ARCHE

Value Management

Focused on Performance Improvement and Value Creation

Value Based Strategy, Management and Economic Profit

An Introduction

Management through the Looking Glass

A simple illustration

- As the CEO of the Island Food Group you are struggling to evaluate the performance of your two major business units. Which business unit do you believe is performing better from an economic standpoint?

	Quality Foods	*Grocer's Warehouse*
Revenue ($000s)	55,000	120,000
Gross Profit Margin	45%	25%
Market Share	20%	35%
Operating Profit Margin	15%	10%
Net Income ($000s)	4,200	10,000
Net Working Capital Turnover	2.40x	6.50x
Capital Investment in Fixed Assets ($000s)	25,000	140,000
Locations	4	2
Revenue per Sq Ft	344	300
Net Income per Sq Ft	26	25
Employees	150	80

- Grocer’s Warehouse generates greater revenues, operating profit and has a larger market share than Quality Foods
- However, Grocer’s Warehouse has much more employed Capital
- ***How do you best measure performance with so many competing and, oftentimes, conflicting measurements and business objectives?***

Pitfalls of Conventional Financial Management

- ***Complexity and Fragmentation*** in financial performance measurement and strategic financial management – too many metrics and inconsistent practices, with little integration and weak performance reporting and analysis

- ***Imbalance*** in financial management with excessive focus on Operating Profit, and insufficient focus on the cost of employed capital -- an imbalance that often increases at lower levels of the organization

- ***Excessive Data Production / Insufficient Data Analysis*** – a classic problem, which elevates the role of control and compliance and diminishes the effectiveness of strategic finance and performance management

- ***Superficial Picture of Performance*** - periodic performance analysis is often limited to high level (business unit) review with little if any review of the economic performance of lower level business units / product lines / customers

- ***Excessive focus on budgeting*** subjugating the role and importance of long-range strategic and financial planning. Target setting, planning and budgeting should be better integrated, simplified and focused on value creation

- ***Heavy screening / weak accountability*** - Over reliance on capital budgeting procedures to direct capital employment and management, ex ante, will not provide ex post accountability for earning the cost of capital on investment, as financial management reverts to Operating Profit and the cost of capital investment becomes at best opaque, and at worst irrelevant

- ***Weak Linkage to Management Incentive Compensation*** – Corporate performance and governance is weaker in situations where management incentive compensation lacks objectivity, transparency and a sound economic basis. Weak implementation simply compounds the problem

Conventional versus Value Based Financial Management

Operational Profitability	*Conventional Financial Management*	*Value Based Financial Management*	
	Revenue	Revenue	*Operational Profitability*
	- Cash Cost of Goods Sold	- Cash Cost of Goods Sold	
	= Gross Profit	= Gross Profit	
	- Operating Expenses	- Operating Expenses	
	= EBITDA	= EBITDA	
	- Depreciation Expense	- Depreciation Expense	
	= EBIT (Net Operating Profit Before Taxes)	= EBIT (Net Operating Profit Before Taxes)	
		- Taxes	
		= Net Operating Profit After Taxes [A]	
		Invested Capital	*Capital Efficiency*
		x Cost of Capital	
		= Capital Charge [B]	
		Economic Profit [A - B]	

- Conventional financial management is distortive, as the generation of Operating Profit becomes the primary focus. Capital is not explicitly managed through the operational financial management system

- Value based financial management provides better balance by systematically recognizing and seeking balance between the generation of Operating Profit and the management of invested Capital

Management through the Looking Glass

A simple illustration (continued)

	Quality Foods	Grocers Warehouse
Revenue	$55,000	$120,000
Cost of Goods Sold, i.e. Purhcased Product, Labour, Energy	30,250	90,000
Gross Profit	24,750	30,000
Gross Profit Margin	*45.0%*	*25.0%*
Operating Expenses, i.e. Selling and Adminstration	16,500	18,000
Net Operating Profit	8,250	12,000
Operating Profit Margin	*15.0%*	*10.0%*
Taxation @ 25%	2,063	3,000
Net Operating Profit After Tax	6,188	9,000
Net Working Capital	22,917	18,462
Fixed Assets, i.e. Stores and Warehouse	25,000	140,000
Invested Capital	47,917	158,462
Cost of Capital	10%	10%
Cost of Invested Working Capital and Fixed Assets @ 10%	4,792	15,846
Economic Profit	$1,396	($6,846)
Economic Profit Margin	*2.5%*	*-5.7%*

Quality Foods is covering its total cost base, i.e. operational and capital cost, and therefore creating value, while Grocers Warehouse is not

- Performance management, when viewed from an economic perspective, involves balancing growth in profitability with the efficient usage of invested Capital
- Is achieving a break-even Economic Profit bad? No, as it implies that Revenue has covered all operating expenses, paid the tax bill, and provided an expected level of return to all investors
- ***Positive Economic Profit is ideal, while negative Economic Profit implies value destruction and the need for operational improvement***

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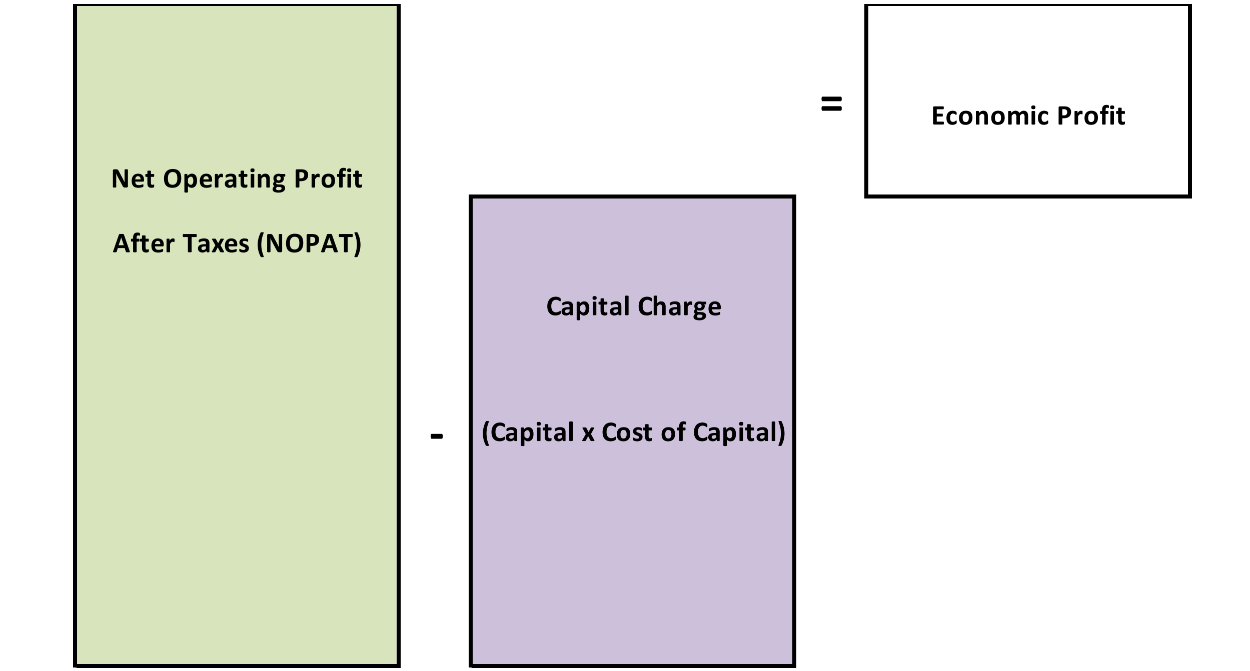
Economic Profit

The Measurement of Value Creation



- Economic Profit is a period performance measurement of the residual profitability available after all costs of a business have been covered, specifically the all operational and capital investment related costs
- Economic Profit is effectively normalized Free Cash Flow, where the one-time (cash based) investment costs of a Free Cash Flow model are converted into a series of periodic Capital Charges
- ***Significantly, the Net Present Value of Economic Profit will yield the same valuation as the Net Present Value of Free Cash Flow. Economic Profit, however, has the joint benefit of being both a performance measurement and valuation tool***

Economic Profit

Performance Measurement Outline – An Example

Operating Approach

	Net Operating Profit After Tax (NOPAT) [A]	150
	Capital	1,000
x	Capital Charge [B]	10%
=	Capital	100
	Economic Profit [A - B]	**$50**

Financing Approach

	Net Operating Profit After Tax	150
÷	Capital	1,000
=	Return on Capital, R	15%
-	Cost of Capital	10%
=	(R - C) Spread	5%
x	Capital	1,000
	Economic Profit	**$50**

- Economic Profit is a measurement of the true residual profit or value creation
- Economic Profit measures true profit as it reflects all sources of Revenue and all sources of Cost incurred by a business, i.e. both the full Operating and Capital cost structures
- Economic Profit can be readily computed from an Operating or Financing Approach, with the same end result
- While positive Economic Profit is the goal, the objective, period to period, should be to focus on the continuous improvement in Economic Profit, regardless of whether the absolute level is positive or negative

Economic Profit

Generalized Industrial Company Application

NOPAT Calculation

	Revenue	800
-	Cost of Goods Sold	500
=	Gross Profit	300
-	Selling, General & Administrative Expenses	100
=	Net Operating Profit Before Tax	200
-	Economic Taxes @ 25%	50
=	Net Operating Profit After Tax	$150

Capital and Capital Charge Calculation

	Current Assets	250
-	Non-Interest Bearing Current Liabilities	150
=	Net Working Capital [A]	100
+	Property, Plant & Equipment	500
+	Long-term Investments	200
+	Intangible Assets	200
=	Long-term Assets [B]	900
	Capital [A + B]	$1,000
x	Cost of Capital	10%
=	Capital Charge	$100

Economic Profit Calculation

	NOPAT	150
-	Capital Charge	100
=	Economic Profit	$50

- **Economic Profit** is composed of the following components:
  - ✓ ***Net Operating Profit After Tax*** – after-tax measurement of operating Revenue minus total operating expenses (definition of operating is critical, here)
  - ✓ ***Capital*** – can be viewed equivalently as the sources of Capital that finance a business i.e. Debt and Equity, or the uses of Capital that drive a business, i.e. Net Working Capital, Property, Plant & Equipment and Other Long-term Assets
  - ✓ ***Cost of Capital*** – cost factor reflecting the (investment Capital) weighted average cost of debt and equity capital

Economic Profit

How to Drive Economic Profit

Value Driver	Example Operational Drivers and Initiatives
Revenue	Improve Pricing Active Management of Discounting Grow Volume Profitably
Cost of Goods Sold	Productivity Improvement Waste Reduction Cycle time Improvement Quality Control and Defect Reduction
Selling, General & Adminstrative Expenses	Value analysis of marketing and selling expenses Active management of support costs
Taxes	Tax Strategy and Management
NOPAT	Sustainable Growth in NOPAT is the Goal
Net Working Capital	Increase Turnover through active Reporting and Management Return Non-productive Net Working Capital General Rule: Minimize Current Assets; Maximize Current Liabilities
Long-term Assets	Don't Overcapitalize *Sweat the Assets* Active Rationalization
Capital	Capital Efficiency is the Goal
Cost of Capital	Proactive Financial Stratey to lower the Cost of Capital
Economic Profit	Continuous Improvement Value is the Goal

- Identifying and linking operational drivers and actions with financial results will result in improved business and financial literacy, and ultimately economic performance, over time

- This capability can be achieved through a well designed and functioning system of Economic Profit based performance measurement and management

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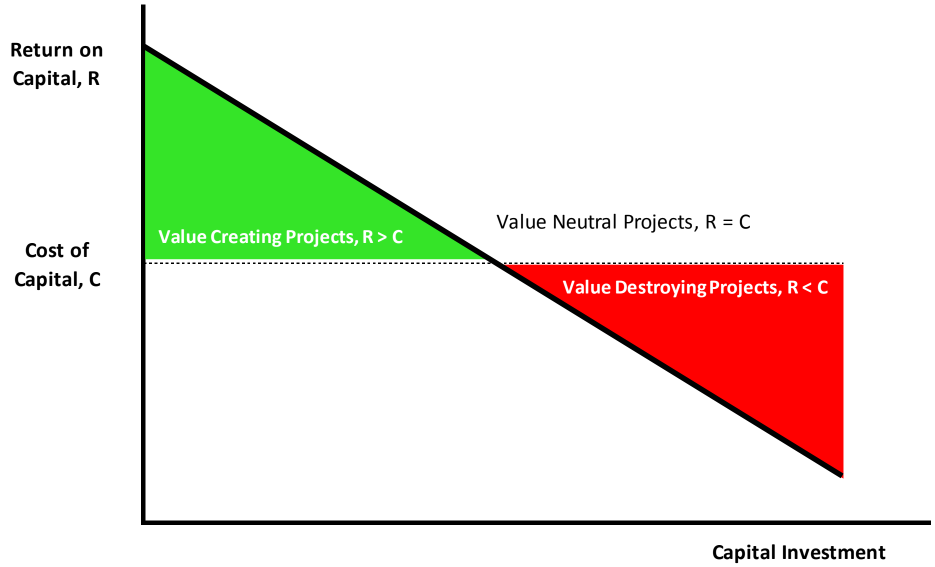
Value Based Strategy and Management

The Foundation



Value is created when R > C

Value is destroyed when R < C

Economic Profit = (R – C) x Capital

- The foundation of value based strategy and management (and business economics in general) suggests:
  - ✓ **invest when the average Return on Capital is expected to exceed the Cost of Capital of a project, over its economic life. This includes situations where the marginal expected return is below the historic average return, but above the Cost of Capital**
  - ✓ **proactively harvest and recycle Capital when the expected average Return on Capital is below the Cost of Capital, over its economic life. Delaying these actions will result in further value destruction**
- Value based strategy and management is built upon this very important investment decision rule

Free Cash Flow and Economic Profit

Equivalent Approaches

Free Cash Flow Model		***Economic Profit Model***	
	Revenue		Revenue
-	Operating Expenses	-	Operating Expenses
=	Net Operating Profit Before Taxes	=	Net Operating Profit Before Taxes
-	Taxes on Operating Profit	-	Taxes on Operating Profit
=	Net Operating Profit After Taxes (NOPAT)	=	Net Operating Profit After Taxes (NOPAT)
-	Net Investment (Change in Capital)	-	Capital Charge (Capital x Cost of Capital)
=	Free Cash Flow	=	Economic Profit

- ***Cash is King,*** as the old business saying goes. Ultimately net cash inflow over time, i.e. cash inflow in minus cash outflow, determines enterprise value. This is the basis of the Free Cash Flow model – the simple reflection of business as a cash box

- While Cash flow is a sound basis for valuation, it should not be used for performance management, as cash flow can increase of decrease for a variety of non-performance related issues

- Economic Profit is an excellent basis for a financial management system given the equivalence between Free Cash Flow and Economic Profit over time, i.e. ***Net Present Value of Free Cash Flow equals the Net Present Value of Economic Profit***, and the fact that Economic Profit is a period measurement of performance, i.e. Total Revenue minus Total Cost of the period

Benefits of Economic Profit and Value Based Management

- ***Streamlined financial management focused on value creation*** More focus and less clutter in the financial management system, with a clear focus on value creation
- ***Integrative measurement and management of growth, profitability and capital efficiency*** through the introduction of an Economic Profit based performance measurement model
- ***Better portfolio review and performance*** as Economic Profit based performance measurement and management is introduced from the consolidated company to product / customer level
- ***Integration of Performance Management with Strategic Finance*** as Economic Profit is effectively normalized Free Cash Flow, it integrates all strategic and financial management processes around the concept of value creation
- ***Improved Capital management*** and ex-post accountability for generating returns that exceed the cost of capital through the systematic introduction of a charge for invested Capital
- ***Enhanced business literacy and managerial capability*** through the introduction of Economic Profit based measurement, management, decision tools and training
- ***Better alignment*** of the goals, objectives and rewards of those who manage the business with those who own the business
- ***Greater Enterprise Value*** as the delivery of value (Economic Profit) builds into shareholder wealth (Enterprise Value and Share Price) over time

Implementing Value Based Management

Process

- Implementing value based management, generally, involves the following major steps:
  - ✓ ***Value Architecture*** - defining systems architecture for implementation of Economic Profit (EP) based performance measurement and incentive compensation
  - ✓ ***EP Based Performance Measurement*** - designing and implementing a comprehensive EP based performance measurement model
  - ✓ ***Financial Policy and Strategy*** – insuring consistency in definition and implementation of corporate and financial strategy with the practice of financial and operations management through the systematic usage of a Cost of Capital
  - ✓ ***EP Based Incentive Compensation*** - designing, calibrating and implementing an EP based system of incentive compensation
  - ✓ ***Strategic Financial Analysis*** - introducing a set of customized EP based tools for strategic financial analysis, i.e. investment analysis, business planning, and operations based financial management
  - ✓ ***Institutionalization*** - Providing comprehensive management education and training on the application and usage of value based management and Economic Profit across the company

Arche Value Management

Focused on Performance Improvement and Value Creation

- The mission of Arche Value Management (AVM) is to support client companies in their drive to improve performance and valuation through the effective implementation of advanced, value focused strategic, financial management and governance practices

- AVM is a Canadian (Toronto based) company with expertise in the design and implementation of advanced financial and strategic management technology, with the effectiveness of this technology being enabled through well designed and implemented management incentive compensation and corporate governance practices

- AVM is led by Mack Ferguson, a leading practitioner in the field of applied corporate finance and value based management technology. Mack was formerly President of the Americas Consulting Division of Stern Stewart & Co. (Canada, Caribbean, Central & Latin America, US), a pioneering firm in the field of applied corporate finance and the developer of EVA® (Economic Value Added)

- Customized consultancy services and solutions are provided in the following areas:

  - ✓ ***Business Diagnostics and Capabilities Assessment***
  - ✓ ***Business Portfolio Strategy, Valuation and Management***
  - ✓ ***Organizational Strategy and Design***
  - ✓ ***Value Based Financial and Performance Measurement***
  - ✓ ***Financial Strategy, Policy Definition and the Cost of Capital***
  - ✓ ***Value Based Business Planning and Target Setting***
  - ✓ ***Managerial Incentive Compensation***
  - ✓ ***Operations based Financial Management***
  - ✓ ***Pre- and Post-Merger and Acquisition Advisory***
  - ✓ ***Managerial Capabilities Building, Training and Education***

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Please contact Arche Value Management at the following address for more information:

Mack Ferguson
Managing Partner

Arche Value Management
116 Madison Avenue, 2nd Floor
Toronto, Ontario M5R 2S5

Tel: 416 848 7794
Email: mferguson@archevaluemanagement.com
website: www.archevaluemanagement.com