Shareholder Value measurement - essential for effective key account management

By Malcolm McDonald, Emeritus Professor at Cranfield School of Management, Professor at Warwick, Henley, Aston, Bradford Business Schools and the Sino-British College USST Shanghai, and Chairman of Malcolm McDonald Consulting

Malcolm McDonald has done a brilliant job capturing all his KAM research and practical experience!

Martin Lamb

CEO, IMI

The most common objective of modern commercial organisations is the sustainable creation of shareholder value. This can be achieved only by providing shareholders with a total return, from capital growth and dividend yield that exceeds their risk-adjusted required rate of return for this particular investment. This article explains how the investment community works and why shareholder value is good, not only for marketing, but also for key account management.

There are two schools of thought about the topic of shareholder value. One school, led by Hugh Davidson, argues that it leads to short-termism. The other school, to which I belong, argues that short-termism has been endemic in Western economies for decades, and that this has little to do with shareholder value.

Introduction

During a 20 year period, up to 2000, every high performing company in the FTSE top ten in terms of ROI subsequently either went bankrupt, or was acquired. The reason isn't hard to fathom. As Collis said in a Harvard Business Review article in 2008, most Directors don't even know what the components of a strategy are, whilst Christensen said, also in HBR, of 30,000 new product failures in 2006, most were caused by poor marketing.

But, to single out shareholder value (SV) as a major cause of this is ingenuous in the extreme, for it is MANAGERS, who are short term in their behaviour, not the financial investment community. It also reveals a common misunderstanding about what SV really is, and how stock markets around and world work.

1. The Central Role of Risk Assessment in Value Creation

Let's first look at the concept of risk.

For most companies, the current share price already reflects some expected future growth in profits. Thus, these current investors and, even more particularly, potential future shareholders, are trying to assess whether the proposed business strategies of the company will produce sufficient growth in sales revenues and profits, both to support the current share price and existing dividend payments, and to drive the capital growth that they want to see in the future.

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Shareholder Value measurement - essential for effective key account management (KAM) (continued)

At the same time they also need a method of assessing the risks associated with these proposed strategies as, obviously, these will have a direct link to their required rate of return. This is where marketing should play a role. As Figure 1 shows, the perceived risk profile of the investment drives the level of return required by investors in each particular investment.

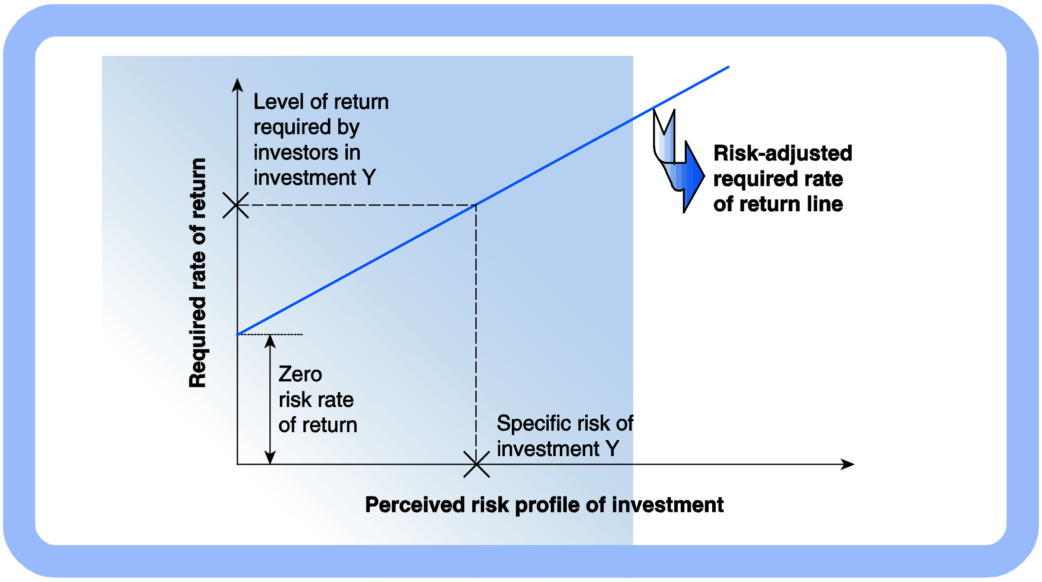


Figure 1: Risk-adjusted required rate of return (McDonald, Marketing and Finance, Wiley, 2013)

Logically, therefore, a normal, rational, risk-averse investor requires an increase in expected future return from any more risky investment in order to compensate for any potential volatility.

Figure 2 illustrates this cause-and-effect relationship.

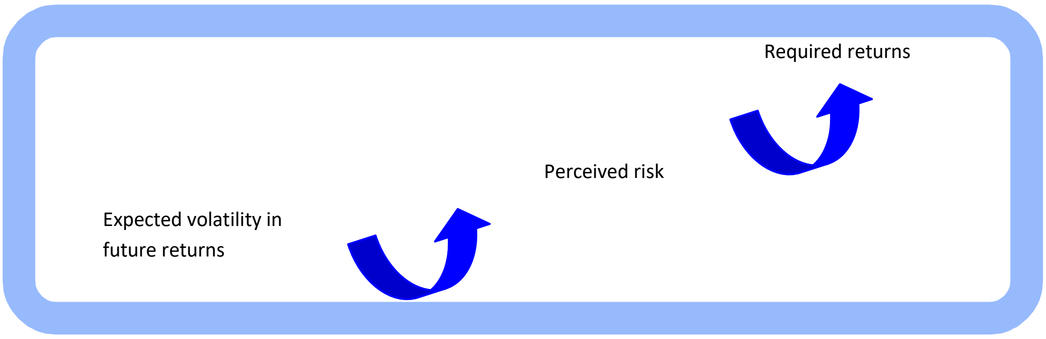


Figure 2: Risk and return (McDonald, Marketing and Finance, Wiley, 2013)

No amount of discussions will alter this inarguable fact of life. It was ever thus and certainly long before Rappaport proposed EVA (the antecedent of shareholder value).

In most government-backed debt investments, investors know in advance exactly what their return will be (i.e. the interest rate payable is stated on the debt offering). However, this is clearly not the case with most equity risk perceptions and, hence, required rates of return. Further, if the historical track record of a company's shares shows significant volatility in share prices and even dividend payments, investors will require much higher returns from the company, as they extrapolate from this past performance to the future likely performance of the company's shares. Thus, life is much more challenging for a highly volatile company, caused by shareholders' natural dislike for risk.

2. The new opportunity for key account management from shareholder value

In the best companies, senior managers carry out proper due diligence on declared future business strategies, taking into account the associated risks, the time value of money and the cost of capital. New strategies have significantly different impacts on risk, which may change their potential for creating shareholder value.

Optimal business strategies seek to increase returns, whilst reducing associated risk levels, and it is these that will create shareholder value. Remember, investors are interested in SUSTAINABLE shareholder value, as it is this which impacts the capital value of shares, not results in a single year manipulated by *short-termism* on the part of managers.

Whether we like it or not, shareholder value will persist as the most logical method of measuring corporate performance, for unless it is created, all stakeholders will suffer. This provides an unprecedented opportunity for key account directors to show the true worth of their work, especially as today intangible assets, (which of course include relationships with customers) now account for about 70% of all corporate value in the United Kingdom.

Figures 3 and 4 set out a very clear methodology for calculating whether key account management (KAM) strategies create or destroy shareholder value. It is this level of sophistication that will get the undivided attention of the boardroom.

Valuing Key Customers

Background/Facts

- Risk and return are positively correlated, ie. as risk increases, investors expect a higher return.
- Risk is measured by the volatility in returns, ie. the likelihood of making a very good return or losing money. This can be described as the quality of returns.
- All assets are defined as having future value to the organisation. Hence assets to be valued include not only tangible assets like plant and machinery, but intangible assets, such as Key Customers.
- The present value of future cash flows is one of the most acceptable methods to value assets including key customers.
- The present value is increased by:

- increasing the future cash flows
- making the future cash flows 'happen' earlier
- reducing the risk in these cash flows, ie. improving the certainty of these cash flows, and, hence, reducing the required rate of return.

Figure 3: Valuing key customers (McDonald, Marketing and Finance, Wiley, 2013)

Suggested Approach

- Identify your key customers. It is helpful if they can be classified on a vertical axis (a kind of thermometer) according to their attractiveness to your company. 'Attractiveness' usually means the potential of each for growth in your profits over a period of between 3 and 5 years. (See the attached matrix)
- Based on your current experience and planning horizon that you are confident with, make a projection of future net free cash in-flows from your key customers. It is normal to select a period such as 3 or 5 years.
- These calculations will consist of three parts:
    - revenue forecasts for each year;
    - cost forecasts for each year;
    - net free cash flow for each key customer for each year.
- Identify the key factors that are likely to either increase or decrease these future cash flows. These factors are risks
- These risks are likely to be assessed according to the factors shown on the next sheet:
- Now recalculate the revenues, costs and net free cash flows for each year, having adjusted the figures using the risks (probabilities) from the above.
- Ask your accountant to provide you with the overall SBU cost of capital and capital used in the SBU. This will not consist only of tangible assets.
- Deduct the proportional cost of capital from the free cash flow for each key customer for each year.
- An aggregate positive net present value indicates that you are creating shareholder value – ie. achieving overall returns greater than the weighted average cost of capital, having taken into account the risk associated with future cash flows.

Figure 4: Valuing key customers (McDonald, Marketing and Finance, Wiley, 2013)

Summary

With legislation around the world placing more and more emphasis on control, procedures, and on corporate governance, and with the increasing potential penalties on individual directors, the need for an objective, recognized, and well-structured review and approval process should be obvious.

KAM is now accepted as a major contributor to sales and profits and requires a change management process to embed it into corporate behaviour. The problem is that unless those responsible for KAM can demonstrate financially that it creates shareholder added value, its chances of success are severely diminished. This is why the processes spelled out in this paper are so crucial to the future of KAM.

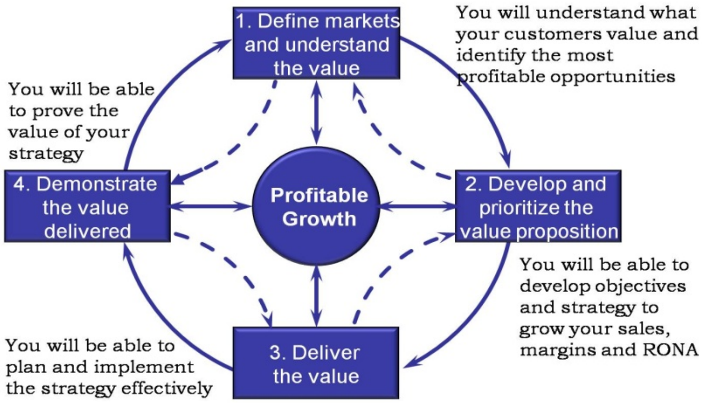
References

Christensen C et al (2005) "Marketing Malpractice: the cause and the cure" HBR Dec pp 77-83

McDonald et al (2013) "Marketing and Finance" Wiley

About Malcolm McDonald Consulting

Malcolm McDonald Consulting Ltd. is a strategic sales and marketing consulting business.



With our end-to-end interactions, from Board level to internal project team, we help companies create value through getting the fundamentals right in strategic sales and marketing, all within budget and the agreed deadline.

Professor McDonald and his team of consultants work with the Boards and internal teams of executives from a number of the world's leading multi-nationals on all continents.

Malcolm McDonald is Emeritus Professor of Marketing at Cranfield University, and Visiting Professor at Henley, Warwick, Aston and Bradford Business Schools. He authored over 40 books on marketing and key account management.

Coming from a background in business which included a number of years as Marketing Director of Canada Dry, Malcolm has successfully maintained a close link between academic rigour and commercial application. He has consulted to major companies from the UK, Europe, USA, Far East, South-East Asia, and Africa, in the areas of strategic marketing and marketing planning, market segmentation, key account management, international marketing and marketing accountability.

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