Increasing the value of your business

Newsletter
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Avondale Perspective:
Time to Rebuild Your Company's Value Model

Welcome to the post-recession economy (we hope). For the past two years, you've survived by doing more with less, and now, finally, you're ready to start investing again in growth initiatives.

Or are you? Are you pulling traditional growth levers but no longer getting the results you expect? Is your management team at odds over what to do next? Are too many conflicting projects and initiatives competing for scarce resources, paralyzing your business just when aligned and focused activity is needed?

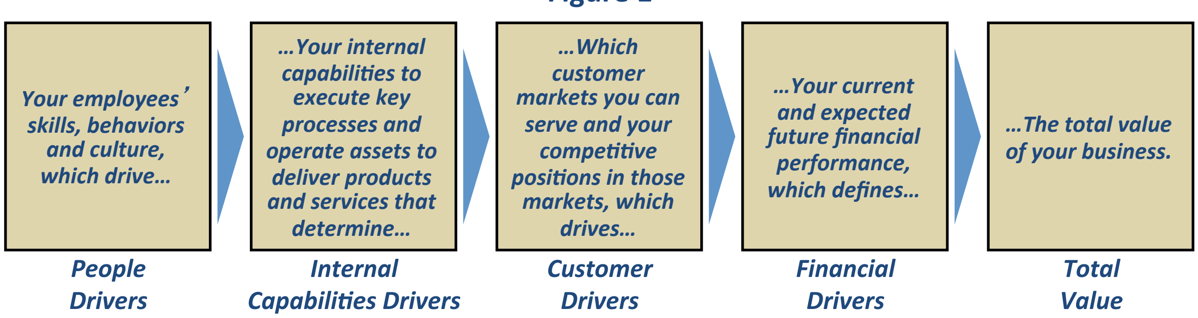
It's no wonder, really. Over the past two years, your customers have changed in fundamental ways, as have your competitors and suppliers. Your employees have changed too – at a minimum, there likely are fewer of them. As a result, you've seen shifts in key value drivers, how they affect each other, and the value they create. In other words, your company's "value model" has changed.

You and your team must align around a new value model. Even if you explicitly and completely understood your value model before the economic downturn, the new business landscape requires you to re-think it. If you didn't have a clue about your value model before the recession, there's no time like the present to develop one.

The Value Model: What Is It?

The value model is a comprehensive framework that links your company's value drivers: people, internal capabilities, customers, and financial performances – in cause-and-effect relationships that describe how and why your business creates or destroys value. The value model describes:

Figure 1



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Many companies have long used a deep understanding of their value model to guide both strategic and day-to-day decisions. These companies know that the economic upheaval of the past two years has altered their value drivers in fundamental ways and have been busy rebuilding their models to create value in the new environment.

Other companies have operated a much simpler model focused on short-term financial performance. Their models do not address the drivers of *expected* future performance, thereby leaving a large component of a firm's intrinsic value at risk. These models look something like this:

Figure 2

Mature companies, whose value drivers had not changed for years pre-recession, usually find this simpler model more efficient. Everyone knows what levers to pull to hit short-term revenue and cost targets, while long-held policies and behaviors that protect the long-term are taken for granted. But the recession has disrupted drivers in mature companies, as well. Traditional levers are backfiring, negatively affecting current performance, expected future performance, or both. These companies must build new value models to lead a transformation of traditional approaches to value creation that no longer work.

Unfortunately, many more companies have used the simple model for unsustainable or dubious value creation. Some of these companies rode a wave of market growth without really knowing why; others milked a healthy organization created by past leaders; others met revenue goals through price reduction or promotion, and cost targets through indiscriminate layoffs, hiring freezes and spending cuts. In all of these cases, current profits and often stock price will grow for a while, but at the expense of future profit and intrinsic value. These companies must build a value model and learn how to create sustainable growth, or risk destroying what is left of their value potential.

It's clear, then, that regardless of their pre-recession history, it is imperative that all companies build or rebuild their value models to capture the growth and investment opportunities that are returning to their markets.

How One B2B Company Used the Value Model

The largest player in a highly fragmented industry – we'll call them B2BCo – had enjoyed preferred access to the largest and most profitable customers in its markets for nearly four decades. Its value model was well understood throughout the company: Secure an "enabling customer" to justify purchase of new equipment capacity, modify the equipment in proprietary ways to create unique competitive advantage, then profitably sell remaining capacity into a growing market.

Figure 3: B2BCo's Traditional Value Model

For decades, B2BCo was by far the largest player in a highly fragmented market, and leveraged powerful competitive advantages in scale and engineering.

People	Internal Capabilities	Customer	Financial Performance	Total Value
• Decentralized decision makers • Loyal to local plant or office • Individual problem solvers – "heroes"	• Industry-leading, custom engineering • Localized, non-standard customer service and IS • Plant P&Ls • Equipment scale	• High volume, long run segments • Little competition for largest customers • Grow with economy	• Steady growth equal to economy plus share gain • Capital intensive • High margins • Cost of capital-plus returns	• Industry-leading multiples • 60/40 current performance vs. future expectations • Market value doubles every 7-10 years

This model worked so well for so long that outcomes were taken for granted and B2BCo reverted to the simple, short-term model. Strategic thinking was replaced by tactical planning to address predictable investment and growth requirements.

Then two shifts occurred: First, production suppliers began building key capabilities into their equipment. Previously, only B2BCo had the engineering skills to add these capabilities after-market. Competitors suddenly could add production capacity that matched B2BCo's for the most attractive customers. Second, new technologies provided substitutes for B2BCo's customers' products, which simultaneously eroded market demand at the margin. Growth slowed and margins began to contract.

Figure 4: B2BCo's Traditional Value Model Disrupted

B2BCo's traditional Value Model was disrupted by changing demand from the markets it served and increased competition.

People	Internal Capabilities	Customer	Financial Performance	Total Value
• "Siloed" functional behaviors • Insular, internal focus • Denial	• Client and industry over-capacity • Non-standard, out-of-date customer interfaces • Engineering skills ceded to equipment manufacturers	• Customer demand eroded by disruptive tech • Emerging needs for pre- and post-production service • Growth of viable competitors	• Growth less than economy • Margins capped by competitive pricing pressures • At or below cost of capital returns	• Average multiples • 80/20 current performance vs. future expectations • Market value contracting or stagnant

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Focused as it was on financial results, B2BCo failed to grasp the implications on its internal capabilities and people. So it continued to follow its traditional model for adding capacity, yet found it increasingly difficult to sell excess capacity for more than variable cost. Pulling the only levers its simple model knew, B2BCo "sold harder" – primarily on price – and cut costs indiscriminately, further eroding competitive advantages it still held.

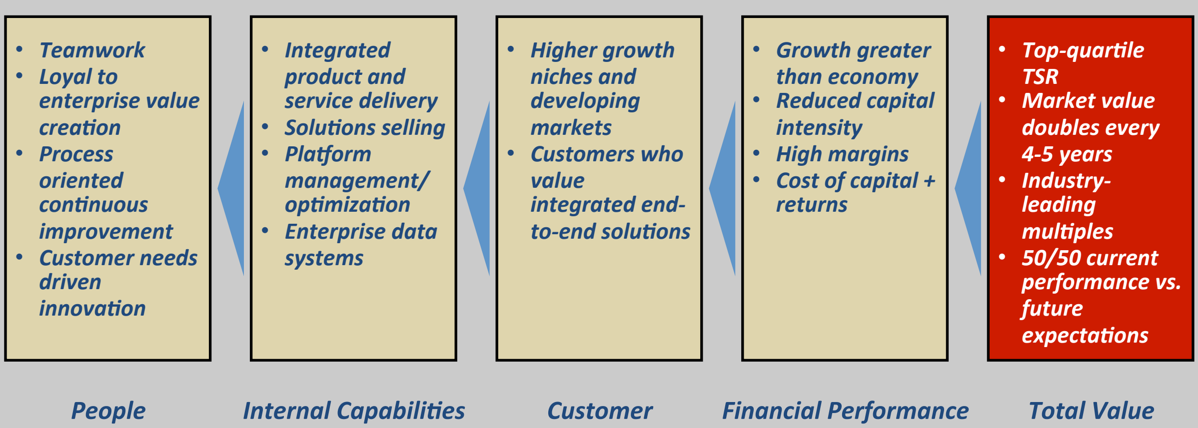
Earnings flattened, returns on investment eroded, and the company's stock price languished. Investors pressured management and the board for change.

Everyone had a different solution. Sales wanted to lower costs (to enable lower prices); IT pushed for an ERP implementation; operations supported new equipment and technology; finance argued for decreasing investment; HR wanted to increase training. The result: too many conflicting projects competing for too little money and resources, resulting in poor execution and accelerated declines in financial performance and outlook.

Successful change efforts began only when management realized the company was operating a value model that was no longer relevant and set out to build a new one. The new value model broke the logjam of conflicting and ineffective change efforts by aligning management on the priorities and sequencing of value drivers, and guided the company's resource allocation, execution, internal communications and investor relations efforts throughout a successful transformation.

Figure 5: B2BCo's New Value Model

B2BCo built its new Value Model from right to left, beginning with a consensus among management and the board around a long term goal for value growth



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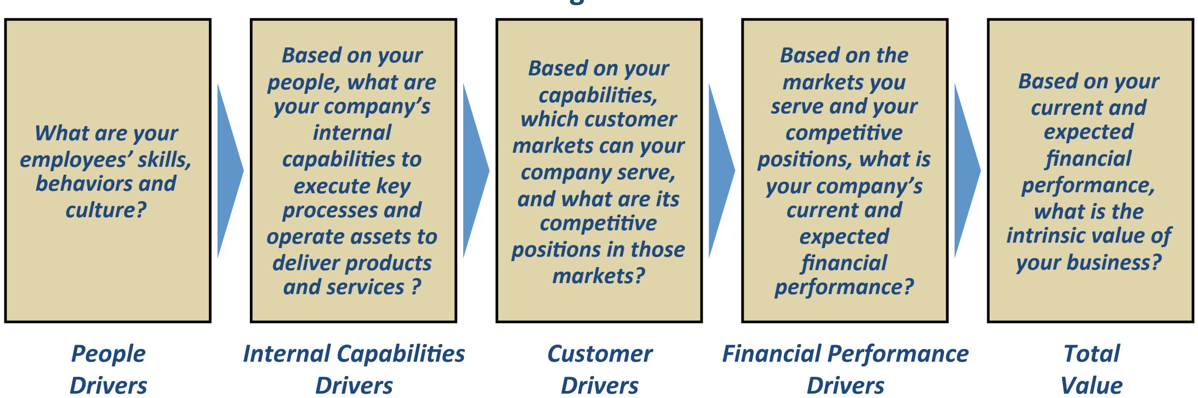
Building a New Value Model

Creating (or re-building) a value model cannot be delegated. At B2BCo, the entire senior management team held several facilitated meetings over three months to build a new enterprise value model. Six business units followed similar processes to build their own models, linked to the enterprise model. Functional and operating staffs were engaged to gather and analyze required facts between meetings.

This approach ensured that all management teams were coordinated and engaged in the resulting plans. B2BCo's experience provides a roadmap that others can use for discovering or revisiting their value model. There are three main steps:

1. **Identify the current value model.**
   You can't set a goal for value growth, or develop a strategy for getting there, without fully understanding your starting point. Identify your current model "left to right," answering in turn the questions in Figure 6. Stay grounded in facts and interpret those facts as a team. This will help to prevent biased conclusions and wishful thinking. A shared, fact-based understanding of the current value model will support a credible assessment of the intrinsic value of the company, which is your starting point for value growth.

Figure 6



2. **Establish your value growth objectives and goal.**
   Set an explicit and well-defined goal for value growth, including a timeframe. For a private company or business unit, the goal may be to double the value every X years. B2BCo, a public company, set a goal to achieve sustainable total shareholder returns in the top quartile of the S&P500. You might choose your industry peer group instead.

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Regardless of the goal, be specific about the language you use to ensure everyone understands and agrees with it. For example, what does "sustainable" mean? How will that goal be measured or observed? How and when will you know if you're achieving or falling short of the goal?

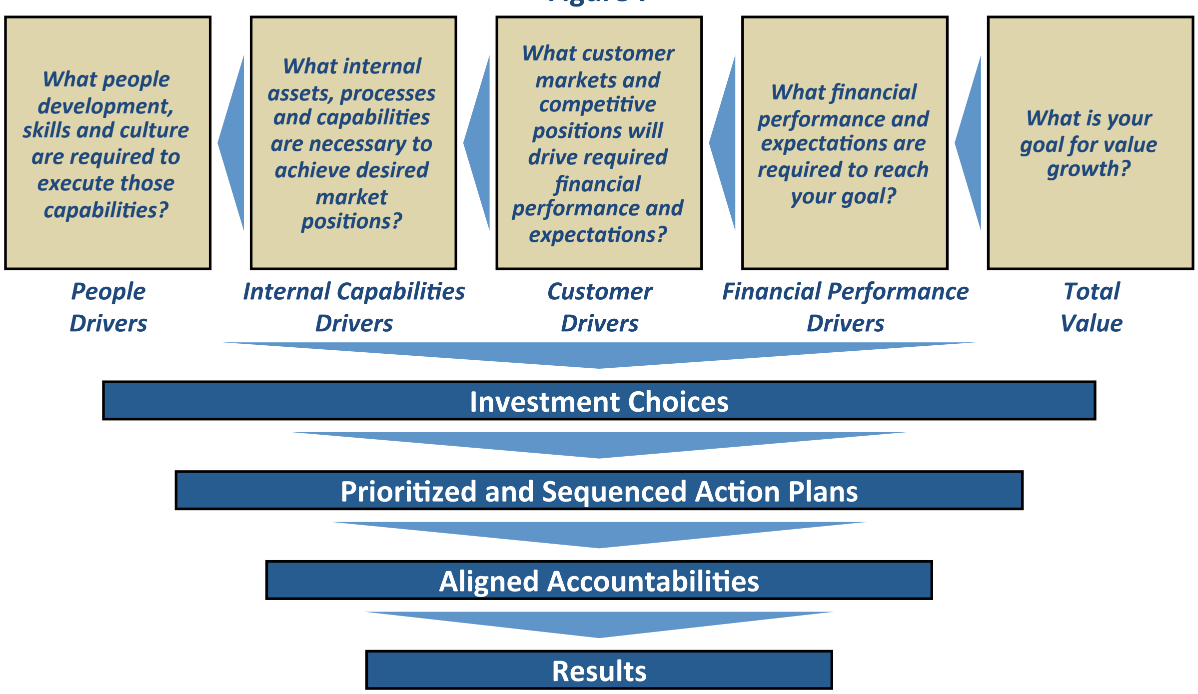
You may have to modify your initial goal as the rest of the value model is developed. At the end of the day, you want an aggressive but realistic goal and timeframe around which all constituents are aligned.

3. **Build the value model required to meet your goal.**

You worked "left to right" to identify your current value model. In this step, work in the opposite direction to determine the value model you need to achieve your goal. Your value goal defines the first "what if" in this process: If my goal is to be worth X, what levels of financial performance and expectations are required?

Continue to build the model "right to left," determining your new value drivers by answering the questions in Figure 7. Your team's first pass may be based more on logic and intuition than on hard facts. The initial model provides a framework to gather and evaluate data, test the original logic, and make necessary and appropriate changes based on deeper analysis.

Figure 7



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Differences or gaps between the new value model and your current one will reveal investment choices to close the gaps. Use your value goal to prioritize the choices and logical dependencies to sequence them. By developing the model as a team, senior management emerges from the process with aligned accountabilities.

At B2BCo, new, more attractive target markets demanded product and service consistency and reliability across the company's manufacturing platform. This in turn required major investments in new shop floor systems, processes and data management (see Figure 5). Yet management knew that previous attempts to implement ERPs had failed because its traditional value model (Figure 3) rewarded employees for being independent and local problem solvers.

This insight led the management team to invest in a comprehensive culture and behavior change initiative that emphasized teamwork and accountability across functions. The effort was directly credited with enabling the required systems investment to come in on time and on budget, and to deliver the required results.

Summary

Building your value model is a powerful exercise to align senior management, the board, employees and investors around your goal and timeframe for value growth, and the strategies for getting there. But the drivers of your value model will shift, as they have over the past two years, because of market and environmental changes and competitive responses. You must diligently measure and monitor your value drivers and adjust them as needed to ensure that the value model continues to deliver your growth objectives.

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About Avondale

Avondale advises corporations on how to create profitable growth and increase the financial value of their business. Avondale works with senior management teams across a range of industries to develop practical and actionable solutions that sustain long-term value creation.

Contact Avondale

For more information on Avondale, contact one of the Principals or visit www.avondaleconsulting.com.

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