

Value Management

Strategic Management Centre

Members Meeting

29th June 2022

Agenda

2.00 pm – 2.45 pm	The holistic value manager
2.45 pm – 3.15 pm	Managing value in the new environment
3.15 pm – 3.45 pm	Break
3.45 pm – 4.45 pm	Leadership lessons from value creators
4.45 pm – 5.00 pm	Summary

Key lessons from value managers

They embrace value creation as the key measure of corporate success

- **TSR is the long-term measure of success, reversion to intrinsic value**
- **Proxies (e.g., EPS, EVA, growth etc) are useful but can be dangerous**

They believe that intrinsic value and long-term TSR highly correlated

- **“discounted value of the cash that can be taken out of a business during its remaining life” “a number that is impossible to pinpoint but essential to estimate” (Buffett)**

Their most common counter-intuitive belief is that growth itself is not a driver of TSR

- **Expectations, unprofitable growth**

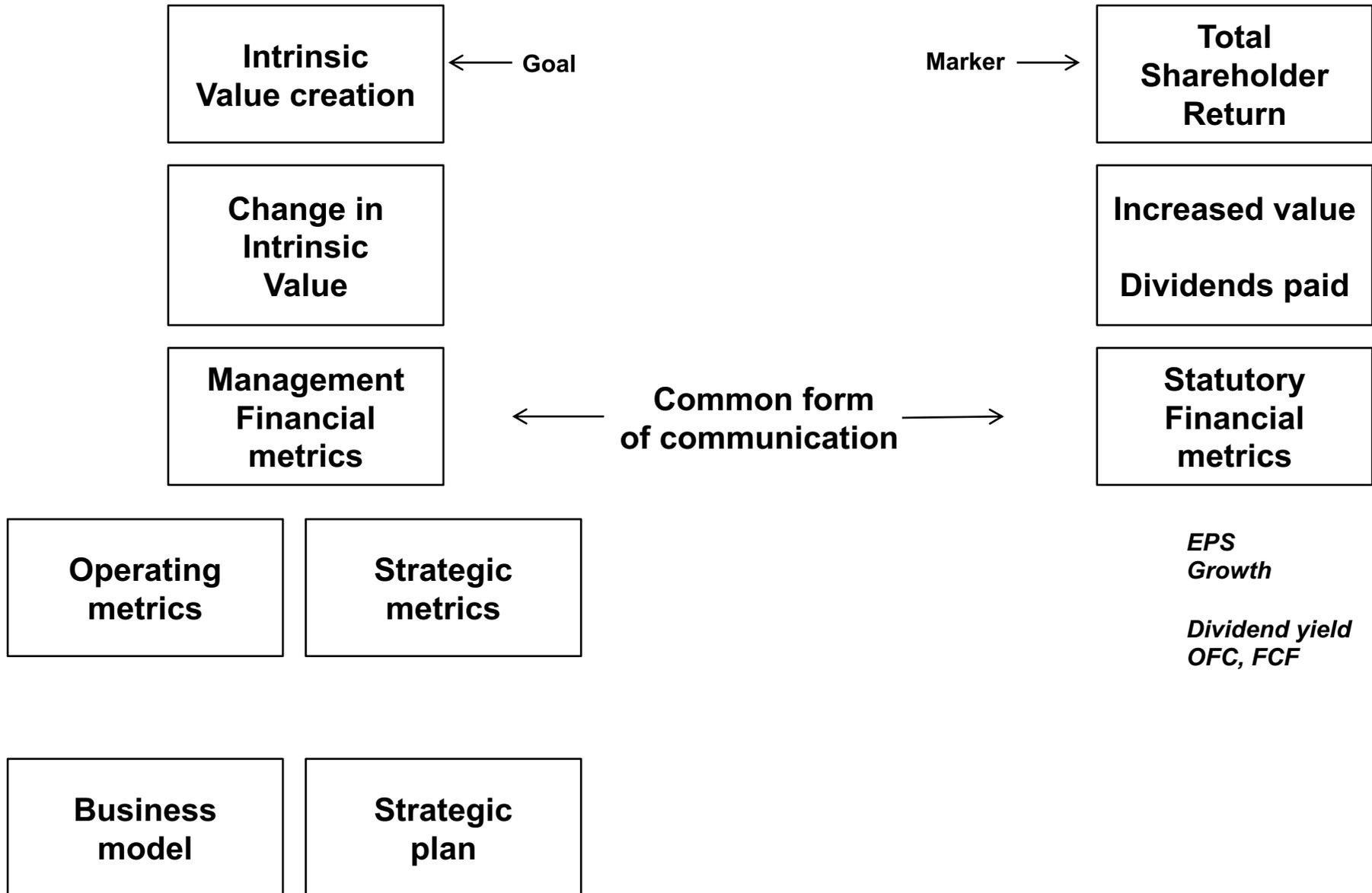
They understand that it's what you do that matters, not your industry, or past performance

- **Clean slate, equal chance**

They know that value creation is strategic and operational

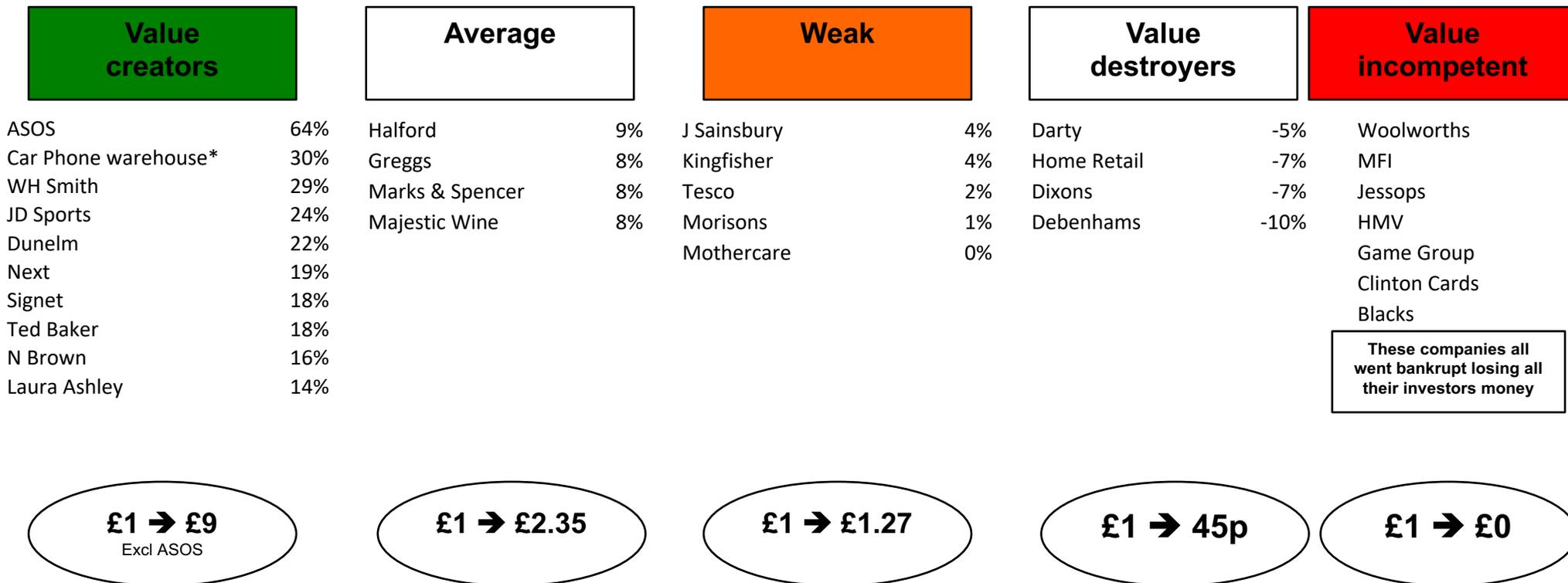
- **Successful (value creating) strategies are situation dependent**
- **Good/bad execution can make all the difference to results**
 - **Especially where value creation challenges industry wisdom**

Value managers manage with a value based metrics map

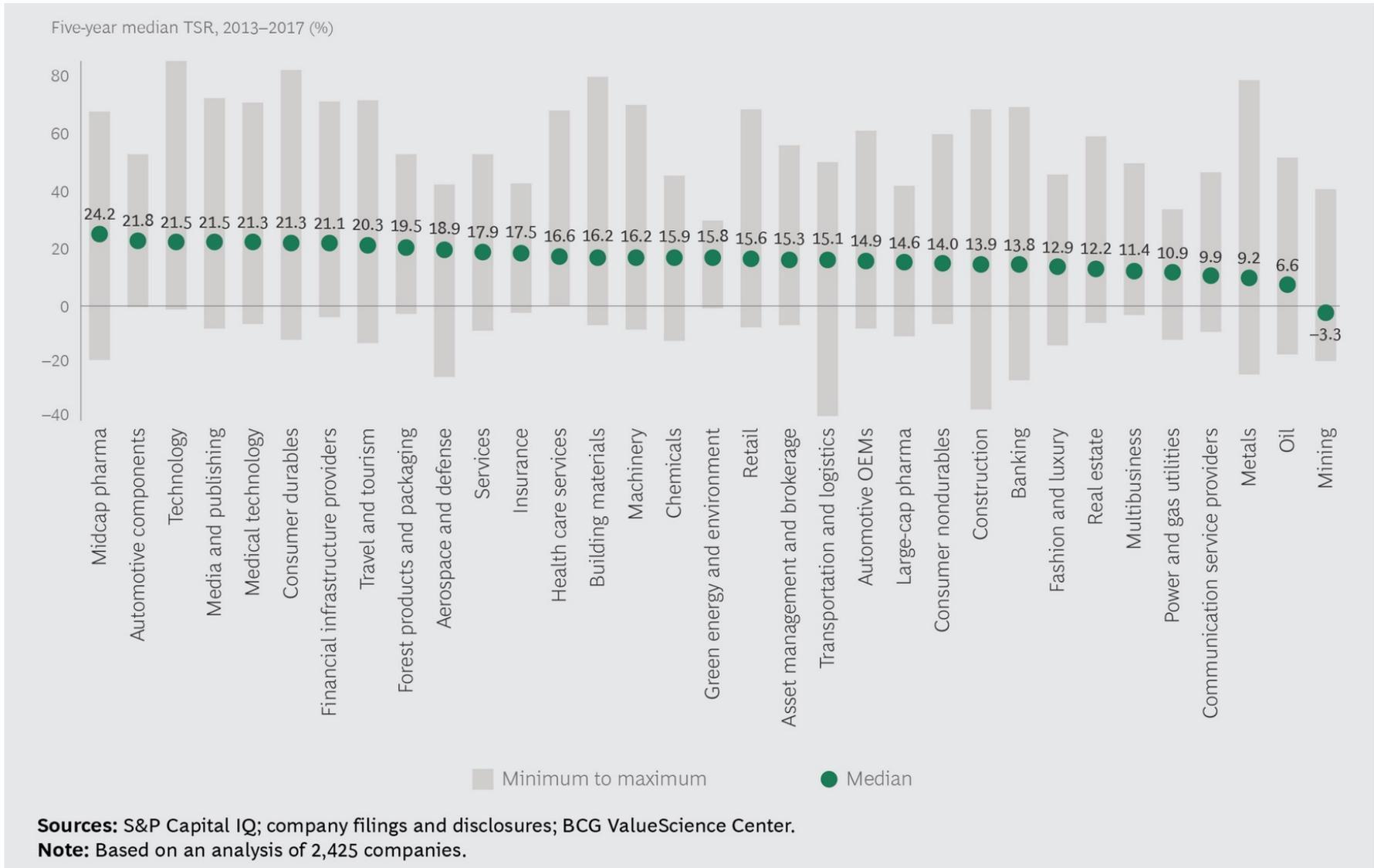


Over the years we explored how each sector comprised a very wide range of value creation

E.g., Annual Total Shareholder Returns 2003-14 in UK retailing



Company TSR performance outweighs industry performance



No simple relationship between sales growth and TSR over the decade examined

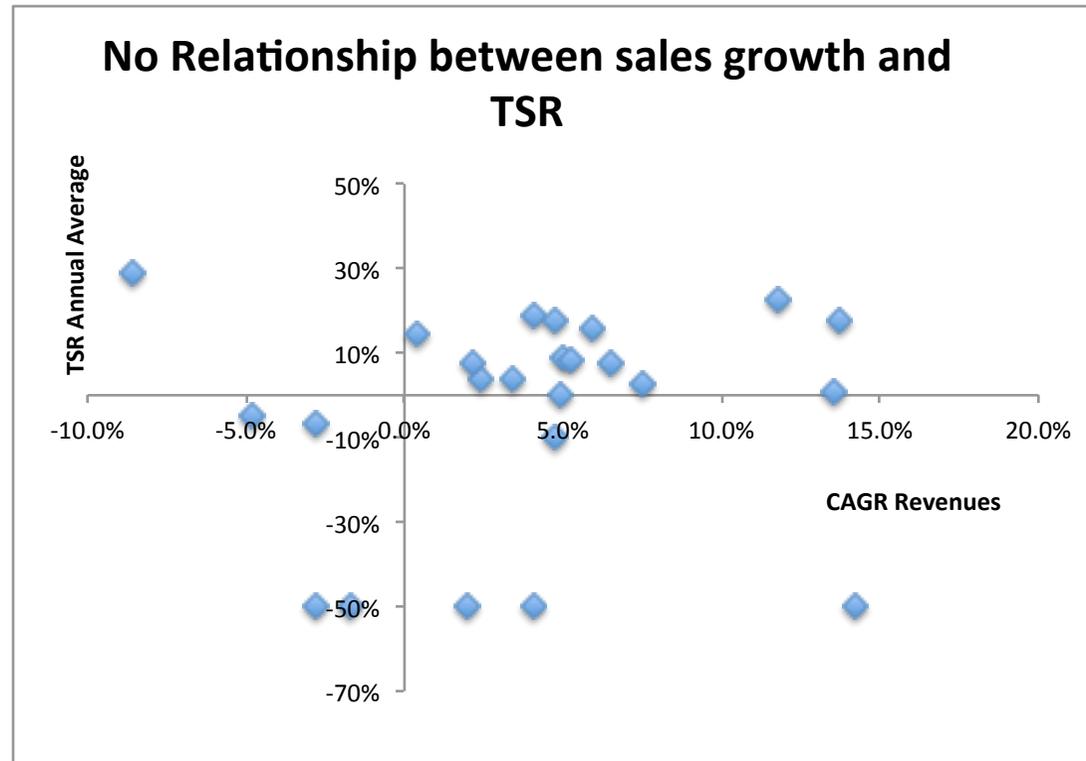
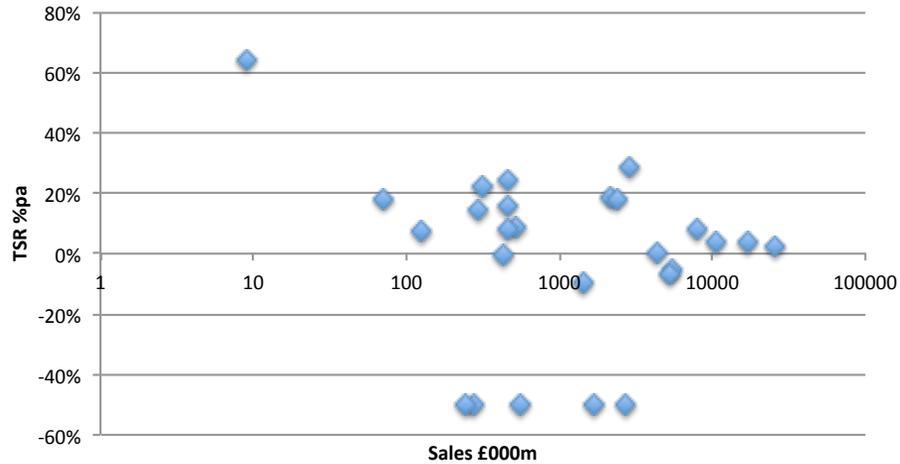


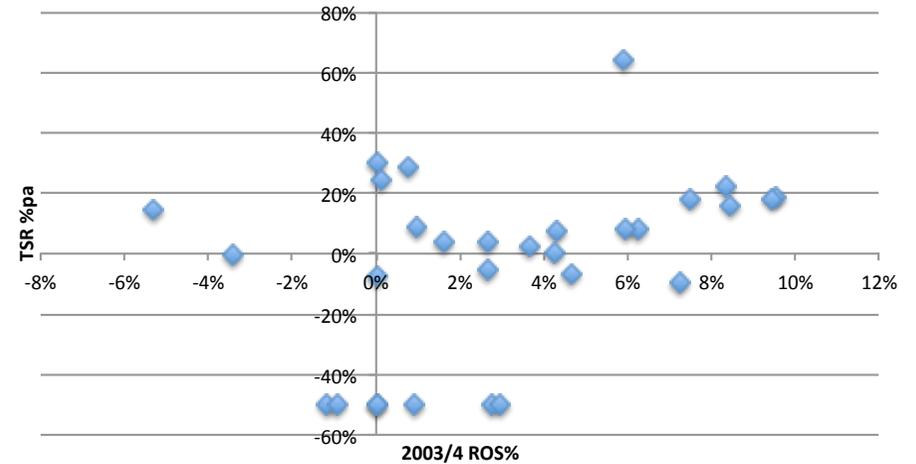
Chart shows the CAGR of revenue for the data set, and the annual TSRs for the same 10 year period (mostly 2004 - 14).

Broader data suggests future value creation (2004 - 14) not closely correlated with starting position (2003)... equal chance

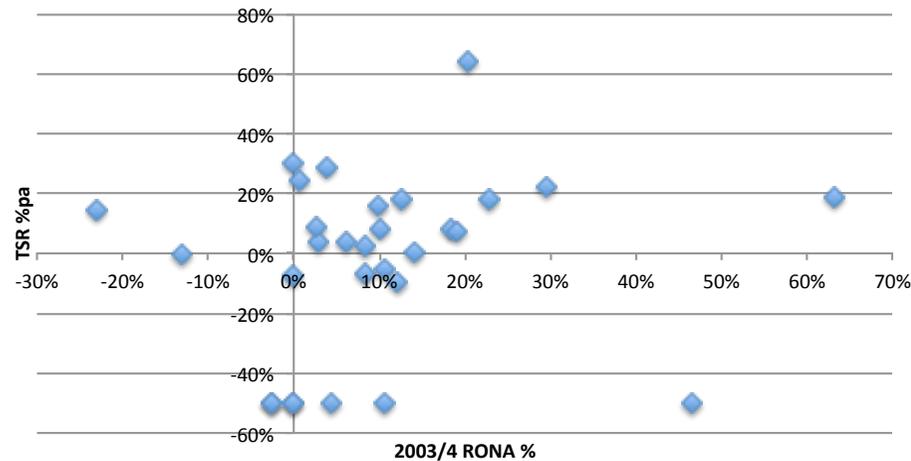
TSR and 2003 Sales



TSR and ROS%



TSR and RONA%



Themes from our value creation case studies (1)

There are a group of CEOs/companies that explicitly manage for value

- They have an objective based on some mix of IV + TSR + Δ Market cap + Δ EPS
- There are others who either have no clear objective, or have selected a strategic or operational objective and made this primary

The value focused CEOs exhibit some common (not universal) practices; they:

- Are clear between means and ends – strong hierarchy of goals
- Are therefore indifferent to many common goals (esp growth)
- Tend to see the portfolio more flexibly, using demergers/ divestments for VC
- Set top-down stretch targets, explicitly derived from their value goals
- Are data hungry about the environment and have few pre-conceptions
- Are flexible about strategy and willing to change course, seeing this as an empirical issue
- Direct capex to high return businesses, or to shareholders
- Consider and use a wider range of levers than others, and rely less on the ones that have worked for them in the past
- Use balance sheets, capital structures etc more actively
- Skew their rewards heavily to value creation, often owning very large equity stakes

Summary themes from the case studies (2)

They see strategy as a way to achieve their goal (of value creation)

- **A means not an end – measure and quantum of value**
- **Are firm that a strategy must create value but are flexible about what comprises a good strategy**
 - **Tend not to have a “preferred” strategy using different strategies in different businesses/situations**
 - **Are data hungry about the environment and have fewer pre-conceptions**
- **Understand strategy is only of value if tied to action**
 - **Must resolve real choices of consequence**
 - **Must be doable**
- **Tend to see the portfolio more flexibly, using demergers/ divestments for VC as much as for other goals**

They take account of the balance sheet, ROCE and cash flows as much as they understand profits, EPS and growth in crafting strategy

- **Direct capex either to high return businesses, or to shareholders**
- **Use balance sheets, capital structures etc more actively**

The allocation of capital is key for value managers

Capital allocation is arguably the most important long-term action for value managers

- Cash deployed over a CEO tenure is very substantial
- Investment returns are very variable, leading to a wide range of returns to capital allocated
 - And thus to company value

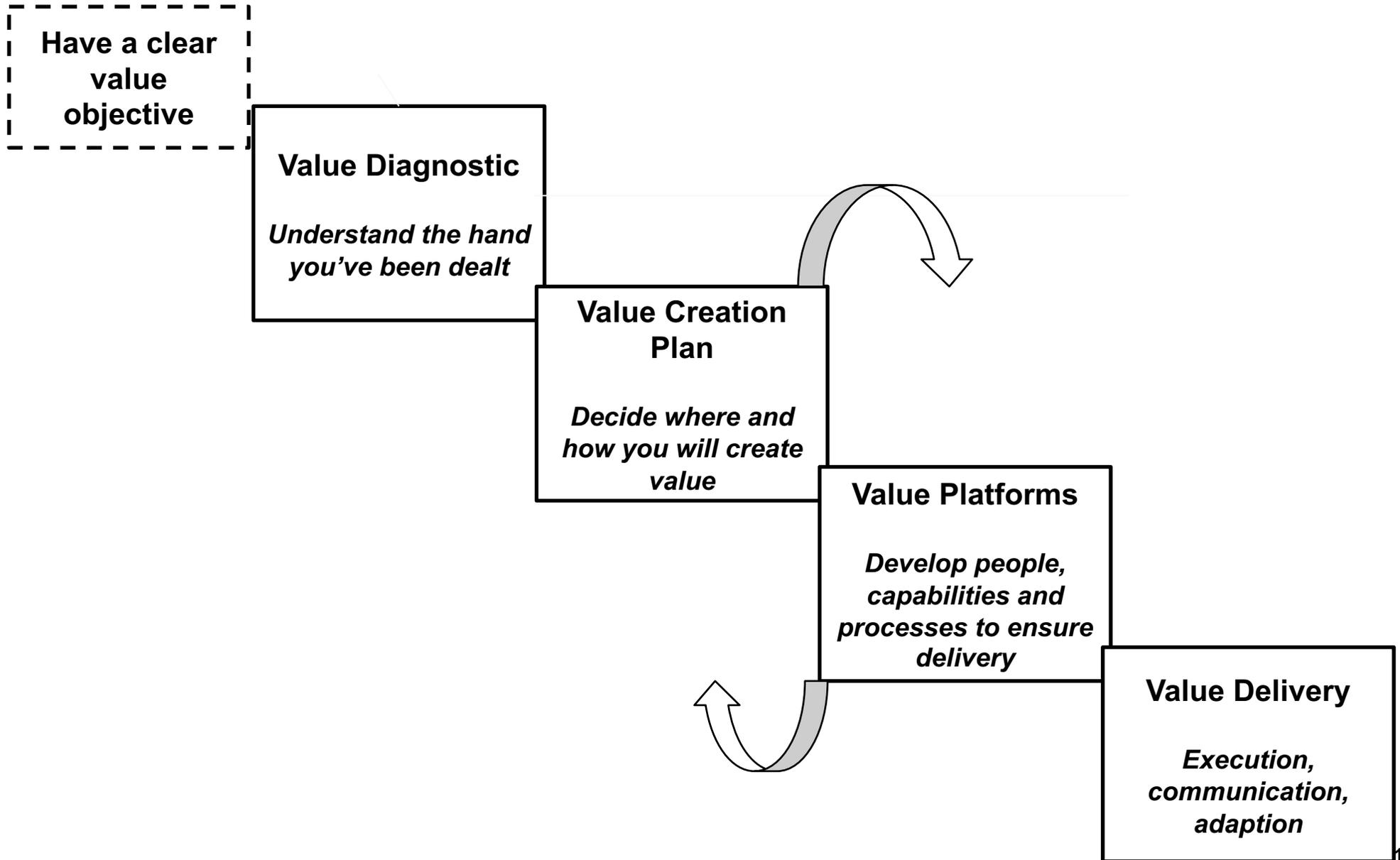
What would we expect value managers to do?

- Invest in high return opportunities
- Not invest in low (or maybe even average) return opportunities
- Not invest for growth per se unless profitable
- Make capital allocation as a corporate rather than business decision
- Compare capex and investments with returning cash to shareholders

"The root of my success is acting rationally about capital allocation"

Warren Buffett

An approach to explicitly creating value: The holistic value manager



Different approaches emerged from qualitative research

Managerial Focus

Goal Focus

Value Focus

- | | | |
|---|--|--|
| <ul style="list-style-type: none"> • Wide range of objectives • Objectives a mix of ends and means • Balanced business scorecard • Capex used to build all businesses • Most capital retained • Radical strategies rarely examined • Tendency to empire build • Targets set by bottom up budgets • Budget process primary • Risk register mostly operational • Prefer internally measured incentives | <ul style="list-style-type: none"> • Handful of key goals • Levers support key goals • Clear link levers to goals; unclear how to trade-off between goals • Capex skewed to key goals • Capex vs returning cash driven by business needs • Business strategy driven by goals • Portfolio optimised to meet corporate goals • Targets set by bottom up budget and top down strategic goals • Budget process shaped by strategy process • Risk register operational + strategic • Mix of incentives | <ul style="list-style-type: none"> • Unambiguous objective of value creation • Neutral on levers of value • Clear articulation of how levers drive value creation • Capex skewed to high return opportunities • Capex vs returning cash driven by prospective ROCE • Business strategy driven by value • Corporate shape driven by businesses value creation • Targets set by value creation goals, inc dividend & capital gain • All management processes aligned around value creation • Risk register operational + strategic + to value • Value creation drives incentive structure |
|---|--|--|

Next and Sainsbury illustrated different approaches well

Managerial Focus

Goal Focus

Value Focus

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(Value) managers are facing a new environment

Lower growth: pandemic, war, less integrated world economy, rise of multi-polar world

- **Lower ROI, lower need for replacement capex, risk of over-supply**
- **Highest growth in most difficult, riskiest markets: China, Nigeria, Pakistan etc**

Higher inflation, negative real interest rates, challenge to maintain real returns

- **Where does pricing power sit in the value chain?**
- **Lower CoC. Cash value eroded: implications for capital structure**
- **Increasing divergence between real and nominal measures (e.g., ROCE)**

Continued technological change despite lower growth

- **Value capture contested by incumbent vs new-entrant**
- **Challenge for some legacy models to maintain returns and invest in new models**

Greater government intervention

- **Increased government spending as % economy, challenge to earn $>$ CoC**
- **Activism: GFC, Pandemic, construction etc**

Strategic implications of the new environment

Greater risk to value given high valuations driven by high multiples

- **Opportunity for management to use low CoC**
- **But big reactions to any business model issues or negative results**

Rational to add financial leverage (lower cash, higher debt) given inflation and low CoC

- **But longer-term debt instruments given risky environment**
- **Buy-backs to return cash quickly and irregularly (vs dividends)**

Lower growth and continuing technology challenges makes value shifts more likely

- **Greater divergence of business returns drives need for portfolio management**
- **Pricing power, technology resilience, asymmetric exposure to underlying attractive markets, government intervention,**

Greater selectivity in choosing where to invest; lower more targeted capex

- **Value in resilience (operating, financial, macro-economic)**

More complex management job

- **Greater divergence in results between better and worse management teams**

Who will underperform in the new environment?

Companies that pursue growth that is not value creating

- Greater investment asymmetry – general capex down, but need to sometimes bet-the-farm to win

Companies that have business models that earn < real cost of capital

- Pricing power, technology resilience, asymmetric exposure to underlying attractive markets, government intervention,

Unexpected profit resets will severely hit valuations

- Driven by high multiples (low discount rate of future cash flows)

Dramatic value compression if innovative business models look challenged

- Low discount rate, all in terminal value (value year 10+)

Companies that over focus on operational excellence in a strategic game

- Three time horizons?

What kind of executive team and leadership is needed to meet the challenges ahead?

We have seen how great value managers have provided leadership

- **Buffett (Berkshire Hathaway), Wolfson (Next), Habgood (Bunzl), Swann (WHS), Hemsley (Dominos), Dunstone (CPW), Becht (Reckitt Benkiser), Adams (BAT), Davis (Imperial), Pitman (Lloyds), Wilson (Booker), Weston (ABF), Chapman (BG)**
- ...

What leadership model will prove most successful in the years ahead?

- **My guess is it the same principles as for the past**
- **But deployed with greater skill and decisiveness**

Mitigated by the fact that more leaders will not be able to meet the challenges ahead

- **Business is a relative, not absolute, game**
- **And challenges, complexity and ambiguity will lead to more super-ego CEOs who promise to reduce anxiety but will often fail**

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Leadership literature not particularly helpful

Early leadership theory tried to identify what it was about an individual that made them a better or worse leader

- Plato's *Republic*, Plutarch's *Lives*, Carlyle's *Heroes and Hero Worship*
- Carnegie, Edison, Rockefeller etc: owners, leaders and operators

Frederick Taylor emphasized the efficient management of business processes

- Professionalization reinforced by separation of owners / managers

Zaleznik asked: Leaders and managers are they different?

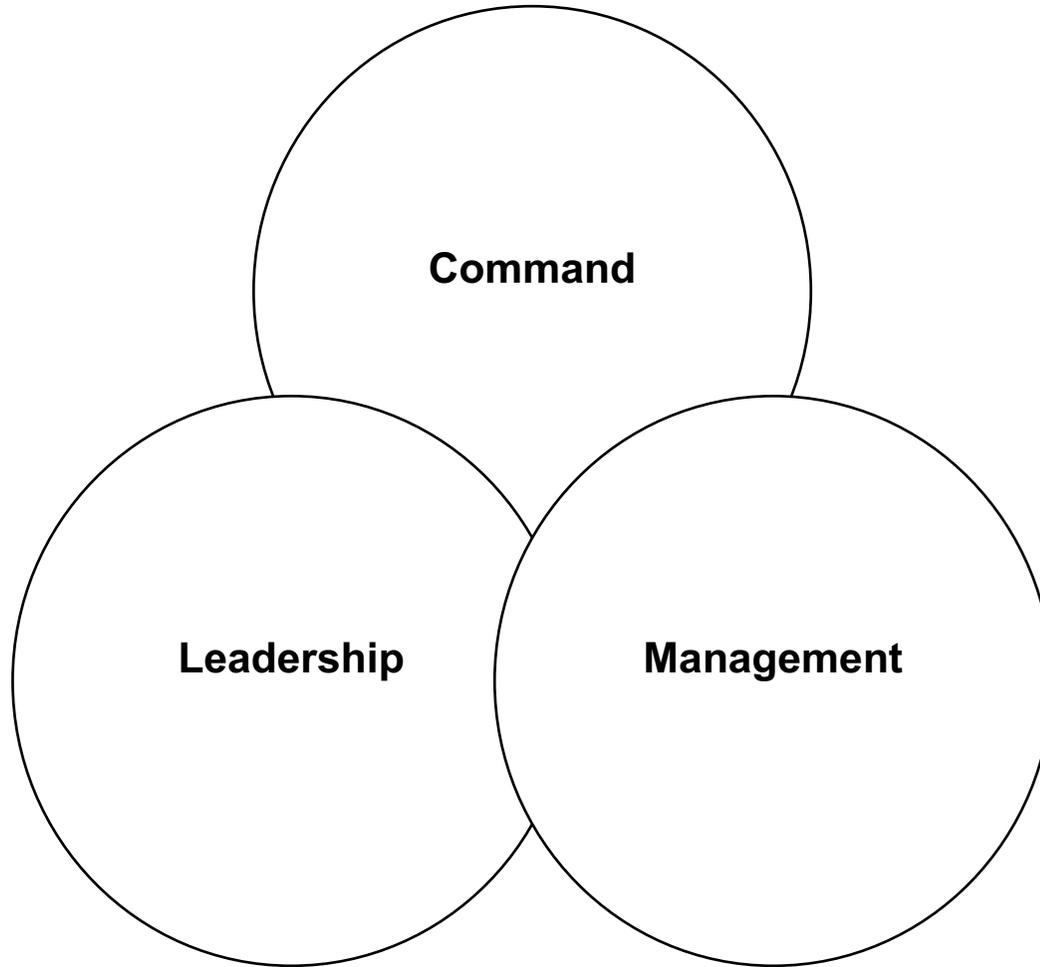
- Reintegrated ego and id, purpose as well as process
- Hedgehogs and foxes

Collins Level 5 leadership model proposes 'executives' have personal humility and professional will; and brutally confront reality and are an agent for change

Academic frameworks rather descriptive

- Autocratic, Authoritarian, Participative, Democratic, Coaching, Affiliative, Laissez-faire, Transformational
- Some confusion between role, personality, behaviour

Is there a link with the Bungay Trinity?



Parallels between value managers and commanders

Value Managers

- Unambiguous objective of value creation
- Neutral on levers of value

- Clear articulation of how levers drive value creation
- Capex skewed to high return opportunities
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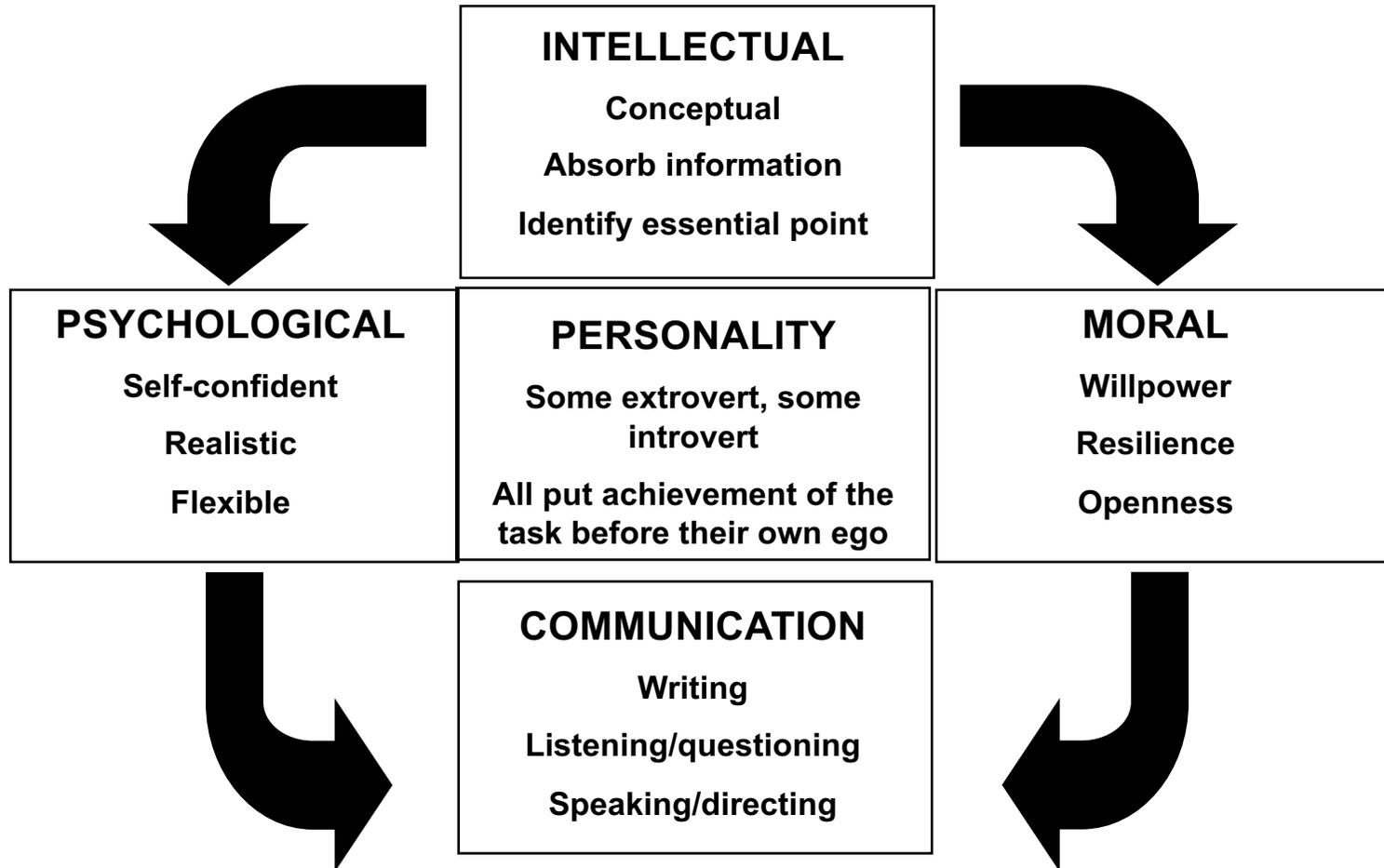
Effective Commanders

- Unambiguous strategic objective – 'maintenance of the aim'
- Flexible on means to achieve the aim

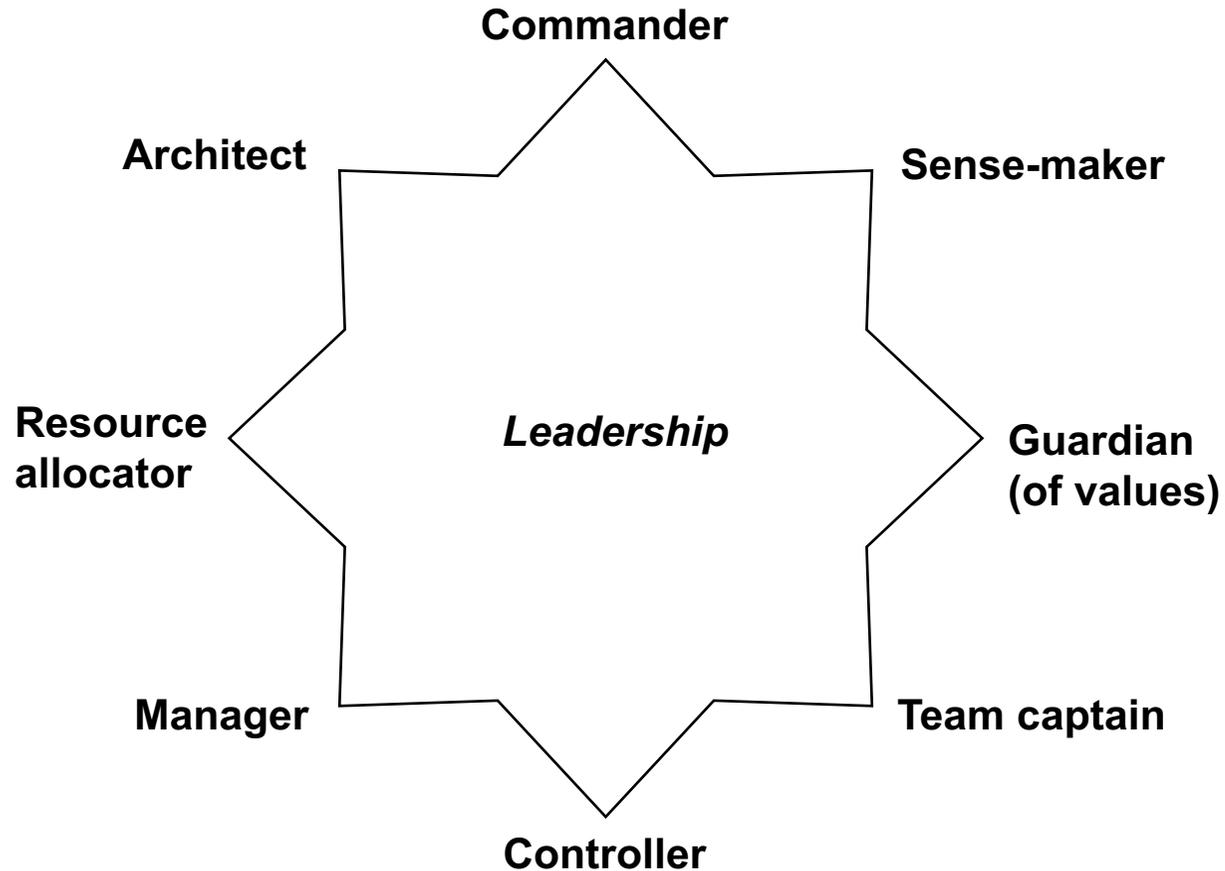
- Clear understanding of the part played by each element of the forces available
- Identification of main effort
- Approach shaped by resources and capabilities
- Strategy driven by achievement of the aim

- Force organization driven by needs of the strategy
- Goals of individual units driven by the needs of the strategy
- Willing to suboptimize parts in order to optimize the whole
- Risks accepted if strategy demands it
- Ensures subordinates motivated to achieve overall success

Distinctive qualities great commanders



The eight roles of leadership based on observation



The eight roles of leadership

These eight roles derived from observation about what leadership entails in successful companies

- Acknowledging that weighting may change due to circumstance

Each role requires specific skills, behaviors etc

- Value managers ensure the roles are cast in the context of a single holistic goal

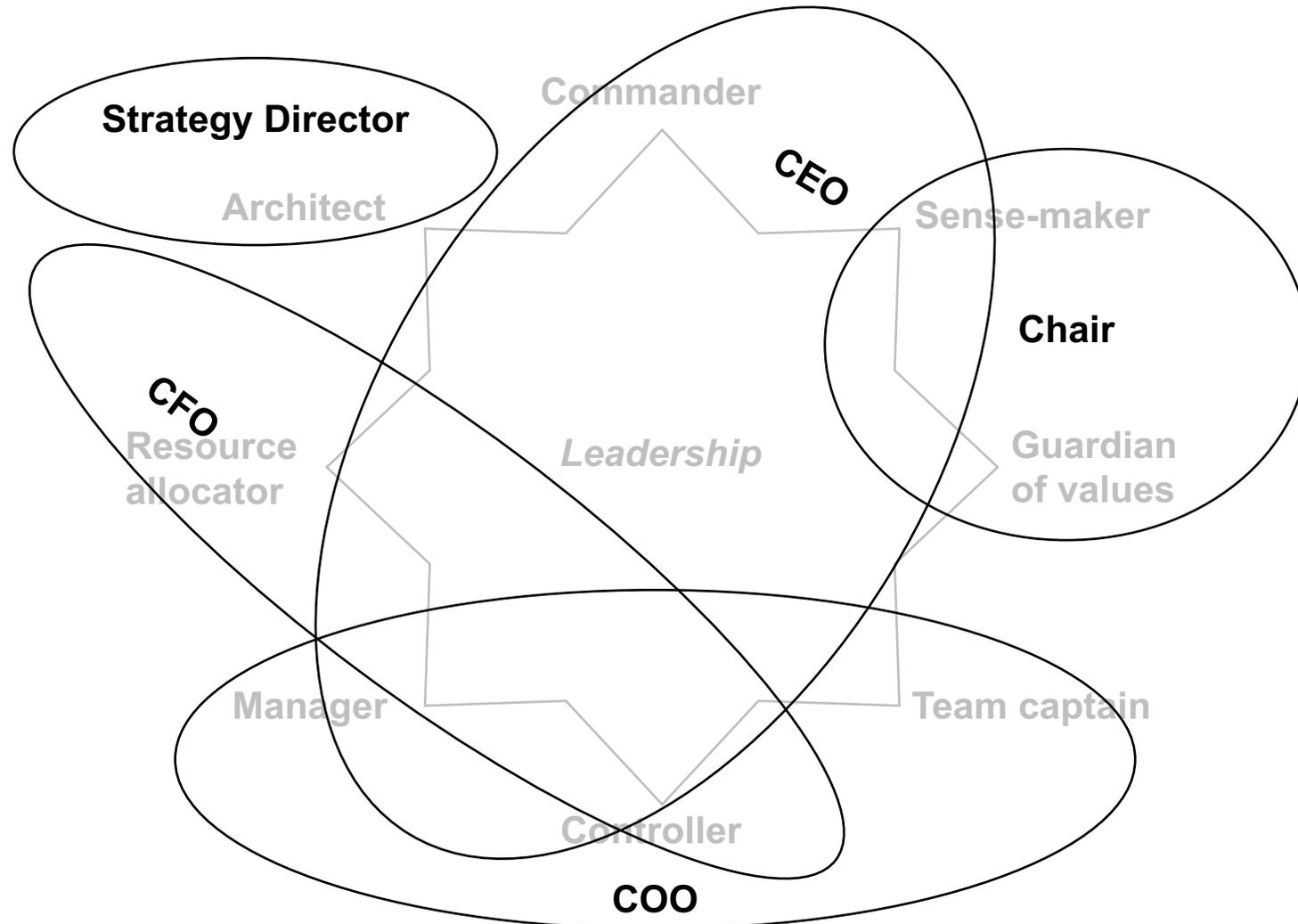
Impossible to find one person to perform all roles well

- Team must balance role-expertise and group alignment

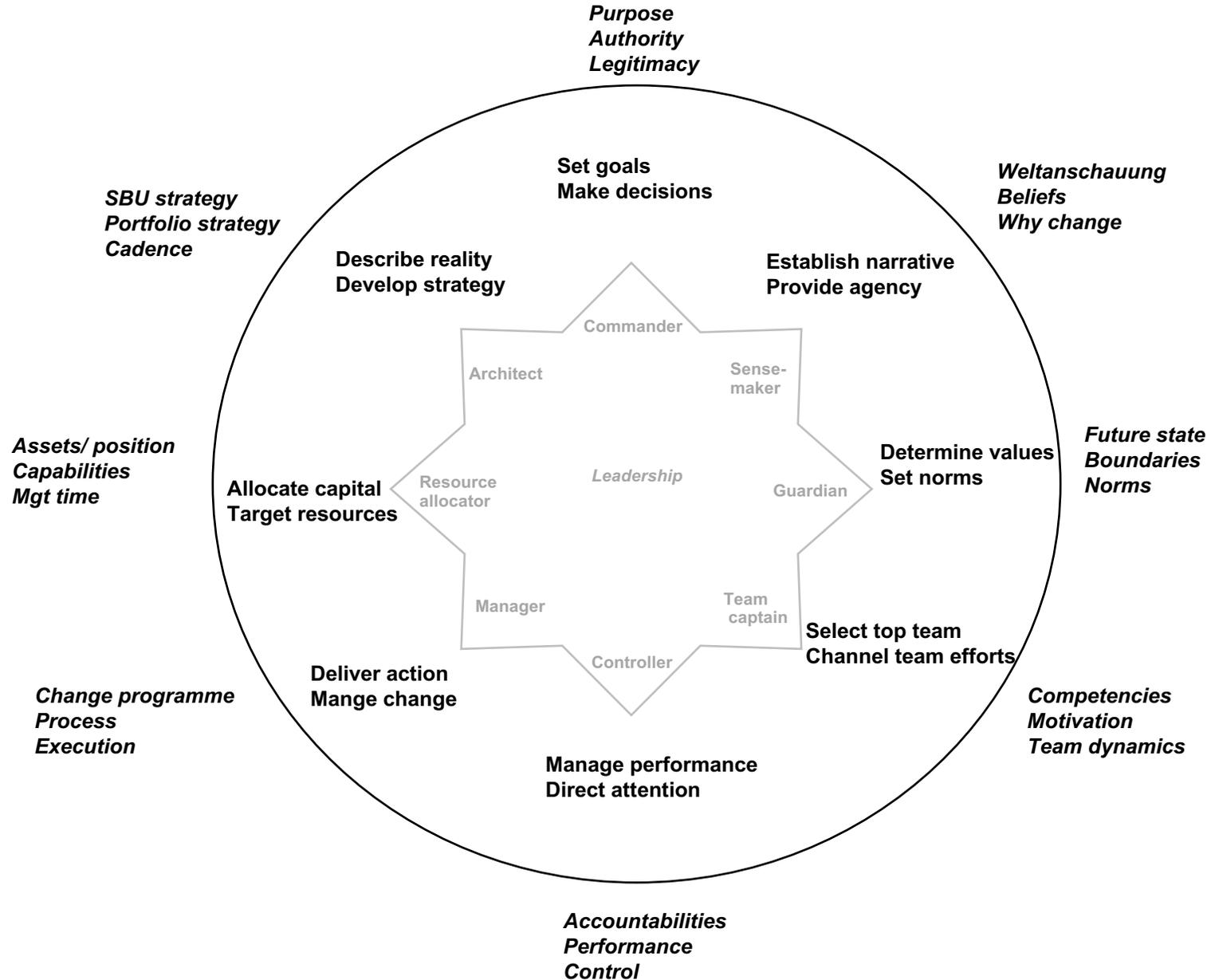
CEO is usually the Commander, coupled with one or two other roles

- Commander/Architect/Resource allocator – Buffett
- Commander/Manager/Controller – Swann
- Commander/Architect/Controller – Habgood
- With others covering off the other roles
 - Or not.....

Often the leadership role can be performed by more than one individual – if leadership team aligned

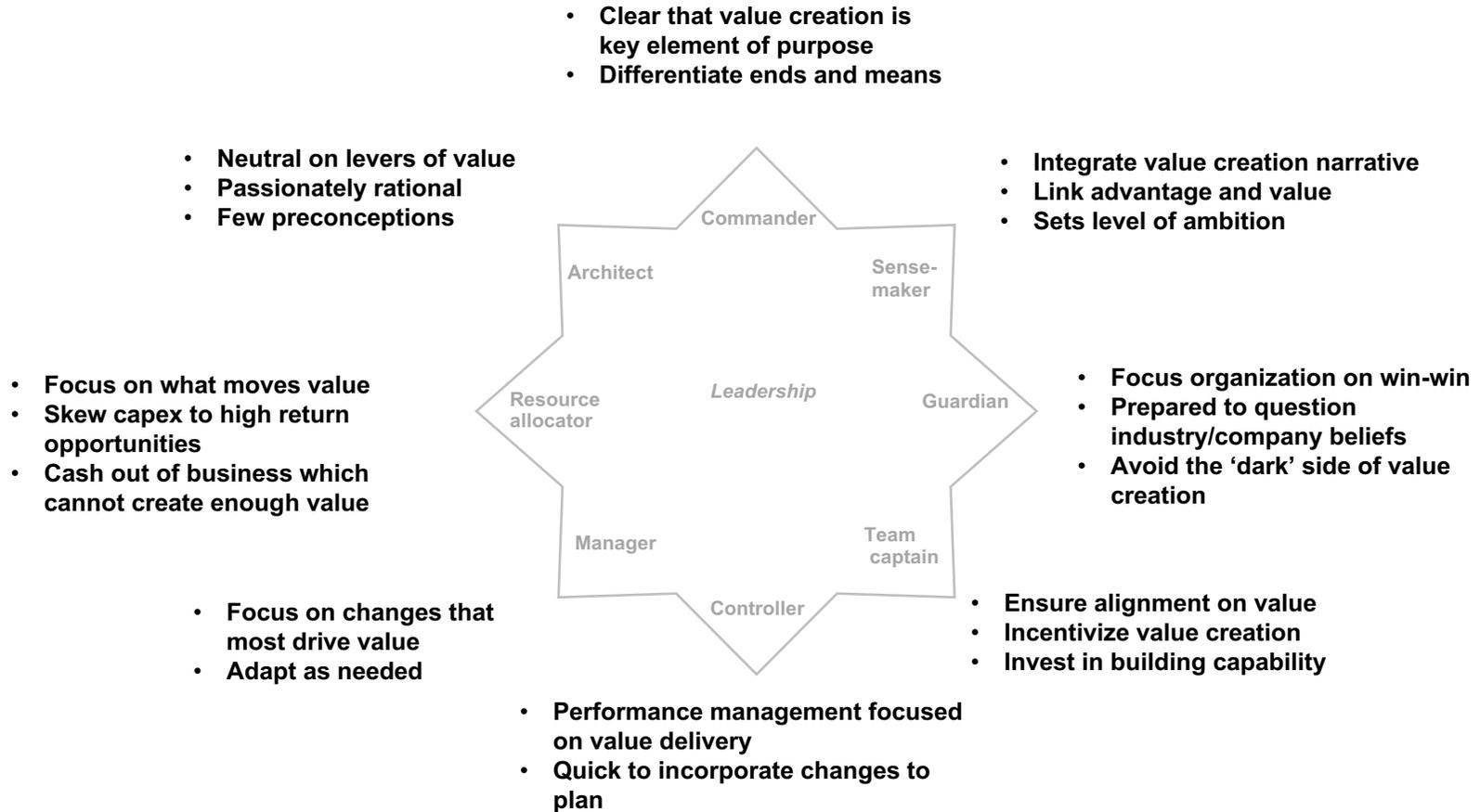


Each role has leadership tasks and tools



Value managers do the same tasks, but differently

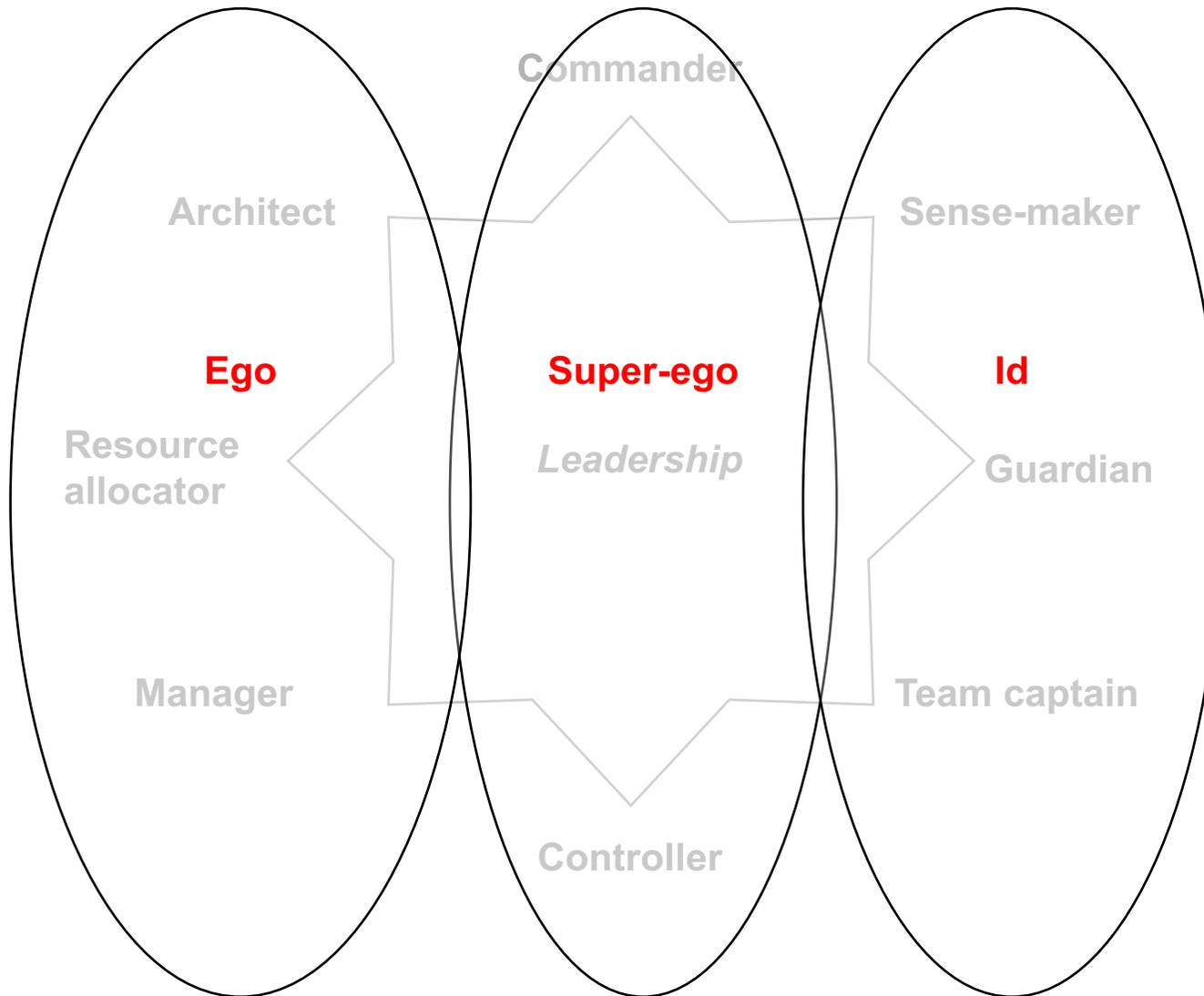
Behaviours



Personality

<p>Rational, empirical Information hungry Openly curious Welcomes contrary views</p>	<p>Low ego but confident Determined, focused, persistent Inner driven Quietly ambitious for company</p>	<p>Comfortable with ambiguity Comfortable with uncertainty Fine with sensible failure OK with unconventional paths</p>
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8 roles builds on Bungay and Zaleznik (& Freud)



Discussion....

What are your reflections on how successful value creators lead?

- **Is it different from non-value creators?**

Do you agree with some of the hypotheses discussed?

- **Leadership task beyond an individual**
 - **But this creates need for alignment as well as specialisation**
- **Value managers use same processes as others, but focused on value**
- **Value managers are hard to identify ex ante**
 - **Maybe passionately rational, comfort with uncertainty and ambiguity predictive traits?**

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