

What is 'shareholder value' really worth?

The concept of 'shareholder value' is all the rage, but is also attracting criticism. Here, Alan Clements of David S Smith Holdings sets out the pros and cons.

'Shareholder value' is not only the flavour of the month in finance, but also in management generally, and among those who appraise companies – fund managers, analysts and financial journalists.

In business, strategies are developed and businesses are evaluated using it; even compensation schemes for senior management are built up around it, and investor relations programmes are guided by it.

We all await the modern text book on corporate finance with a whole section devoted to shareholder value – or at least some do! For many, at any rate, shareholder value concepts have amounted to a breath of fresh air, imparting practical realism into the otherwise fuzzy counselling of the management gurus.

Already, however, there are critics who claim that newly-installed management teams, encouraged by shareholder value concepts to make their companies more 'focused', too quickly sell peripheral or non-core businesses, possibly borrow a bit more money, and then indulge in share repurchases in order to enhance earnings per share.

They are misled, it is argued, into thinking that price (ie share price) is the same thing as value, when really they are taking the easy option.

Furthermore, it is claimed they become obsessed with short-term, rather than long-term, price, and of course their incentive compensation schemes support what they are doing.

A fresh pinnacle

The new philosophy or 'school' seems to reach a fresh pinnacle of financial ingenuity in the shape of 'leveraged capital' funds, whose main contribution to capitalism is a process whereby companies, and bits of companies, become merely stock in trade to be bought and sold, or floated on the exchange,

possibly only to be bought back again, all in pursuit of returns which the equity investor of old never dared dream of.

Where is the truth between these opposing views? Has shareholder value a net present value or not?

First, one minor complaint. Shareholder value texts are already littered with capital letter abbreviations. The theory could become, eventually, worse than modern finance with its EMH, MPT, CAPM, β , DCF, NPV, IRR, APV, APT, ADR, NTV & WACC, to mention just those I can recall.

Shareholder value has added, to date, EVA or SVA, NOPAT, FCF, MVA, SHV, CFROI, TSR, RONA and VBM. We are approaching the point where we need Penguin to publish a dictionary of financial terms, some of them with more than one meaning or connotation!

What, however, is it that shareholder value claims to bring to the party which is new? And does it, in fact, do so successfully?

The literature – books as well as articles – is pretty clear; the shareholder value concept makes three claims which are new, or at least reasonably so, in the general body of financial theory. They are:

- it is based almost exclusively on cash



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flows, not on profits or earnings (regarded as flawed accounting concepts);

- it has developed the best method of evaluating businesses – by comparing the cash flow return on capital with the cost of capital, in order to see whether shareholder value, i.e. economic value added (EVA), is being created or not; and
- similarly, it has produced the best method of evaluating companies, acquisitions and strategies, by discounting (at the cost of capital) cash flows, in order to deliver present values which can be compared with current or other values, again to reveal whether shareholder value will be realised, or not.

Does shareholder value deliver?

As it stands at the moment, does shareholder value really deliver these promises? The answer must be a guarded 'yes', but there are problems which need to be resolved before this can become a wholehearted affirmative.

The valuation basis is cash-flow, not earnings or profits

But is it? Where free-cash-flows (FCFs) are being discounted at the cost of capital to arrive at present values of companies or strategies the answer is clear enough – 'yes'.

But EVA, the popular technique which emphasises the necessity of achieving a return on capital in excess of the cost of capital, is a different kettle of fish.

EVA uses NOPAT (net operating profit after tax) and it is not immediately obvious that this is a cash flow measure. While tax is deducted on a payments basis, how, for example, is an allowance made for depreciation and capital expenditure? Only by a close examination of the entrails does it become apparent that depreciation is added back, but that the deduction for

capital expenditure is often assumed to be the same as depreciation. There was, I seem to remember, an old accountancy tenet that depreciation was the amount which must be reinvested to maintain the profitability of the business but if EVA is based, among other things, on such principles, it 'depreciates' in my opinion.

The whole concept seems to become less factual and more subjective than its advocates would have one believe.

This seems to be borne out by a recent article in the *Investor's Chronicle* on 'return on equity', and its role in the valuation of equities (24 July 1998). It hails EVA as a major step forward, but when analysing SmithKline Beecham EVA produces 1997 equity 'profits' of either £1.1bn or £1.6bn, compared with a free cash flow valuation of £0.62bn.

Promoting the former figures in preference to the free cash flow valuation, it proclaims – "Accounting returns, meanwhile, smooth income and costs across financial years to reflect when the work was actually done." The harsh reality of cash, it seems, can be mitigated by the superior wisdom of the accountants. So much for the claim that shareholder value is based on the certainty and inevitability of cash flow!

Cash flows, or EVAs, are discounted at the cost of capital to arrive at 'present values'

But just what is the 'cost of capital'? Most text books and articles refer, somewhat quickly, to the capital asset pricing model (CAPM) measure of the after-tax cost of capital, and then use something in the 10%-15% range, or more recently a figure even lower than 10%.

The assumption seems to be that modern financial theory has resolved this problem, and that one only needs to turn to a modern text book to find the answer.

Unfortunately, the texts are by no means clear. The cost of debt is not a major problem, but the cost of equity is. There seem to be at least three methods of arriving at the cost of equity:

- history – effectively, what sort of return, in the form of dividend yield and capital value growth, have investors in the company enjoyed in the last five, 10 or 15 years of the company's history? Will current owners, and potential ones, not expect at

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- least the same in the future?
- the current market situation – effectively the company's current dividend yield, plus its potential growth rate (its NOPAT retention rate multiplied by its return on equity). This method brings into play some of those subjective elements which worry those who seek certainty e.g. what return?, what equity? Nevertheless, it is a method which has its supporters; and
- CAPM – the method advocated by most of the texts, and by the great majority of the articles on shareholder value. It seems simplicity itself – a risk-free rate of interest, plus an equity premium, the latter adjusted by a factor which takes into account the extent to which the company share price moves, up and down, with the market as a whole (the β). Unfortunately, unanimity on the risk-free rate, the equity premium and the validity of the β is conspicuous only by its absence.

The list is by no means an exhaustive one. To make it complete, one would have to mention arbitrage pricing theory, adjusted discount rates, market derived discount rates, and a cost of equity arrived at by using the annualised cost of a call option.

But just employing the three methods listed above can produce equity costs (in

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real terms) ranging from 6% to over 11% pa. What is one to do in practice? In a talk given in 1993, admittedly on Japanese finance, Merton Miller needed to use a cost of capital figure – I think it was a cost of equity.

He said he would use 10% – "what else?". But when evaluating a strategy, or valuing a company, the problem cannot be dismissed as easily as that. A cash flow of 10 per annum (admittedly to infinity) valued at 10% becomes 100; at 8%, 125. The appropriateness of the rate is important. So far shareholder value does not seem to have clarified the issue.

It has developed the best method of evaluating businesses

The method referred to in this claim is EVA which is arrived at by comparing the cash-flow (or NOPAT) return on capital with the cost of capital. The problems one faces in trying to use NOPAT and the cost of capital have already been mentioned. The claim would receive more support if only one had more confidence in the basic figures!

It has produced the best method of evaluating companies, acquisitions and strategies

Any comment on this claim is rendered difficult by the fact that the shareholder value literature contains more than one method! Fortunately, there are two principal ones.

Let us think in terms of the evaluation of a new business strategy.

Strategy one – the entity's cash flows (preferably free cash flows) expected with the strategy and any associated debt finance are discounted at the cost of equity to give a present value – the 'strategy value'. This can then be compared with 'pre-strategy value' to see whether the proposed strategy does produce extra value or not.

But what is 'pre-strategy value'? Book value as of now? Some writers use it, others dismiss it summarily. Book value adjusted to current values, by inflating historical cost figures at inflation rates experienced since purchase?

Tobin¹ favoured this method. Rappaport², on the other hand, advocated capitalising current NOPAT, using the weighted average cost of capital (WACC). Others still would simply use the present day market value of equity. If the decision were left to those

Glossary of terms

ADR	Adjusted Discount Rate
APT	Arbitrage Pricing Theory
APV	Adjusted Present Value
Beta	The measure of market risk
CAPM	Capital Asset Pricing Model
CFROI	Cash Flow Return on Investment
DCF	Discounted Cash Flow
EVA	Economic Value Added
EMH	Efficient Market Hypothesis (or Theory)
FCF	Free-Cash-Flows
IRR	Intended Rate of Return
MPT	Modern Portfolio Theory
MVA	Market Value Added
NOPAT	Net Operating Profit After Tax
NPV	Net Present Value
NTV	Net Terminal Value
PAT	Profit After Tax
RONA	Return of Net Assets
SHV	Shareholder Value
SVA	Shareholder Value Added
TSR	Total Shareholder Return
VBM	Value Based Management
WACC	Weighted Average Cost of Capital

advocating the new strategy, it is pretty clear which figure would be adopted. Perhaps the answer is to use the pre-strategy cash flows discounted at the same cost of equity that is used in the strategy-inclusive NPV calculation.

Strategy two – the strategy's EVAs, (i.e. NOPATs) during the period in which they are growing under the impact of the new strategy (usually 5 to 8 years) are discounted to give a present value. Because these are differences (a return minus a cost), and because they are valued for a limited period, to this present value must be added an opening value, and the present value of a terminal

value (calculated at the end of the growth period), in order to produce a 'strategy value'. There are problems with both the opening and the terminal values.

The problem with opening value is much the same as that we experienced with 'pre-strategy value' – how to calculate it. Book value is normally frowned upon, yet in recent studies showing how the S & P Industrials can be valued on an EVA basis, Goldman Sachs used just that.

Other bases have their supporters. Perhaps the opening value does not matter too much if it is total value one is seeking (a low opening value results in higher EVAs and a higher terminal value, and vice versa for a high opening value – the total value must emerge the same, and also equivalent to the present value of the FCFs). But, if one is interested in the methodology, one has the nagging feeling that the opening value ought to have meaning.

The terminal value is usually calculated by simply capitalising the EVA of the last year of the growth period. That value is then reduced to a present value. In many calculations most of the shareholder value which emerges stems from this terminal value.

But often those who are asked to accept the calculations find it difficult to conceive of the company being valued, in five to 10 years' time, on much the same basis as a perpetual gilt. A figure which is crucial in justifying the strategy somehow lacks the necessary credibility.

These are the main criticisms of the detailed mechanics of shareholder value calculations. To some they will seem pedantic, relating as they do in the main to the valuation of a company now, in five years' time, in 10 years' time, and under the current strategy or under a new one.

A serious discipline

It could be argued that this has been a weakness of corporate finance ever since it emerged as a serious discipline. It could also be pointed out that EVA is extremely useful in looking at the year by year performance of the company and its businesses, and in discovering whether or not the returns on capital invested exceed the cost of capital.

But the question of valuation is important – after all, it is 'shareholder value' we are talking about. And it becomes the more significant when it is

connected to the criticism that corporate management does not seem to be learning the right lessons from 'shareholder value'. EVA, for example, has been showing returns on the increase, while at the same time the cost of capital has been falling. Nevertheless investment of an organic nature in the recovery of the 1990s has been disappointing when compared with that of the 1980s. It has been suggested that a principal cause of this has been the way in which 'shareholder value' techniques drive home the necessity of delivering value quickly.

Organic investment is just too lengthy a process when compared with divestment and acquisition, or gearing up and returning cash to the shareholders, or a company split, or some other form of downsizing and outsourcing.

It may well be that 'shareholder value' studies compel management to concentrate on policies which deliver superior returns, and highlight for them those 'value drivers' which constitute the real basis of companies' cash flows.

But at the same time there is an emphasis on the quick solution, the speedy turn-round, and the generation of the maximum amount of cash in the shortest possible time. There is a danger that 'shareholder value' will become perceived as an integral part of the management of the relative decline of a large part of the corporate sector, profitably for some but not for all.

In their standard text on corporate finance, Messrs. Brealey and Myers, in chapter 36, list 16 major problems. Six are labelled 'do knows', ten 'do not knows'. Shareholder value is not among them, but if it were added to the list, I fear the 'do not knows' would increase to 11. ■

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¹ *Tobin – one of the group of economists who helped to found and develop CAPM. Also well known for the 'Tobin-q', the relationship between market value and the replacement cost of a business (a concept 'borrowed' from Keynes).*

² *Rappaport – regarded as the real founder of shareholder value thinking. His book 'Creating Shareholder Value' is a standard test.*