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Putting value back in value-based management

Value-based management programs focus too much on measurement and too little on the management activities that create shareholder value.

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Value-based management (VBM) burst onto the scene a decade ago with a revolutionary promise: a company that traded in traditional management approaches in favor of VBM could align its aspirations, mind-set, and management processes with everyday decisions that truly add shareholder value. Name the initiative—investing in a new project, say, or spinning off a subsidiary, or implementing new customer-service guidelines—and management could not only pinpoint better projects but also better understand the value they would create for shareholders. Indeed, well-implemented VBM programs typically deliver a 5 to 15 percent increase in bottom-line results.

Sadly, even as VBM has evolved, most programs are notable more for their implementation shortfalls than for their successes. In our ongoing work and discussions with executives, we have begun to identify a few common pitfalls that have repeatedly plagued underperforming VBM programs going back years as well as some newer wrinkles that stanch the benefits that VBM can deliver. We've also developed an anecdotal view of how the most successful practitioners push the principles of VBM to achieve its real promise for shareholders.

Simply put, ailing VBM programs typically settle for merely measuring value creation in business initiatives, while successful approaches push to link tightly the measurement to how the business can be improved. For example, some companies mechanically measure historical performance but then fail to apply what they've learned to the strategies from which value should flow. Most also neglect to account for future growth and sustainability. Others make this important link but then set targets in ways that fail to mobilize the troops needed to make VBM pay off. Still others go to great lengths to implement VBM programs but then relegate them to the finance department, where they languish without the commitment of senior-level management.

Troubled VBM programs do not necessarily manifest all these symptoms at once. In our experience, however, the vast majority suffer from at least one. Moreover, the best practitioners have learned to overcome them and can provide guidance about how to push VBM to better fulfill its potential.

Missing the link between measurement and value

The original breakthrough of value-based management was to draw attention to the failure of traditional accounting measures, such as net income and earnings per share, to account for the cost of capital. Traditional managers focused far more intently on improving cost and gross margin and paid little if any attention to the capital invested in the business. As a

EXHIBIT 1

Metrics designed to measure value have strengths—and weaknesses

Traditional P&L and balance sheet approaches	Value creation: historical metrics	Value: forward-looking metrics
• Revenues • EBITDA[1] • Net income • Book value • ROS[1] • EPS[1] (diluted or not)	• Return ratios –ROE[1] –ROCE,[1] ROIC[1] –ROA[1] • Economic profit or EVA[1]	• DCF[1]-value • Discounted EVA[1] • IRR[1] • CFROI[1]
• Relevance for management declining, but still widely used by companies for communication to investors (e.g., EPS) • Economic cost of the capital invested ignored • Growth, long-term performance, and sustainability not taken into account	• Widely used concepts orientated towards taking into account the economic cost of the capital in the business • Growth, long-term performance, and sustainability not taken into account	• Required for active management of company's value • Explicit consideration of growth and long-term impact of decisions • High correlation to market value of company • Much harder to measure accurately and so can be gamed

[1] EBITDA = earnings before interest, taxes, depreciation, amortization; ROS = return on sales; EPS = earnings per share; ROE = return on equity; ROCE = return on capital employed; ROIC = return on invested capital; ROA = return on assets; EVA = economic value added; DCF = discounted cash flow; IRR = internal rate of return; CFROI = cash flow return on investment

Source: McKinsey analysis

result, it was common to find projects in which much of the capital deployed in businesses was wasted.

As managers focused on value creation and the true economic cost of capital deployed in the business, VBM proponents introduced metrics to measure a business's or program's value, including return on invested capital (ROIC), economic profit, cash flow return on investment (CFROI), or economic value added (EVA™).[1] The advantages of different measures vary (Exhibit 1), but they all attempt to recognize the cost of capital in the benchmarks managers use to gauge the value their decisions create.

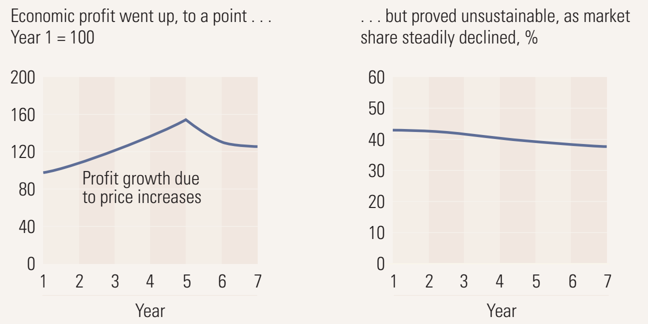
Yet many companies fall into the trap of focusing their measurement too much on historical returns, which are easily quantified, and too little on more forward-looking contributors to value: growth and sustainability. For instance, one consumer goods company (Exhibit 2) was able to demonstrate strong economic returns for five years as measured by economic profit. But because the company delivered its growth by increasing prices, it ultimately damaged its customer franchise and could not sustain its growth rate.

Companies that apply VBM at a more advanced level move beyond measurement to help the management team focus on the levers that can be used to improve the business. The best programs use value trees[2] to identify underlying drivers of operating value. These have long been at the core of VBM theory, but we find that they are still conspicuously missing in many applications.

Savvy VBM practitioners use these trees to identify areas of improvement, pushing deep into a business's operating performance and comparing it with others to create clear benchmarks. These benchmarks can also be pegged to the performance of peers outside the company, or to the performance of similar internal businesses. One particularly informative and credible internal benchmark comes from analyzing the historical

EXHIBIT 2

Financial measures alone are inadequate



Source: McKinsey analysis

performance of the same business over time. For example, one processing company's analysis found that daily performance alone varied so widely that the management team didn't need to look for outside benchmarks. Instead, they could improve the overall performance of the company enough just by focusing their efforts on the levers that led to the most severe underperformance on bad days.

The error in focusing on targets rather than how they are set

A second common VBM pitfall stems from the way executives set performance targets and hand them down to the individuals responsible for meeting them. These targets may seem perfectly reasonable to the managers who set them, but they often appear arbitrary and unrealistic and convey little sense of ownership to the teams that receive them. In our experience, only when those assigned to meet the targets also actively help in setting them is a company likely to generate the understanding and commitment needed to deliver outstanding performance (Exhibit 3). Indeed, we find the process of setting targets to be the single biggest factor in delivering superior VBM performance.

Consider the experience of one global consumer goods company. When the corporate technical manager ordered that all the company's bottling lines should achieve 75 percent operating efficiency, regardless of their current level, some plant operators rebelled. Operators at one US plant, concluding that at 53 percent their plant was running as well as it had ever run, worked only to maintain performance at historical levels. Yet after the plant launched an inclusive process to permit the operators to set their own performance goals, they raised performance levels above the 75 percent target over a period of only 14 months.

The most effective VBM programs fine-tune this dynamic even more. As they set targets, some build in a challenge from peers running similar businesses. This approach helps to stretch targets, to highlight accountability in view of peers, and to create the sense of commitment and purpose that comes from collaborating on tough issues. Because colleagues running similar businesses will be familiar with all the opportunities for improvement, they will be much more effective than line managers at providing such challenges. Companies that have excelled at VBM programs arrange them not only on overall profitability but also on capital expenditure, growth, pricing, and costs—as well as performance during the year. Others create formal processes that encourage mutual support among colleagues to improve the performance of the business. At one of Canada's largest privately held companies, for example, stronger performers are explicitly assigned to help their colleagues who are not performing as well.

Or consider how one chemical company designed a more effective way to review

EXHIBIT 3

Involve managers early in KPI[1] definition process to ensure acceptance and accountability

Success factor	This	Not this
Guided self-discovery	• Managers discover the key value drivers and KPIs for themselves • The process, rigor, and insights will be shared between units	• External team (or a staff team) does the analysis and develops value drivers and KPIs
Strong senior management leadership	• Management actions and messages emphasize value creation and value-based shaping of the management agenda	• Senior managers, publicly or privately, communicate or act in ways that do not reflect the value drivers and KPIs
Inclusive and open communication	• Relevant staff is involved both in analysis and rollout, with a clear understanding of the ultimate objective	• Staff is told what the new value drivers and KPIs are
Fact-based debate and challenge	• Discussions and decisions are based on facts	• Discussions and decisions are based on personal preferences and past actions
Link to 'real deliverables'	• KPI framework leads to clear assignment of accountabilities for targets and actions	• KPI work is done separately from the budget and targeting processes

[1] Key performance indicator.
Source: McKinsey analysis

performance. A year after introducing a VBM approach to make reported data more transparent, the company had yet to see the improvements it expected. Worse, nearly everyone in the organization recognized that official discussions about performance were something of a sham. Some managers misrepresented reports of their actual performance in order to create the appearance of meeting targets; others built enough slack into future performance targets to make sure they would easily be met.

The company's response: change the review process. What had been a one-on-one review involving the division head and unit leader became a broader discussion between the division head and all unit leaders together. And rather than simply reviewing the data, the meeting focused on the most important lessons from the previous reporting period, as well as the greatest risks and opportunities expected to appear in the coming reporting period. Emphasis at the meeting shifted away from individual successes and failures to a combination of shared lessons and problem solving on future risks and opportunities.

Next the company introduced a series of peer meetings among unit leaders without the division heads present. These meetings aimed to review plans and identify risks and opportunities in order to set priorities for allocating capital and resources. In the first year of operating under the new processes, capital outlays dropped 25 percent and underlying profits, adjusted for the usual modulations of the business cycle, rose by 10 percent.

Not ingraining VBM in day-to-day business processes

Setting targets and committing to meet them is one thing. It's another to make sure that performance targets are acted upon. This process happens by making certain that specific individuals are accountable and responsible for making decisions and by guaranteeing a link between performance and an individual's evaluation process.

One energy company, for example, implemented a VBM program that seemed to have all the right parts. But management then failed to carry it over from a discrete program in the finance department to engage the entire company. This result was despite the fact that the company's finance team developed a first-rate scorecard covering financial performance, operating drivers, organizational health, and customer service. Nearly a year later, there was no discernible impact. Beyond top-level conversations, few of the company's managers used the scorecard—some didn't even know what it was. They had had no involvement in the program's development, little understanding of why the new scorecard was necessary, and no incentive to use it. The few that did use it found that targets regularly were missed.

Until a VBM program is an integral part of how a company manages, it will always be simply something else to do and will inevitably fail.

Some companies overcome this pitfall by using a formal performance contract to explicitly link the key performance indicators—such as sales, profit margin, return on investment, and customer satisfaction—with roles such as sales manager, business unit manager, finance manager, and call-center manager respectively. This link forces an explicit conversation to take place about whether roles and decision rights are correctly lined up. Other companies link their people-evaluation system to hitting targets, with explicit rules about dismissals for individuals who fail to meet their targets more than once. By tying performance evaluation and compensation to individual objectives, performance can also be aligned with the objectives of the VBM program.

A rule of thumb: until a VBM program is an integral part of how a company manages, it will always be simply "something else to do" and will inevitably fail as employees continue to perform as they always have. Finance department input is essential, for example, but delegating VBM to the finance department as a discrete, isolated program is a surefire way to snuff its potential.

Too few VBM programs have fulfilled their early promise. But recognizing common patterns in programs that have gone awry is a first step in moving VBM closer to its goal to help line managers deliver better performance for shareholders. **MoF**

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[1] EVA is a registered trade mark of Stern, Stewart & Co., New York, and is synonymous with the more generic term, "economic profit."

[2] Tom Copeland, Tim Koller, and Jack Murrin, *Valuation: Measuring and Managing the Value of Companies,* third edition, New York: John Wiley & Sons, 2000.

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