Are you creating value for your firm?

It’s a tough world out there and only firms that succeed in creating value will survive in the long-term. The key is to focus on what your customers really want.

Economic crises are not without a silver lining for those who can recognise a good deal. Amid the wreckage of recession, “There are plenty of opportunities as long as you have the talents and skills to manage them,” says Kevin Kaiser, INSEAD Professor of Management Practice, and Director of INSEAD’s Advanced Valuation Programme to be held in September 2012 in Paris.

It’s not just a matter of buying up assets at bargain-basement prices, however. The price you pay is one thing, but the value that you generate, or fail to generate, is quite another. Winning a bidding contest is easy if you don’t care about value destruction, Kaiser says. “You just pay the price that wins.” But winning and creating value is much harder. Cheap prices don’t necessarily equate with good value.

“That requires both an understanding of value and of the business you are buying as well as the skills and ability to deliver the value in a way that more than compensates for the price you paid."

Misguided incentive schemes

Kaiser also believes that focusing on the bottom line alone is another cause of value destruction. When boards of directors "end up orienting their company around short-term targets that often require value destruction in order to deliver, they pay people, literally, to blow up the company". Kaiser points a specifically accusatory finger at boards of directors who design incentive schemes for their senior executives based on short-term indicators such as market share, earnings per share or their company's share price. Sometimes, he says, these targets can only be met by destroying value rather than creating it. That happens, for example, when companies sell products at prices below production cost in order to boost short-term sales.

Such strategies can work for a while. A car manufacturer can sell a lack-lustre model by offering discounts, special payment terms and other incentives. An airline can fill seats even though its planes are uncomfortable and often delayed as long as travellers have no alternatives. In the long run, however, such companies go to the wall.

Why companies fail

Value destruction has certainly been evident amid the current financial and economic crisis. Firms have laid off millions of workers, factories have been left idle and construction projects unfinished. Rather than being a result of the crisis, however, Kaiser says, value destruction has been at the root of it, and it has been taking place over decades.

Now, as its full extent becomes apparent, the crisis is entering a phase in which "people are finding it more and more difficult to sustain what has become unsustainable." This creates opportunities to reallocate inappropriately deployed resources to more profitable areas. For the process to be profitable, however, these resources must be managed efficiently.

Many companies fall by the wayside, either because they fail to adapt to changing circumstances or because they follow misguided strategies. Instead of reallocating resources to take account of new market conditions, they "keep people in jobs that they shouldn't be in and don't allow them to adapt and develop the skills needed to be relevant and value-creating," says

Kaiser. Instead of trying to understand what people want and then producing and selling it, they “focus on selling the customer what they have to sell”.

A Darwinian view

A 20-year veteran at INSEAD who has worked on mergers and acquisitions strategy at McKinsey & Company and on business finance at a venture capital-financed start-up, Kaiser takes a Darwinian view of corporate endeavour. In the cut-throat world of commerce, he asserts, only the fittest firms survive.

The key to success, as he sees it, is a proper understanding of value and how to create it. Deliver value on a project and you will prosper. Destroy value and you are doomed.

Creating value is the theme of Kaiser’s teaching at INSEAD. Among the many skills required for successful acquisitions and investments, Kaiser says, “The first is to understand the value of what you are buying and the second involves your ability to manage the business once you have bought it.”

Understanding the value of an investment requires a long-term view. In the context of an acquisition, Kaiser explains, value consists of “the cash flows that you now have access to because of what you just bought”.

Calculating investments

Start by calculating what he calls the “free cash flow”, i.e. the cash that will be left over after you have paid for the initial investment plus also all future costs, including salaries, payments to suppliers, taxes and future investments in the business.

Then adjust this figure to take account of the period over which the cash will become available. That gives you the estimated “present value” of the acquisition, enabling you to calculate the return that you can expect from your investment. Compare this with the “opportunity cost of capital”, i.e. what could have been earned by deploying the resources on an alternative project of similar risk. For example, for an investment of very little risk, a comparable investment might be in government bonds of a government with very low default risk.

If all these calculations turn out positive, you may be onto a winner. But once you have acquired the asset, the next challenge is to manage it. What companies should be doing, he says, is focusing on customer satisfaction. “There are lots of customers out there and they love their iPhones, their flat-screen TVs and their new cars. If you are willing and able to provide these things and cover your costs, using your people efficiently while you do it,” says Kaiser, “there are lots of opportunities.”

Kevin Kaiser is Professor of Management Practice and Director of ***Transition to General Management*** *and* ***Advanced Valuation Programme*** *at INSEAD.*

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