A user's guide to 'operationalising' value

Many corporates want to 'operationalise' shareholder value into their treasury – an easier task than finding it in the dictionary. Tom Gunson of PwC explains.

Whether we believe that shareholder value (and the techniques proposed by business schools and global management consulting firms to measure it) is just a passing fad does not matter. The fact is, many of the world's leading corporations have embarked on initiatives to introduce shareholder value concepts into their businesses, from selected reporting of key performance indicators to full re-engineering of strategies, processes and systems around the concept. It is hardly surprising, then, that eventually the company treasurer is asked how his or her department is contributing to those goals.

What's your reply?

On the surface, the answer to this question is relatively easy – there are many ways of demonstrating tactical efficiency improvements and cost savings made by treasury. However, the answer is more difficult when it must be given in the context of the value-based management framework developed by the business to embed shareholder value objectives into its core business activities.

Such frameworks normally show that head-office functions in the organisation destroy value by not actively creating it. Treasury, however, can provide evidence to the contrary.

Figure 1 shows the value-based management framework we have used to link operational activities to shareholder value objectives. It is built on the SVA measurement method in which shareholder value is estimated as the present value of future free cashflows of the business discounted at the weighted average cost of capital (WACC) of the company, less value of debt.

There are seven drivers that influence the company's net value:

- revenue growth;
- operating profit margin;
- cash tax rate;
- investment in working capital;
- investment in fixed assets;
- WACC; and
- competitive advantage period.

Each of these drivers can be further analysed into sub-components (for example: level of borrowings, operating and other costs and net foreign currency assets.) If we map treasury's activities against these sub-components, it quickly becomes evident that treasury has the potential to impact significantly a number of these drivers (see *Figure 2*). More importantly, such drivers (ie, operating profit margin and WACC), are also those that for many companies produce the most significant movement in their shareholder value. Clear opportunities therefore exist for treasury to demonstrate its contribution to shareholder value through management of these sub-components.

Investing in value-adding activities

So how do we realise this potential and ensure that treasury's efforts are invested in value-adding activities?

Treasury has the potential to influence significantly the company's value objectives at two distinct levels:

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- at the corporate level through financing and investment decisions; and
- at a business unit level, by providing support to the decision-making processes of the business managers (see *Figure 1*).

If we agree that value is created or destroyed where decisions are made, then we need to understand which treasury decisions create the most value for the company.

By developing a 'process chain' for treasury, detailing day-to-day activities and decisions across treasury's main and support processes, and linking this to the shareholder value drivers we begin to see the direct relationship between these activities and the company's shareholder value objectives.

Key treasury processes might include:

Main process chain

- treasury strategy setting;
- risk management;
- cash/liquidity management;
- banking services;
- business interface/support; and
- reporting.

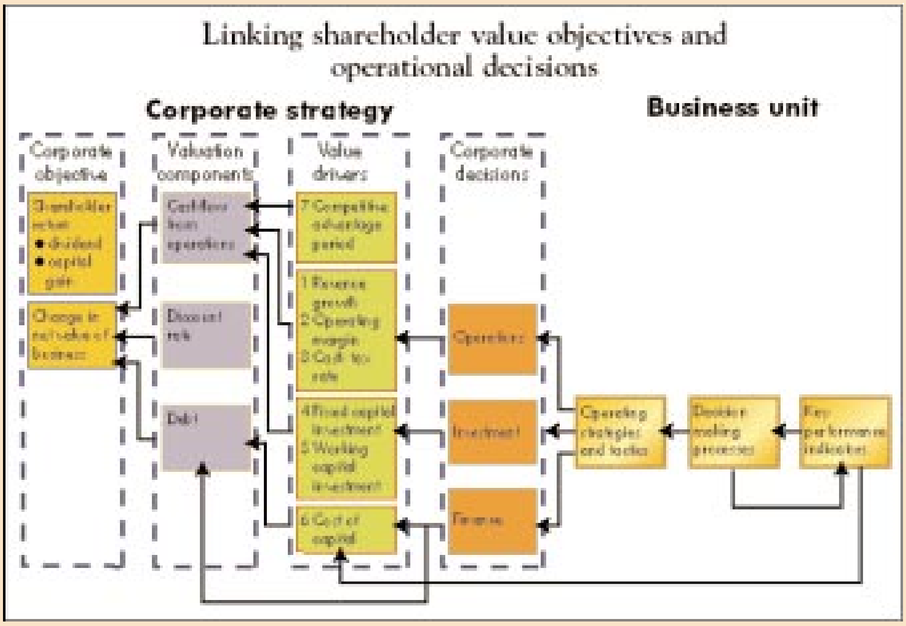
Support process chain

- organisation structure;
- governance and control;
- people and skills;
- transaction processing; and
- technology/systems.

At this point we can evaluate, based on a particular decision path, how day-to-day activities or processes might protect, create or destroy value. Let's look at two alternate decision paths under the risk management process.

It could be argued that hedging the underlying exposures of the business to achieve budget is protecting value rather than creating it. Alternatively, a hedging strategy with the clear objective of impacting one or more of the above drivers to produce maximum cashflow

FIGURE 1



benefit for the company, may be seen as creating value.

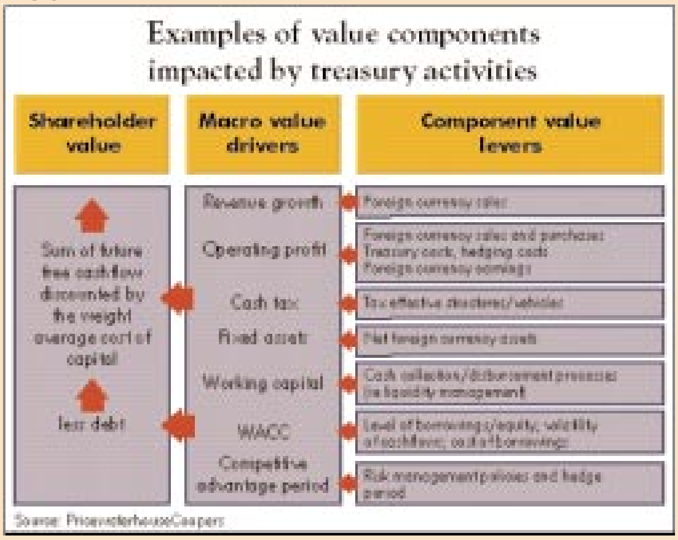
This could occur just by using new risk management products to reduce hedging costs. For example, several leading corporations are evaluating the cost of managing financial and insurable risks in-house vs. the cost of outsourcing them to insurance companies and banks using new risk integration or fusion products. A more complex strategy might involve leveraging off the interrelationship between hedging activities, the impact these have on reducing cashflow volatility and the resulting optimal gearing for the company. Key shareholder value drivers are impacted either by reducing hedge cover (impact on operating profit margin driver) relative to a constant level of gearing or by maintaining the same hedge cover, but higher gearing (impact on WACC driver). The latter requires appropriate investor and credit agency communication to increase the company's gearing without taking it into financial distress. (See box on page 53 for further details.)

Other activities or decisions through which treasury can contribute significant value, include:

- share buy-backs;
- efficient liquidity management (by means of cash collection/pooling structures);
- assisting the business managers with risk management (ie, commodity risks);
- specialist advice on merger, acquisitions and disposals;
- management of the level and cost of debt;
- balance sheet hedging; and
- management of bank relationships and services.

Certain of the contributions to value enhancement associated with these activities can be realised by structuring treasury as a centralised service centre. This would involve using treasury's specialist skills or leveraging off advances in technology and banking services to perform processes more efficiently and at a lower cost. The key issue is how to monitor and measure these contributions.

FIGURE 2



What value do these activities create?

The most commonly used technique to monitor and measure the delivery of value is through a balanced scorecard, containing both qualitative and quantitative performance measures categorised into four segments: financial, process, people and customers. A typical balanced scorecard for treasury is shown in *Figure 3*. The performance measures (or in consultant speak, key performance indicators) are identified by using the treasury process chain as the starting point.

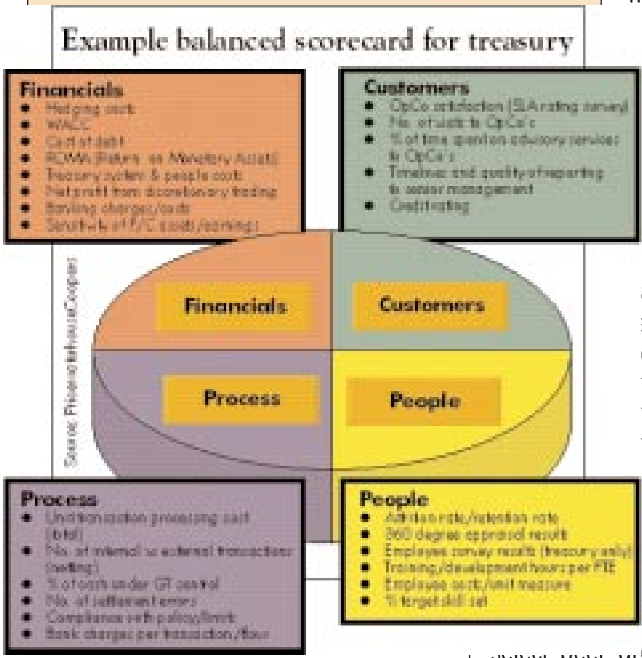
A major European pharmaceutical company developed such a performance framework for its treasury by applying the following process:

1. stating value objectives for each key treasury process;
2. identifying the critical success factors in achieving those objectives;
3. determining what decisions treasury needs to make around these critical success factors; and
4. defining what information (ie, indicators) treasury needs to be able to assess the quality of the decision taken?

The framework was developed across the entire organisation providing a consistent basis for measuring and rewarding performance. Successful implementation was then achieved by demonstrating the value created in a scorecard reporting system and getting treasury team ownership through linkage to the appraisal and compensation systems.

Whether it is concentrating on new activities or simply structuring existing ones more efficiently, there is clearly an opportunity to evaluate the current treasury framework in the context of its ability to realise and measure the value created across all treasury processes. The desired end-state is illustrated in *Figure 4*.

FIGURE 3



How do we evaluate the current treasury framework?

We have employed the following steps in the past to help clients develop a rigorous shareholder value focused framework for their treasury functions.

Step 1: Understand the objectives and drivers. This means understanding the overall vision, direction and objectives of the organisation and evaluating treasury strategies and goals relative to these, including identifying the key value drivers for the company and the sub-components of these drivers that treasury has the potential to influence.

Step 2: Develop a process chain to map key treasury activities. This includes all the activities conducted by treasury across the key processes, such as risk management, liquidity management, operating unit support and bank relationship management. By establishing a link between these activities and the drivers of shareholder value it is possible to identify those activities with the potential to create most value.

Step 3: Benchmark current activities and practices. This is a critical step in that it involves evaluating the effectiveness and efficiency of current activities or identifying new activities with value-creating potential, relative to the practices of some of the leading companies in the market or a select peer group. These practices are often referred to as 'best practices'.

Step 4: Confirm or redesign current treasury framework. This involves using the information gathered in the previous steps to evaluate alternative models or combinations of the following:

- organisation structure;
- policies and processes;
- banking services to support processes;
- reporting;
- systems; and
- performance measurement.

Each of the models is evaluated against a pre-defined set of criteria, such as potential value added/cost savings, efficiency, control and business support. The quantifiable and non-quantifiable benefits of each model is then identified.

Step 5: Implement required changes. Bridge the gap from the current state to desired state via initiatives/projects, eg:

- review of banking structure and services;
- restructuring of resources and roles/ responsibilities to meet objectives;
- development of a balanced scorecard and key performance indicators for treasury including setting shareholder value enhancement targets;
- automation of processes and enhanced decision support tools via the selection of new treasury management and banking systems; and
- redesign of key risk and liquidity management processes.

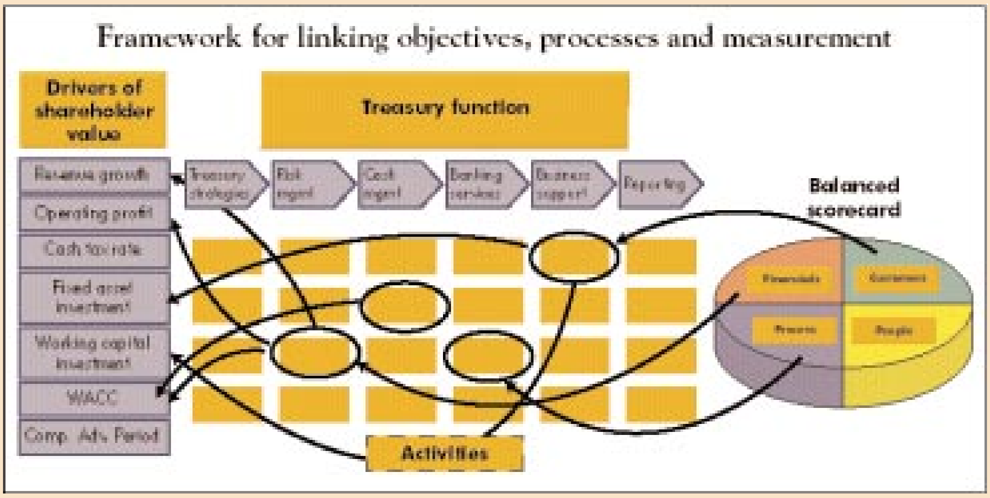
Step 6: Communicate new framework to stakeholders. The new framework must be communicated to both internal (ie, senior management, business managers) and external (ie, banks, investors, credit rating agencies) stakeholders so everyone is clear about the role treasury plays in creating and protecting shareholder value.

Fact not theory

The move towards embedding the company's shareholder value objectives into the treasury organisation is now fact and not theory. More and more corporates in the UK are re-engineering their treasuries so they remain at the leading edge in this area. Technology and banking service providers are focusing product development to support these initiatives.

Most companies understand the basic concepts of shareholder value; some are attempting to show the value creation contribution of their treasury through a rigorous shareholder value-focused decision framework. The key question must be: are these companies and their treasuries better placed to deliver value consistently to their shareholders over the long term? ■

FIGURE 4



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Focusing on the basics to release value

This recent case study shows actions taken by a large multinational company, following a significant merger, to release value through effective integration and restructuring of the treasury functions. Both legacy companies involved had established treasuries that employed cash concentration structures and actively managed foreign exchange risk.

Objectives of the project

The key objectives of the group treasurer from the integration project were to:

- ensure uninterrupted provision of treasury services to the operating companies;
- combine treasury staffs into a single site in each region;
- streamline operating costs to yield cost efficiencies;
- maximise the efficiencies derived from netting of currency and cash positions;
- restructure bank relationships to benefit from increased 'economies of scale'; and
- ensure the resultant treasury functions conformed to good practice.

So how is treasury linked to the corporate drive for shareholder value? Integration was undertaken in the context of enhancing shareholder value in areas, such as:

- **optimising cost efficiency through:**
  – *bank services* ensuring that costs for all financial transactions reflect the combined volumes of the two groups, and planning and executing a revised bank strategy for each region to reduce the number of bank service providers; and
  – *use of technology* neither of the treasuries was an effective user of technology. The combination required the selection of a single treasury system and integration of the positions of both legacy treasuries to enable them to be managed as a single position going forward. The full implementation of the system was coupled with a more effective and extensive use of electronic banking systems for payment initiation, reporting and reconciliation;
- **decision-making** – a key point of the shareholder value framework is the concept that value is created or destroyed when decisions are made. A significant factor in the operating plan of the treasury is to bring treasury and operating companies together to enable each to understand the decision-making process and how they can enhance this for each other; and
- **minimising cost of capital (WACC)** – the acquisition was financed by bank debt and cash resources. A major exercise was conducted to determine an optimally efficient debt structure for the group; previously limited structural debt had existed in either legacy group. Treasury and tax were the key functions driving the debt planning, which involved raising external debt in a significant number of countries to finance the final ownership structure. The primary objective of the exercise was to minimise WACC by maximising use of forecast tax capacity to ensure the minimum post-tax cost of debt.

Key steps in integration

Step 1: Bringing the teams together

The treasurer faced several challenges in achieving this objective, including:

- the constraint of the actual transaction date; no moves could take place until after completion
- the practical issues: space, moving logistics and the need for an interim organisation structure to ensure continuity of service to operating companies in each region;
- workers' councils and employment law in several European countries.

To deal with these issues without losing momentum in terms of realising benefits, two treasury functions were operated on one site for almost three months. Regular workshops for each key treasury area ensured that activities were focused on common objectives and provided the opportunity to debate the most effective ways of achieving them.

Step 2: Achieving financial and efficiency synergies

In the process of combining the two treasury teams, it was opportune to review the treasury processes fully to establish best practice in each area by benchmarking existing practices against those of other leading multinationals. This would enable efficiency gains and the restructuring of external relationships to be more efficiently achieved and managed. Some of the specific initiatives undertaken to achieve financial and efficiency gains included:

- *cash concentration structures* – analysis showed that cost and administrative benefits would be realised by linking the legacy national and regional cash concentration structures and gaining a greater level of balance offset;
- *bank relationships* – the integration had the immediate effect of lengthening the list of banks. In cases where banking relationships coincided, treasury moved quickly to consolidate the relationship. In common with many corporates, the process of rationalisation is an on-going drive;
- *foreign exchange* – while no significant netting benefits were identified due to similar currency risk profiles, economy of scale benefits existed in this area as well as those identified under bank relationships and cash management;
- *systems – treasury management* – the migration of data to a single treasury system enabled the treasurer to reap benefits by getting better information, enabling better and quicker decision-making. Effective use of base treasury management system functionality interfaced with bank systems reduced the level of investment in manual and low value processes; and
- *people* – following the co-location it was eventually possible to begin to build a final organisation structure which allowed activities to merge to a single group activity giving rise to savings of a '2+2=3' nature.

Focus on the basics

The focus of the treasury team throughout this integration project has been on the basics – cash management, balance sheet structuring, bank relationships and foreign exchange (including underlying processes and systems) – but also increasing the level of interaction with operating companies. The company continues to focus on these basics as it believes that the greatest source of value to be released is in getting these right. ■

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