

## Add Value to Your Planning

By Dr Steven Bishop, Executive Director, EMCS

As the start of the strategic planning period approaches for many companies, I am reminded of my first meeting with one of the founders of Marakon Associates (a foundation firm of the value based management movement). A comment he passed was broadly:

*"Before we started Marakon we were working with an investment bank valuing businesses. Typically, we used a DCF model and we realised that we were really valuing the business strategy reflected in the financial forecasts. By changing strategy, management would change expected cash flows and therefore the value of the business. Change the strategy will change the value – use it to help choose the best strategy – the one that provides the most value.*

*So we could use the link between strategy, forecasts and value to help businesses quantify, develop and evaluate strategy - the best strategy will provide the highest value.*

This statement has remained with me as simple and compelling logic for building what is a natural bridge between strategy and business value. Strategy often uses the language of "building competitive advantage" whereas finance uses the language of "creating and delivering value". The two are really the same. Therefore, we should expect that any valuation that has positive value creation should be tested against whether there is some form of market attractiveness or relative competitive advantage that supports it. If none exists, then a valuation that shows a market to book ratio greater than one is probably flawed. Similarly, a strategy that is believed to have competitive advantage but doesn't translate into value creation is also flawed. Valuation can be used to test the veracity of the strategy and vice versa. We encourage a planning process that builds this bridge and adds value to the resultant planning outcomes.

Another simple but compelling message that has stuck with me over the years is a statement about strategy and the strategic planning process. This was to the effect that:

*"Strategy discussions often happen in corridors and/or at the time of unexpected events, like a takeover offer or opportunity. **The strategic planning process is therefore really about establishing an agreed "fact base"** so that on-going strategy discussions are constructive and on shared facts rather than based on intuition and opinions about the underlying competitive landscape that may well differ. Without a*

*shared view of the fact base around the competitive environment then it is unlikely that there can be a shared view on the best strategy and path forward."*

This places an important requirement on the annual planning process and one which we have always encouraged. It is about building the fact base and a shared view on issues and alternatives which facilitates constructive and ongoing discussion about strategy and strategy implementation. After all, strategy development is really ongoing and creative. The world is not actually ordered around an annual strategic planning process.

From our valuation perspective, the annual process, ideally, provides a fact base to support a valuation of the current strategy and of alternatives.

EMCS is certainly of the view that the strategic planning process can be improved by embracing financial projections and a valuation of the projections is an integral component. There is an informative feedback loop arising from this process. It forces quantification of possible outcomes and reflection. This, in turn, requires a partnership between the strategic planning and finance roles.

Adding a strategy valuation to the planning process adds many benefits including:

#### **As Input to the Process**

- Understanding where in the business value is created and why e.g. what businesses, customers, products, geographies create or erode value;
- Identifying the key strategic and operating drivers of value in the business;
- For listed companies, checking the current internal view of business value against the market value – is there a value gap and, if so, why? What needs to be done to fill it?
- Applying the cost of capital to a projected invested capital profile over time to provide a minimum EBIT profile. This encourages discussions around how the minimum can be beaten using revenue, cost and/or asset-based analysis.

#### **As part of the Process**

- Assessing whether the process is best focused on improving returns or focusing on growth – this could be quite different for each segment (if the ROI is near or below the cost of capital, an increasing returns focus will add more value than growth. If the ROI is well above the cost of capital, a growth strategy will add more value than a return strategy);
- Assessing what may happen to value under a no change scenario and then under alternative change scenarios. In other words, encouraging thinking about, and modelling outcomes from alternative strategies;
- Assessing whether alternative strategies are better (i.e. creates more value) than the current strategy and having a basis for communicating this;
- Forcing some hard thinking about the likely operational and financial outcomes of the strategy – it provides a focal point;

- Reasonability checking value created against a strategic position assessment - is there consistency?

#### At the end of the process

- Providing the key input to the capital expenditure (i.e. resource allocation) and performance management processes – clearly these should be intricately linked. Ideally capital is allocated to support value creating strategies rather than individual stand-alone projects;
- Setting the performance targets for the budgeting process;
- Setting the minimum targets for the incentive compensation system – what management must achieve to obtain their target payout and beat to earn above the target;
- Providing a basis (including a fact base) for value discussions with analysts and investors.

We encourage businesses to **add value to their planning**. We also encourage businesses to use **Economic (or Residual) Profit** as an essential part of **strategy development** and **performance assessment**.

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