Creating value: investor relations is key

Many companies fail to create value for their shareholders. But Paul Hayman of KPMG Consulting has a framework for success.

Pick up the annual report of almost any listed company, turn to the chairman's statement and you will read about the organisation's commitment to creating value for its shareholders. Indeed, a recent KPMG Consulting pan-European research report, 'The growing importance of shareholder value in Europe', found that satisfying shareholders was the governing objective of 95% of senior executives. So does this mean that almost every company in Europe is adopting a value-based approach to managing its business?

Of course not. Many companies fail to translate worthy intentions into wealth for their shareholders, because they do not adopt a framework that enables each individual to identify and manage the sources and drivers of value within the business.

What should we communicate?

Firstly, it is essential to understand that value is created when the company's worth, as reflected in the share price, exceeds the capital invested by shareholders. This premium on invested capital is known as the 'market value added' (MVA). A positive MVA occurs when investors believe that the company will generate an adequate stream of profits in future years. Every year a firm generates a return on investment in excess of its cost of capital it creates 'economic profit '(EP).

Businesses compete for capital; those that outperform their peers will be the investors' first choice. But it is not enough for an enterprise to have a good history, it must be able to commit credibly to deliver against investors' expectations of future performance. When determining company value, these expectations are key. A company's share price reflects the market's expectation that it will be able to sustain a valuable dividend stream into the long term. Indeed, since dividend yields tend to be less than 10% we can conclude that for most companies about nine-tenths of their market worth is wrapped up in expectations concerning future performance, with only one-tenth covered by this year's dividend. Expectation is therefore almost everything.

In the absence of a crystal ball investors have to arrive at expectations concerning future performance by gathering as much insightful information on the company and its competitive environment as possible. Investors can then develop quantitative and qualitative models of the enterprise by which they can predict future performance and arrive at a long-term valuation. One of the most important elements in this equation is a commitment made by the executive to generate value for its shareholders. For example, recently Lloyds TSB has been both transparent and vocal in its commitment to 'double the share price in three years'.

Such goals must be credible and supported by an explanation of how and where value will be created and what action will be undertaken to ensure the goal is achieved. Every listed company should provide information that enables the market to conclude rationally on expectations regarding future performance. Value-based companies base these conclusions on hard facts concerning the identified sources and drivers of value for their business. Furthermore, they identify and advise the market on the critical areas that must be addressed to deliver value, and set targets for related key performance indicators.

Paul Hayman

Value-based investor relations is about communicating current performance and future plans in terms of where, how and how much value, in terms of economic profit, was (and will be) generated by the enterprise. Once executives have stated that value creation is their governing objective they will need to satisfy the investor community's appetite for information. They will also be required to quantify their goals in value terms and to demonstrate how their business plans will achieve them.

In this way, equity analysts will be able to consider all relevant information, amend their expectations and recommend whether the company's shares should be bought, sold or held. Unless reliable, thorough information is produced, the credibility of a value-based management initiative and its supporters will be the first casualty.

How should we communicate?

In an increasingly complicated market, companies are competing not only for investors' capital; at a more basic level they are competing for the analytical time of investors, and at the most profound level, companies are competing for investors' trust.

Investor relations is not just about providing information. It is more about creating a credible and legitimate perception by providing investors with a service that enables them easily to analyse the stock while creating a trusting relationship between both parties. As such, investor relations is similar to marketing – where only the truth is acceptable and the goal is to ensure the

intrinsic value of the business is fairly reflected in its share price.

As with any marketing venture, it is essential to understand the character of your product. Value Based Management (VBM) provides a framework for analysing the attributes of your business since it enables managers to identify the most important sources of value and the key drivers of financial performance. It is also essential to understand your customers. The key customers for investor relations are numerous, but identifiable. Each investment bank has a limited number of analysts, there are a finite number of fund mangers who carry your stock and a list of your shareholders is always maintained.

Once the right information has been identified it must be communicated in the right fashion. It is not enough for the information to be accurate, it must also be conveyed in a manner that enables the market to conduct a rapid analysis to arrive at conclusions about future performance.

If not, then a mismatch of expectations, poor market perception and a lack of trust between the market and the business may result One convenient form of communication is the posting of downloadable standard reports and presentations on the internet. These can be rapidly communicated, easily manipulated and readily incorporated into the analysts recommendations.

A need to know?

To truly embrace shareholder value goals, the board must be encouraged to disclose information to manage investors' expectations appropriately. However, the market's unquenchable thirst for information must be balanced by the need to comply with legal obligations, the need to sustain competitive advantage and the resources of the investor relations department.

Frequently, the company's legal department and investor relations find themselves at odds since the first reaction of a lawyer may be not to disclose, especially if the information is price-sensitive. The irony is that price-sensitive information is exactly what the market needs if it is to arrive at an appropriate valuation for the company.

Another problem may come from operating managers who feel that their competitive advantage may be given away by too exhaustive a disclosure of company strategy or value creation.

> CEOs often talk about shareholder value. But talk is cheap. Unfulfilled expectations of value creation can destroy investor trust and may result in the removal of executives

This problem can be addressed by advising managers that it is essential for both the market and employees to have a common understanding of business strategy; while the veiled reporting of figures using index values and comparative instead of actual figures will enable managers to balance secrecy and transparency.

All appropriate parties within the business must be rigorously and consistently briefed to provide a coherent message. Information should be consistent with the management framework and relate to the value goals previously communicated and should refer to the financial and operational performance of the business. Every communication should consider the business in terms of the value-based management framework, regardless of whether the audience is internal or external. All processes and messages should use a common language and be developed in line with a common methodology.

Even given this drive for transparency, the market accepts that there is a limit to the information that can and should be supplied. All parties accept that the business should define and maintain a policy concerning what information is disclosed as a matter of course, what is disclosed under special circumstances, and what information is prohibited. But regardless of their content, all disclosures must be made in a manner consistent with stock exchange regulations with all parties given the same information without prejudice or favour.

Action not words

All CEOs want to satisfy their shareholders – if they don't, they'll be out of a job. The market is obsessed with value creation. CEOs know this. Businesses in general, and CEOs in particular, talk constantly about value. But talk is cheap. Careless talk of value creation, raising expectations which are destined to be unfulfilled, costs careers. It destroys trust, undermines investor confidence and results in the removal of executives.

Talk of the creation of value must be backed by real organisational change, VBM facilitates this change. It creates an environment through which the words of the CEO are substantiated by performance improvement derived through all individuals consistently acting to create value through enhancing operational performance and the adoption of new value-maximising strategies.

A concrete foundation

This rigorous link between share price, market value added, and expectations concerning annual economic profit, provides the concrete analytical foundation for any value management programme. It provides managers and investors with an objective benchmark for appraising business performance, while providing a framework for constructive investor relations. It provides executives with a language through which they can persuade investors of the company's ability to generate adequate returns on investments today, access to capital in the future, and thereby an ability to sustain value creation over the long term. Further, it provides the executive with a tool to fulfil its obligation to ensure that the intrinsic value of the business as perceived by management equates to the market value of the company as perceived by investors.

Once a credible framework is established, everyone in the business can communicate consistently. Where companies adopt a common language, philosophy and framework for delivering value, powerful perceptions are created. In a value-based organisation the executive can be confident that their statements are echoed by the action and language of all staff in the operating units. Therefore, board members can talk confidently about value, and should do so at every opportunity. ■

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