ECONOMIC VALUE CREATION IN SPAIN: AN OVERVIEW OF BEST PRACTICES

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Abstract

To create economic value is the objective of any business organization. Focusing the company's activities on the creation of value represents a cultural change that must be carefully managed, and it is no easy task. But it may become impossible if the proper issues are not addressed, and the operating solutions are not provided. An organization interested in implementing management models based on creation of value must ask –and answer- the following questions:

a) What is economic value?

b) How is this economic value measured in the organization?

c) Which are the main problems to be resolved to implement this value orientation?

This document includes the findings obtained when analyzing how a series of non-financial Spanish companies, in the process of implementing value based management models, have replied to these questions. In the sample selected there are companies listed in the Madrid Stock Exchange and others that are not. The companies listed in the Madrid Stock Exchange represent fifty percent of total market capitalization value when the study was carried out (end of 1999), and are leading edge in creation of value, according to a rank by Expansión-Stern Stewart. The companies not listed in the Madrid Stock Exchange are eighty percent multinational subsidiaries listed in their respective countries, and pioneers in the introduction of these techniques and in value creation, according to a recent rank of Business Week magazine. The sample therefore, comprises large non-financial capital intensive companies, in the process of implementing value based management models and on the leading edge of value creation, according to reputable classifications.

The results are discussed in terms of their significance for financial theory and their practical implications for value management.

Keywords

Economic value, value creation, best practices, value management.

Introduction

In the business world there is a lot of talk about value creation. A high number of managers consider it an indispensable objective, an essential commitment, a measurement of the success of the strategy undertaken. Lists of the companies that generate the most value are published, objectives to create value in specific amounts and defined periods are taken on, and corporate statements and images are adopted in order to reinforce the management team's commitment with this objective. All seem contestants in a race in which no one wants to be last.

Indeed, rarely and on few issues has there been a greater consensus on the need to base management actions on value creation. Likewise, rarely and on few issues has there been a greater gap between the objective pursued and the implementation of specific measures to enable it: creating sustained economic value in a business organization is a rather more complex task than making wishes and/or setting up more or less willing and well-meaning goals.

To base management action on value creation it is necessary to pose the proper questions, understand their meaning and provide answers that best suit the organization. This is not usually easy when the basics are not clear. The work of basing management actions on economic value creation must not be confused with finding a universally accepted magic formula that will solve all the company's problems. On the contrary, this focus admits different solutions to different problems, but has the common denominator of focusing the organization and each one of its members on economic value creation.

The experience of many companies trying to introduce value based management, reveals that the process represents a cultural change in the organization that must be managed and for which it is necessary that all stakeholders have operating solutions, in their area of responsibility, to questions such as:

- What is creating economic value?
- How is that economic value measured?
- What activities create value?
- How is the necessary information obtained to measure that value creation?
- What means are available to create value?
- What amount of value must be created during a specific period?
- How will that work be compensated?
- What are the areas for improvement in value creation?

Obviously, the success of value based management depends on the answers to these questions, bearing in mind that any solution must combine the right concept with the actual possibilities of application in the organization. In this regard, there is a general consensus on the critical factors that must be considered when implementing a value based management model, among which the following stand out:

- 1) Define economic value metrics that are operative and easily understood by the whole organization.
- 2) Obtain explicit support from Senior Management.

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- 3) Gain acceptance from those involved in the process, which requires establishing the proper communication channels and the training means necessary.
- 4) Show how it helps decision-making in the whole organization, and not only the finance department.
- 5) Integrate this focus on value creation with planning and control tools.
- 6) Clearly establish the basic concepts and focus on practical applications.
- 7) Ensure availability of data for example, information on property of business units.
- 8) Define standardized formats for internal and external reporting system.
- 9) Link compensation system to value creation.
- 10) Link operating decisions -short-term- and resource allocation decisions -medium and long-term- to value creation.

Table 1 shows the most recent evolution of the Value Based Management concept, from a more conceptual initial focus to final practical situations.

Table 1

EVOLUTION OF VALUE BASED MANAGEMENT			
	Phase I	Phase II	Phase III
STAGES	Financial Engineering (1980's)	Value Metrics (1990's)	Performance Metrics (end 90's and 2000's)
REFERENCE	RJR Nabisco	Culture of owner behavior	Create value: better than competitors
EMPHASIS	Restructure Spin-offs Corp. Control	Cash Flow. Cost of Capital	Implementation Sustainability Motivation/Comp.

In theory it all seems reasonable and logical, but experience shows that when one tries to apply principles that seem obvious, difficulties usually arise. There is plenty of literature describing the main practices used by companies in the process of implementing value based management models. And the limitations encountered along the way. This study aims to describe analyze and discuss the situation in Spain, through the information provided by a series of companies that are pioneers in the implementation of these principles.

Objectives and scope of the study

In line with similar studies referring to other countries, especially the United States, this report intends to identify the main problems originated in a business organization in Spain when it tries to apply the value based management principles. Specifically, the following areas were analyzed:

- 1. Metrics used to quantify the creation of economic value.
- 2. How operating objectives -short-term- and those of capital allocation -medium and long term- are related to value creation.

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- 3. How the compensation system is related to the creation of value.
- 4. How these principles have been implemented and which have been the main obstacles encountered.

The list of companies surveyed, through a questionnaire and personal interviews, is included in Annex 1.

The sample selected is made up of non-financial Spanish companies that are implementing value based management models. The companies listed in the Madrid Stock Exchange represent 50% of the total market capitalization when the study was conducted (end of 1999), and are leading edge in creation of value, according to a rank by Expansión-Stern Stewart. The companies not listed in the Madrid Stock Exchange are 80% multinational subsidiaries listed in their respective countries, and pioneers in the introduction of these techniques and in value creation, according to the latest rank of Business Week magazine. The sample therefore, comprises large non-financial, capital intensive companies, in the process of implementing value based management models and on the leading edge of value creation, according to reputable classifications.

Annex 2 includes a summary of the questionnaire sent to the companies, and may serve as a self-test on the undertaking of these concepts in one's own company.

Annex 3 shows the results of a similar study carried out in USA.

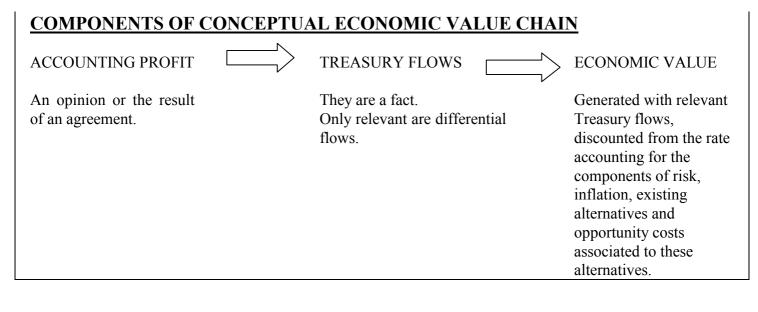
Summary of main findings

Metrics of economic value

Accounting profit presents significant concept limitations when used as a measure of economic value creation. Economic profit tries to bridge some of these gaps, including considerations on fund generation, cost of opportunity and risk level.

In a diagram, the conceptual connection between the accounting profit and the economic profit can be represented through the components of the so-called economic value concept chain as shown in Table 2.

Table 2



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Based on the accounting profit, cash flow generation is deducted through three different ways: operations, investments and equity compensation. These funds, discounted at the appropriate rate for the existing risk level, will determine the business economic profit.

It is evident that in the course of this conceptual value chain, what is gained in theoretical correctness may be lost in simplicity of calculation and application. As so many other times, a compromise must be reached to prevent the best becoming the enemy of the good.

This seems to be the situation of the companies analyzed, since most of them (81%) use accounting profit metrics -operating profit- as an indicator of economic value. Around 44% also use some economic profit metrics (mainly EVA, MVA and CVA), while 61% remain half way, considering Operating Cash Flow an economic value indicator.

In summary, less than half of the companies use conceptually "correct" value metrics, although most have overcome what some authors call the "myopia of accounting results".

The immediate question is: is this good, bad, or indifferent? The answer is: it depends. What does it depend on? Basically on the existing awareness of the limitations of the metrics used and that they be used consistently.

Regarding the first point, Table 3 shows the results obtained on the level of satisfaction with the value metrics used. The analysis of these data allows drawing the following general conclusions:

- 1) There is no awareness of the problem of using value metrics, which are deemed to reflect the business economic results properly.
- 2) There is, therefore, a tendency not to distinguish between accounting profit and economic profit.
- 3) An inconsistency has been identified between the metrics used and their application in medium and long-term decision-making (allocation of resources, valuation).
- 4) Only companies that use metrics based on economic profit use them as tools for short and long-term decisions.

To research the consistency in the use of metrics two points were analyzed: business value drivers and base parameters upon which the company establishes objectives. In both cases results were those expected. Thus, most companies mention value drivers referred to balance sheet -turnover (72%), pricing policy (39%)-, while those related to property or future variables are less frequent –control of current assets (22%), innovation (14%). On the other hand, internal objectives reflect the existing concept on economic value: all companies have objectives based on net accounting profit, 75% also use operating cash flow and only 31% mention as well an economic profit objective.

In short, the companies analyzed mostly use value metrics based on accounting profit, which they consider appropriate and they apply consistently. The companies not using economic profit metrics are aware of the limitations they face to link short and long term decisions using that value metrics. The next section covers this issue in depth.

Table 3

LEVEL OF SATISFACTION WITH VALUE METRICS

1. <u>Appropriateness of value metrics used by your company and the following statements</u> (rank from 0 to 10, where 10 equals total agreement)

Metrics used in my company properly reflect business economic performance

7.8

Metrics used in my company provide a fair and motivating base to measure management performance

7.3

Metrics used in my company present a balance between short and long term vision

6.3

2. <u>Benefits associated with using value metrics in your company (percentage of companies</u> <u>mentioning the item indicated)</u>

Allows establishing clear individual objectives	55%
Used as criterion for resource allocation	39%
Allows uniform communications	36%
Used in valuation decisions	22%

Planning process and value creation

83% of companies have a formal medium and long-term planning process, and 63% establish objectives for the metrics used. In this planning, 86% of the companies use non-financial value indicators, while the remaining 14% only use financial indicators.

What are the most frequently used non-financial indicators? The following:

Strategic needs	39%
Market share	30%
Quality	22%
Job safety	17%
Environment	13%
Customer satisfaction	9%
Corporate image	9%

What are the financial indicators used in the planning process? Table 4 shows the results, from which we

- can draw the following conclusions:
 - 1) Companies use both indicators directly related with value creation (NPV and IRR), and indicators based on accounting data (Pay Back).
 - 2) Medium and long-term planning decisions are mainly evaluated with NPV and IRR, which are employed jointly as first and second valuation criterion.
 - 3) Consequently, companies measure short-term results using accounting data, and allocate resources and evaluate medium and long-term plans through value metrics based on economic profit.

In an interview published in The New York Times on November 17, 1999, Peter Drucker pointed out that the most important job of any manager is to achieve a balance between short and long-term. This seems to be the case of the companies surveyed. And once more the failure to distinguish between accounting profit and economic profit is confirmed, leading to inconsistent situations that may have undesirable results: what sense is there in measuring future decisions based on economic profit and those in the past based on accounting profit?

Table 4					
FINANCIAL INDICATORS					
	Use as <u>Indicator</u>	First <u>Indicator</u>	Second Indicator	Third <u>Indicator</u>	
IRR	78%	31%	44%	3%	
NPV	72%	39%	19%	14%	
Pay Back	47%	14%	6%	17%	
P/B discounted	33%	8%	9%	16%	

Compensation system and value creation

94% of the companies analyzed have implemented a variable compensation system linked to results which, in accordance to the points above, is considered mostly accounting: 70% link variable compensation to achievement of an accounting profit level, while only 39% define this objective as fund generation.

At what level is this variable compensation applied? Only 28% have implemented it for the whole organization. In 90% percent of companies it is used for senior management and 53% also includes a series of selected employees.

Table 5 shows the results on the level of satisfaction of the organization with the variable compensation system: once more we can see the practical inconsistency between short and long-term objectives, as a result of establishing objectives according to the metrics used to quantify value creation.

Table 5

LEVEL OF SATISFACTION WITH VARIABLE COMPENSATION SYSTEM

If your company has a compensation system linked to results, rank it from 0 to 10 (10, totally agree):

It is applied consistently throughout the organization	7.33
It is fair, understood and motivating	7.28
It is linked to the objective of creating value	6.75
It is balanced between short and long-term objectives	5.97

It is not surprising that when asked about possible inconsistencies between manager behaviors, value creation objectives and the existing compensation system, the three most mentioned where:

Excessive orientation towards short-term	45%
Lack of balance between personal and group objectives	33%
Excessive stress only on revenue	32%

In other words, companies value mostly the achievement of accounting results, according to the value metrics used, and they apply this variable compensation to management staff. There is awareness of some of the problems this entails, but not of the main limitation.

How implementation has been carried out

With all the considerations indicated in the sections above regarding the value concept used, implementation of the value based principles in these companies has been limited, so far, to a select group of managers: only 29% state having extended these principles to the whole organization.

The main obstacles encountered in this process are the acceptance and understanding of the system, and the management of the cultural change undergone in the organization –see Table 6-. On the other hand, 61% of the companies admit that the implementation process has helped them to improve the establishment of clear objectives, and shared by those in charge of their achievement.

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Table 6

MAIN OBSTACLES OF IMPLEMENTATION

Rank the main obstacles encountered in the implementation of these principles in your organization (10, maximum obstacle)

Acceptance of the system	6.83
Internal communication	6.78
Management of cultural change	6.25
Understanding of the system	6.17
Relation with compensation system	5.69

In light of these obstacles, future actions considered necessary were improving internal communication (59%) and increasing training (24%). Only 12% deemed it necessary to reconsider the metrics used for value creation, which confirms that there is no awareness of the problem of using accounting metrics.

Finally, most companies think that, in future, these principles should be extended to all the Areas of the organization (72%), and, individually, the one most mentioned is Marketing and Sales (36%).

Summary of conclusions

The principal findings may be summarized as follows:

- 1) Most companies measure value creation through accounting profit metrics.
- 2) Less than half use an economic profit indicator.
- 3) As a result, the most important value driver is turnover (both in volume and pricing).
- 4) Little importance is given to the management of current assets as a value driver.
- 5) Objectives are established mostly based on accounting data.
- 6) There is a lack of integration between short-term vision (operations, measured by accounting data) and medium and long-term vision (decisions on allocation of resources and investments, for which economic profitability metrics are used).
- 7) Although most companies have set up a variable compensation system linked to results, these are measured mostly by accounting results, and the variable compensation is applied essentially to the management team.
- 8) There is a high level of satisfaction with the metrics used, as a result of not distinguishing between accounting profits and economic profits. There is no awareness of there being a problem in using value metrics based on accounting data.
- 9) The companies that use accounting metrics do not use them for medium and long-term decision-making (allocation of resources, valuation).
- 10) Companies using metrics based on economic profit, use it in medium and long-term decisions and to measure results applicable to compensation linked to objectives.
- 11) Most companies use non-financial value indicators, which are not sufficiently coordinated with the financial criteria to select alternatives or allocate resources.
- 12) Implementation of practices based on value creation is found mostly at the management level. Very few companies have tried extending it to the whole organization.
- 13) There is a problem of acceptance and understanding of these practices, for which it is necessary to increase internal communication and training.

14) Most companies deem it appropriate to apply these principles to the whole organization.

The information provided by the companies included in this study shows the interest there is in applying the value based management principles, but also that their application is in the initial stage.

As has been mentioned, the whole implementation process must take into account the existing business reality, both external and internal. However, this awareness of the operating limitations must not make us forget problems derived from using simplistic or inappropriate solutions and consider them adequate.

The data provided by this study do not allow assuring that this is the case of the companies analyzed, although there is evidence pointing in that direction. On the one hand, there is a clear awareness of the inconsistencies that may take place when using short-term decision criteria based merely on accounting data, and long-term criteria including economic profit criteria and non-financial elements. On the other hand, there is a high level of satisfaction with the value metrics adopted and it is not considered a priority to change this focus which, anyhow, is still being applied only to senior management.

It is often said that the success of value based management undergoes the three stages of:

- a) overcoming accounting profit near-sightedness
- b) measure and compensate long-term results
- c) balance property risk and benefits

From the results of this study we can confirm that less than half of the leading Spanish companies in value creation are using, consistently and in an integrated manner, practices leading to the achievement of these objectives.

The good news, therefore, is that there is still a lot to be done and there seems to be an interest in doing it. The not so good news is that the value creation process cannot be limited to the creation of a series of merely accounting objectives and affecting a reduced number of people in the company. Certainly there is still a long way to go which will require a great amount of business knowledge, work and skills.

Annex 1

List of companies included in the study

A) Companies listed in the Madrid Stock Exchange

	Capitalization (1)	Position in VC (2)
Telefónica	48.8	1
Endesa	19.9	2
Repsol	16.1	4
Agbar	2.4	10
Unión Fenosa	3.9	19
Zardoya Otis	1.6	23
Uniland	0.3	25
Iberpistas	0.5	30
Uralita	0.4	31
Ercros	0.1	41
Tabacalera	3.6	47
Valenciana de Cementos	2.5	

(1) In Euro billions (end of 1999)

(2) Value Creation as per Expansión-Stern Stewart rank, of 20/11/98

Annex 1 (Cont) List of companies included in the study

B) Companies not listed in the Madrid Stock Exchange

World position in VC (3)

Microsoft	1
IBM	3
Coca-Cola	11
MSD	12
BT Telecommunications	26
Glaxo Welcome	30
Dell Computer	37
Eli Lilly	45
American Express	74
Xerox	114
Dow Chemical	169
ABB	354
RJR Reynolds	466
Toys R Us	755
Cruz Campo	
Iberyeso	
Carrier	
Bacardi	
Iberia	
Cartier	
Sanitas	
Phillips Ibérica	

Corporation Peña Santa

(1) Value Creation as per Business Week rank, 12/7/99

Annex 2

QUESTIONNAIRE ON IMPLEMENTATION OF VALUE CREATION PROGRAMS IN SPANISH COMPANIES

INTRODUCTION

The purpose of this study is to identify the main problems encountered by an organization when it tries to apply the economic value creation based management principles. Specifically, the areas we wish to analyze are:

- a) Metrics of economic value creation in the organization
- b) Relation between the value creation objective and the establishment of strategy
- c) Relation between measurement of performance and compensation system
- d) Problems encountered in the implementation of a culture based on value creation

This questionnaire is divided into four sections, corresponding to the points above.

Please, do not write on the shaded areas, reserved for data processing.

In order to parameterize results, please provide us with the following information on your company (if it is a multinational subsidiary, data referring to the Spanish affiliate):

A. ANNUAL TURNOVER VOLUME (CIRCLE THE CORRESPONDING NUMBER)

	()
• Less than 1,000 million pesetas	1
• Between 1,000 and 5,000 million pesetas	2
• Between 5,000 and 10,000 million pesetas	3
• Over 10,000 million pesetas	4

B. ANNUAL BUDGET FOR FIXED ASSETS INVESTMENTS (CIRCLE THE CORRESPONDING NUMBER)

	()
 Less than 100 million pesetas 	1
 Between 100 and 500 million pesetas 	2
• Between 500 and 1,000 million pesetas	3
• Over 1,000 million pesetas	4

A) ECONOMIC VALUE METRICS

1. With which value metrics are your company's results measured? Mention, if any, possible metrics used to measure results.

		()
•	short-term	1
•	long-term	2
•	financial	3
•	non-financial	4

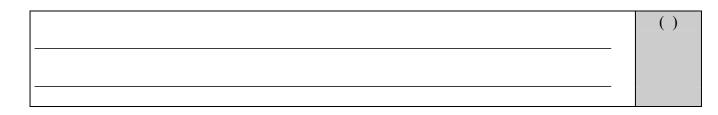
1. Upon which basis are objectives established in your company?

		()
•	Annual budget	1
•	Market comparison	2
•	Annual improvement	3
•	Pre-established standards	4
•	Other (indicate which)	
	· · · · · ·	

1. Do you consider that the metrics used in your company... (Rank from 0 to 10, where 10 equals total agreement and 0 equals no agreement)

 Are the proper reflection of the company's economic performance? Provide a fair and motivating basis to measure management performance? Present a good balance between short-term vision and long-term vision? 		SCORE FROM 0 TO 10
	•	
	•	

4. Do you think there are benefits associated to using value metrics in your organization? List some of them.



5. Has your organization identified the key value drivers?

	()
 — • YES	1
• NO	2

6. Do you think their undertaking is effective for the general value creation objective?

• YES 1	()		
	1	—— • YES	
• NO 2	2	• NO	

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()

B) RELATION BETWEEN STRATEGY ESTABLISHMENT AND VALUE CREATION

1. Does your organization have a formal medium and long-term planning process?

• YES	1
• NO	2

2. In your long-term planning process (whether formal or not) and the company's strategy establishment, are objectives for the value metrics set up?

	()
 • YES	1
• NO	2

3. Give an example.

	()
-	
-	

4. In this planning process, does your company use value indicators that are not strictly financial?

	()
• YES	1
• NO	2

5. Indicate which ones are used.



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6. What are the criteria your company follows to carry out allocation of resources for the various investment projects and/or the various business units? If several are used, indicate priority.

FINANCIAL CRITERIA	USED	PR	IORITY
	()		
Pay back	1	()	
• Discounted Pay back	2	()	
Net Current Value	3	()	
• Internal profitability rate	4	()	
Value Metric	5	()	
• Other (indicate which)			
		()	
		()	

	NON-FINANCIAL CRITERIA: INDICATE WHICH	
•		()
•		()
•		()
•		()
•		()
•		()

7. Do you consider that in your organization there is an adequate understanding of the key economic value drivers? Rank on a scale from "0" to "10", where "10" means total understanding and "0" means no understanding.

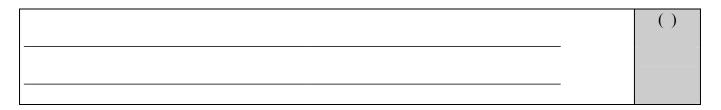
For example: Driver: Turnover level Level of understanding: 10

DRIVERS		SCORE FROM 0 TO 10
	() () () () ()	

8. In your opinion, does your organization have the right focus to identify possible economic value projects?

	()
• YES	1
• NO	2

9. Provide reasons supporting your opinion.



10. What are the key information elements in the reporting system of your company, for follow-up and control of short, medium and long-term objectives?

1.	SHORT TERM	
	•	
	•	. ()
2.	MEDIUM TERM	
	•	
	•	()
3.	LONG TERM	
	•	()
	•	()
	•	

<u>C) RELATION BETWEEN MEASUREMENT OF PERFORMANCE</u> <u>AND COMPENSATION SYSTEM</u>

1. Is there in your company a variable compensation system linked to performance?

	()
• YES	1
• NO	2

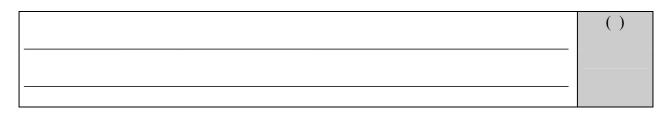
2. Indicate the results sought

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2. Indicate application level:

	()
Board of Directors	1
General Managers	2
Operating / Functional Managers	3
• Selected employees (indicate under what criterion)	4
Employees in general	10

4. If your company has an incentive system linked to performance, indicate which one and on what levels it is applied. (For example, stock options, and at CEO level)



5. If your company has an incentive system linked to results, rank on a scale from "0" to "10", how you see it in terms of... ("0" means least score and "10" maximum score)

		SCORE FROM 0 TO 10	
a) b) c) d)	Considered fair, understood and motivating Balanced between short and long-term objectives Applied consistently throughout the organization Linked to the value creation objective	() ()	

6. If any, indicate an example of inconsistency between manager behavior, incentive system and economic value maximization objective.

	_ ()
	-

D) PROBLEMS ENCOUNTERED IN THE IMPLEMENTATION

1. At what implementation level of value creation based management is your organization?

		()
a)	Senior management level	1
b)	Operating / functional manager level	2
c)	Whole organization level	3
d)	Other: indicate which	
,		

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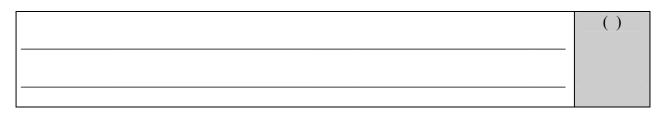
2. Up to now, which have been the main obstacles encountered when trying to apply the value creation principles in your organization? Rank them from the most to the least important:

OBSTACLES		PRIORITY	
 Acceptance of the system Understanding of the system Relation with compensation system Internal / external communication Management of cultural change Other (indicate which) 	() 1 2 3 4 5		

- 3. To date, which are the key positive points your organization has learnt in this implementation process of value creation orientation? (please reply in the table below in the space reserved)
- 4. In which areas does your company consider it most appropriate to apply this orientation? (please reply in the table below in the space reserved)
- 5. In which areas does your company consider it necessary to improve application of these principles? (please reply in the table below in the space reserved)

Q.3		Q.4		Q.5	
1.	()	1.	()	1.	()
2.	()	2.	()	2.	()
3.	()	3.	()	3.	()
4.	()	4.	()	4.	()
5.	()	5.	()	5.	()
6.	()	6.	()	6.	()

6. What future steps - if any- do you consider necessary for the application process of your company's value creation orientation?



Annex 3

Some international experiences

Since 1999, the Wharton School has been undertaking a research program on value creation practices in American companies. The objectives of this study are:

- 1) To identify the main value drivers in these companies
- 2) To analyze how these value drivers are used in relation to corporate objectives, compensation and the allocation of resources.
- 3) To study the impact of external communication on the value.

With regards to value drivers, the most important ones are:

- EMPLOYEE SATISFACTION
- COLLABORATION OF PROVIDERS
- CUSTOMER SATISFACTION
- PRODUCT INNOVATION
- FINANCIAL RESULTS
- OPERATIONS
- ALLIANCES

It is obvious that the American companies included in this study, selected with criteria similar to those used in our report, have a more developed concept of economic value than their Spanish counterparts. However, what is qualitatively clear, is not so much so quantitatively, since most of these companies admit they do not have consistent metrics to measure the degree of progress achieved with these value drivers.

As one of the managers of this research project, professor David F. Larcker, has said, "If you do not have good results metrics, a good strategy can be useless".

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