STRATEGIC AND FINANCIAL DRIVERS OF BUSINESS VALUE CREATION

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Abstract:
The main objective of any business activity is to create value for the owners. Taking into consideration the complexity of today's organizations and circumstances of growing customers' demands in which they compete, it is essential that the company's value-oriented goals are effectively managed at every level of the organization. A well-considered strategy can only be successful if the company's objectives are transparent, understandable for the employees and controllable. The article describes strategic and financial drivers of business value creation and presents methods of their communication across an organization, such as the Balanced Scorecard or KPIs.
Keywords: *business value, value creation, free cash flows, capital structure, cost of capital, Balanced Scorecard, KPIs*

1. Introduction

In the theory of company finance it is generally accepted that the main objective of any business activity is to create value for the stakeholders, of whom the most important ones are the owners of the capital – the investors. In the traditional microeconomic theory as well as in journalistic papers, the aim of running a business is often reduced to profit maximizing. This simplification is unjustified due to the fact that such an approach concentrates on present results while disregarding the structure of revenues and profits in time. Also, it omits the aspect of risk connected with managerial decisions, which has an impact on the value of a business. In particular, in the circumstances of increased competition and growing customers' demands it is essential for the managers to maximize efforts to seek opportunities for achieving a competitive advantage and maintaining value growth duration. As K.J. Hatten and M. L. Hatten stated (K.J. Hatten, M.L. Hatten, 1988): "the job of the managers is ultimately to create value" (p. 3).

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Since value creation is the main purpose of any business, a question arises as to what factors carry value and how to manage business processes so that they are oriented on value creation. The value of a business can be created by different drivers, which recognition and controlling lead to enhanced efficiency of the company business activities. This process is strongly connected with the concept of value based management, hence formulation of a value-oriented strategy has to be proceeded by identification of the key factors that influence the value of a business. Such drivers have to be effectively communicated in the organization so that every person in charge understands the company strategy and contributes to the process of business value creation.

The article discusses the key strategic and financial drivers of the business value and methods of their communication across an organization with the Balanced Scorecard and the usage of KPIs.

2. Strategic and financial value drivers

The necessary condition for value existence is an ability of a separated, organized set of items to generate income (Borowiecki, 1992, p. 27). But the sufficient condition for business value creation is the ability of a company to consistently maximize its risk-adjusted income generation.

In this sense, four types of value drivers can be distinguished, three of which are directly related to managerial decisions on operational, investment or financing issues and the fourth, general one, referring to a so-called period of competitive advantage duration (Rappaport, 1999, p.37, p.p. 78-79). The value drivers, according to the concept of A. Rappaport are presented in Table 1.

Table 1. Strategic business value drivers according to A. Rappaport

General	Operational	Investment	Financing
value growth duration (period of competitive advantage)	sales growth operating profit margin income tax rate	fixed capital investment working capital investment	cost and structure of capital

Source: developed on the basis of (Rappaport, 1999, pp. 78-79).

The Rappaport's strategic drivers of business value are factors which stay within the scope of a company's managerial board responsibilities. The Rappaport's set of drivers was broadened by the additional factors proposed by D. Walters (Walters, 1997, p. 711):

- customers loyalty,

- suppliers and customers engagement in the value creation process,
- operational leverage,
- strategic competence management.

Loyalty of customers and their engagement with suppliers in the value creation process enable reduction of costs connected with seeking new customers and eliminate the cost of changing suppliers.

The operational leverage depicts the structure of fixed and variable costs in the total costs of a company. In the case that business activities are profitable, the higher the fixed costs are, the higher margin the company achieves, as the variable cost per unit is lower. However, in the case of low sales volumes, the higher level of fixed costs is more difficult to cover.

As far as strategic competence is concerned, companies should take notice of the possessed human abilities that are essential for different types of activities – for instance, trading companies should focus on selling competence while production companies would be rather interested in creativity and innovation.

It stems from the above presented sets of drivers that the value of a business is conditioned by the factors which are either operational, investing, financial or intangible. All of them are connected with each other and together can build the value of a business.

The strategic value drivers are closely related to key financial factors which are used to evaluate the effectiveness of business undertakings. Based on them, guidelines for value creation can be developed. These are: free cash flows and the cost and structure of capital.

Contemporary approaches to value driven management are inclined towards the utilization of discounted free cash flows in forecasting future financial results and also – business valuation. In the income-approach methods of valuation, the present value of a company is calculated by adding the residual value to the sum of discounted free cash flows of a several-year period of detailed financial forecast. The concept of free cash flows is complex and contains the above mentioned: general, operational and investment carriers of value, while the cost and structure of capital determine the discount rate. In this way, discounted free cash flows reflect the Rappaport's business value drivers.

Free cash flows represent a surplus of cash generated from operating activities. It is 'free' cash which is left for investors after covering all operating costs and investment expenditure. The question then arises as to why free cash flows are usually adopted as value carriers instead of results calculated in accordance to accounting accrual basis. The subject literature explains this fact claiming that on the financial market, investors are more inclined to make their decisions on the basis of risk-weighted cash flows rather than accounting

results (Cornell, 1999, pp. 90-92; Michalski, 2001, p. 49). Moreover, authors (such as: Copeland, Koller, Murrin, 1997; Rappaport, 1999) argue that managers who intend to create business value should focus on cash flows due to the fact that they allow for consideration of future capital expenditure and are less distorted than the accounting financial result.

In order to present the above problem, A. Black, P. Wright and J.E. Bachman (1998) have conducted a research which consisted in comparing accounting results calculated by managers from different countries on the basis of the same financial data. The outcomes of the study are presented in Tab. 2.

Table 2. Accounting results calculated with different accounting rules application

Specification	The mostly expected result	Maximum result	Minimum result
Belgium	135	193	90
Germany	133	140	27
Spain	131	192	121
France	149	160	121
Italy	174	193	167
Netherlands	140	156	76
Great Britain	192	194	171
arithmetic mean	150.5714	175.4286	110.4286
standard deviation	23.50	22.76	51.08
coefficient of variance	16%	13%	46%

Source: developed on the basis of (Black, Wright, Bachman,1998, p. 43).

The research shows that there are high deviations between the accounting results calculated by different managers. The mostly expected results vary by 16% from the average and the coefficient of variance for minimum results amounts 46%. As P. Fernńdez (2006), remarks: "a company's (…) net income is quite an arbitrary figure, obtained after assuming certain accounting hypotheses regarding expenses and revenues. On the other hand, its cash flow is an objective measure, a single figure that is not subject to any personal criterion".

There are two types of free cash flows that can be distinguished:

- free cash flows for equity (FCFE), which constitute the difference between cash inflows and outflows in a given period that are left for the capital owners, and:
- free cash flows for the firm (FCFF), which are hypothetical cash flows for equity that a company would have if there are no debts.

Free cash flows for equity are calculated according to the below formula:

Net income
+ Depreciation
+/- Change in working capital requirements (decrease +, increase -)
+/- Change in financial debt (increase +, decrease -)
- Capital expenditures

FCFE

Whereas free cash flows for the firm can be calculated as follows:

Net income
+ Depreciation
+/- Change in working capital requirements (decrease +, increase -)
+ Interest (1 – tax rate)
- Capital expenditures

FCFF

Thus, the difference between FCFE and FCFF is:
FCFF = FCFE -/+ Change in financial debt + Interest (1 – tax rate) ,
which means that in the case that there are no debts, the two types of cash flows are equal.

In practice, when focusing on the value of a business, the anticipated future free cash flows are taken into consideration in managerial decisions. Referring to the future results from different points of time requires discounting the values for the same time moment. Depending on the type of free cash flows, a different discounting rate should be used. In the case of FCFE the suitable discount rate is equity cost, whereas for FCFF it is the cost of total capital.

Business activity can be financed by the capital which is either own or borrowed. Own capital is provided by the business owners in a form of shares or retained profits, while borrowed capital has usually a form of loans, bonds, lease obligations or other payables. The diversity of financing methods depends on the company's needs and preferences, but also (Maćkowiak, 2009, p. 47) on: capital availability, flexibility, preferred financial leverage and last but not least – its cost.

The cost of capital is a fundamental issue in the company finance theory, a key factor in the income-approach methods of business valuation as well as methods of assessing investing projects (such as NPV, IRR).

Different definitions of the cost of capital are cited in the subject literature, such as for instance (Szczepankowski, 2007, p. 85):

- the anticipated, average rate of return on an alternative investment of a similar risk level,
- minimum, risk weighted rate of return which a company should generate from its assets in order to be accepted by the business owners (Weston, Copeland, 1992, p. 438),
- minimum profitability for which investors are willing to plough their capital into a project to achieve anticipated profits (Kufel, 1992, p.p. 37-38),
- minimum rate of return on the invested capital needed to retain a business value for the owners (Czekała, Grześkowiak, 1999, p. 83).

It stems from the above definitions that the cost of capital is not an actual cost of capital invested in a business, but the anticipated by the investor minimum rate of return at a given risk level.

The concept of the cost of capital is vital due to the fact that in order to maximize the value of a business, expenditure has to be optimized and the cost of necessary capital – minimized. All decisions on planned investments require assessing the cost of capital needed.

There are several types of the cost of capital that can be distinguished on the ground of company finance theory (Szczepankowski, 2007, pp. 86-87). In general, the cost of capital invested in a business is the sum of the risk free rate and the business premium (Zarzecki, 1999, p. 177). The business premium reflects the investment risk of a particular undertaking and it is a factor which differs rates of return on public bonds, considered as risk-free instruments from risky investments in the shares of companies.

Another category is the cost of borrowed capital. It constitutes a demanded by a lender rate of return after the tax shield effect, which consists in reducing fiscal liabilities of a company as an effect of incurring costs of interests which are tax deductible. The cost of borrowed capital refers to alternative sources of financing available on the market, not the actual interest rate on the company's debts. It reflects the cost of changing the existing debts with a newly borrowed capital.

An important type of the cost of capital is the equity cost. It reflects the rate of return on the invested capital anticipated by the shareholders. Taking into consideration the order of satisfying claims – the priority of creditors before owners, equity cost is the riskiest and, as a consequence, the most expensive form of capital.

Equity capital can be calculated by the following formula (Zarzecki, 1999, p. 177):

equity cost = risk free rate + business risk premium + financial risk premium

The additional financial risk is related to uncertainty and instability of profits for the business owners and can be calculated as:

$$\textit{financial risk premium} = (1 - \text{tax rate})\left(\text{cost of capital invested in business} - \text{demanded rate of return on borrowed capital}\right)\frac{\text{debt}}{\text{equity}}$$

The above approach to the equity cost is just one of numerous methods presented in the subject literature and used in practice. Another popular way of equity cost estimation is the method based on Capital Assets Pricing Model (CAPM).

In CAPM the risk of investing in shares of a company is divided into systematic (market) risk and unsystematic (specific) risk which refers to an individual stock. According to CAPM, the return on an individual stock should equal its cost of capital, which is calculated in the following way (Dudycz, 2005, p. 81):

equity cost = risk free rate + β (anticipated market rate of return – risk free rate)

In the model, the equity cost is the sum of the risk free rate and the equity market premium multiplied by a β -coefficient.

Owing to the fact that equity cost is an anticipated value, all parameters for the cost calculation have to be estimated. The problem refers to, in particular, the market risk premium and the β -coefficient.

The market risk premium, which is the difference between the anticipated market rate of return and the risk free rate, plays the key role in CAPM. The premium has to be estimated on the basis of historical data from a given period of time. According to A. Damodaran (1994, after Szczepankowski, 2007, p. 92) it should be at least a period of ten years. The exemplary risk premiums for different countries, by A. Damodaran are systematically updated on http://pages.stern.nyu.edu/.

CAPM introduces β as the relevant measure of specific risk. It describes relative volatility of a security, which means reaction of a stock price to

changes of the market index (http://www.investopedia.com/articles/06/capm.asp).

Beta can be calculated on the basis of historical data by the formula:

$$\beta = \frac{cov\,(r,\, r_m)}{\sigma^2_m}$$

where: $cov\,(r,r_m)$ means covariance between rates of return on a security and the market portfolio, and σ^2_m means variance of rates of return on the market portfolio. Interpretations of possible β values are presented in Tab. 3.

Table 3. Beta values interpretations

β value	**Interpretation**
$\beta > 1$	Security price changes in the same direction that the market but it is more volatile
$\beta = 1$	Return on the security is the same as on the market portfolio
$0 < \beta < 1$	Changes of the market index cause changes of the security price in the same direction but less than the benchmark
$\beta < 0$	Security price changes in the opposite direction than the market

Source: author's elaboration developed on the basis of (Szczepankowski, 2007, p. 89)

The last but not least category of the cost of capital is weighted average cost of capital (WACC) which is the total cost of equity and borrowed capital, weighed by the share of each type in the sum of capitals. The level of WACC is a measure of the minimum accepted rate of return for all financing parties and it influences the present and future condition of a company. WACC is often applied for the purpose of business valuation and in value based management. It also plays a key role in economic value added (EVA) calculations (see also: Maćkowiak, 2009).

The structure of capital is, beside its cost, a factor influencing the value of a business. Capital structure means combination of equity capital and long-term debts, which constitute fixed capitals of a company. It informs about the level of long-term indebtedness. Capital structure is connected with a broader issue of financing structure which covers all liabilities of a company (Szczepankowski, 2007, p.p. 83-84). The relations are the following:

$$\textit{financing structure} = \frac{\text{total liabilities}}{\text{equity capital}}$$

$$\textit{capital structure} = \text{financin structure} - \frac{\text{short-term liabilities}}{\text{equity capital}} = \frac{\text{long-term liabilities}}{\text{equity capital}}$$

3. Communicating value drivers across organization

The Rappaport's strategic drivers of the business value are factors which stay within the scope of the managerial board responsibilities. However, in order to manage the company strategically, it is necessary to take into consideration three different levels of strategic management. These are (Pierścionek, 1996, p. 78-80):

- corporate level,
- business unit level,
- functional (departmental) level.

The corporate level deals with problems of development policy and allocation of resources. It manages businesses portfolio ensuring they are compatible with the corporate strategy. This level is, by nature, value-oriented and conceptual, whereas the other two are more concrete.

Managing on the business unit level consists in choosing the type of strategy which fits to the product or the business cycle. The strategic issues on this level are more practical. The managers of the business unit level develop tactics to beat the competition. They aim to achieve and sustain a competitive advantage for the products or services that are produced.

The third level of strategic management contains operational methods for implementing tactics (2nd level) and developing the general corporate strategy (1st level). The strategic issues at this level are related to functional business processes and value chain.

The central strategy of a company is formulated at the top of the organization and has to be effectively communicated from the top to the bottom. It is an important point of business value creation process because strategy itself does not drive financial performance – execution does (Lowy, 2013).

The Balanced Scorecard ("BSC") is a method of describing the corporate strategy so that it is transparent and understandable by all people in the organization. It was first developed by R. Kaplan and D. Norton (see: Kaplan, Norton, 1992). BSC translates the value oriented strategy developed at the top of the company into more particular objectives, measures of performance (such as KPIs) and bottom-up initiatives, decisions and other operational activities (see Fig.1).

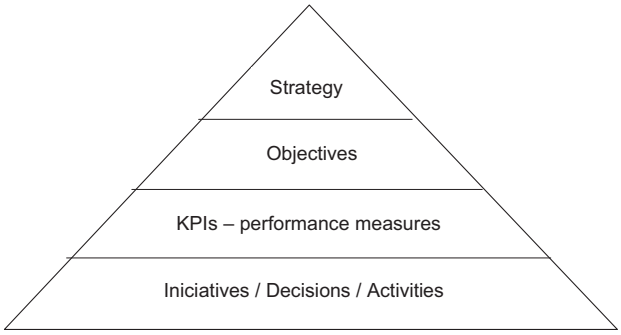

Figure 1. Utilization of Balanced Scorecard to describe the company's strategy
Source: based on (Deloitte, after: Gorzeń, Piernicki, Pniewski, 2008, p. 133).

The objectives which should lead to value creation as well as their measures are grouped into four perspectives (Świderska, 2006, p.147-150):

- financial – which contains financial goals, including the general objective of value creation. It answers the question of how we look to shareholders. The examples are: cash flows, sales growth, operating income, ROE, ROA, EVA;
- customer – describes the picture of how we are seen by the customers. It contains the most important – market goals and measures which depict the effects of the company activities in the field of customer relations. From this point of view, the key measures are: market share, percent of sales from new products, customer loyalty level, level of customer satisfaction;
- internal business processes – enables to control efficiency of the strategically essential processes which empower financial and customer objectives. The question that is asked in this perspective is "What must we excel at?". The measures of internal business processes are such as: product quality, length of production process, unit cost, level of technological advancement;
- learning and growth – indicates the existing deficiencies in ability of people, IT systems and procedures which have to be amended. In this perspective the question is "How can we continue to improve, create value and innovate?" and the exemplary measure are: level of employees' education, employee satisfaction, measures of IT systems flexibility, time to develop new generation of products.

The BSC focuses on the factors which are essential for achieving the business value growth and puts them together in a single report. Therefore, it is helpful to communicate the strategic goal of the company across the organization. The BSC can ensure that the managers of functional level steer in the same direction as the management board of the company. The value-

oriented strategy formulated at the top of the organization can be described in a complex way by the usage of the Balanced Scorecard. The BSC enables us not only to communicate the main goal of value creation but also to control its accomplishment.

Communicating the value-oriented strategy has to accomplish two tasks (Gorzeń, Piernicki, Pniewski, 2008, p. 137). Firstly, it should help to inform effectively all employees of the value growth strategy and ensure it is understandable. Secondly, it is aimed at building motivation in people for strategy realization.

The so-called key performance indicators (KPIs) are a way of translating the company's strategic targets so that they can be understood and manageable by all people in the organization. The company has to be broken down into basic financial value carriers and for the chosen controllable ones, indicators of performance can be determined, as presented in Fig. 2. A set of well-considered KPIs is an instrument of setting objectives on the departmental level.

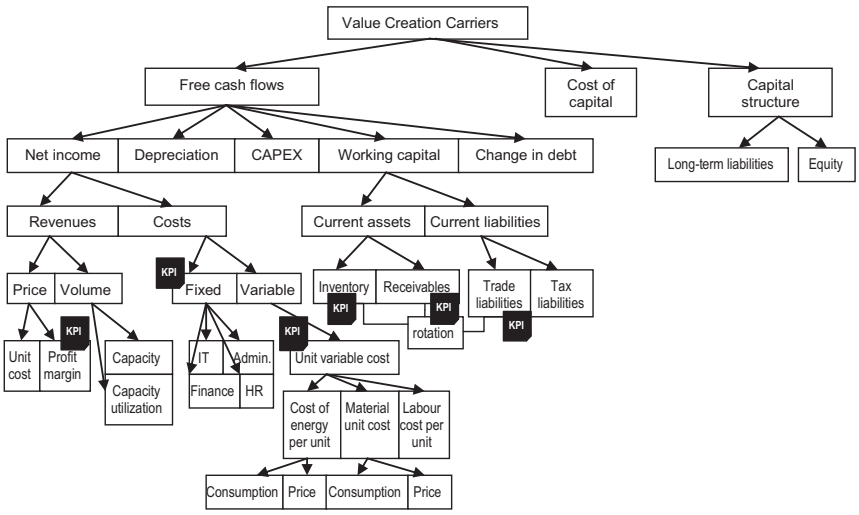

Figure 2. Value creation model with exemplary selected value drivers for KPIs
Source: Author's work based on the concept of (Gorzeń, Piernicki, Pniewski, 2008, p. 120).

There are three processes which connect KPIs to value creation (Sever, 2007): selection, formatting and communication. Selection of KPIs should be preceded by deliberation and discussion on the inputs, production, outputs and losses. This raises awareness of the business operational process and helps to identify value losses which occur at every stage of it (Fig. 3).

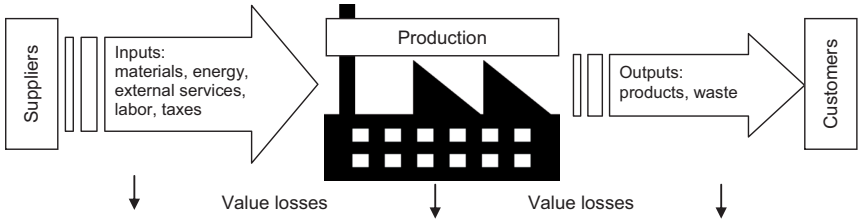

Figure 3. Value losses occurrence at each stage of the business process

In the process of KPIs selection it is essential to ensure that people who will later be responsible for chosen metrics are involved as much as possible. It is equally important that the people in charge are able to actually impact measures which are appointed to them.

KPIs formatting consists in choosing dimensions for the variables. It is useful to put four dimensions: prior period, actual, budget and target to see in a perspective about the past, the present, the plans and the possible best.

After selecting and formatting, KPIs have to be communicated to all their users. Good understanding of the KPIs as well as employees' awareness of their share in the process of value creation is essential to achieve the added value from introduction of the system of indicators. Presenting KPIs in a form of groups of charts is a useful and approachable way to communicate value-oriented strategy across the organization. Moreover, grouping of charts for departments which should cooperate together can facilitate removing barriers and enable for the process orientation. Good KPIs communication can change an organization culture by introducing a collaborative problem-solving language, it also helps employees to see themselves in a 'big picture'.

4. Conclusion

The article depicts the strategic and financial drivers of business value creation and methods of their communication across the organization. Reassuming the above deliberations, an effective value-oriented strategy should focus on value drivers such as free cash flows as well as cost and structure of capital. However, developing a successful strategy that would ensure value creation, has to be effectively communicated from the top to the bottom. It can be achieved by

splitting the value-creation objective into factors which are understandable by the company employees, so that they can see their place and role in the whole process, because it is eventually people who create value. The usage of the Balance Scorecard and KPIs can ensure that the company's strategic goal is transparent and controllable at every level of strategic management.

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