

VALUE-BASED MANAGEMENT – It’s Still Around and Evolving Into A “Best Practice” 3-Dimensional Operational Tool

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In our April column we ended with a challenge: “Find value-drivers at all levels of your organization and translate them up and into the whole company.”

What is a Value-Driver?

A value driver is any variable that affects the value of the company. However, to make useful, value drivers need to be organized in a manner so that managers can identify which have the greatest impact on value and assign responsibility for them to individuals who can help the organization meet its targets.

The most important part of VBM is a thorough understanding of the performance variables that will actually create the value of the business—the key value drivers. It has to act on things it can influence—customer satisfaction, cost, capital expenditures, and so on. Additionally, it is through these drivers of value that senior management then learns to understand the rest of the organization and can establish a dialogue about what it expects to be accomplished.

Value drivers are defined at a level of detail consistent with the decision variables that are directly under the control of line management. Chart below shows that value drivers can be useful at three levels:

- Generic, where operating margins and invested capital are combined to compute ROIC;
- Business unit, where variables such as customer mix are particularly relevant;
- Grass roots, where value drivers are precisely defined and tied to specific decisions that front-line managers have under their control.

Focused Goal Sites

Strategies for maximizing value are agreed, they must be translated into

specific focused goal sites. Goal sites are highly subjective, nonetheless its importance cannot be overstated. Goal sites are the way management communicates what it expects to achieve. Without goal sites, organizations are directionless. Set sites too low, and they may be met, but performance will be ordinary. Set them at unachievable levels, and they will fail to provide any motivation.

In applying VBM to Focused Goal Sites, numerous general principles should be applied:

- Base your Goal Sites on key value drivers; include both financial and nonfinancial targets. The two together prevents “gaming” of short-term financial targets. One solution is to set a nonfinancial goal, such as progress toward specific R&D objectives, in parallel with the financial targets.
- Adapt the Goal Sites to the different levels within an organization. Senior business-unit managers should have targets for overall financial performance and unit-wide nonfinancial objectives. Functional managers need functional Goal Sites, such as cost per unit and quality.

- Connect short-term Goal Sites to long-term ones. Ten-year Goal Sites express a company’s aspirations; three-year Goal Sites define how much progress it has to make within that time in order to meet its ten-year aspirations; and one-year Goal Sites is a working budget for managers. Ideally, set Goal Sites in value: However, value is always based on long-term future cash flows and depends on an assessment of the future, short-term targets need a more immediate measure derived from actual performance over a single year. Economic profit is a short-term financial performance measure that is tightly linked to value creation.

Economic profit measures the gap between what a company earns during a period and the minimum it must earn to satisfy its investors. Maximizing economic profit over time will also maximize company value.

It is defined as:

Economic profit = Invested capital × (Return on invested capital—Weighted average cost of capital)

Next month we will cover VBM Action Plans & Budgets. **CW**

Levels of Value Drivers

