

Avondale Perspective:

Achieve Sustainable Growth in Market Value by Focusing on Intrinsic Value

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Avondale Perspective:

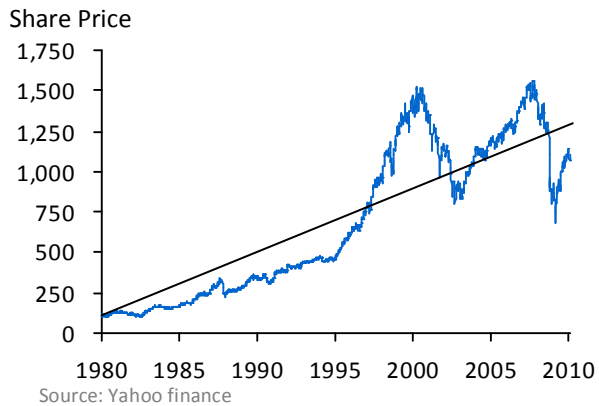
Achieve Sustainable Growth in Market Value by Focusing on Intrinsic Value

If you are focused on achieving sustainable growth in your stock price over the next 10 years and beyond, or plan to own your private company for an indefinite period and want to sustainably grow its market value, then you must accept the following paradox: The key to achieving sustainable, long-term growth in *market* value is to focus strategy development and execution on *intrinsic* value.

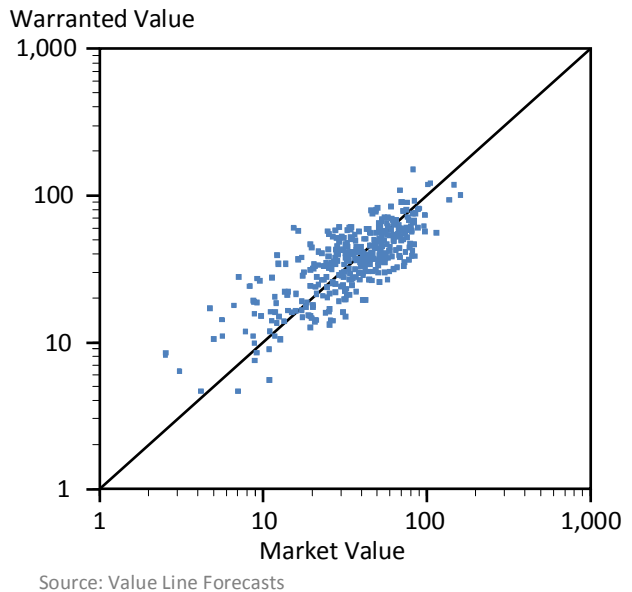
What’s the difference between the two? Intrinsic value is a function of expected future cash flows to be generated and consumed by the operations of the business. Market value is a function of expected future cash flows arising as a consequence of owning shares in the company.

Our experiences during two major economic bubbles over the past decade have shown that market value and intrinsic value are not always the same. We’ve also seen that market values do converge, eventually, to intrinsic values. To paraphrase, you can fool some of the market some of the time, but not all of the market all of the time.

**Market Convergence:
S&P 500 Index Price 1980 to 2010**



Capital Market Evidence: S&P 500



For a business to create sustainable value growth, its management efforts, board attention, investor communications, and management processes and incentives all must focus on intrinsic value and its drivers. It's not an easy place to reach, in large part because there is no independent, objective arbiter of intrinsic value. In other words, people tend to disagree on what intrinsic value actually is, and how it's created.

So how do you reliably and credibly manage your public or private business to intrinsic value? First of all, you can't manage to intrinsic value if you don't know what it is, and to quantify it you must be able to forecast expected future cash flows with confidence.

Where to Begin?

Unfortunately, forecasting future cash flows is typically a dysfunctional exercise driven by a combination of biased, self-serving opinions and wishful thinking. The only way to overcome such distortions is by building a deep, fact based understanding of the key drivers of expected future cash flows. This requires 1) identifying the real market drivers of revenue growth, price and share, and 2) determining the internal assets and capabilities (costs) required to support those market realities.

These two steps are extremely valuable because they lead to a deep understanding of the business model, which not only helps define intrinsic value, but is crucial to growing it. Many management teams, however, never get to this point, because they believe they lack the time, resources and commitment required to build such a comprehensive fact base. So they stick with their current forecasting methods, however dysfunctional they may be.

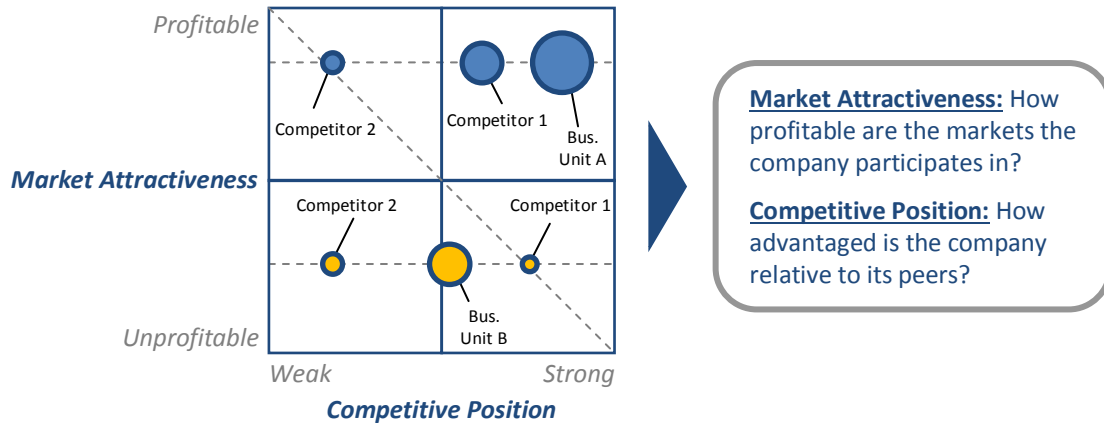
Building a better fact base, however, does not necessitate a massive up-front investment. Management teams can phase their approach by creating an initial valuation using existing, or "first pass," estimates of future cash flows. They can then refine this valuation over time as they gather a more robust set of facts.

Existing financial forecasts are often more "aspirationally" driven by growth goals than "strategically" driven by market realities. A primary purpose of the initial valuation based on such forecasts is to elicit the kinds of questions that motivate relevant fact-gathering. These questions typically begin with, "What would we have to believe in our markets and our competitiveness for this forecast to be credible?"

Fact Based Market Drivers

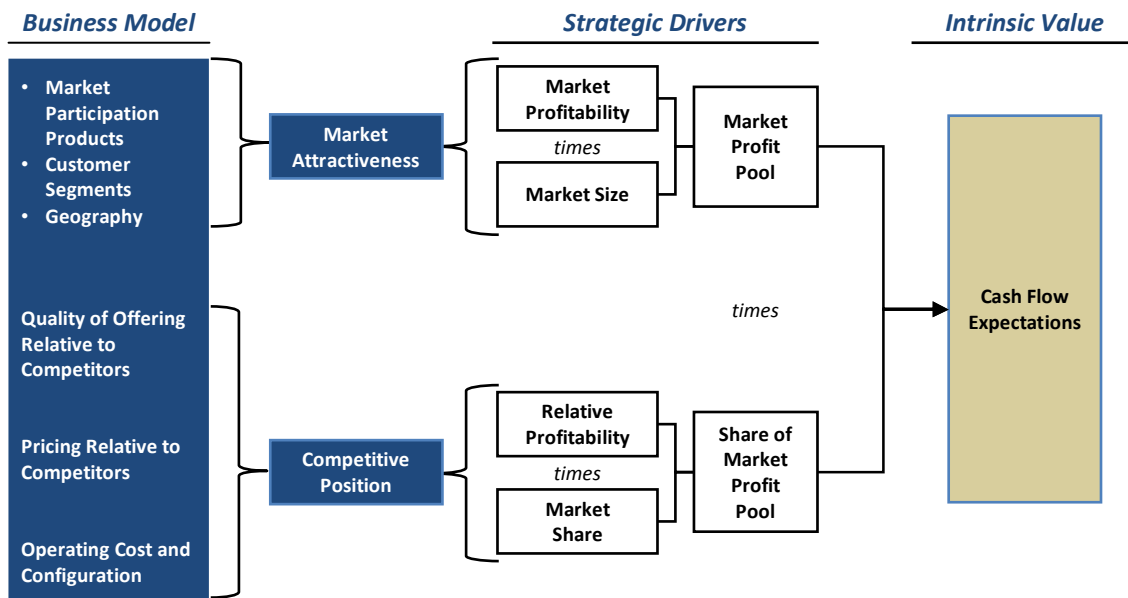
Expectations for revenue growth, price and share are driven by three factors:

- the attractiveness of the markets in which the company competes
- the competitiveness of the company in those markets
- expected changes in these two positions.



The key to linking these drivers to future cash flow expectations is to develop quantified views of “market attractiveness” for each of your company’s markets as well as your “competitiveness” in each of those markets. You can start by quantifying the market growth, pricing, profit margin, and share changes that are expected over time.

Later, you can refine these drivers by calculating the size and expected growth of the market profit pool (the aggregate amount of profit earned by all firms serving that market), and further understanding the drivers of share in that profit pool. The market profit pool may be estimated by current volume or revenue, expected growth rates, and current average margins. Over time, you can further refine this estimate by calculating differences in pricing and margin among competitors.



Similarly, achieving a more granular view of the company’s share of the profit pool might involve estimating customer drivers of share, e.g., drivers of price premium and share gain/loss and expected changes in those drivers over time.

One of our clients took the aforementioned approach to estimate its intrinsic value. The initial valuation was built on the high-level observation that the company’s underlying market was growing at 3%. The company’s historical ability to gain share added an additional 3% expected growth. Management also planned to reduce costs over time to offset price pressure from customers.

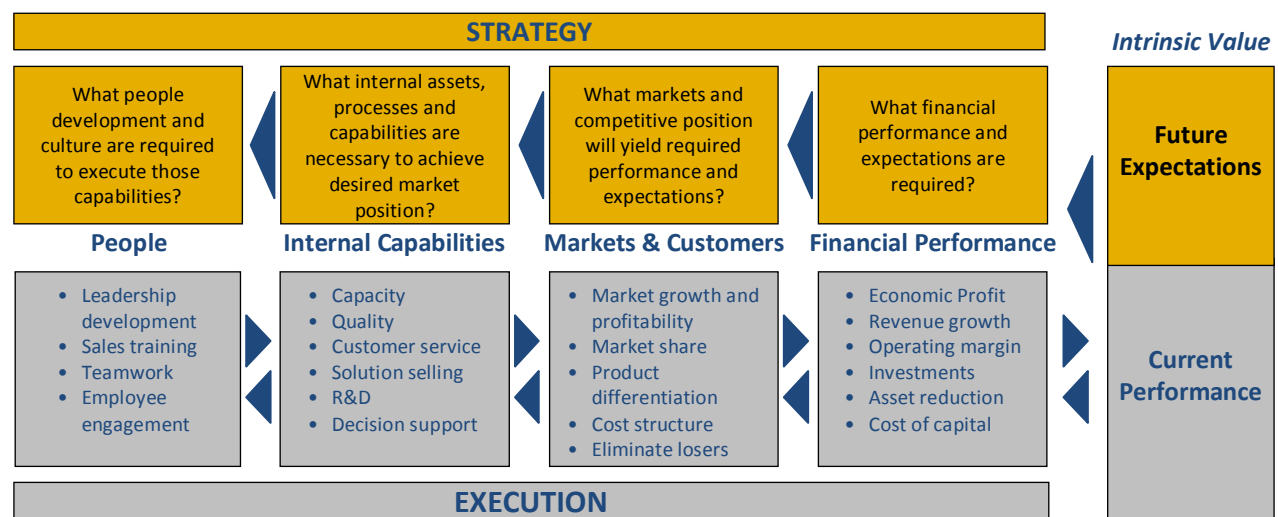
These first-pass assumptions produced a cash flow forecast driven by 6% top-line growth over 5 years and consistent profit margins. Management further assumed that growth would ramp down to market levels in years 5-10.

We helped our client refine this forecast by developing a more detailed view of the profit pools in each of their sub-markets and customer segments. Armed with this fact based link between market drivers, revenue and margins, management could clearly see the changes in market participation and competitiveness necessary to reach their goals for intrinsic value growth.

Required Internal Assets and Capabilities

Once you have grounded your expectations for revenue and margins on fact based, unbiased assessments of the company’s markets and its competitiveness in those markets, you can assess the assets and capabilities necessary to maintain or enhance your market position, along with the people and culture necessary to achieve that goal.

Our Value Equation framework (see below graphic) is an effective way to link your assessments of market position, internal capabilities and people to your estimate of expected future cash flows and intrinsic value. Its emphasis on non-financial, leading metrics of the drivers of lagging financial results provides verifiable logic to the investments and costs required to execute a market strategy. This, in turn, builds confidence in the intrinsic value calculation.



We used the Value Equation framework with a manufacturing company seeking to differentiate in its historically commodity-driven customer market. Its market strategy had two key components: 1) surrounding the core commodity offering with value-added services and 2) rendering the underlying manufacturing and distribution processes invisible to the customer.

Years of effort to execute the market strategies were unsuccessful until a deep analysis of the Value Equation revealed the need to transform how the company's manufacturing platform was managed, how its sales efforts were governed and executed, and the culture required to do both. The management team was able to justify more than \$120 million in multiyear investments in manufacturing floor systems, marketing and sales training, and a culture change program by successfully linking the investments directly to their impact on market strategy and value growth.

Conclusion

It's tempting for senior management teams and directors to focus on short-term changes in their company's stock price and bow to the pressures of quarterly expectations. True leaders, however, are dedicated to achieving and sustaining growth for their business well beyond the next earnings announcement.

These leaders understand the difference between market value and intrinsic value. While ensuring alignment of the former through effective communication, they focus their strategic objectives around the latter. The ability to forecast future cash flows with confidence is the first step in managing your business around intrinsic value.

It's not the only step, of course; leadership teams must also align their entire organization – people and processes – around intrinsic value, so that it becomes an integral part not just of strategic planning, but day-to-day operations. And no leadership effort will be sustainable without full and effective engagement of the company's investors, public or private.

We will explore these topics in more depth in future newsletters.

About Avondale

Avondale Consulting advises corporations on how to create *profitable growth* and increase the financial value of their business. Avondale works with senior management teams across a range of industries to develop practical and actionable solutions that sustain long-term value creation.

Contact Avondale

For more information on Avondale Consulting, contact one of our Principals or visit www.avondaleconsulting.com.

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