

Taking the Measure of Your Stock's Future Value Premium

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Research Note

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In its fiscal year 2005, Wal-Mart reported record sales and earnings, and CEO Lee Scott wrote in his letter to shareholders that the company's "health and future growth prospects have never been stronger." Yet investors saw things differently, as the company's share price fell by five percent over that period even while competitors' share prices grew by 10 percent. Evidently, investors had changed their opinion about Wal-Mart's ability to grow at the same rate as it had in the past.

The problem faced by the mega-retailer is not uncommon. Many a management team has been forced to explain why investors have not rewarded a company even though it has met its short-term financial goals. The simple explanation for this phenomenon is that while executives are often primarily focused on hitting targets for sales, earnings, return on invested capital, and so on, investors are making judgments about a company's prospects for future growth even as they assess performance in the short term.

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This is not to say that management teams are not focused on the future; no company could survive for long with leaders who were satisfied with the status quo. The problem is that existing management tools and concepts, especially reporting and incentive systems, tend to push executives to manage for current performance, not future growth. Fortunately, top managers need not accept their lack of insight into investors' behavior as a problem that has no solution. New tools are being developed to help senior executives manage for future as well as current value.

In the past, Accenture has written extensively about the concept of future value.¹ In simplified terms, future value is what's left after a company's current value (the present value of its current operations, in perpetuity) is subtracted from its overall enterprise value (the sum of its debt and equity). How important is this figure? In a 2003 analysis of the Russell 3000, Accenture found that nearly 60 percent of the collective enterprise value of those companies was bound up in investors' expectations of future growth rather than in their analysis of the value of current operations. And yet it's precisely that 60 percent that tends to be undermanaged because of the lack of well-developed analytical tools.

In our ongoing efforts to develop such tools as part of Accenture's broader research into high-performance business, we have further refined the concept of future value. In this research note, we explain an important element of future value called "future value premium" and show how it can be calculated. This refinement is not esoteric. An analysis of Wal-Mart's performance in FY 2005, for example, indicates that while its share price dropped by five percent, its future value premium fell by a whopping 43 percent. This is not a metric that can be safely ignored, in short. By analyzing future value premium, in fact, a management team can begin to isolate the amount of value that investors are ascribing to

a company's strategy. And in a "commoditized" industry—one that may impose de facto limits on the amount of future value that companies in the industry can collectively capture—that analysis can show managers whether they are outpacing their rivals in commanding investors' attention.

Finding the Premium in Future Value

A company's future value, as reflected in its share price, has three basic components. The first is merely a matter of the market's belief that the company should increase its cash flow at some general rate of economic growth; in most industries, the rate of growth in gross domestic product is the benchmark. This component, then, is unrelated to investors' confidence in management's ability to create and execute a differentiated strategy.

The second component of future value concerns a company that is earning a return on invested capital that is less than its weighted average cost of capital. Such a company can be said to be suffering from an *operating disadvantage*. Some companies in this position may simply be in decline. At others, investors may expect the management team to bring about a turnaround and make up the difference in the future. In such cases, the share price will reflect the market's belief that the company has at least some future value but necessarily any premium.

Once a future value figure has been adjusted for general economic growth and any operating disadvantage, what remains is the future value premium. This number reveals investor expectations about management's ability to drive growth through strategy and thus either to outpace or fall behind competitors in the future. A few simple calculations show how such numbers can be derived.

Future Value from GDP Growth

Consider the case of a fictional company that produces a return on invested capital exactly equal to its weighted average cost of capital. Such a company would be at the breakeven point for economic profit; it would have neither an operating advantage nor a disadvantage. Now consider that some of the company's future value can be attributed to simple expected economic growth. In other words, investors have already figured into the share price any likely growth in a nation's gross domestic product (GDP). When one calculates a company's breakeven free cash flow at the rate of GDP growth and discounts it back into today's dollars, the result is the net present value of all of the cash flows related to GDP growth.

To make that calculation, assume that the company has an enterprise value of \$100 million, broken equally into future and current value, as in Figure 1. Assume as well that its weighted average cost of capital, or wacc, is 10 percent, and that GDP growth is 3.5 percent. In this case,

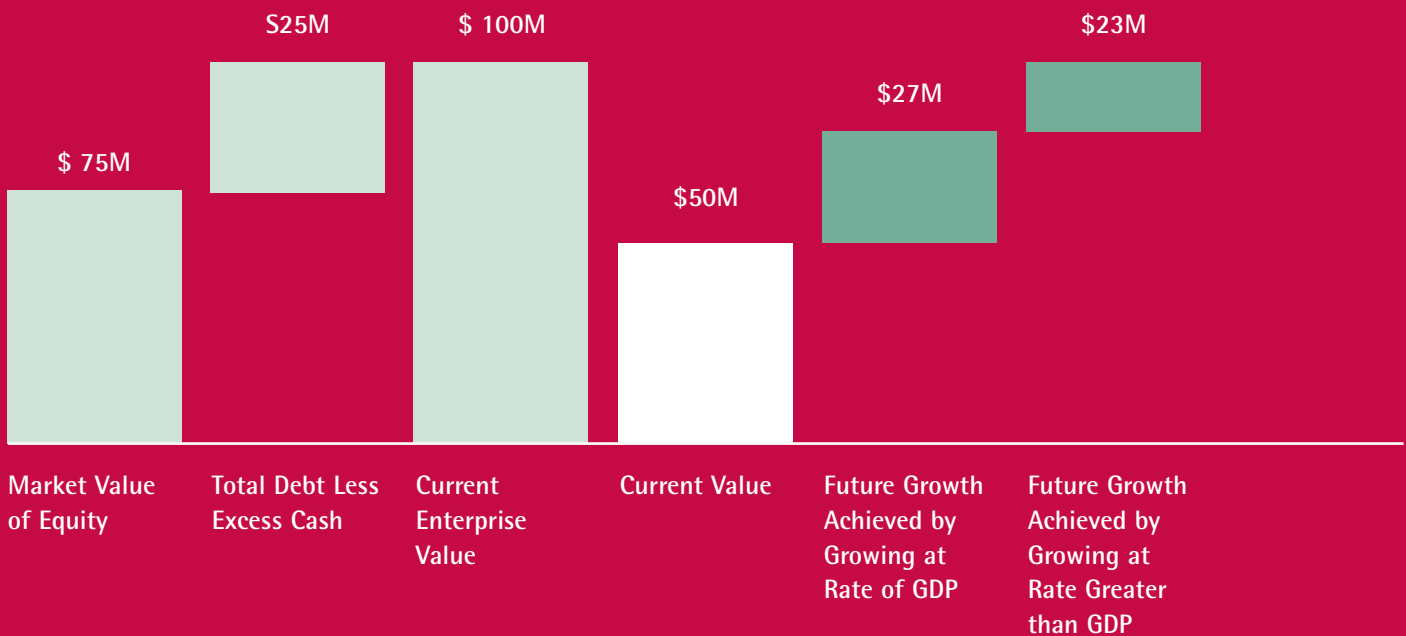
the company's free cash flow (fcf) is \$5 million, a figure derived by multiplying the company's current value by its weighted average cost of capital (\$50 million x 0.1). A simple equation subtracts the rate of general economic growth from the company's weighted average cost of capital:

$$\text{fcf} \div (\text{wacc} - \text{GDP}) - \text{current value (where current value} = \text{fcf} \div \text{wacc}) = \text{the GDP component of future value.}$$

$$\text{Thus } \$5 \text{ million} \div (0.1 - .035) - (\$5 \text{ million} \div 0.1) = \$27 \text{ million.}$$

In other words, of the \$50 million in future value that investors expect in additional free cash flow growth, \$27 million will come simply from growing cash flow at the rate of GDP growth. The remainder, \$23 million, is the company's future value premium. While this analysis looks fairly simple, it provides a powerful insight into what investors think about a company's strategy for growth. In this case, investors have a very positive view of the company's future.

Figure 1: Adjusting Future Value Premium for GDP Growth



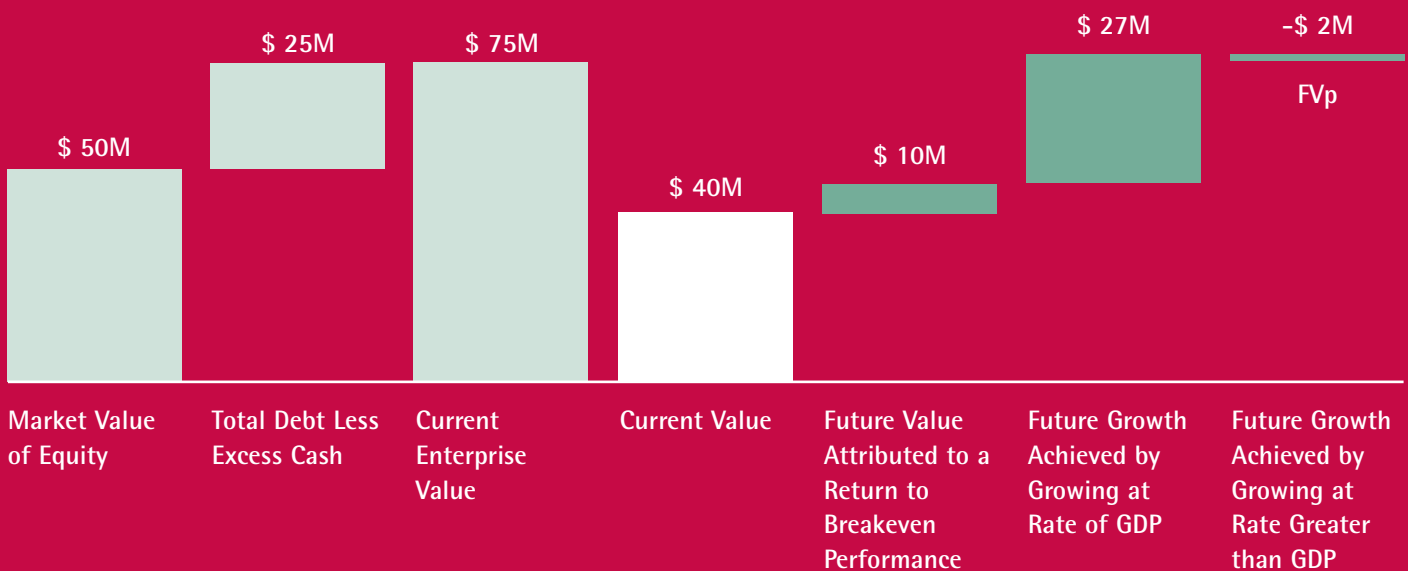
Operating Advantages and Disadvantages

In the real world, companies are unlikely to generate economic profit of exactly zero. Thus it is not enough to adjust future value for GDP growth; it is also necessary to adjust for operating disadvantages (negative economic profit) and advantages (positive economic profit).

For a company operating at a disadvantage, the size of the disadvantage must first be calculated. Assume that the fictional company in Figure 2 is not breaking even; it is earning only \$4 million in free cash flow as opposed to the \$5 million it needs. Thus its current value is \$40 million: \$4 million x 0.1 (the wacc is still 10 percent). To get to the operating disadvantage, multiply the shortfall in economic profit by the wacc; thus \$1 million x 0.1 = \$10 million, the total of the current operating disadvantage. If investors believe that the company will get back to the breakeven

point, are awarding the company any future value at all, they are revealing that they believe that the company is worth at the least the value of its invested capital. So out of \$35 million in future value, the company will have to earn \$10 million to close the operating gap; growing at the rate of GDP growth should yield another \$27 million. In this case, however, investors are "awarding" the company with a future value premium of negative \$2 million, indicating a lack of confidence in management's ability to create and execute a future growth strategy.

Figure 2: Adjusting Future Value Premium for an Operating Disadvantage



For a company that is earning more than its cost of capital, as in Figure 3, one can again assume that it will grow at the rate of GDP growth; in this case, that would again yield \$27 million in future value. The first part of its future value premium comes from investors' confidence in its ability to sustain that operating advantage. The second part of its future value premium comes from investor expectations that the company's strategy for creating future growth will produce value above and beyond what the average company, growing only at the rate of GDP growth, will generate.

Assume that the fictional company generates \$6 million of free cash flow compared with the \$5 million it needs to reach breakeven and cover the cost of its borrowed capital. Taking the \$1 million of cash flow above the breakeven point and dividing it by the cost of capital (\$1 million x 0.1) yields \$10 million; this is the company's operating advantage.

Now the company's future value premium can be split into two pieces. The calculation for the part of it that comes from an operating advantage is this:

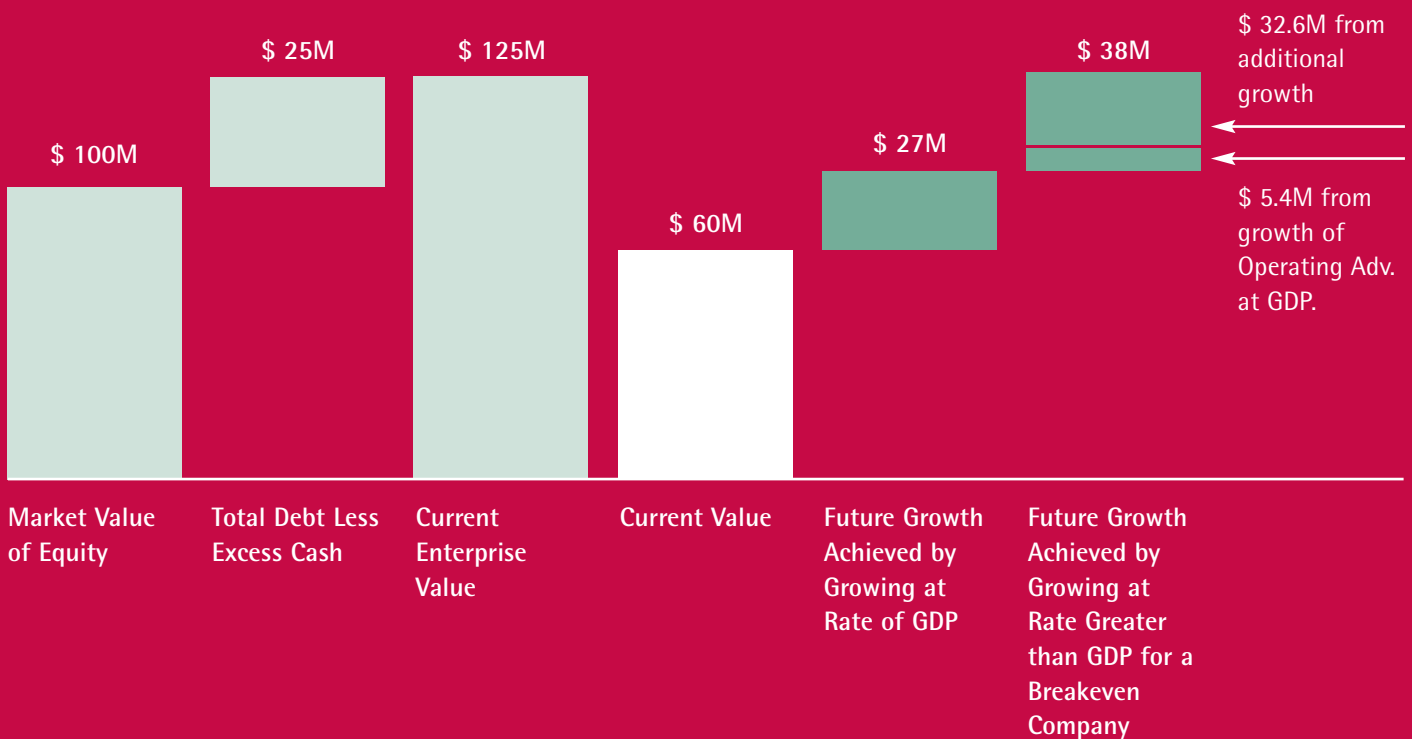
$$\text{Economic profit} \div (\text{wacc} - \text{GDP}) - \text{economic profit} \div \text{wacc} = \text{operating advantage.}$$

In this case, \$1 million \div (0.1 - 0.035) - (\$1 million \div 0.1) = \$5.4 million.

Thus \$5.4 million is the amount of future value premium that is driven by the current operating advantage. The remainder is the portion of future value premium that would come from investor expectations of growth produced by management's future strategy.

This formulaic approach may need to be adjusted in certain cases. For example, in a high-growth industry where growth is expected to surpass GDP significantly for a period of 10 to 15 years, using GDP as the nominal growth rate for the average company would be too conservative. Also, in some cases exchange rates and overall market movements need to be adjusted in order to view the data in a time series for comparative purposes. Looking at a company's future value premium relative to an industry's average may help correct for these movements.

Figure 3: Adjusting Future Value Premium for an Operating Advantage



Adjusting the Focus

When senior executives lack a complete picture of the components of their businesses' share prices, they are managing at a disadvantage. For example, they will not be able to fully gauge the inherent tradeoffs between investing to meet current goals (such as higher same-store sales) versus investing to position the business for future growth (through the development of potentially disruptive technologies, for instance). Ideally, such choices should be more than just a matter of the CEO's gut telling him what to do.

Establishing a culture that manages for today's challenges and tomorrow's opportunities cannot be accomplished overnight. Most companies have executive incentive plans, management systems, and cultures that reward people and units for achieving results that can be measured in financial performance over the previous quarter or year. But tracking the future value premium over time can help reorient a company's focus so that it is more balanced between the present and the future. As the premium goes up or down—reflecting the market's degree of confidence in a management team's ability to create, communicate, and execute a strategy—corporate leaders can adjust more quickly and make strategic decisions that are more likely to achieve the growth that investors seek.

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The Accenture Institute for High Performance Business creates strategic insights into key management issues through original research and analysis. Its management researchers combine world-class reputations with Accenture's extensive consulting, technology and outsourcing experience to conduct innovative research and analysis into how organizations become and remain high-performance businesses.

Notes

- 1 See, for example, John J. Ballow, Robert J. Thomas, and Göran Roos, "Future Value: The \$7 Trillion Challenge," *Outlook*, October 2004; and John J. Ballow, Roland Burgman, and Michael J. Molnar, "Managing for Shareholder Value: Intangibles, Future Value, and Investment Decisions," *Journal of Business Strategy*, Vol. 25, No. 3, 2004.

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