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BY AARON GILCREAST AND LARRY JONES

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If you are a senior executive of a publicly held company, you probably pay significant attention to the standard financial metrics of the capital markets: your share price and earnings per share. We'd guess you are probably paying too much attention. Financial advisors and the media often make the same mistake. They regard your share price as the ideal target of your strategy and the primary reflection of its effectiveness.

Of course, share price matters, as do your shareholders. But your share price is, by its nature, an output: a complex, rolled-up reflection of company performance, conjecture, fickle asset-class preferences, risk appetite, ownership mix, supply–demand equilibriums, and fluid expectations held by millions of shareholders who can change their minds in a millisecond. Good luck trying to manage that.

Moreover, your share price is subject to a more fundamental paradox that affects every publicly traded company: the paradox of market equilibrium. The better your operating results, the harder it is to create shareholder value. Not only is it harder to outperform the market, but you run a greater risk of underperforming the market.

This paradox exists because millions of shareholders base their expectations for future performance, at least in part, on prior performance. If you continuously deliver exceptional performance, investors expect you will continue to do so. They will price the value of that future performance into your share price.

To create shareholder value by generating actual stock returns, you must exceed the embedded expectations of your investors. But if your operating performance is good, they already expect you to improve, and it is harder to surprise them. Do even better, and they will expect even more. Like the Red Queen said in Lewis Carroll's *Through the Looking Glass,* it may take all the running you can do just to stay in the same place.

In this situation, even with good basic management, the best you're likely to do in terms of total shareholder return (TSR) over time is to match the cost of your equity capital. Make a misstep and miss the expectations, a much more likely outcome at the top of a cycle, and investors will clobber your share price.

You cannot avoid this paradox; it is the nature of the market. But there is an alternative, financially based management objective that can help you create a more consistently viable and nimble enterprise, and thus a more sustainable value proposition for investors. It is known as intrinsic value, and it is the key to strategic surprise: to raising your potential for growth and innovation by using a more disciplined and rigorous approach to valuing your strategic alternatives.

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The Nature of Intrinsic Value

Intrinsic value is a forward-looking measure of the fundamental worth of a business. Defined as the present value of future cash flows generated by assets, it is a truer reflection than shareholder returns of the value of your strategies and your ability to execute them. When you use intrinsic value instead of TSR to guide decision making, you are less likely to worry about the factors you can't control directly, such as your share price. You are more likely to focus on the inputs that you can control: your corporate and capital strategies, and the alignment between them.

This simple and logical principle is familiar to most business leaders; it's closely tied to the logic of value investing, exemplified by Warren Buffett and his former mentor, investment scholar Benjamin Graham. But putting it into practice is another matter entirely. In many companies, the strategic focus on intrinsic value is insufficient (or entirely absent); its measurement is improper or inadequate; leaders don't fully understand the linkage between intrinsic value and corporate strategy; and, consequently, the company's business doesn't grow as rapidly or easily as it could.

Graham once said, "In the short run, the market is a voting machine, but in the long run, it is a weighing machine." A strategy based on intrinsic value allows you to look past the froth of everyday "voting" and build a more substantial enterprise that continually surpasses its past performance

In their 1934 book *Security Analysis,* Graham and his fellow Columbia Business School faculty member David Dodd introduced the concept of intrinsic valuation: a way of converting a qualitative judgment about a company's future prospects into a metric that can be used to compare businesses. A number of alternative intrinsic valuation methodologies have been developed over the years, but all of them estimate the value of a company at a particular date on the basis of expectations about future cash flows. A valuation of this sort typically incorporates estimates of the expected cash flow available to debt and equity holders for some discrete projection period after the valuation date. Beyond the discrete projection period, a "terminal" value is calculated to measure the value of normalized cash flow expected to continue into perpetuity. Projected cash flow and the terminal value are discounted to present value at a rate of return commensurate with the time value of money and systematic market risks. Though none of these elements can be known for sure, it is possible to generate relatively realistic estimates, and the estimates become more realistic when they are calibrated against actual results over time.

A well-designed calculation of the intrinsic value of your company will reflect the acumen of your strategic decisions and the effectiveness of your execution. Over time, this will attract investors, and thus raise your TSR. Market values measured with share price oscillate, but in most sustainable companies, they gradually come to reflect intrinsic value. The better the judgment captured in the intrinsic value metric, the more likely the market value is to correlate, because intrinsic value is a kind of predictor of ultimate market value. Only when you make decisions that consistently improve your intrinsic value can you develop sustainable value for your shareholders.

Measuring Intrinsic Value

As a member of a senior management team, you can do more to rigorously quantify how your strategies create or consume intrinsic value across the organization. It should become a habit to consider value first, and share price second, when making decisions.

Measuring value is sometimes described as an art form, a reflection of experiential knowledge. That's true to a degree, but valuation is also a science that is rooted in decades — indeed, centuries — of academic and applied financial and economic research. There are now widely accepted theories about the relationship between risk and return, with enough objective reliability that you can feel confident measuring the reasonableness of your business judgment. It is critically important that the professionals you assign to measuring value have a deep technical understanding of the science of valuation. They should also be well trained in building effective computer-based models for estimating economic impact. Model quality is an often overlooked consideration, and a substantial majority of models have material errors.

In our experience, three foundational questions about intrinsic value yield the most useful information for making these assessments. Address these questions in a detailed way, quarter after quarter, and you can properly form and execute strategies that drive intrinsic value — and thus, in the long run, your share price:

• What investor expectations about intrinsic value are embedded in your current share price?

• When, where, and why is intrinsic value being created and consumed by your company and your industry competitors, and how may these patterns shift over time?

• What is your strategy agenda? This is your framework for longer-term decision making, reflecting the potential value impact of regularly renewing your strategic options.

These three foundational questions represent a way of shifting your strategic orientation toward intrinsic value. Each question is a step in that journey. Let's consider each in more detail.

Investor Expectations

This is the first foundational question: What investor expectations about intrinsic value are currently embedded in your share price? Before you can consider value objectively, you need to think more clearly about your market value. Share price is an indicator of the "wisdom of the crowd": a signal of the investment community's perception of your company's future growth and profitability. Understanding your investors' judgment is important for several reasons, but primarily because it gives you a baseline for your strategic plans. Once you have gained a better understanding of the bar you are expected to clear, you can turn your attention to meeting and exceeding those expectations.

Total shareholder return is typically analyzed as the sum of price appreciation and dividend payouts over a given time period. But this analysis is problematic, because both of these component metrics represent the allocation, not the source, of created business value. They don't explain what created the value that drove the share price higher or generated the cash needed to pay a dividend.

The actual drivers of value creation are return on capital and growth (net of investments to generate the growth). These drivers, combined with fluctuating investor expectations about future capital returns and growth, in turn drive TSR. Reframing TSR as a function of these actual drivers is a useful way to get from price to value because the analysis begins to reveal how investors are translating your business performance into share price.

Value Creation Patterns

By asking the second foundational question, you gain a better understanding of the value creation patterns within your company and your industry. Do you know when, where, how, and why you and your competitors generate value? Do you know how you consume value? Do you have a good idea of how these patterns may shift over time?

When we pose these questions to company leaders, they often reply, "Of course!" But when we look more closely, it frequently turns out that the approaches they use to answer these questions don't yield enough optimal or actionable information. If your company is typical, you need more sophisticated analytical tools to illuminate value creation and consumption patterns for your organization and industry.

To solve the puzzle of long-term intrinsic value, you have to look thoroughly at value performance within your organization. For example:

• **When is value being created or consumed in your enterprise?** Isolate the precise time periods when you are creating net value and when you are consuming it. Two of the most commonly used valuation methods — discounted cash flow and market approaches based on analyzing acquisitions of similar companies — are inadequate for this purpose. Methodologies that focus on period metrics such as excess return on capital, which ties together profit and the cost of capital required to generate the profit, are preferable. If capital returns exceed capital costs in a given time period, value is created; if the opposite is true, value is consumed.

• **Where is value being created or consumed in your enterprise?** This question should be asked at a granular level — down to the geographic market, individual product or service, or some other unit of account. Valuation methodologies applied at a broader level, such as regions or consolidated businesses, rarely yield actionable intelligence because value creation is typically highly concentrated within companies. As a rule of thumb, one-third of a company's customers (or products or invested capital) are generating more than 100 percent of its business value. Another third are likely consuming value (that is, generating negative capital returns). The remaining third are value neutral.

• **Why is value created or consumed in your enterprise?** Can you link value creation and consumption to specific assets or capabilities? Identifying the sources of your competitive advantage is an important step in analyzing value creation patterns and setting corporate strategy. Do you have an advantaged patent or technology position? Are your customers sticky, and, if so, can their loyalty be sustained? Does your brand yield a price premium? Which of your core capabilities help you win in the market? Of course, you probably consider these questions on a recurring basis, but have you linked them to a comprehensive view of your own company's habitual patterns of creating intrinsic value? Here again, a good quantitative proxy for this is your capital returns above capital costs.

This analysis can be bolstered by looking at complementary aspects of value creation, that is, related indicators that can help you see your offerings more clearly. For example, the metric of return on invested capital (ROIC) reflects the market economics of your offerings. By plotting it against your relative competitive position (using, for example, the spread of your company's ROIC compared to that of your industry), you can see where value is being created or consumed in your enterprise.

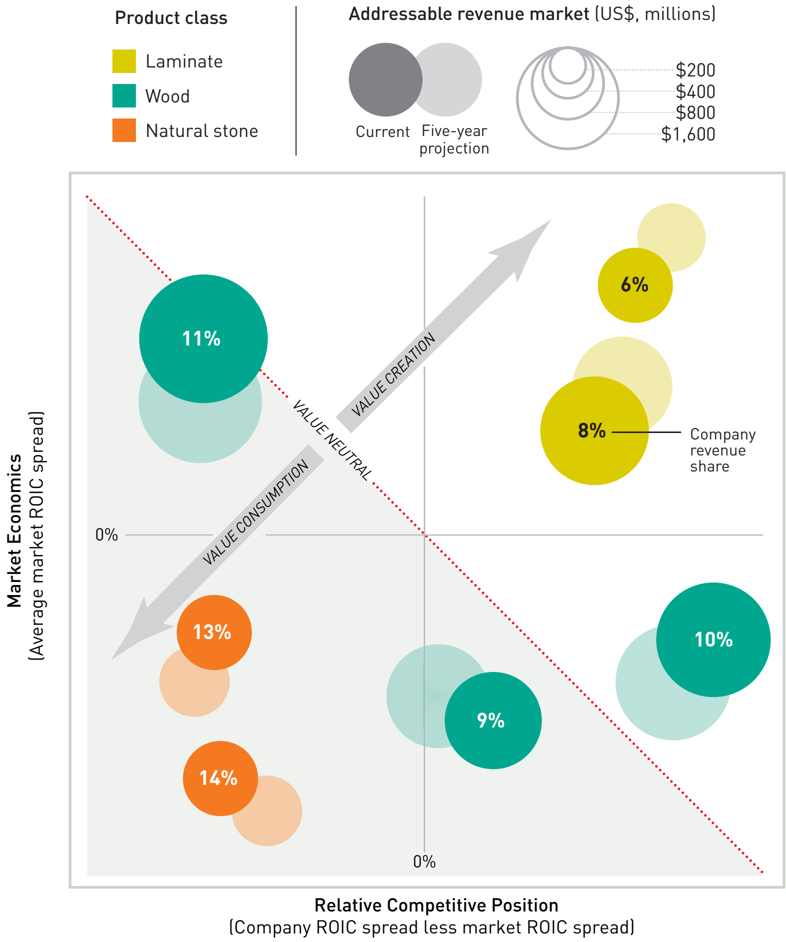
"Intrinsic Value in a Business Portfolio" (next page) shows an analysis of these two measures for a hypothetical enterprise typical of the building materials industry. If you were in this company's leadership, what strategies would you consider optimal? In the top right quadrant, laminate is an advantaged product in an attractive market. You credibly estimate that its sales and profits will expand. You should invest in that product for growth. In the bottom left quadrant, natural stone is a disadvantaged product in an unattractive market, so your options are to take the product in a new direction — or exit, by selling the division or even shutting it down. In the other two quadrants, wood-based products face difficult competition and their prospects are daunting. You need to apply the capabilities you already have to improve their competitive edge.

You must also look closely at your industry competitors and the future. That analysis includes these assessments:

• **How do your value performance patterns compare with those of your peers?** Research and analysis can typically yield enough information about competitors' products to discern their value performance patterns. One of your products may deliver excess capital returns for your business, but if rival products generate even greater excess capital returns, you may have a disadvantage in the market. If a product lags the products of your industry peers in value creation, that does not necessarily mean you should abandon the product. But it does mean you should rethink your strategy, and comparative return on capital data — yours versus theirs — is a critical factor to consider.

Intrinsic Valuations in a Business Portfolio

Strategic positions of several businesses in a hypothetical materials company in North America, modeled after case analyses of several real enterprises. The product classes inside the gray triangle are net consumers of shareholder value and must be improved or sold.



Source: PwC US

• **What changes might you expect in performance patterns for your industry?** You may have a product with a competitive advantage relative to all your peers, but if that advantage is likely to fade (maybe a competitor has a better product on the horizon), you may choose a different strategic path.

Your Strategy Agenda

The third foundational question is oriented to action: What is your strategy agenda? This is a framework for longer-term decisions, taking into account the potential value impact associated with different strategic options. A corporate agenda of this sort can consistently raise your value performance; it sets a context where you are continually thinking about strategic surprise. For example, it will give you the insights you need to evaluate growth opportunities in terms of excess capital returns and sector-leading competitive advantages. It will also show which products you should consider divesting — either because they have low or negative capital returns now, or because their capital returns are likely to diminish over time.

To create your agenda, you need to lay out several strategic options, and make rigorous estimates of the potential value impact associated with each. This analysis is based on three main factors, each a fundamental area in which management allocates capital to affect intrinsic value: growth (organic and inorganic), optimization (divestitures and the rightsizing of costs and capital), and capital returns (dividends and buybacks).

In assessing growth, go beyond the basic valuation concepts that many business executives apply to strategic decisions (for example, calculating the potential return on investment for several forecasts or scenarios). Those basic efforts are typically static: They measure the impact of decisions already made. Dynamic valuation is far more powerful. In dynamic valuation, you assess the potential value of decisions still to be made, and revise your valuation approach based on the results of those decisions. Ideally, the dynamic valuation takes into account changes in investor expectations, as revealed through the actual share price — and leads to new ways of moving beyond your past approaches.

There are several methodologies for dynamic valuation. In our view, the best choice is decision-tree analysis. This approach incorporates a complex series of what-if scenarios, including forecasts for sequential trade-offs or strategic choices, branching off into multiple potential options. Another approach is real options, which use option pricing calculations to represent the value of multiple alternatives; however, we generally do not recommend this complex method except in highly uncertain environments.

In a dynamic valuation exercise, you need to settle on just a few value drivers, metrics that represent the outcomes you are trying to deliver. You may be drawn to some value drivers that are easy to define and forecast, like cash flow and ROI. They seem relatively straightforward and tangible: You invest a certain amount and expect a certain return. Don't rely on them exclusively. You will gain a better assessment from more intangible attributes that represent less easily defined value drivers.

These intangible attributes might seem hard to quantify at first, but it is always possible — and worthwhile — to consider their effect on value in a more disciplined, measurable way. For example, consider the hoteling of staff (having people work at home and come into the office only when they're needed, which cuts down on the total office space required). Here, the tangible costs and cash flow benefits seem obvious at first glance: Invest in technology and space-planning requirements to support hoteling and capture the savings from a smaller real estate footprint. But does this rough idea capture all the relevant attributes with enough rigor?

If co-located teams are important to your organization, what is the value impact of having your teams sitting apart from one another or working from home? In most companies, time is money. When people have to spend time each day looking for teams, signing into offices, and gathering their files, how does it affect productivity and thus value? Does morale suffer when hoteling leads to a no-personal-effects policy, with no photos, plants, or other personal items allowed on shared desks? How does the reduction in face-to-face contact affect the onboarding of new employees? What is the value impact of increased turnover if professionals choose to leave for companies that have not implemented a similar policy? What is the effect on productivity — positive or negative — when staff work at home or at satellite offices and communicate by phone and computer? The answers to these questions will vary from one company to the next, but the upside and downside can always be quantified.

Hard-to-quantify value attributes can help you reconcile shareholder and stakeholder objectives. A decision that might look good from a shareholder perspective, one based only on analyzing tangible attributes — for example, a decision to shutter a money-losing plant — might look very different from a stakeholder perspective when intangible attributes are included. If the plant is part of a regional system that supports a particular group of customers, closing it will disproportionately affect sales to those customers in other locations. If this is considered a business with growth potential, the right decision for both shareholders and stakeholders may be to keep the plant.

Consider your growth and optimization value drivers in terms of the ideal operator of the business. The optimal management team in principle is the group best positioned to build and exploit capabilities and assets to maximize cash flow. Are you the best possible operator for all your products and services? Or would you unlock more value for your shareholders if you divested some of them to another enterprise with more appropriate capabilities?

You can sometimes develop discrete measurements of what a company's intrinsic value might be under different operators by conducting due diligence for a merger or acquisition. But even in the absence of a potential transaction, you should still assess the hypothetical intrinsic value of your businesses if they were operated by someone else. This can help you establish strategies that maximize value. If one of your businesses does not fit well with your capabilities system, but has high value creation opportunities, a sale to a more optimal operator that is willing to pay for those opportunities would be a value-maximizing decision.

Valuation, Uncertainty, and Leadership

When your company establishes a credible long-term strategy — including a way to play in the market and the capabilities to deliver — it sets up a high level of certainty. In valuation terms, your market value (your shareholders' expectations) will more closely reflect your intrinsic value (the profits you consistently create). This is a tremendous source of strength, but it also triggers the paradox of market equilibrium.

You thus have to embrace a relatively high level of risk and uncertainty if you want to overcome this paradox and generate shareholder value. You can be certain and stable in your capabilities, but you have to put those capabilities to work in uncertain ways.

To be sure, you can take another path. Instead of creating shareholder value, you can adopt a more defensive strategy, making decisions that preserve the value you have already created. Sometimes, this is the right course to take. A company with massive amounts of cash might be tempted to make risky technological bets. An investor might skeptically look at this decision, and prefer getting the capital back instead. Activist investors usually assume there is more potential value in making the decisions on their own. A company that accepts this logic would be more inclined to offer buybacks and dividends, and less inclined to pursue growth.

But that company is not likely to be as successful, in the long run, as a company that can consistently create strategic surprise and outpace the market. In the end, it comes down to the acumen of your top leadership. The difference between a truly innovative, growth-oriented CEO and someone who is merely moving the organization along is the leader's ability to look at intrinsic value, understand how that value would be created in the future, and transcend the curve. If you have a great management team, immersed in the dynamics of the business, chances are you can do this far more successfully than a financially driven group of external investors — as long as you have the right analytical approach.

Indeed, if you have that capability, we believe you have a fiduciary responsibility to exercise it on behalf of your shareholders. You're not supposed to be day traders. Your job is to increase the long-term intrinsic value of your company. In the end, this value cannot be properly captured in a single, static number. It reflects your management team's ability to build and exploit the capabilities and assets required to win in the market. Too many company strategies are based on qualitative or quantitative analysis alone. If you can combine the two in a disciplined, rigorous, and continuous assessment of value performance, it will improve the outcomes of your strategies, increase intrinsic value, and, ultimately, drive your share price higher. +

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