Translating Strategy into Shareholder Value: A Company-Wide Approach to Value Creation

by Raymond J. Trotta
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This text looks at how the strategic planning process can be applied directly to the achievement of shareholder value, and provides a practical methodology.

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Too often there are serious missed signals between a company's stated goals and the methods employed to try to reach them. *Translating Strategy into Shareholder Value* is a unique look at how the planning process relates to the achievement of shareholder value, and ways to ensure that the two directly complement each other. Using tools and a special case study to analyze past, present, and future performance, the book takes readers through a host of steps, including:

- Comparing existing strategy to the competition and the economy as a whole
- Analyzing productive capabilities and costs
- Bringing nonfinancial metrics to test how future strategy creates value
- Selecting the right analytical tool and looking at strategic solutions

If corporations are to truly maximize their success, managers need to understand how to translate corporate strategy to the bottom line—and that means seeing the big picture.

About the Author

Raymond J. Trotta is a management consultant and academic. He is a cofounder of iValue, a consulting firm focused on the valuation of information technology.

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Raymond J. Trotta
American Management Association

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To my parents for their dedication and resolve
To Sherry Trotta, my wife, for her motivation and support throughout this effort.
To Father Sabas Kilian, deceased professor of Fordham University, whose inspiration drove the actuation of our ideas.

Preface

STRATEGY deals with creating a sustainable competitive advantage for a business. The focus of business strategy is traditionally long-term in nature and is primarily concerned with the longevity of the business. Finance, on the other hand, is concerned with making management decisions in order to achieve its objective of increasing wealth for its owners. Finance looks at ways to obtain, manage, and utilize funds for wealth maximization. The two disciplines are many times perceived as working against each other. Yet, business leaders know that firms that have a sustainable competitive advantage become more valuable than their competition.

I have focused on the problem of aligning strategy with value creation for many years—as a management consultant serving global clients. The conceptual inspiration for this work can be traced to 1997, when I met Jim Hudick, who was the Global Practice Leader in Finance for the American Management Association (a worldwide management training organization). Jim contributed his thoughts around the conceptual framework and the notion of an economic filter, as well as the initial draft of the introduction and preface of this book.

During Jim's tenure at the AMA, we joined forces to develop a new management-training seminar. In that seminar, we presented the financial and economic aspects of corporate strategy as a critical step for the creation of shareholder value. Subsequently, we also worked together on a special conference entitled "*Partnering to Create Shareholder Value*" held in Newport Beach, February 2001. This book is an outgrowth of those earlier works. The focus of this effort is on "shareholder value creation", which is the central business issue confronting organizations. All businesses have a common goal—to increase in shareholder value. Nevertheless, many companies do not link strategy and finance in a concerted effort to achieve strategic goals. There is a disconnect between functional disciplines within the corporate architecture and an organizational obstacle that needs to be overcome. This disconnect has been recognized by numerous academic organizations. "We're trying to prepare people to appreciate that technical silos are not very effective in the workplace".[1]

I intend to continue this essential integration of disciplines by increasing an understanding of the interrelationship of finance, strategy, and value creation. One of the biggest challenges in business is to create a collective approach between the various functions of the business. I am writing this book to bridge the gap between strategy and finance. Strategists are proactively shaping the future of the business to assure its long-term dominance. Meanwhile, financial analysts are quantitatively measuring (and controlling) the results of these plans on a current/ short-term perspective versus budget.

I will help to bridge the gaps and resolve the conflicts that exist between the functional disciplines (as described above). All sides can gain from this book because it builds a bridge between vision (strategy) and value creation (shareholder wealth). The development and implementation of strategy to create shareholder value must be a team effort. All disciplines must partner together to achieve a common goal—creating shareholder value. Financial techniques serve as a method of validation that business strategy is creating shareholder value and not as an end in itself. "The whole idea is that CFOs pushing buttons to create shareholder value is an abstraction from reality if they don't have a feel for marketing strategies, and don't develop financial strategies that make sense to the other side of the house".[2]

This book is a must-read for all businesspeople regardless of discipline. The book is intended for every businessperson who wants a practical, grassroots method of how to assess the alignment between strategy and shareholder value. My purpose is to provide businesspeople (and students) with a basic understanding of how business strategy translates into shareholder value. I will focus on the financial and economic assessment of strategy as a means for value creation using a step-wise approach.

This book is for businesspeople of all backgrounds—both financial and nonfinancial—at all levels of the organization. Just about every decision maker in business can benefit from the principles we will present. I will attempt to explain complex ideas in simple terms using easy-to-understand examples. I will provide readers with concepts and frameworks that can help create a collaborative approach to shaping strategy across all executive and operational functions throughout their organizations. In addition, this book provides a perspective required for corporate advancement. A critical competency of a senior manager is to understand how to translate strategy into the bottom line. After reading this book, the reader will have a better capability to:

- Understand the impact of economic conditions and market (industry) forces on his business.
- Assess the financial repercussions of strategy.
- Identify and assess Strategic Alternatives.
- Evaluate Strategic Alternatives within the context of fluid business conditions.

Notes

1. *CFO*, April 1997.
2. Ibid.

[1]*CFO*, April 1997.

[2]Ibid.

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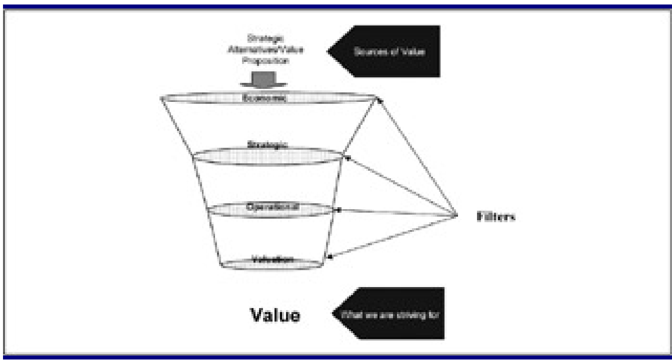
Introduction

THIS BOOK links strategy and finance through a Step-Wise Approach to Value (SWAV). The Step-Wise Approach to Value is an analytical framework that combines strategic and financial analysis to evaluate Strategic Alternatives. The framework is conceptual in nature, so it has the flexibility to accommodate different types of cases. A Strategic Alternative (SA) is defined as an initiative that is implemented to increase shareholder value. The central premise of the SWAV is that the effectiveness of business strategy is validated through the creation of shareholder value.

This work follows the analytical flow of the SWAV, as illustrated in Exhibit I-1. It is similar to a funnel because it becomes increasingly more difficult to pass through the filters. I will first examine how value is created. I will look at the following strategic alternatives: mergers and acquisitions, technology, reengineering, and outsourcing.

Exhibit I-1: The Step-Wise Approach to Value.



I will then discuss tools that are used in each filter. The goal is to develop a conceptual understanding of these analytical tools and how they are applied. The Step-Wise Approach to Value applies four filters, or screens, to assess the creation of shareholder value. The filters are designed to eliminate the Strategic Alternatives that do not have the prospect of creating shareholder value. As each filter is applied to an SA, one makes a decision to subject the Strategic Alternative to the tests in the next filter, or to remove it from consideration. A side benefit of SWAV is that it facilitates the planning process by continually focusing the planning group on viable alternatives.

What are the four filters in the SWAV framework? They are:

1. The economic filter
2. The strategic filter
3. The operational filter
4. The valuation filter

The Economic Filter

The economic and strategic filters take a macro view, which is a high-level assessment of a Strategic Alternative. These aspects of the SWAV involve analysis based on trends in the economy and industry.

Economic factors play a significant role in the successes and failures of businesses. In the case of large companies, value is tightly linked to the performance of the economy. As a company grows to Fortune 1000 proportions, this relationship increases in strength. Revenues, profits, and value tend to move in lockstep with economic conditions. This filter looks at key economic drivers and their impact on market demand. Our definition of market demand is simply:

Product Price × Number of Buyers = Market Demand.

Based on market demand for a product or service, you can understand whether the Strategic Alternative will create or destroy shareholder value. This economic filter tests the alignment of the SA with the direction of market demand.

The Strategic Filter

The strategic filter looks at how Strategic Alternatives impact your company's competitive advantage. This can be done in two ways. The first is by using the Porter Model. This involves framing the industry landscape in the context of five forces that shape industry change. I will describe how to discern your position in the value chain. Then I will help you to identify weaknesses in your current strategy.

The second is the Balanced Scorecard. This tool brings nonfinancial metrics into the managerial tool kit. I will describe how the Balanced Scorecard can be used to assess your strategy. It can be used as a tool for addressing critical success factors across four perspectives: financial (satisfying your shareholders), customer, internal business process, and ability to change and improve (learning and growth).

With the results from the analysis using the Porter Model and the Balanced Scorecard, you can determine whether the SA creates value by improving competitive advantage.

The Operational Filter

Now that we've tested the Strategic Alternative with the economic and strategic filters, we move to the operational aspect of the SWAV. A number of tools are used to analyze financial performance. Measurement of management performance (using the DuPont Model) and value creation using intrinsic value models (discounted cash flow analyses) will be demonstrated. The drives of shareholder returns: profit margins, efficient utilization of assets, and leverage are then presented. How to assess your management of 1) the income statement to increase cash flow and 2) the balance sheet to increase asset turnover (utilization of assets) will be illustrated. By understanding these tools you will be in a position to increase return on assets. This discussion will also show you how the use of leverage (change in the amount of debt used to finance corporate investments) can help to further optimize return to shareholders.

The use of activity-based costing to obtain meaningful information for decision making will be described. Most financial reporting systems and standard costing systems simply don't do the job, particularly in today's competitive environment. They look backward and are general ledger and transaction–orientated.

Accordingly, focus will be on the application of ABC/ABM Models to quantify resources consumed and the real cost of each activity. ABC (activity-based costing) models help businesses understand the true costs of doing business. ABM (activity-based management) models are systems that use ABC techniques to help managers improve the financial performance of their businesses by identifying ways to reduce the costs to production, customer service, and sales channels. I will also look at the estimation of the true costs of production and determination of real, measurable benefits.

Examination of operational drivers is key in addressing both short- and long-term impacts of Strategic Alternatives on shareholder value.

The Valuation Filter

Here, a guide to the analytics necessary to test how future strategy creates value is provided. The starting point is the use of statistics and regression methods to facilitate strategic planning and forecasting. An ability to model and forecast key business drivers is important. Intrinsic value techniques are utilized to estimate future financial results. Ability to consistently achieve sustainable growth rates and still maintain a positive financial spread over the cost of equity is a key factor for future success.

Dealing with uncertainty poses special problems requiring sophisticated financial forecasting techniques. Simulation models refine the inputs to shareholder value analysis.

The outcome of this filter is to determine if the Strategic Alternative creates shareholder value. Shareholder value is created when there is an increase in intrinsic value. "Intrinsic or estimated value is the present value of the expected cash flows from that asset".[1]

Now that an analytical arsenal has been built, we offer our final thoughts on the deployment of the approach in the business environment. Change is invariably meet with resistance. The barriers that may be encountered in implementation of analytical and quantitative systems from consulting experience are delineated here. These will prove helpful as you migrate your organization to a value-based company.

This work is not intended to be an exhaustive in nature. Our objective is to provide the reader with an approach to bridge the gap between strategy and shareholder value that has been tested in client settings. New tools are continually introduced into the marketplace, and there are other Strategic Alternatives that companies can use to increase value. This book provides a foundation from which new strategic and financial innovations can be added.

[1]Charles P. Jones, *Investments: Analysis and Management*, 7th ed. (New York: John Wiley & Sons, 2000), p. 198.

Note

1. Charles P. Jones, *Investments: Analysis and Management*, 7th ed. (New York: John Wiley & Sons, 2000), p. 198.

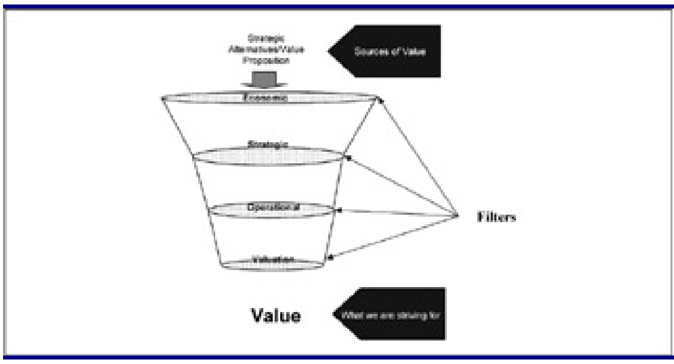
Part 1: Introduction to Strategic Alternatives

Chapter 1: Value and Value Proposition

Overview

THE STEP-WISE Approach to Value (SWAV) is a method to assess the value derived from a Strategic Alternative (SA). Following the path illustrated in Exhibit 1-1, we need to understand what we are looking for (shareholder value) and how it is generated (value proposition) before discussing the value filters. This chapter will deal with the concept of value; more specifically, what it is and how it is derived.

Exhibit 1-1: The Step-Wise Approach to Value.



Value has become a buzzword. We constantly hear executives say things like:

- They are adding value.
- The value added of a product is &"listitem">

  This is of great value.

Value seems to be an ubiquitous term, yet if you speak with a hundred executives, you will get a hundred different definitions. The major problem is that there is no clear definition with regard to the concept of value. If the objective of a business is to create value, then it needs to be clearly defined. We need to clear up this issue for the purposes of this work. This problem also exists in finance. This chapter will look at three concepts of value: book value, market value, and lastly the valuation concept upon which this book is based. Intrinsic value is the best form of value for our purposes because it is based on cash flow; it is forward-looking and can be quantitatively measured.

After establishing this concept, we will present a way to understand how value is created. More specifically, we will answer the question, "How are we adding value?" It is critical to understand the value proposition for an SA. The value proposition will be described in terms of three distinct sources of value: revenue increase and maintenance, competitive repositioning, and efficiency. It is important to clearly describe the value proposition so that it can be assessed using the filters of the SWAV. When it comes to creating intrinsic value, there are a limited number of ways to do it. Using this method of categorizing value propositions will help to eliminate confusion and will tend to eliminate value propositions that do not increase shareholder value. This keeps the company focused on Strategic Alternatives that will tend to increase shareholder value.

What Is Value?

The objective of this book is to link strategy to finance. Hence our concept of value will be driven by financial constructs. We will first discuss three concepts of shareholder value (book value, market value, and intrinsic value) and present their strengths and weaknesses.

Book Value

This form of value is the worth of a company based on its financial statements. This means the net asset value of a company, as illustrated in Exhibit 1-2.

Exhibit 1-2: Book value.

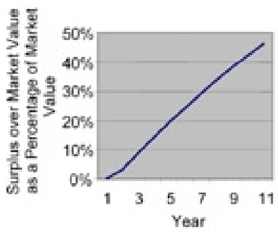
Book Value
Total Assets
Less: Depreciation and Amortization Equals
Net Assets
Less: Liabilities
Equals
Book Value

Year	Book Value (1)	Market Value (2)	Surplus over Book Value	Distortion (3)
Purchase	$1,000,000	$1,000,000	Same	None
1	$970,000	$1,000,000	$30,000	3%
2	$940,000	$1,030,000	$90,000	9%
3	$910,000	$1,060,900	$150,900	14%
4	$880,000	$1,092,727	$212,727	19%
5	$850,000	$1,125,509	$275,509	24%
6	$820,000	$1,159,274	$339,274	29%
7	$790,000	$1,194,052	$404,052	34%
8	$760,000	$1,229,874	$469,874	38%
9	$730,000	$1,266,770	$536,770	42%
10	$700,000	$1,304,773	$604,773	46%

(1) Depreciation over 30 years ($30,000 per year) with a $100,000 salvage value
(2) Appreciation rate of 3% per year
(3) Surplus divided by market value

There are some major problems with this definition as presented in Exhibit 1-2. First, it uses accounting principles that do not necessarily reflect realistic conditions. Total assets are adjusted for deprecation and amortization, which are allowances taken to adjust for the decline of the price of an asset. Depreciation is an adjustment of the book value of an asset to allow for wear and tear. For example, assume you had a commercial building that was purchased for $1 million and it was depreciated over a thirty-year period, a salvage value of $100,000. Now suppose that the market price of the building increases at a rate of 3 percent per year. The amount of cash the property could be sold for may be rising, and the book value could be falling, as also illustrated in Exhibit 1-2. Over a ten-year period the distortion in value (surplus over book value divided by market value) grows to 46 percent of market value (Exhibit 1-3).

Exhibit 1-3: Value distortion.



The next issue is that the book value method is based on historic transactions. The value of the building on the books is determined by what the company paid for the property less depreciation (adjustments may be made for improvements over time). The problem is that book value does not look at future growth in value based on changes in demand and the receipt of future cash streams.

Market Value

Market value is the price at which buyers and sellers trade similar items in an open marketplace. In the absence of a market price, market value is the estimated highest price a buyer would be warranted in paying and a seller justified in accepting, provided both parties were fully informed and acting intelligently and voluntarily. This is the price that a willing buyer and a willing seller would pay if the transaction would be consummated today or in the near future. The market value of a stock is what it is trading for today. The problem with this form of value is that it may be based on a "market bubble". Market bubbles are over-valuations in assets based on irrational behaviors of investors. For example, many Internet stocks in the late 1990s were overvalued based on hype in the business community. Technology analysts saw great growth in market demand for the Internet by consumers and businesses. The bubble did burst as the hype did not transform itself into reality. The ability of the Internet companies to generate cash was in many cases nonexistent.

Analysts have created ways to rationalize the future growth in terms of market price by using the earnings multipliers. They use the following formula to understand value:

Market Value = Earnings × Price/Earnings Multiplier

This equates the value of a company with its earnings and a multiplier. Another way to think about this formula is that the multiplier represents some premium that a buyer will pay over current earnings. The premium is in many respects an adjustment for the ability of a company to produce earnings and future growth. The major issue with the multiplier approach is that earnings are not a strong indicator of value and cash generation.

Intrinsic Value

We mentioned that intrinsic value is an estimate of value based on the present value of cash flows. In its simplest form an equation for intrinsic value is:

$$\text{Value} = \frac{\textit{Sum of Future Cash Flows}}{\text{Adjustment of Time and Risk}}$$

We will discuss the math behind intrinsic value in Chapter 11. Why is this superior to market and book value? Most importantly, the intrinsic value model is cash flow–based. Cash flow is defined as benefits less costs and taxes. Research has shown that the value of companies has a strong correlation to value.[1] This method is more conducive to analyzing SAs. Alternatives that involve changes to the way companies do business are difficult to value, based on market and book value concepts. Reengineering, for example, would most likely be accounted for as an operating expense and not an asset. Hence, a book value calculation could not be used. It would be difficult to find a market for a reengineering initiative because of the specialized and proprietary nature of this alternative. In addition, the intrinsic value model is forward-looking. It focuses on future cash flows.

This valuation concept is not without weaknesses. If assumptions are performed incorrectly, such as in estimation of cash flows and time/risk adjustments, the quality of the analysis is just as flawed as the market and book value models. We will deal with the weaknesses and how to offset them in the section dedicated to discounted cash flow in Chapter 11. On the other hand, the intrinsic value model has the best fit for our purposes.

[1]McKinsey & Company, Inc., Tom Copeland, Tim Koller, and Jack Murrin, *Valuation: Measuring and Managing the Value of Companies*, 3rd ed. (New York: John Wiley & Sons, 2000), p. 77.

Understanding the Value Proposition: How Is Value Created?

With our objective defined (intrinsic value), we must focus on how to get there (value creation). Based on the SWAV, adding value would be increasing intrinsic value, which is increasing future cash flows. In the introduction to this chapter we mentioned hackneyed expressions like "adding value". The way SAs increase value is called the value proposition. The SWAV will test whether value propositions are increasing or adding value using the successively more stringent filters. There are three types of value propositions:

1. Revenue increase and maintenance (RIM)
2. Competitive repositioning
3. Efficiency

The goal is to turn these value propositions into a stream of cash. The objective of the SWAV is to increase the probability of creating a cash stream that will increase intrinsic value. Let's explore these value propositions in detail.

Revenue Increase and Maintenance

One aspect of this value proposition is in many respects self-explanatory. A Strategic Alternative will increase value if it generates cash from increasing revenue. The relationship is that rising revenue will drive increasing cash flow. The assumption here is that costs and taxes do not exceed the revenue boost. Increasing revenue becomes more difficult in established industries. This occurs because there is greater competition for the same dollar of revenue. This intense competition tends to drive down cash flow because of pricing pressures (see the Porter Model in Chapter 5). This value proposition is normally associated with mergers and acquisitions.

The maintenance aspect of the RIM value proposition is less intuitive. Revenue maintenance is thwarting the loss of revenue driven by market conditions. A company may invest in a technology initiative to improve customer retention. For example, computer telephony interface (CTI) technology improves the flow of information from core systems to the point of contact with the customer. The benefit is improved customer service through improved access to account information and less wait time. The key assumption here is that a Strategic Alternative will protect the existing stream of cash flow. The underlying premise is that revenue and hence cash flow will be lost if the investment is not made. Revenue maintenance investments are normally made if companies feel that they are catching up to their competition. In the CTI instance, the other competitors would already have this technology. The evaluating company would consider a CTI investment as a "strategic necessity". In the past, managers would use the strategic necessity argument to move forward with SAs that did not have strong quantitative support. With the analytical rigor of the SWAV, SAs will need to be validated through the generation of intrinsic value.

Competitive Repositioning

This is an increase in competitive position that results in increased intrinsic value. Competitive repositioning increases value through:

- Increasing or maintaining market share
- Improving competitive intelligence
- Differentiating the company from its competition

Increasing or Maintaining Market Share

The underlying assumption is that there is a direct relationship between market share and cash flow similar to RIM and cash flow. This assumption requires rigorous testing through the SWAV. There have been many mergers that were justified on increased market share that have destroyed value. Integration expenses reeled out of control and resulted in a future cash drain as opposed to an increase.

Improving Competitive Intelligence

Competitive intelligence is knowledge and/or information that gives a business a competitive advantage over its rivals. A competitive advantage is obtained by acquiring information about customers, suppliers, markets, and channels. (For instance, a point of sale capability that collects information on customer buying behaviors.) This type of information gives a company the ability to stock shelves with products that customers want. This type of intelligence gives a company an advantage over its competition because it has a better idea about what will sell. The key to this value proposition is that having the information does not necessarily mean that a company can use it to improve future cash flow.

Differentiating the Company from Its Competition

This aspect of repositioning assumes that cash flow will be improved by doing things differently. An example of differentiation is a company who makes an acquisition to obtain a proprietary business process that will improve cash flow.

The major issues that will be vetted in the SWAV for repositioning value propositions are their longterm orientation and difficulty of measurement. The time frame to realize benefits from realization is generally long-term. This means that the adjustment for time and risk discussed above will dramatically mitigate the intrinsic value of the cash flow stream created. In addition, the benefit stream from differentiation is hard to measure. It takes a great deal more effort to analyze and measure the increase in value from an SA than through an increase in revenue, or the next value proposition category efficiency.

Efficiency

Efficiency improves cash flow by performing business processes better, faster, or cheaper than the current operation. Doing things better results in superior quality, such as lower defects in manufacturing environments. In a service environment one result could be better customer service.

Performing business processes faster can refer to the time to make a car or to approve a loan. Doing things faster must result in consumption of less resources or a lift in revenue to improve cash flow. For example, a furniture company buys new equipment that reduces labor costs by cutting down the amount of time it takes to build a table. The important thing to remember is that reduced time does not necessarily reduce costs. An illustration on the revenue side is cutting product introduction time. Introducing products faster can improve cash flow by improving profitability (the difference between benefits and costs).

This value proposition can also be justified by reduction or avoidance of costs. Costs are defined as operating and investment costs. Operating costs are costs associated with the maintenance and operation of a business. These costs are generally referred to as expenses and are found on the income statement of a business. Cost of goods (raw materials), labor, and maintenance contracts are examples of operating costs. Investment costs are those that create assets. These costs are found on the balance sheets of businesses: capital expenditures (purchase of buildings and equipment), capitalized intangibles (purchase of software, goodwill, or patents), and working capital (inventory and accounts receivable). Value propositions centered on efficiency are easier to measure and to quantify than repositioning and RIM.

Conclusion

This chapter dealt with understanding value and value propositions. Three concepts of value were discussed: book value, market value, and intrinsic value. Shareholder value based on a book value convention is net asset value less liabilities. Shareholder value based on a market value concept is the price paid by a willing buyer and a willing seller. Intrinsic value is the sum of future cash flows adjusted for time and risk. We have chosen the intrinsic value method because it is cash flow–based, future-oriented, and accommodates the assessment of Strategic Alternatives.

The three main categories of value propositions are revenue increase and maintenance (RIM), competitive repositioning, and efficiency. RIM–related value propositions assume that increase or maintenance of revenue will have a similar impact on cash flow.

Competitive repositioning assumes that increased cash flow will be driven from increasing/maintaining market share, competitive intelligence, and differentiation. Efficiency assumes cash flow improvements from making business processes better, faster, or cheaper.

Note

1. McKinsey & Company, Inc., Tom Copeland, Tim Koller, and Jack Murrin, *Valuation: Measuring and Managing the Value of Companies*, 3rd ed. (New York: John Wiley & Sons, 2000), p. 77.

Chapter 2: External Strategic Alternatives

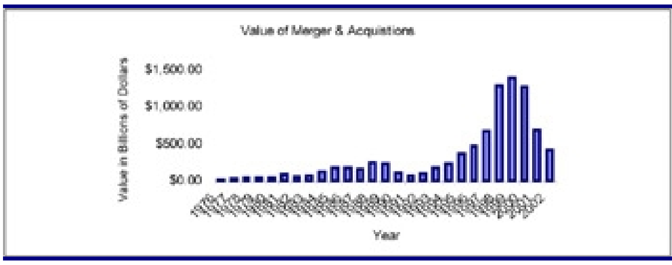
OUR OBJECTIVE in this chapter is to get a deeper understanding of external Strategic Alternatives. These are initiatives that involve tapping outside sources to increase value. Our focus will be on mergers and acquisitions (M&A) and outsourcing—two common external SAs that are prevalent and have questionable track records for success. One reason for the weak track record is the ill-formed linkage between the value proposition and shareholder value. The rationale for many mergers is predicated on "strategic reasons" that are not validated from a financial perspective. These strategic reasons tend to have a destructive influence on the business as a whole because the benefit streams are not adequately forecasted and the risks are not well articulated. Outsourcing alternatives are especially popular during economic downturns, but can trade short-term savings for long-term value. These arrangements tend to be used as a stopgap measure to satisfy short-term demands of institutional investors and industry analysts. They tend to be justified by short-term expense reduction. Outsourcing can be more expensive in the long run and create risks for the long-term viability of the business. Our focus will be on a description of these alternatives and the factors that determine success and failure—more specifically their rationale and risks. Let's begin by looking at M&A.

Mergers and Acquisitions

Business combinations and acquisitions are one of the most broadly used methods to execute strategy.

Mergerstat, an authority on M&A, tracks activity in this area. Their results over thirty years show increasing deal value (market value) over time (Exhibit 2-1). In addition, the number of mergers increased over time. There is a tendency for deal making to increase in times of economic expansion, both in number and in value. This is especially evident between 1994 and 1999. During recessionary periods activity tends to decline.

Exhibit 2-1: Value of mergers and acquisitions.



What are the implications of increasing deal value? The obvious conclusion to be drawn is that the sellers are getting wealthier. The seller's shareholders benefit from these price premiums, but the benefit to the acquiring company is not as clear. In a M&A strategy, the key question for the acquiring company is: How is shareholder value enhanced through buying companies? Let's look for answers in the rationale for mergers and acquisitions.

Rationale for Mergers and Acquisitions

Mergers and acquisitions can become extremely complex. Transactions require expertise from strategic, legal, financial, and operational disciplines to be successful. Each of these groups may have different criteria for success. There are many cases where deals are structured to hurdle tax and regulatory barriers. While these factors are beyond the scope of this book, it is important to understand that these issues introduce transactional complexities into the deal. Our view is purely strategic in nature, and our concern is limited to how mergers and acquisitions can deliver shareholder value through improving the strategy and operation of the business. To simplify the analysis, M&A can be rationalized in three ways: 1) competitive integration, 2) supply chain movements, and 3) diversification.

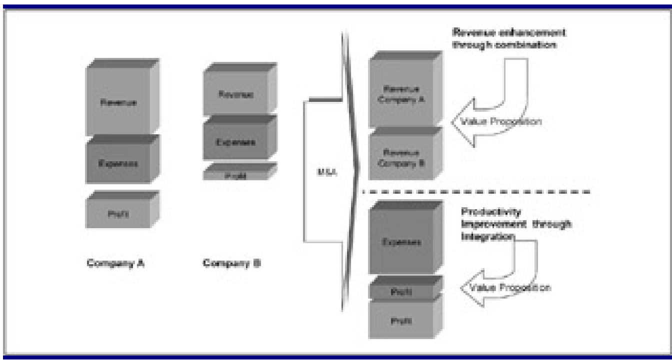
Competitive Integration

Competitive integration occurs when companies in the same business&"Profits and balance sheet developments at U.S. commercial banks in 1998":

> Bank consolidation continued and included some particularly large mergers. As a result, the share of industry assets at the largest one hundred banks rose to 70 percent at year end, up from 67 3/4 percent a year earlier and around 50 percent in 1985. The number of commercial banks fell by 371, as the number of newly created banks was more than offset by the 588 banks that ceased to exist [almost entirely because of mergers]. At the end of 1998, there were 8,817 commercial banks in the United States, more than one-third fewer than the 14,393 banks that existed in 1985. Banking industry consolidation was also evident in mergers between holding companies, whose numbers declined by 139 last year, to 5,971. The largest fifty holding companies continued to steadily increase their share of industry assets, from 74 percent at the end of 1997 to 76 percent at the end of last year.[1]

Exhibit 2-2 is a sketch of how value is driven by competitive integration M&A. The two primary drivers of competitive integration mergers are revenue increase and operational efficiency. Revenues are increased dramatically through acquisition. This is evident in the exhibit as the revenues for the combined entity are significantly larger than company A and company B. Executives feel that increased market share and geographic presence will enhance the prospect for growth of the combined entity. Operational efficiency results from improved economies of scale. Since both companies are in the same line of business, their operations can be integrated to become more efficient. Unit costs decline, thereby increasing profitability. The dark green bar depicts the profit improvement from economies of scale.

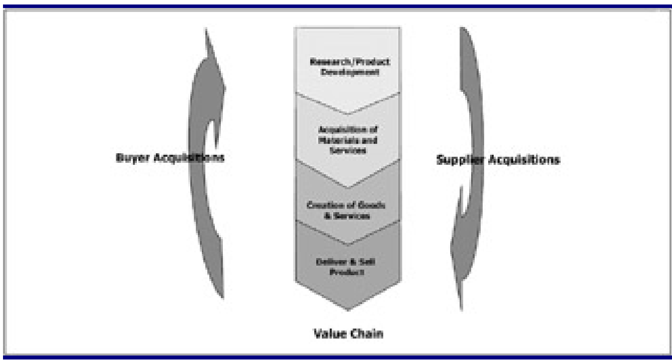
Exhibit 2-2: Driving value through horizontal M&A.



Supply Chain Movement

Supply chain movement M&A is a combination of a company and its buyers or suppliers. General Motors buying an auto parts manufacturer would be an example of a supply chain movement merger. This type of merger allows the acquiring company to reach across the supply chain and take advantage of the benefits available to its trading partners. Supply chain movement mergers and acquisitions typically take one of two forms: 1) supplier acquisitions or 2) buyer acquisitions (see Exhibit 2-3). Shareholder value is derived from supplier acquisitions because these acquisitions eliminate cost layers for materials and services. Shareholder value is derived from buyer acquisitions because these acquisitions enable companies to sell in their markets with lower cost structures and serve the end customer in the supply chain.

Exhibit 2-3: Supply chain movement.



Supplier Acquisitions

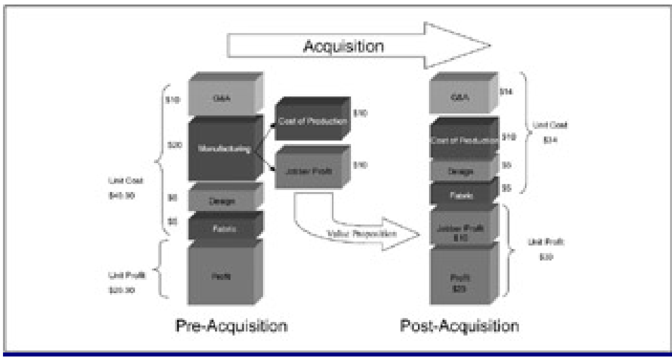
Through supplier acquisitions, margins can be improved by reducing the cost of goods sold. To illustrate, let's look at how a supply chain movement acquisition would improve the cost of production of a hypothetical apparel designer, Ann's Enterprises. The average garment sells for sixty dollars. The total cost per unit is forty dollars. The components of the costs are designated in Exhibit 2-4.

Exhibit 2-4: Design example.

Fabric	$ 5
Production	$20
Design	$ 5
General and Administrative	$10
Total	$40

The designer relies on a jobber to produce the clothing at twenty dollars per garment (manufacturing). As illustrated in Exhibit 2-5, the jobber has a cost of production of ten dollars and profit of ten dollars per garment. By purchasing the jobber, unit profits would increase to thirty dollars per garment since the jobber profit has been eliminated. The value proposition is the shift of the jobber profit to the designer as shown by the curved arrow. Value is driven through an improved efficiency as unit profit increases.

Exhibit 2-5: Supply chain movement and cost reduction.

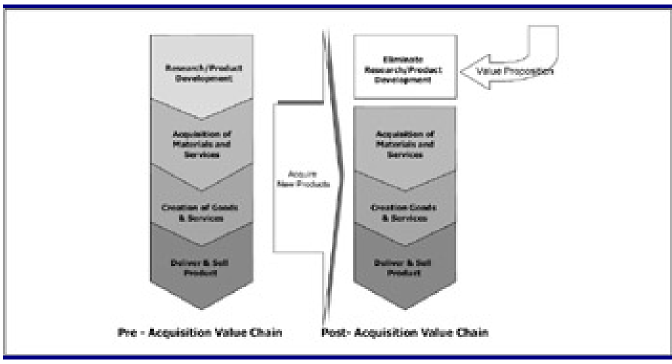


Buyer Acquisitions

Buyer acquisitions produce a competitive advantage by enabling a company to sell to its customers at a lower price. The advantages are lower cost (similar to supplier acquisitions) and better access to materials. To illustrate, let's look at what would happen if a microchip maker bought a cell phone manufacturer. The buyer would have faster access to new components and improved control over inventory.

Many companies use mergers and acquisitions as a method of outsourcing research and development. From a strategic perspective, supply chain movement acquisition provides companies with a method of acquisition of fresh intellectual capital and new products. This can help reduce competition by capturing new innovation that solidifies market share. Companies may also gain access to substitute products (other product lines not within the current product mix) through acquisition. This strategy is extremely effective in fluid markets such as high tech. The variety of products and speed of change has made it difficult to continually innovate cutting-edge solutions. This type of activity is common in the software industry. Peoplesoft Enterprise Resource Planning software recognized the need to expand its suite of applications to include data presentation capabilities. Peoplesoft's product mix included software solutions for human resources, financial, and e-business applications. Peoplesoft purchased a company called Vantive to extend its product line into data presentation. Product line expansion is also a method of diversification, which we will discuss later in this chapter. It mitigates the risk of having a single product and eliminates pressure from substitute products in the marketplace. It is prevalent in industries that have high levels of product evolution (see Exhibit 2-6).

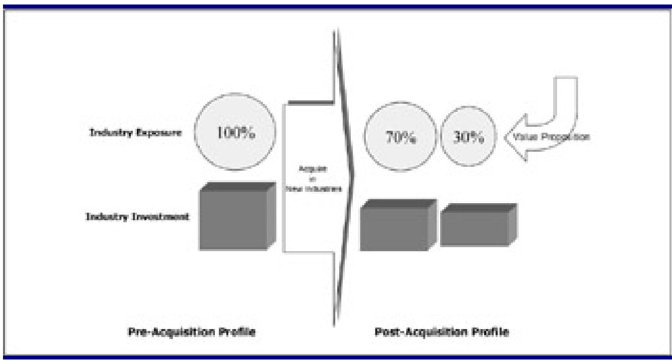
Exhibit 2-6: R&D outsourcing and the supply chain.



Diversification

Diversification mergers and acquisitions are combinations of businesses in unrelated industries. One example of this type of business combination is a pickle manufacturer buying a software company. These companies do not compete against each other and are not in the same industry. The strategic issue addressed by diversification combinations is industry risk. The underlying concept behind diversification activity is closely aligned with holding a portfolio of diversified stocks. Investment risk is being spread across numerous industries (see Exhibit 2-7). Lack of performance due to industry conditions in one industry can be offset by superior returns in another. Diversification mergers mitigate the impact of forces emanating from industry pressures by spreading risk across multiple industries or markets. General Electric is a leader in diversification through mergers and acquisitions. It is involved in a diverse set of businesses—from medical equipment to financial services. In the case of the acquisitive pickle manufacturer, its exposure to pressures from suppliers of cucumbers declines because it is less reliant on revenues and profits from pickles. The primary value proposition is driven by revenue increases and a more sustainable cash flow.

Exhibit 2-7: Diversification and investment.



Value from diversification combinations may also be derived from efficiency gains. Economies of scale can be attained through integration of business sustaining functions such as finance and human resources. These synergies may not be as great as competitive integration because business-sustaining functions may be specialized within industries. A bank has different reporting requirements than a biotechnology company. The improvement comes from elimination of duplicated functions. A combination of two companies may lead to elimination of administrative staff such as accounting personnel. If both companies have one hundred people in their accounting departments, they may be able to perform the combined accounting function with 120 workers. This results in savings of eighty employees. The elimination of workers, fixed assets, and other duplicated resources leads to an overall reduction of operating expenses in the long run. This assumes that the function performed requires no specialized knowledge of the specific industries.

Risks of Mergers and Acquisitions

There are three distinct risks to mergers and acquisitions: 1) lower interim productivity, 2) completion, and 3) realization of benefits. Each of these risks can be influenced by many factors.

Interim Efficiency Loss

All mergers and acquisitions require operational change that may temporarily compromise short-term financial performance. However, shareholder demand for short-term results in the form of increased earnings from the business combination does not wane. It is critical that the combined business gets to its target margins as soon as possible. This is why the stock of the acquiring company will normally go down after a merger announcement. Effectively managing this risk of efficiency loss is critical to a successful M&A strategy. The impact of these pressures on the ability to integrate effectively underscores the need for accurate forecasting. This is not to say that there will not be variances to budget, but estimates need to be within a gross order of magnitude. Painting an overly optimistic picture of the expected results from mergers and acquisitions can be the worst enemy of the integration team.

M&A Completion

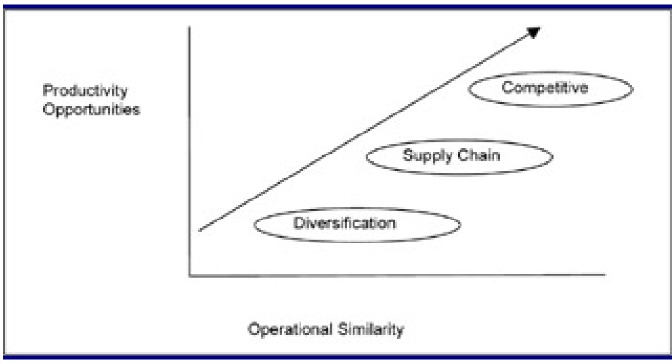
The initial stages of the M&A process are time-consuming and expensive. In most cases, they involve the most talented individuals in the company. As these individuals are pulled away from their day-to-day responsibilities, business operations may suffer. These efforts are lost if the company cannot identify and successfully close on the appropriate targets. In addition, many transactions are structured with break-up fees if the deal is not consummated.

Realization of Benefits

This issue is at the heart of managing value in a merger. The central question is: When the integration is completed, will the acquirer attain the benefits they envisioned in the strategy and rationale stage of the M&A process? Normally, lower interim productivity is recognized as a risk and accepted by management and shareholders. However, patience wears thin as:

- Synergies are not realized. Webster defines synergy as "combined action or operation".[2] Synergies should dramatically improve the competitive position of both firms. Examples of synergies are complementary sales channels, improved market share, supply chain efficiencies, and improved product lines. If the synergies are not compelling or attainable, the deal should not be done.
- Financial returns are weakened. There is an opportunity for efficiency improvement in all types of mergers (Exhibit 2-8). However, the potential for productivity improvement, and the resulting cost savings, is much greater when the companies have similar processes and technologies.

Exhibit 2-8: Financial returns.



Combinations that are driven by diversification can target business-sustaining functions such as finance and human resources as potential areas for cost reduction. Competitive mergers have the greatest opportunity in this area because the organizations have similar supply chains. This can improve margins and cut costs per unit. The risk is that fixed costs normally increase to support a larger organization. If revenues soften, then profits will decline and margins weaken. Many mergers are predicated on overly aggressive cuts in expenses that cannot be realized. The causes are unattainable expectations and inability to judge the savings opportunity.

Summary: Mergers and Acquisitions as a Strategic Alternative

Mergers and acquisitions can be rationalized in three ways. Companies merge to achieve competitive integration, supply chain movement, and diversification. Competitive integration is done to increase revenue and take advantage of synergies. Supply chain movements help improve margins, lock up new innovations in the marketplace, and provide access to end customers in the supply chain. Diversification helps companies reduce their exposure to specific industries. The major risks of M&A are the inability to realize economies of scale from synergies, consummation of the transactions themselves, and lower interim productivity that ultimately result in weakened financial performance.

[1]Antuilo Bomfirm and William R. Nelson, "Profits and Balance Sheets Developments at U.S. Commercial Banks", *Federal Reserve Bulletin*, Vol. 85, No. 6 (June 1999), pp. 369-395.

[2]*Merriam Webster's Collegiate Dictionary*, 10th ed. (1999).

Outsourcing

> We outsource a number of functions, from help-desk technical support for our employees to the physical production of our software packages. It's far more efficient for many companies, including Microsoft, to have an outside company handle installations and support for desktop machines.
>
> Bill Gates, *At the Speed of Thought*

Outsourcing is the practice of using third-party resources to perform functions and/or business processes. Virtually any process can be outsourced, from sales to product delivery. Industry experts have sized the global market for outsourcing in the trillions of dollars. The industry continues to grow as businesses recognize the value potential of this strategic alternative.

Types of Outsourcing

The rapid growth of outsourcing indicates a dramatic shift in how we think about our businesses. The management mind-set has changed from control to competence. The key to competitive strategy is now based on management of core competencies and not control over functions. As an example, management used to view having the entire IT function performed by a third party as absurd. Today, many companies outsource the majority of their IT functions. The rise in the cost of implementation and operation of largescale technology initiatives has fueled tremendous growth in the outsourcing industry. The need for new technology has outstripped the capabilities of many businesses. This has created a gap in both resources and risk. The intensive demand for human capital with knowledge of new technologies has far outstripped the supply of internal resources. Yet at the same time these systems become obsolete very quickly and require major enhancement to stay current with market conditions and business needs.

This trend does not strictly apply to technology. This concept has been extended to business-sustaining functions or business services. Many companies are assessing the viability of outsource arrangements for all general and administrative processes. For example, the finance, payroll, human resource and IT functions are now on the radar screen. Customer service is being outsourced by companies like Microsoft. Many medical insurance providers are contracting out many policy administrative functions as well. Many large firms feel that these functions are no longer a core competency and can be contracted to outside firms. In order to maintain a level of control, they are structuring contracts that involve equity stakes in the outsource provider. The early-stage sales process was never considered an area that could be performed by an outside firm. Now companies have recognized that early-stage sales is an expensive, low-probability process that is best done by a service provider to reduce risk and lower cost.

There are four main reasons for a company to get involved in outsourcing: 1) to increase strategic focus, 2) to improve processes, 3) to reduce costs, and 4) to share risks. In the past many managers have focused solely on cost reduction because it is the easiest to quantify; however, the potential value of the other types of outsourcing is equally compelling.

Strategic Focus

Keeping your sights locked on improvement is an essential part of strategic planning. Identification and execution of core competencies is essential to success. A core competency is a function or process that is critical to the success of a business. Outsourcing allows companies to keep up with best practices in other functions while remaining focused on core competencies. With outsourcing, businesses have access to highly skilled personnel without having to maintain a large staff. This is relevant in information technology. Application service providers (ASPs) develop, maintain, and enhance entire systems, giving clients freedom to focus on their business. This eliminates concerns about hardware/software upgrades, staffing, and training. What is the value proposition? A company's competitive position is improved by focus on what it does best.