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L.E.K. Consulting Shareholder Value Added

Managing for Superior Total Shareholder Returns

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In his revised edition of *Creating Shareholder Value: A Guide for Managers and Investors* (Free Press 1998), Dr. Alfred Rappaport provides practical guidelines for generating superior total shareholder returns. This is defined as stock price appreciation plus dividends greater than an index of peers. Building on this pioneering work, Dr. Rappaport's Harvard Business Review article, *New Thinking on How to Link Executive Pay with Performance* (March/April 1999), describes how to measure and reward performance at all levels of an organization in order to facilitate the quest for superior shareholder value. The following summarizes his ideas on how to better align compensation to superior total shareholder returns:

Senior management rewards should focus on outperforming competitors.

In the early 1990s, company boards concluded that stock options represented the best way to link management and shareholder interests. Based on this view and bolstered by the strongest stock market in history, stock options have become the fastest growing component of pay and now represent

more than 50% of total pay for CEOs of the largest U.S. companies.

Although stock price represents the right *measure* of performance, traditional stock options (with an exercise price equal to stock price at grant) rewards both superior and sub-par *levels*

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Our objective in producing this newsletter series is to present topics that you have expressed an interest in and that illustrate the benefits of applying Shareholder Value to your strategic and operating functions. If there is a Shareholder Value topic that you would like to see discussed, please contact Leon Schor at 1-800-929-4535 ext. 9565 or by e-mail at l_schor@lek.com. If you would like to receive a complete set of our SVA Newsletter series or if others in your organization would like to receive our publication, please feel free to contact Leon.

Managing for Superior Total Shareholder Returns was written by David Rhoads, Vice President in L.E.K.'s Chicago Office and Robert Roath, retired Chief Financial Officer of RJR Nabisco, and Chairman, L.E.K. Advisory Board.

of performance because any increase in share price rewards executives. In contrast, indexed stock options with an exercise price that varies up or down based on the performance of a peer group or market index provides rewards for superior performers. In exchange for this increased performance risk, top executives should receive an increased number of options.

Indexed options offer several important advantages. First, they are fair, as they reduce rewards for underperformers in rising markets and they do not penalize superior performers in declining markets. Second, they align the interests of managers and shareholders. Peer indexing is applied in Securities and Exchange Commission disclosure requirements. Also *The Wall Street Journal* and L.E.K. Consulting have selected this as the measure for the annual *Shareholder Scoreboard*.

Determine the contribution of each business unit to the overall performance of the company.

Today, stock options constitute over 25% of total compensation for group heads managing businesses with annual revenues of less than \$1 billion, while annual and longer-term incentives constitute another 40%. Stock options will not give managers of independent operating units the rewards they deserve because their activities usually have a limited impact on the company's stock price. On the other hand, the various accounting measures typically used to assess business unit financial performance are not reliably linked to superior shareholder returns.

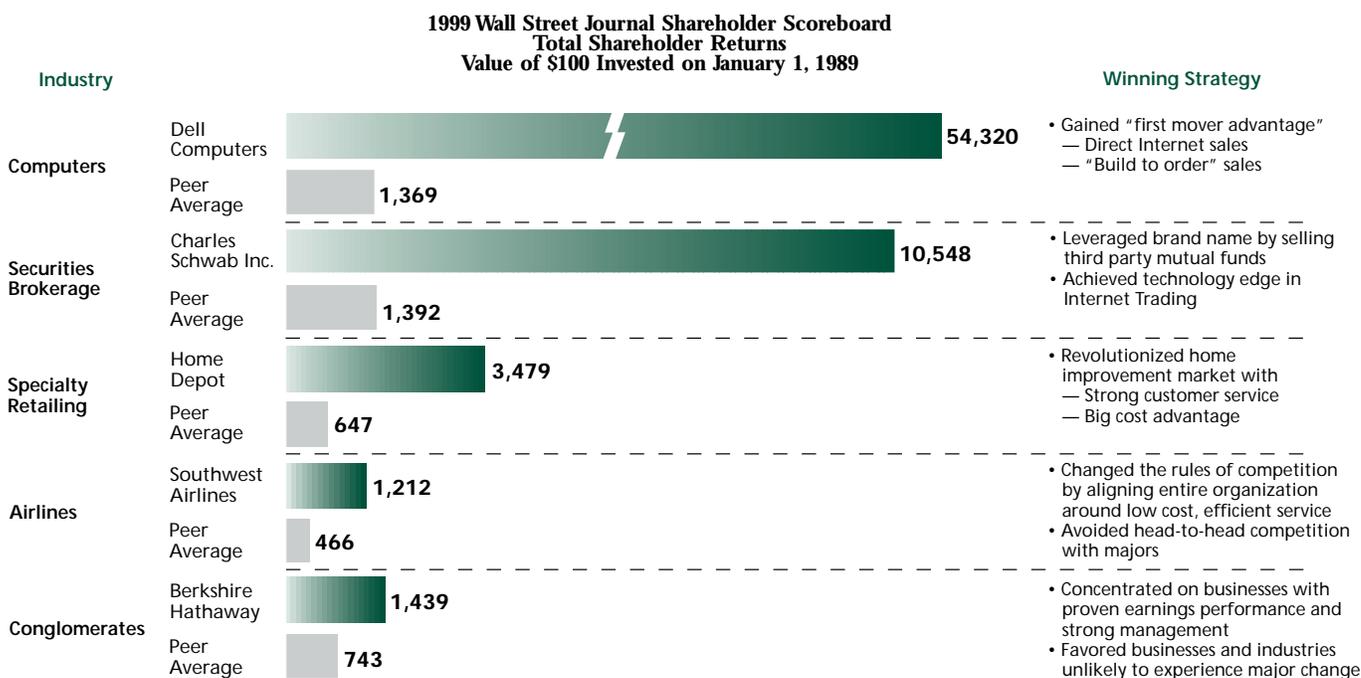
Since shareholder value is ultimately created at the unit level, Dr. Rappaport argues for rewarding business unit management for Superior Shareholder Value Added (SSVA™). SSVA™ determines changes in the future cash flow of a business unit. It is calculated by applying standard discounting techniques to forecasts of operating cash

flows for a specified period, minus the incremental future investments anticipated for that period. If a company is to deliver superior returns to shareholders, then its business units must create better than expected SVA that is, superior SVA. This standard rewards managers for meeting or beating investor expectations rather than their beating a budget disconnected from expectations.

Involve all front line managers and workers in the quest for value.

Finding measures that guide hands-on decision making by front-line workers and are correlated with the long-term value of the business is the final set required to drive superior total shareholder returns. Middle managers and front-line workers need to understand what actions they can take to ensure that investor expectations are met or exceeded. Dr. Rappaport refers to these measures as "leading indicators of value," or key value drivers, and views them as an essential basis for calculating incentives for front-line employees.

How have top value creators rewarded shareholders?



Six Questions to Consider

Generating superior total shareholder returns over time is an enormously demanding objective. Since a company's share price reflects current market expectations for future performance, beating peers requires exceeding investors' expectations more than peers do on a regular basis.

But potential rewards are staggering. Based on the L.E.K. analysis published in *The Wall Street Journal Shareholder Scoreboard*, the figure on the opposite page shows how top value creators beat the odds and exceeded their peer group's total shareholder returns over the past ten years. While their strategies and operating styles differ, each management team is passionate about understanding the evolution of their industry structure, enhancing sources of competitive advantage, and creating shareholder value.

Despite the increasing emphasis on stock options and stock ownership for senior management, few companies have fully realized the potential benefits of aligning and managing for superior total shareholder returns. The objective of this edition of L.E.K.'s Shareholder Value Added newsletter is to help you diagnose your company's capabilities across six areas essential to managing for superior returns.

Senior executives frequently overestimate the extent to which their company is aligned with superior shareholder value performance. Consider the following six questions. Your answers and those of your management team will help you identify where your strengths and potential weaknesses may be.

Question 1: Is your corporate success defined as superior total shareholder returns?

The way an organization defines success has a profound impact on the business. It provides a benchmark for setting performance goals, evaluating strategies, making investment decisions, and rewarding management.

However, defining success and communicating it effectively can be a double-edged sword. The right definition of success stimulates organizational improvement, profitable growth, and value creation. The wrong definition diffuses focus, reduces motivation, and works against goal achievement. Incorrect measures can lead to inappropriate actions and counterproductive activities.

The single best measure of overall company and management performance is relative total shareholder returns, or a company's total return compared to a group of comparable peers. This measure offers a number of important advantages over the others. It is the most direct measure of a company's performance for shareholders, free from distortions related to alternative accounting practices. Since it is indexed to eliminate the effect of market and industry specific price movements, it minimizes the influence of events outside management's control. It therefore provides an unbiased yardstick for gauging management's ability to execute strategies that beat competitors in both the product markets and the capital markets.

However, for the total shareholder returns measurement to be effective, several conditions must be met. Management must accept the fairness of the peer group or index used to judge relative performance and there needs to be an understanding of the link between management's actions and the company share price.

Question 2: Are your business unit strategies based on an externally validated understanding of industry attractiveness and competitive position?

The two primary strategic determinants of value creation are industry attractiveness and competitive position. Factors driving industry attractiveness include expected market growth, supply and demand fundamentals for customers and suppliers, technological change, the distribution of relative market share and power (between buyers and sellers as well as among competitors), entry and exit barriers, vertical integration potential, threat of substitutes, and competitive intensity.

Industry attractiveness reflects factors which an individual ordinarily has minimal influence. In contrast, key aspects of a firm's competitive position are relative product differentiation, economic cost (including capital costs), and relative market share in strategic segments. By its choice of strategy, a business can change its relative position within its industry, thereby making the industry more or less attractive *for the business*.

Industry attractiveness and competitive position drive future prices, volume, cost, required investment, and business risk. These factors in turn determine value creation potential. Consequently, business strategies must be supported by an externally validated, fact-based understanding of the potential impact of future industry trends on the competitive position of the business.

Many companies do not allocate the resources necessary to properly assess industry attractiveness and competitive position in this manner. Typical reasons are that many managers rely on intuition and limited internal data to make strategic investment decisions, although it is widely accepted that both are frequently unduly optimistic. To be fair, business unit managers are rarely held accountable or rewarded for delivering long-term value and few companies even bother to compare past forecasts with actual results. In addition, few business units have the internal capabilities and resources required to collect

and analyze external market data, and to develop realistic financial forecasts.

To validate business unit strategies, a process must be created that explores industry attractiveness and competitive position to discover where value is created today and in the future. This entails the development of an externally validated cash-flow forecast supported by a realistic assessment of industry attractiveness and competitive position as well as the current strategy for calculating the value and SVA of each business unit. Evaluating the alternative strategies ensures the ones selected are those which create the most value.

Question 3: Will your corporate business plan exceed investor expectations?

Companies and the stock market are engaged in an on-going signaling and monitoring process. Companies provide information via published reports, news releases and other communications. Investors incorporate this information into their expectations

and collectively express their view of a company's prospects in the stock price. Stock price, in turn, signals what performance is required if shareholders are to earn their required return. Stock prices convey important, low cost information to management and are available 24 hours per day.

If a shortfall in the value of the current business plans relative to market expectations exists, identifying opportunities to close the gap should become management's top priority. If, on the other hand, a realistic valuation of the plans exceed the current stock price, management may need to do a better job of communicating future prospects. In any case, understanding any value gap is essential for decisions ranging from issuing new shares, repurchasing shares and financing acquisitions. This concept is discussed more fully in SVA Newsletter Volume Nine, *Market Signals Analysis: A Vital Tool for Managing Market Expectations*.

How can fact-based analysis explain Competitive Position and identify sources of Competitive Advantage?

Client Issues

- What purchase attributes matter most to customers and non-customers?
- How do competitors compare across key attributes?
- What products and customers are creating value (and why)?
- What organizational capabilities will be required to be successful in the future?
- What strategic insights can be used to generate new business opportunities?

L.E.K. Analysis

- Evaluated market size, growth and key trends
- Conducted customer and non-customer interviews
- Profiled competitor position by product and customer type
- Evaluated customer profitability by product

Client Implications

- Identified strategic customer segments
- Re-defined product offering to meet needs of target customers
- Eliminated non-core products and unprofitable customers

In terms of measuring actual versus forecasted financial performance, one way to evaluate business units is by estimating Shareholder Value Added. SVA has one clear advantage over residual income measures: it is based entirely on cash flows and does not introduce accounting distortions. It can therefore serve as a sound basis for a management incentive plan.

SVA values the future cash flows of a company or business unit. It is calculated by applying standard discounting techniques to forecasts of operating cash flows for a specific period, minus the incremental future investments anticipated for that period. If a company is to deliver superior returns to its shareholders, then its units must create better-than-expected or superior SVA (SSVA™). Calculating SSVA™ requires the following steps:

- Develop expectations for the standard drivers of value—sales growth, operating margins, and investments—using historical performance, the unit’s business plan, and competitive benchmarking
- Convert the expectations about value drivers into annual cash-flow estimates and discount them at the business unit’s cost of capital in order to obtain the value of each operating unit
- Aggregate the values of each operating unit to verify that the sum is approximately equal to the company’s market value
- Establish the annual expected SVA over the performance period from the cash flows used to value the operating unit—typically a three year period

- Compute the actual SVA at the end of each year, based on year-end results. The calculation will be the same as in the previous step, with actual numbers replacing estimates
- Calculate the difference between actual and expected SVA. When the difference is positive, you have SSVA™

Just as value creation potential can vary greatly among companies, so too can they vary within a company’s business units. An approach based on expectations establishes a level playing field by accounting for differences in business prospects. Managers who perform extraordinarily well in low potential businesses will be rewarded, while those who do poorly in high potential businesses will be penalized.

Question 4: Are your performance measures and goals linked to key value drivers?

Performance measures and goals that align the interests of management with superior total shareholder returns are critical to the value creation process. Any inconsistency diffuses management focus and actually works against goal achievement.

Strategies that maximize business unit value should provide the basis for setting annual and long-term performance goals. To assess periodic performance, actual results should be compared to financial forecasts and value driver based goals that are linked to the optimal business unit strategy. In order to reinforce an extended time horizon, performance should be measured over periods of at least 3 years.

To maximize SVA, key value driver goals should be established for each business. Key value drivers are defined as measurable and easily communicated current accomplishments that have a significant positive impact on the long-term value of the business. Top value creators frequently track the achievement of strategic goals and milestones as well as financial objectives. Examples include market share in strategic customer segments, global expansion, on-time new product launches, total cost per unit, or the timely opening of new stores.

Although some companies have introduced SSVA™ type measures, most companies still do not link performance measures and goals with superior total shareholder returns. Common shortcomings include budget-based goals rather than goals linked to value maximizing strategies, annual goals rather than multi-year goals, insufficient use of value drivers, and the improper use of economic profit and other residual income measures.

Question 5: Do your management incentives reward the right behavior and action across the business?

Management incentives can be a catalyst for driving value creation, or they can be a source of unintended consequences. For example, simplistic revenue goals have sometimes resulted in excess product being shipped at period end to inflate sales and profit. Some units have become adept at using reporting mechanisms to their short-term advantage.

Incentive systems that reward corporate performance below investor expectations, or a system that rewards business units largely on overall company performance are unlikely to drive sustained superior total shareholder returns. Rather, they foster complacency among weak performers and frustration among top performers. Therefore, it is extremely important to focus incentives on the appropriate key value drivers and behavior so rewards go to those who create value.

Corporate leaders of publicly traded companies need to have long-term incentives linked directly to total shareholder returns performance relative to peers. Targeting rewards to superior total shareholder returns sends a clear signal to the rest of the organization. This system sends an equally powerful message to investors that management is totally committed to exceeding peer total shareholder returns performance.

Question 6: Does your long-term incentive plan reward superior performance?

L.E.K.'s preferred method for linking senior management rewards to superior total shareholder returns is indexed executive stock options. They represent the most economically sound way to link rewards to a fair assessment of performance.

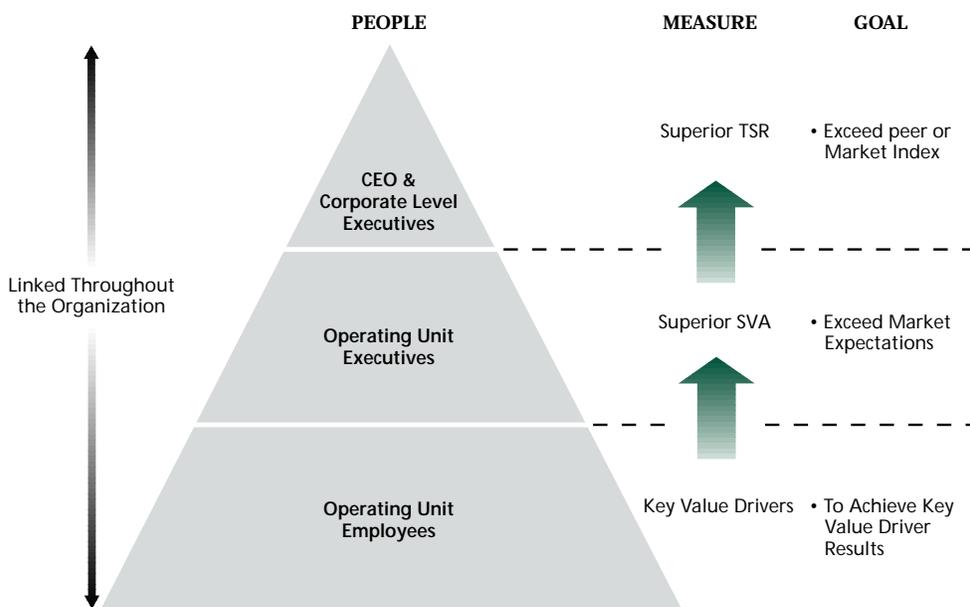
In recent years, several alternative performance-based equity incentives have been introduced by companies such as Monsanto and Proctor & Gamble. Although each achieves some of the benefits of indexed executive stock options, the goals specified are

often not tied to superior performance for shareholders.

- **Premium Priced Options** carry an above market exercise price. This price can represent a single fixed premium for the term of the option or can incorporate a series of fixed, but increasing exercise prices over the term. While shareholders have welcomed the introduction of these plans, achieving premium prices would be extremely difficult in a down market.
- **Performance Vesting Options** carry an extended “cliff” vesting period (e.g., 10 years). Vesting accelerates if pre-established performance hurdles are achieved, typically expressed in terms of absolute or relative stock price. While companies introducing these types of options do not incur an annual accounting charge, these options vest at the end of their term, regardless of performance. As a result, they are less performance-based than indexed executive stock options.
- **Performance Based Restricted Stock**—At the end of a 3–5 year performance period, a participant receives a portion (0 to 100%) of a large up-front grant of shares based on achieving specified goals (e.g., relative total shareholder returns or financial goals). While this alternative involves real shares (which vary up or down in value), companies introducing this type of incentive incur an annual accounting charge.

From experience, no single approach is right in every situation and for every company. Instead, organizations need to evaluate each in terms of simplicity, performance orientation, accounting efficiency, tax efficiency,

How should people and performance measures be aligned with superior total shareholder returns?



participant perceptions and investor perceptions. Pay is an extremely visible and emotional issue. For some, it may be appropriate to transition to more performance based equity incentives over time.

Answers

Few companies can say “yes” to all six questions posed here. Managing for superior total shareholder returns requires a total commitment. Although some companies do it naturally, others have to focus on it explicitly to effect change. L.E.K. is dedicated to helping clients manage for superior total shareholder returns. Founded on the principle that cash flow drives value, our holistic approach applies shareholder value principles to define investor expectations, to develop business unit strategies, to allocate capital and to both measure and reward superior performance.

How Much are Executive Options Worth?

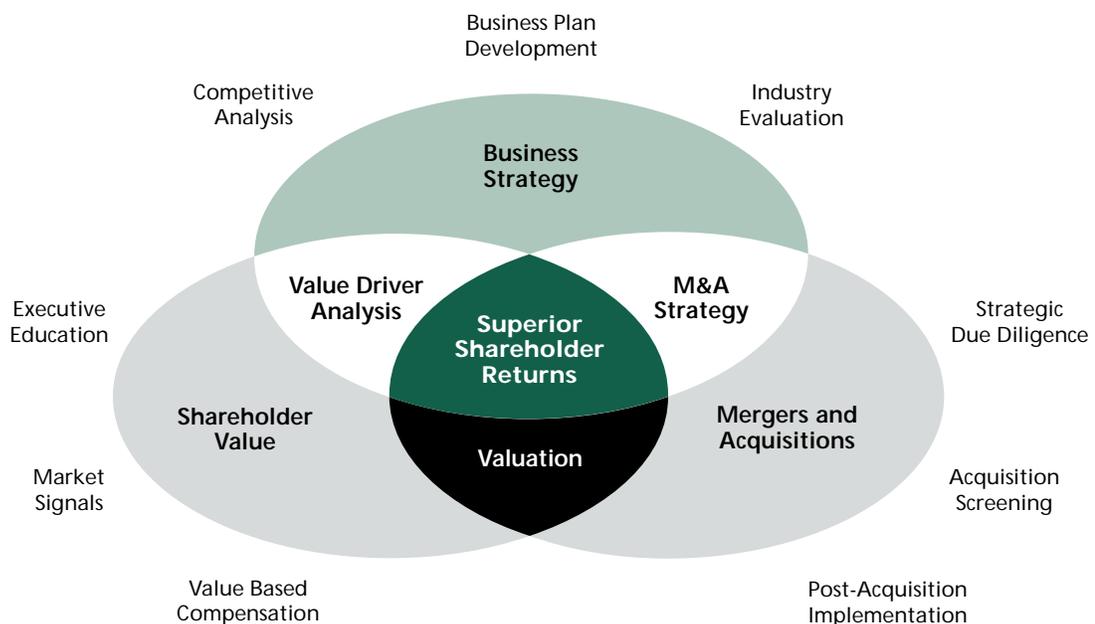
Pricing executive options is a key issue for shareholders, companies and their executives. Shareholders and companies need to ensure that options are valuable enough to attract managerial talent, but not so valuable that they “give away the store.” Executives must compare different types of options and select the one that best suits their expectations and appetites for risk.

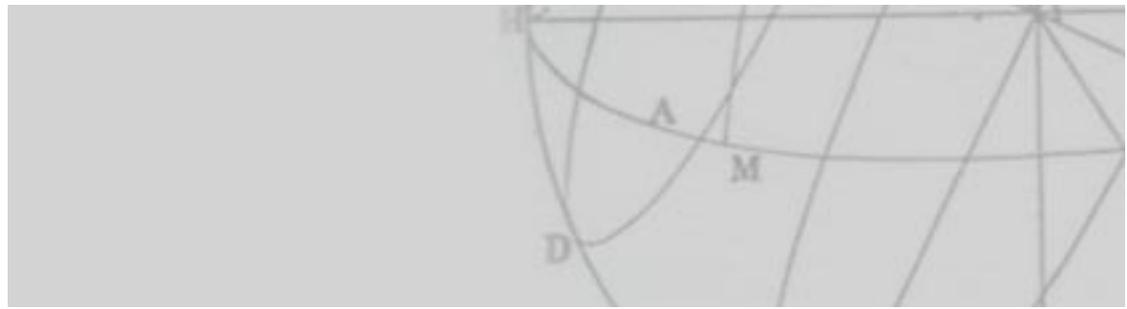
Unfortunately, valuing different types of options can be tricky. It involves choosing an appropriate pricing model (e.g., Black-Scholes or Binomial) and adjusting the model

for factors such as whether or not the options are indexed, premium-priced, or discounted.

In conjunction with options expert Dr. John C. Hull from the University of Toronto and author of *Options, Futures, and Other Derivatives* (Prentice Hall, 1997), L.E.K. Consulting has developed the capability to calculate the values of indexed and non-indexed executive options. This facilitates the exchange of one type of option for another by ensuring all interested parties that the expected value of equity incentives remains the same.

What activities are associated with a holistic approach to managing for superior shareholder returns?





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