

Measuring and Managing Shareholder Value

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In recent years, the words “maximizing shareholder value” have become a battle cry for managers and directors of both public and private companies throughout North America. Following such a declaration, an organization often undergoes drastic changes such as a major restructuring or the divestiture of one or more of its business segments. But do those initiatives actually create value for a company’s shareholders? This article examines the principal drivers of shareholder value and the impact that corporate initiatives such as investment decisions, acquisitions and divestitures, restructuring, and dividend policy have on the creation or destruction of shareholder value.

Measuring shareholder value

Shareholder value is a function of the amount and timing of discretionary cash flows to the (common) shareholders of a company. Discretionary cash flow to shareholders represents a return on invested equity where it is:

- withdrawn from the business in the form of dividends, remuneration above market rates (which is common in privately held companies), and so on; or
- retained in the business for investment in incremental growth opportunities (or held in the business as a ‘redundant’ asset), thereby increasing the equity value of the business; or
- used to reduce the outstanding interest bearing debt of a business, thereby increasing the equity value component of the business’ total value (i.e. its ‘enterprise value’).

Discretionary cash flow to shareholders normally is calculated as follows:

Earnings before interest, taxes, depreciation and amortization ('EBIT-DA')
less: income taxes on EBIT-DA
capital expenditure requirements (net of the related income tax shield)
incremental working capital requirements
debt servicing costs (interest expense net of tax and changes in principal)
Equals: Discretionary cash flow to shareholders

Shareholder value is created where the discretionary cash flow to shareholders that is generated from invested equity (expressed on a percentage basis) exceeds the required rate of return on equity. Prospective shareholder value typically is best measured pursuant to a discounted cash flow ('DCF') methodology, whereby prospective discretionary cash flows to shareholders are discounted at the required rate of return on equity. This necessitates preparing cash flow projections that are both reasonable and internally consistent.

The required rate of return on equity is the return that shareholders need in order to place capital at risk given the prospects of a particular company, the nature of its operations, the industries in which it competes, and other prevailing factors. The required rate of return on equity must take into account both operating risk and financial risk. Operating risk refers to the risks associated with the principal operations of the business, such as revenue generation, cost structure, industry composition, economic factors, and so on. Financial risk represents a premium over and above operating risk where a corporation employs debt or preferred shares in its capital structure, which rank ahead of equity holders in terms of their claim against the cash flows and underlying assets of the business. Financial risk is a function of a company's capital structure (i.e. its mix of debt and equity)ⁱ.

Investment decisions

With respect to investment opportunities, such major capital expenditures, shareholder value is 'created' where the present value of prospective discretionary cash flows to

shareholders expected from the investment project discounted at an appropriate rate of return on equity exceeds the initial cost of the investment. That is, where the net present value of the investment project, measured pursuant to a DCF methodology, is positive.

A common misconception is that growth, in terms of revenues, net income, and so on, translates into higher shareholder value. This is not necessarily the case. As a simple example, assume that a company currently is expected to generate discretionary cash flow to shareholders of \$3 million per annum on gross revenue of \$60 million. Further assume that an appropriate rate of return on equity (a 'capitalization rate') is 15%. The value of the Company's equity would be calculated as \$20 million, being $\$3 \text{ million} / 15\%$.

Now assume that the company is contemplating expanding its production facilities for an initial after-tax cost of \$10 million in new equity capital, and that such investment would increase the company's annual revenue and discretionary cash flow to shareholders to \$90 million and \$4.5 million, respectively. Further assume that the required rate of return on equity (15%) remains unchanged. Under this scenario, the gross value of the company's equity, post-investment, would increase to \$30 million, being $\$4.5 \text{ million} / 15\%$. However, deducting the initial cost of \$10 million results in a net value of \$20 million. Therefore, while the expansion initiative may cause the company to grow in terms of size, it has not created incremental shareholder value.

Acquisitions and divestitures

Acquisition opportunities are an extension of investment decisions. As with investment opportunities shareholder value is created in corporate acquisitions where the discretionary cash flows to shareholders that are generated exceed the required rate of return on equity. However, the analysis of corporate acquisition opportunities often has an added element of complexity in terms of the identification and quantification of synergies and strategic advantage that may be anticipated following an acquisitionⁱⁱ.

Many companies have used corporate acquisitions as the primary vehicle when pursuing a diversification strategy. Diversification frequently is believed to reduce overall

business risk, which normally would suggest a lower required rate of return on equity and hence an increase in shareholder value. This line of thinking often stems from public-market portfolio management theory, whereby investors pursue a diversified portfolio strategy. However, many companies have discovered that acquisitions undertaken solely for the purpose of risk reduction through diversification did not produce intended results, possibly because:

- full diversification in a publicly equity market sense proved impractical at the corporate level; or
- the consequences of diversification, which frequently include a lack of management focus on one particular industry, were not sufficiently considered.

In general, public market equity investors can diversify more efficiently and effectively than corporations can, and investors often seek out ‘pure play firms’ in order to better balance their portfolios. As a result, in recent years, many businesses that previously were conglomerates have divested of their ‘non-core’ operations to focus on their principal business.

Corporate restructuring

Companies frequently seek to restructure their operations in an attempt to create shareholder value. Restructuring initiatives may include the divestiture of one or more operating segments, the realignment of various divisions, significant changes in senior management personnel, and so on. Restructuring decisions should be consistent with a corporation’s overall strategy.

The assessment of a particular operating segment or division should not only consider the amount of discretionary cash flows generated by that segment, but also the resources that are required to generate said cash flows, including capital assets and working capital. Further, it is important to consider both the cost-benefit of an operating segment on its own, as well as in conjunction with the business’ other operating segments. Therefore,

while a particular operating segment may not be expected to generate a return on capital that is adequate to justify its continuity on a stand-alone basis, the implications of discontinuing that segment on other operating segments of the business must be considered. There may be important strategic reasons for retaining a particular operating segment that cannot be readily quantified.

In some cases, although a particular operating segment is expected to generate acceptable returns, there may be an opportunity to create greater long-term shareholder value by divesting of the segment and re-deploying the proceeds into other segments of the corporation. In some cases, a third party purchaser may be willing to pay a significant premium over the 'stand-alone' value of an operating segment based on synergies it anticipates will arise following the acquisition. Again, the implications of the divestiture on the remaining segments of the business must be considered.

Restructuring initiatives typically are costly. In addition to the tangible costs such as severance, there are intangible consequences caused by such things as employee uncertainty and the resultant loss of 'knowledge assets' that frequently occurs. Managing the restructuring process to avoid unanticipated issues is at least as important as deciding on what restructuring initiatives to undertake.

Dividend policy

Dividend policy normally is viewed as an extension of the capital structure decision. In theory, a company should pay dividends where its investment opportunities are not expected to generate a return that is at least as high as its required rate of return on equity. The payment of dividends provides shareholders with a direct source of value in the form of immediate cash, as opposed to an indirect source of value in the form of higher equity value on a per share basis through reinvestment of discretionary cash flows into the corporation.

Dividend policy typically is more a concern in publicly held companies whereby the Board of Directors attempts to manage shareholder expectations pursuant to regular

dividend increases. Dividends provide a 'signal' to the public equity markets as to management's expectations of the company's prospective cash flow generating ability. As a practical matter, public companies typically are hesitant to decrease dividend payments given the usual short and mid-term implications on the company's stock price, and resultant 'hostile' shareholders meetings following dividend cuts. Further, many managers (of both private and public companies) prefer to reinvest discretionary cash flows into a corporation for the self-serving purpose relating to the benefits of managing a larger corporation (which may include manager ego and higher remuneration).

Finally, a corporation's dividend policy must take into account the tax situation of its investors. In light of recent tax changes in Canada, individuals pay a lower rate of tax on capital gains realized through higher values per share as contrasted with the effective tax rate on dividend payments.

Conclusions

Shareholder value creation stems from management's ability to generate discretionary cash flows to shareholders in excess of the required rate of return on equity. A DCF methodology typically is the best approach for measuring shareholder value. Strategic decisions involving investment opportunities, corporate acquisitions and divestitures, restructuring, and dividend policy all have long term economic implications to a corporation and the value that it creates for its shareholders. In the end, shareholder value analysis is a complicated undertaking that necessarily involves subjectivity and judgment. However, by understanding the quantitative and qualitative implications of various corporate initiatives, managers should be better able to make informed decisions that will positively influence shareholder value over the long term.

ⁱ For more on the topic of rates of return, see "Kicking the Tires: Determining the Cost of Capital in an Acquisition Target", *CMA Management Magazine*, May 2001.

ⁱⁱ For more on the topic of synergies, see "Creating Synergies: Realizing the Strategic Value of Acquisitions", *CMA Management Magazine*, July / August 2000.

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