their assessment of the management team and its strategy. The operating value conveys the company's accountancy value based on its current profitability. It shows the operating business' contribution to market performance. The strategic value lets you forecast the income and profit expectations, and define them as objectives both for the corporation and its separate divisions. This data allows you to see the organization from the outside in, which is a criterion for a top-down approach to strategy and planning. Of course, you can also elicit investors' profit expectations according to the current market value. For highly diversified companies, the additional benefit of market-value analysis is the ability to compare business divisions to those of peer companies.

## Keeping Track of the Acquisition Radar

Market-value analysis can do even more for you: If a company's strategic value grows faster than its operating value, you can assume potential for success. With this information you can identify takeover targets and also assess your own company's risk of takeover. Value-based performance measures turn this market-value model into an acquisitions radar. When depicted graphically, it gives considerably more information than the conventional price-earnings or market-to-book ratios. The radar also identifies troughs and turning points which make it a suitable tool for predicting business cycles. You should take the acquisition radar into account half-yearly or yearly.

## Early Recognition of Weak Points in Profitable Divisions

The “operative index” can help you interpret value-driving performance figures. You can compare performance figures within a division, across different divisions, or against those of the competition. That way, you can identify the state of your divisions and peer groups, your company’s (and its divisions’) strengths and weaknesses, and its divisions in comparison with the market. You will be able to recognize potentially problematic areas much easier with this index than with traditional performance calculation, especially for highly profitable divisions. For example, you will be able to see straight-off where weakening results stem from: the breaking-away of a share of the turnover? An increase in costs? You can then react accordingly. In that way, the operative index supports top-down strategy and planning. It should also be reviewed half-yearly or yearly.

### Stimulating Relative Objectives

Because of its relative reference points, the operative index, as a strategic instrument, paves the way from fixed objectives (i.e., x% increase in turnover) to relative objectives (i.e., x% more return on investment than the market average). These relative objectives are more enduring. You don’t need to renegotiate them every year, and can leave them in place. They encourage top performance more than fixed objectives do. At the same time, they inhibit employees’ potentially harmful strategies of trying to reach fixed objectives at all costs.

> “An operative index describes the development of a certain performance metric over a period of time compared to the corresponding values in the peer universe.”

It’s obvious: Management needs to reposition itself to define goals beyond fixed budget targets. A new management culture and organizational structure is in order. However, if your company thinks and plans beyond the budget, it won’t be able to promise quarterly figures to the capital markets. Instead, you should publish the actual figures in a well-structured way, and communicate potential risks and strategic initiatives openly to the public.

> “When implementing value-based management, it should not be overlooked that the basis of every approach for accretion is a deep understanding of a company’s actual value drivers.”

Manage your current assets actively. Comprehensive Working Capital Management (WCM) releases liquidity and improves the financial situation. At the same time, the return on capital grows. Together with the supply-chain manager, financial managers should exert direct influence over storage, manufacturing time, and purchasing and handling processes. To have a successful WCM, you need reliable forecasts concerning sales, material requirements and production.

### The Helicopter Perspective

You need a tremendous amount of data for competitive value-management framework. To capture all of the value-driving performance figures at a glance, use a star-shaped graph, the “Stern radar,” to plot the change of each considered performance figure: turnover growth, gross margin, EBIT, EBITDA or NOPAT margin, turnover of the net current assets or invested capital – one axis for each performance metric. Use the percentile performance as a measure to show by what percentage the competitor is worse than your company. Show your own status in a different color. Doing this gives you an overview of the position of the whole company (or separate divisions) in relation to the competition. With the aid of several Stern diagrams, you can gauge how the organization’s overall performance has grown – or how a business division over several years, or several business divisions within the same year have fared. The Stern radar is particularly valuable as an early warning system.

### Implementing Objectives with the Balanced Scorecard

The Balanced Scorecard is most suited to implementing objectives. This strategic tool is well-known, and you may already have it in place. However, it is crucial to link the Balanced Scorecard to other management instruments, especially those used with value-based management. Specify important influential factors for the acknowledged value drivers and derive performance figures from them. When you link the value-driver concept with the Balanced Scorecard approach, consider, along with financial considerations, customer and process perspectives, and learning and development expectations. The graphical representation can help you recognize causal chains and deduce appropriate target values. Realize that the shareholder-value concept is often too narrow: Customer and employee perspectives actually form the basis for value-based management.

## About the Author

**Hermann J. Stern** is manager of the CFO Intelligence Force Obermatt. The Swiss organization specializes in value and risk analysis for finance experts and decision makers. He received his Ph.D. from the University of St. Gallen, and worked as CFO for a leading telecommunication provider in Switzerland and as financial manager for a computer company. He is author of *The Value Cockpit* and several other books.