A Financial Perspective on Value Creation

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Abstract

The recent financial crisis, together with the economic bubbles and cycles of explosions have all proved us that creating, evaluating and maintaining value represent not only a competitive advantage, but also a requirement in uncertain situations. And when also the interests are not intercorrelated within the groups, the only way to effectively employ the available resources and to help the economy is by seeking to achieve long lasting value development. The principles used in establishing the value, followed by measurement techniques have stood the test of time. In a world where short-termism still remains a topic open to debates, it is mandatory to be able not to think of creating value for shareholders as a path for enlarging short-term incomes. Otherwise, confusing these fundamental elements can lead to an intensification of risk with regards to shareholder's interest and company's value.

Key words: return on invested capital, the conservation of value, risk diversification
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1. Introduction

The recent financial crisis, together with the economic bubbles and cycles of explosions have all proved us that creating, evaluating and maintaining value represent not only a competitive advantage, but also a requirement in uncertain situations. Every attempt on deciding upon a strategic cause requires some compromises. And when also the interests are not intercorrelated within the groups, the only way to effectively employ the available resources and to help the economy is by seeking to achieve long lasting value development.

The principles used in establishing the value, followed by measurement techniques have stood the test of time. In a world where short-termism still remains a topic open to debates, it is mandatory to be able not to think of creating value for shareholders as a path for enlarging short-term incomes. Otherwise, confusing these fundamental elements can lead to an intensification of risk with regards to shareholder's interest and company's value.

A financial perspective on value creation is structured in 5 sections, as follows: part two reveals some theoretical background with regards to value creation theory, while in the third section, some financial drivers of performance are being presented. Summarizing the next part, the role of risk in creating value is being put into light. As for the last chapter, the main ideas of the paper are being emphasized.

2. Theoretical background

In reality, for a hardened investment decision to be taken is not sufficient to have access only to firm's reported financial results and to their personal appraisal on how the company is evolving, its capacities and managers' virtue. In addition to this, understanding which are the key factors that drive the processes within and how the options are being analyzed and chosen by the managers will unquestionably help in having a more detailed picture on how the company is behaving. Because, for instance, an increase in its margins may be explained by the discovery of new and more adequate methods of actions, but also by reducing the costs for advertising, research and development or maintenance.

Although may seem unrealistic, companies can jeopardize value when trying to develop it. This is why a careful attention is needed when choosing and implementing the pillars that will be expected to lead to a long-lasting value achievement. In absence of such guides, the managerial decisions won't be sustained, so even the existing value could be deteriorated, having a negative and unstable impact on the entire framework, with future implications. A 2010 book entitled The Four Cornerstones of Corporate Finance exemplifies and highlights the existence of four cornerstones of finance that guide the creation of lasting corporate value: the first one is that companies create value by investing capital from investors to generate future cash flows at rates of return exceeding the cost of capital; the second cornerstone is referred to as the conservation of value; the third is called the expectations treadmill and the last one of the best owner (Koller *et al*, 2010, p.4-6).

Managers may have specific skills or functional abilities in a wide range of fields, but in order to succeed in creating value their managerial competences need to be a driving force in that certain industry where the business operates. Those who possess the needed information on how not only the industries, but also the entire market will progress, can take the opportunities and enlarge the current businesses or, why not, generate new branches. When analyzing a company's value, we also have to take a closer look to who is managing it and what types of strategy are being conducted. Instead of talking about an inherent value, we should better keep in mind that distinctive owners will definitely produce various revenues for a firm, and all because every manager possesses uncommon skills that help raising value.

Sometimes a company's value is surpassed by the expectations present on the market, making it mandatory for the company to try to achieve that level and outperform itself. Any boost in the share prices does not mean that the actual performance of the company has changed, but can be explained by an increase in the stock market's anticipations. No matter how we perceive reality, the price offered for an asset has to disclose the amount of cashflows that are forecasted to be produced after investing in it. But of course, like any other theory, also this one had to face some contradictions: the value of an asset can be established only by finding those investors who are prone to pay a certain amount, without being supported by reality.

Although the patterns for value analysis may appear to be quantitative, the entry factors can be intensely evaluated in a subjective manner. For instance, any appraisal model is being influenced by company's characteristics and market accessibility, leading to adjustments in value, because of the new data revealed. Taking a closer look to all the information available on the markets and the speed of change, we can observe that also the valuation has to be brought up to date, analyzing whether the changes influence only the firm, the whole industry or all the companies active on the market.

It is often believed that coming up with a more integrated and heterogeneous technique should unveil undeniable valuations, but this is not always the case. As methods are more and more robust, also the minimum number of inputs required increases, making it prone to mistakes. This kind of errors appear especially when the model becomes too complex, turning into a 'black box' where analysts feed in numbers into one end and valuations emerge from the other (Damodaran, 2002, p. 6). Doubts arise not from the types of models that are being used, but from the uncertainty that constantly prevails. Estimating the future events has become almost impossible and meanwhile, financial analysts and investors handle with the lack of information and uncertainty, as apologies for their optimistic estimations. "When the facts change, I change my mind. And what do you do, Sir?" (Kay, 2015)

3. Financial drivers of performance

Every asset, no matter its type, has a certain value and can be valued anytime. The differences arise from the methods of valuation that are used, which of course will range, depending on how easily that asset can be valued. This is why it's vital to discover and comprehend not only the significance of value, but also the source of it, in order to obtain a successful investment and a high performance in managing the assets. Also, in terms of creating value, sometimes the big and productive entities are not worth investing in. Fruitful investments and return on investment can be obtained by transforming an unsteady company, instead of trying to improve the actual performance of a successful one. It is for certain that a great company does not mean that a potential investment in it may also turn to be a great one. The reason why for investors it is more important to find an upside potential in a company relies in the fact that people's expectations can be easier surpassed. On the other hand, well-known firms may already have their potential and future great accomplishments included into their present share price.

Of great concern for any company should be the structure of its capital and whether it has sufficient capital to achieve the desired goals and to face possible deficiencies that may arise. The problem with scarcity in a company's capital is not only the fact that opportunities along the way will be missed, but what is more important is an eventual inability to pay the debts, or simply stated, insolvency or bankruptcy. Finding an effective balance between equity and debt implies a meticulous analysis and solid decisions to be taken. Because, on one hand, equity supports unanticipated advantages like mergers and acquisitions and it also contributes to a certain stability and adaptability when confronting with unforeseen events. On the other hand, debt has also positive aspects, allowing some tax reductions and a financial self-control. What is for certain is the fact that debt can either build or demolish value through its impact upon the cash flows that are generated in a company. Also, in terms of allocation debt intensifies the expected return for the investors, being perceived as riskier in this uncertain macroeconomic context.

In such a complex framework, unexpected events will always occur, but what is truly essential is to try to identify and estimate their potential unwanted repercussions. Understanding the effects on the operating cash flows is an important step forward that will help companies identify if the existing structure can create value or not and in which directions.

Even if between cash flows and earnings can be often found a correlation, they cannot alone offer all the necessary details in regards to value creation, this being the reason why aiming all the attention at earnings can frequently mislead the companies. But, dividing cash flows into two main parts: revenues and return on invested capital (ROIC) will provide a clearer explanation on what is really driving a company towards higher achievements. Improvement in terms of revenues, return on invested capital and cash flows being strongly connected give the alternative of comparing the company with the industry or even the entire economy in terms of growth and with the competitors or its own past achievements in terms of return on capital.

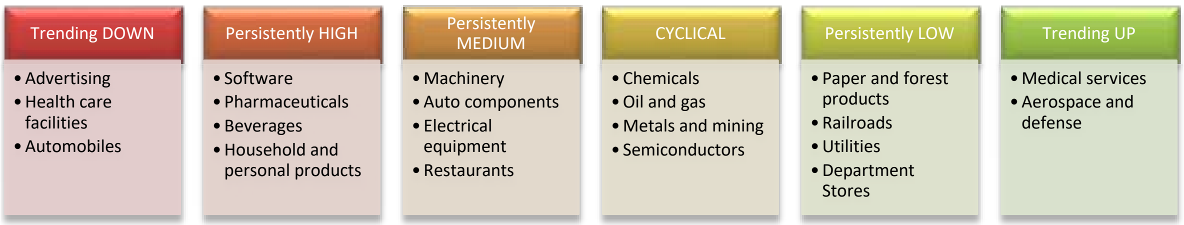
Taking a closer look to these financial concepts, we can notice that no matter at which point growth is, value will always enlarge when also the return on invested capital will progress. Or, simply stated, in caeteris paribus conditions, an increase in ROIC has only benefits, although this is not the case when referring to growth. With an increase in ROIC and in growth, also the value will expand, but when ROIC registers lower levels, a quicker growth will diminish the current value. A break point where we can analyze more accurate whether growth has positive or negative effects on value is when the cost of capital has the same value with the return on capital. Because, for instance, in case of returns surpassing the cost of capital, a rapid growth will automatically push value up. Vice versa, at the point where the cost of capital is the same with the return on capital, value is neither improved, nor diminished and it doesn't matter how swift the entity is trying to evolve. The foundation of creating business value by acquiring a return on capital that surpasses the cost of the capital dates back in 1890, when Alfred Marshall exposed this timeless doctrine.

As for the factors that influence every company's ROIC, it is mandatory not only for the investors, but especially for the managers to seek in the industry's characteristics and see which are the main competitive forces of their own company and how the competition is acting and reacting in response to them. If succeeding in doing so, the company will undeniably create itself some occasions for a solid value creation. A company that is aware of its strengths will definitely achieve a higher level of return, no matter if their strategic steps are aiming towards premium prices or, by contrary, reducing the costs per unit.

The way in which every industry on the market is shaped reveals not only the behavior of the participants, but, moreover, discloses also insights about the degrees of performance that can be obtained. For example, while the industries with a significant ROIC seem to have an appealing architecture, the low-ROIC industries show some weaknesses and deficiencies in their business models. Undifferentiated products, capital intensive and limited alternatives for improvements and innovation are just some of the arguments that describe a low level of ROIC industries. But, of course, this doesn't mean that there are no exceptions. Barriers of entry on the market, the accelerated ability of technology to quickly create and destroy business models (Sanwal, 2007, p.34), new laws and regulations can all have an impact for a specific firm or for the whole industry.

Another focal point in determining how to create and conserve value is represented by the sustainability of the return on capital invested, because aiming to possess a high level of ROIC for as long as possible will generate more and more value. The economy is proving us that when we refer to the companies' and industries' performance based on their ROIC, they lean not to change their position for long period of times (Figure 1). Being part of an innovative industry, where patents conserve the most successful ideas, results in a persistently high ROIC, while in the commodity industries superior price or product differentiation are nearly impossible to accomplish. As for the cyclical industries, the ones that are characterized by a strong volatility, it is hard to consider them as being part of only one category, without fluctuating.

Figure no. 1. Persistence of industry ROICs



Source: (Koller et al, 2010, p.131)

As any other approach, also this one had to face some contradictions, being called into question the relevance of the return on capital, justifying that the economy has evolved in new directions, where companies don't possess anymore so much physical capital and the intellectual property plays now a major role on the market. Although in the recent years a multitude of innovative changes have occurred transforming the economy, it was not enough to make the principles of economy forgotten, especially in regards to the theory of value creation.

4. The role of risk in creating value

Although value is undoubtedly the most representative parameter of a business in a market economy, risk assessment as well should not be treated with less importance, because of its effects not only for the near future, but also for longer periods of time. Despite the time value of money, meaning that tomorrow the same amount of money will worth less than they are today, investors demand a value for their investments, high enough to offset the risk they are facing. Finding, anticipating and managing the risk that persists in every business, industry or in the whole market is of great concern, because of the complexity of this phenomenon. Despite its complexity and multitude ways of impacting the companies, risk has different meanings for the main categories of shareholders, each having a different perspective and a subjective manner of analyzing.

One of the most important drawbacks in trying to measure the risk arises from the fact that singular risks may anytime merge with others, resulting a conglomerate uncertainty, which seems almost impossible to detect before it breaks out. Despite this threat, it is a common mistake to think that all risks have to be lessen, without thinking of the opportunities that may derive from the unknown, not to mention the fact that investors won't see any advantages in a company that doesn't assume any risk. Whether we refer to companies that are part of the same industry, the decisions concerning the reduction of some risks and the acceptance of others it will always be a particular one, depending on circumstances and the objectives that are set. Short-run financial risk is often called transactions exposure (the exposure typically arises because a firm must make transactions in the near future at uncertain prices or rates), while a firm's exposure to long-run financial risks is often called its economic exposure, because long-term exposure is rooted in fundamental economic forces (Ross *et al,* 2003, p.815-816).

Finance theory is teaching us that under no circumstances, managers should accept risks that may threaten the future of the entire company. It is advisable to try a diversification on the cost of capital, which can be translated into a separation of the risk. We should diversify across industries because firms in different industries, especially industries with different economic characteristics, have lower covariances than firms within an industry (Markowitz, 1952, p.14). Keeping in mind that investors are expecting a higher return only for the risks that can't be diversified, a reduction in the price of risk will mean, at the same time, a decrease in the risk that investors are accepting. Despite this, a total conservative approach won't bring any benefits, but instead can lead to a neglection of the appealing, but precarious investment alternatives. Managers should not aim to exclude tolerable volatility that is present in cash flows and also in earnings, because it is normal to have a certain degree of exposure to the macroeconomic uncertainty, even if this means interest rates or currency risks.

Lacking in a factual risk culture, companies are not able to project various scenarios and every investment decision, whether we are talking about an acquisition or a capital expenditure is being summarized by only one financial forecast. This happens mainly because managers are cautious about a more optimistic scenario, having in mind that maybe the investors will consider this one the expected and demanded result. Vice versa, managers are hesitating to expose as well the drawbacks of a project, thinking that maybe the idea will be dismissed. In absence of an open dialogue about real upside potential and the flaws of risk, in many cases earnings are not high enough to exceed the cost of capital.

While some might mistakenly consider value investing a mechanical tool for identifying bargains, it is actually a comprehensive investment philosophy that emphasizes the need to perform in-depth fundamental analysis, pursue long-term investment results, limit risk, and resist crowd psychology (Graham, 2008, p. XIII-XIV)

5. Conclusions

Creating value and adopting its benefits transform companies into more fruitful and vigorous entities, which, together with the investments in sustainable growth are improving living guidelines, are discovering new circumstances and choices for humans and last, but not least, are establishing trustworthy economies. Relying on information, together with analytical data, broad analysis and a strong comprehension in regards to the characteristics of the industries are all vital elements in attaining permanent value and power. The structure of an industry is possibly the most essential factor that generates a competitive leverage and satisfying degrees of return on capital and its shape reveals not only the behavior of the participants, but, moreover, discloses also insights about the degrees of performance that can be obtained.

Whether we talk about value creation or value conservancy in particular, or value, in general, it is important to associate these concepts with the return on invested capital, or in other words, the rate that investors are expecting to gain in exchange for the amount of money invested. Adjustments in every company's strategies are also influenced by how the firm operates in terms of returns on invested capital and growth, so succeeding in increasing the revenues and using the capital at tempting rates of return will clearly generate more value. Improving the stock market performance of a company can be achieved also by determining long-term value especially for the shareholders, this action having as a result financial and human capital benefits for other stakeholders, as well.

In such a complex framework, unexpected events will always occur, but what is truly essential is to try to identify and estimate their potential unwanted repercussions. Understanding the effects on the operating cash flows is an important step forward that will help companies identify if the existing structure can create value or not and in which directions.

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