

Implementing Shareholder Value Analysis

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Shareholder value analysis (SVA) is one of several nontraditional metrics being used in business today. SVA determines the financial value of a company by looking at the returns it gives its stockholders and is based on the view that the objective of company directors is to maximize the wealth of company stockholders.

What You Need to Know

How is shareholder value calculated?

Shareholder value is calculated by dividing the estimated total net value of a company based on its present and future cash flows by the value of its shares of stock. The resulting figure indicates the company's value to stockholders.

Why adopt SVA?

The underlying principle of shareholder value is that a company adds value for its stockholders only when equity returns exceed equity costs. Once the amount of value has been calculated, targets for improvement can be set and shareholder value can be used as a measure for managing performance.

What are the advantages of using SVA?

Shareholder value analysis:

- takes a long-term financial view on which to base strategic decisions;
- offers a universal approach that is not subject to differences in companies' accounting policies and is therefore applicable internationally and across business sectors;
- forces the organization to focus on the future and its customers, particularly the value of future cash flows.

What to Do

Obtain the Commitment of Top Management

Underlying SVA is the belief that the creation and maximization of shareholder value is the most important measure of business performance. Top managers need to commit to this objective in order for the SVA approach to proceed and take root. They should also agree that traditional measures and approaches may not succeed in achieving this objective.

Understand and Calculate the Company's Shareholder Value

Before adopting shareholder value as a significant financial objective, you need to understand its implications and the best way for your business to approach it. It can be helpful to first plan the approach with professional advisers such as accountants or consultants who specialize in this area. A company's value is calculated by subtracting the market value of any debts owed to the company from the total value of the business.

The total value of a business has three main components:

- the present value of future cash flows during the planned period;
- the residual value of future cash flows from a period beyond the planned period;
- the weighted average cost of capital.

Total business value is calculated by adding present value of future cash flows to residual value of future cash flows and dividing it by the weighted average cost of capital.

If the result of this calculation is greater than one, then the company is worth more than the invested capital and added value is being created.

- Future cash flows

Future cash flows are affected by growth, returns, and risk. According to Alfred Rappaport in *Creating Shareholder Value*, these factors can be explained by seven key value drivers that must be managed in order to maximize shareholder value:

- sales growth rate
- operating profit margin
- income tax rate
- working capital investment
- fixed capital investment
- cost of capital

- value growth duration
- Residual value of future cash flows

The residual value—the price at which a fixed asset is expected to be sold at the end of its useful life—is an important figure that represents cash flows arising after the normal planning period (usually five to ten years). It has been estimated that as much as two-thirds of the value of a business can be attributed to cash flows arising after this planning period. Viewed another way, only one-third of the value of a business results from cash flows arising during the normal planning period.

- Weighted average cost of capital (WACC)

The WACC is the cost of equity added to the cost of debt. It represents the return a company needs to earn in order to justify the financial resources it uses. The WACC therefore expresses the opportunity cost of the assets in use. The WACC is entirely market-driven—if the assets cannot earn the required return, investors will withdraw their money from the business.

Analyze the Company's Key Value Drivers and Set Targets

Shareholder value is about maximizing cash flows. In order to achieve this you need to identify and analyze the key value drivers of the business (the seven identified by Alfred Rappaport). For example, improvements in the operating profit margin are affected by sales and expenses; these in turn are driven by a number of other factors that are themselves driven by still other factors.

This analysis of value drivers links financial and operational objectives and provides a framework in which to:

- set performance targets;
- assign responsibility to individual managers;
- review the company's financial performance (and benchmark against competitors);
- develop strategic plans.

Identifying the key factors influencing each value driver will be a process of trial and error. However, this process is fundamental to managing, controlling, and making improvements in the business, leading to your goal—improved cash flows.

Communicate the Approach and Train Staff

Managers need to understand the broad concept of creating shareholder value, particularly when assessing the value of potential projects, but are unlikely to be concerned with the technicalities of SVA. They should instead understand the importance of identifying, controlling, and improving the performance of the value drivers and the key factors that influence them. Adopting SVA and

setting new targets may meet with resistance on the part of managers who have “always done it this way.” They will be told to reevaluate previous approaches and perhaps discard them in favor of new approaches and new targets.

Unlocking shareholder value is essentially a change process and requires that the people making the key operational decisions be fully trained.

It is also important when implementing an SVA approach to achieve early, high-profile successes. As with any change, early successes demonstrate the value of the change, highlight its benefits, and win over skeptics.

Change Managers’ Financial Incentive Packages

Review and revise your incentive packages to reward managers for performance that adds shareholder value. Incentives for senior managers should reflect the need to increase shareholder value over realistic time periods instead of focusing simply on short-term profit growth or earnings per share.

Change the Company’s Information Systems to Monitor and Measure Progress

The company’s financial reporting systems and information systems will likely need to be upgraded when SVA is implemented. Traditional reporting systems are unlikely to provide all the information required or to provide it in the most helpful format. The implementation of SVA requires managers to regularly measure and monitor information about the company’s key value drivers and targets.

Monitor and Review Progress

Creating sustained value requires continuous monitoring and resetting of targets as circumstances change. Appraisals, performance reviews, management meetings, and key decisions should all focus on the progress that has so far been achieved and the actions required to continue building shareholder value. Without consistent emphasis on value creation, managers may continue to focus on targets that have become irrelevant or that can actually harm the long-term value of the business.

What to Avoid

You Think SVA Can Be Implemented Overnight

Developing and implementing SVA can be a long and complex process. It takes time, energy, and commitment and may require a complete overhaul of the way in which the business is run. Accurately estimating future cash flows, a key component of SVA, can be extremely difficult. Inaccurate projections can lead to strategic decisions being based on incorrect or misleading figures. Explaining the SVA approach to managers and training staff can also be difficult and time-consuming. So do not cut corners or be impatient. Unlocking shareholder value is likely to take time. Some estimates claim two years is the norm.

Where to Learn More

Book:

Rappaport, Alfred. *Creating Shareholder Value: A Guide for Managers and Investors*. 3rd ed. Free Press, 2000.