

About Shareholder Wealth / Profit:

Profit is the earnings a company realises after all costs, expenses and taxes have been paid. It is calculated by subtracting all business expenditures (e.g. depreciation, interest and tax costs) from revenues. Profit is the supreme measure of value as far as the market is concerned. Profit is also called earnings or net income.

Profit can also be referred to as the difference between the price received for a product and its cost (the price of the factors of production used to make it); excess of revenues over expenses; an entrepreneur's reward for using factors of production in economic activity.

Profit is the overarching mission of many private-sector companies. Nonprofit or governmental organisations either operate at a loss or attempt to achieve a zero profit; for them the overarching mission is a charter for a service, or a goal to be achieved. Therefore, there is a basic distinction in measures of strategic success between profit and nonprofit or governmental organisations.

The goal of most companies is to increase shareholder wealth. Shareholder wealth is increased by increasing the company's profit. For instance, in a company involved in manufacturing, reducing the cost of the factors of production is essential for growth.

One of the major components of production costs is labour. When it comes to labour costs, the company and its workers usually have very different goals. The company wants to pay the worker as little as possible, while maintaining the productivity and quality required by its customers. The worker, on the other hand, seeks to increase his or her personal wealth by demanding the highest possible wages and benefits.

Due to this somewhat adversarial relationship, companies and their workforce have developed strategies to strengthen their positions. One of Labour's main defenses is to form trade unions. The existence of unions can be an effective method of gaining a position of strength, especially when dealing with power corporations. Depending on the size of the corporation, they might have the power to employ methods which are difficult for the workers to prevent or counteract.

However, in today's marketplace, improving shareholder wealth is central to business success. Shareholder value analysis is an important element of the strategic planning process, and value-based planning is replacing more traditional methods. A successful business is therefore, one that creates value for its owners.

With the ever-present competitive pressure to deliver, business managers have recognised their obligations to all of their major constituencies, particularly their shareholders, customers and employees. Shareholders expect value-based strategies that assure long-term growth; customers expect value for money, the correct mix of quality products, and service; and employees expect to be rewarded fairly for their effort. Maintaining a balance among these three strategic values is complicated (but essential) and can be assured only if the business is capable of achieving and sustaining success.

A company must implement a strategy that continues or develops strong operating performance, and must devise a complementary plan for growth and investment. In order to implement this strategy, the company should have a balanced view of the present and the future; a true picture of its stakeholders; and a management approach that ensures adherence to the company's stated principles by rewarding successful achievement of its objectives.

In the light of these developments, many companies have turned to carrying out a Shareholder Value Analysis (SVA). The application of SVA is based on the premise that discounted cash flow (DCF) analysis techniques can be applied to the business as a whole and not just to capital budgeting, acquisition justification, lease-or-buy decisions, etc. The process is based on a relatively simple two-step approach: evaluate individual projects for their ability to generate cash flow and thus contribute to the economic value of a business unit; and assess the potential economic contribution of each business unit to the company's overall strategy.

It is at the business unit level that value is created or destroyed. The process of reconciling business strategies and their economic value forces management to focus on the steps needed to ensure adequate return on current and future investments. This process challenges the notion that growth is essential regardless of costs. True shareholder value is the favourable ratio of a firm's equity and debt to the real replacement value of its assets.

Shareholder wealth is created in two ways:

- i. through the maintenance of a positive spread between return on equity and the cost of equity capital, i.e., profits exceed what investors require from companies in the same risk class; and
- ii. through investment in new assets, i.e., growth opportunities, at a positive spread. A negative spread destroys shareholder value, and accelerated growth only speeds the destruction.

The SVA approach considers a company's strategic plan to be a portfolio of market- or product-related, investment-requiring opportunities. Generally speaking, SVA assumes that a business is worth the net present value of its future cash flows, discounted at the appropriate cost of capital.

Because SVA emphasises cash flow, an early step in the SVA process is necessary to identify the measures of business performance and value that drive shareholder wealth or factors that influence a company's cash generating capacity. Examples of value drivers: investment, sales growth rate, operational cash flow, etc.

Few companies have a consistent link between the processes of formulating and valuing strategies. Formulating the strategy involves analysing the attractiveness of the industry, evaluating the business's competitive position within the industry, and identifying sources of competitive advantage. In the process, the company often focuses on customers and competitors without testing the impact on shareholder value. Evaluating the strategy includes an assessment of its ability to create a sustainable competitive advantage. Gaining a competitive advantage depends on a company's ability to provide a comparable product at lower cost than competitors, or to provide superior value to the customer through higher quality, special features or post-sale service without incurring long-term costs, including the cost of capital, that exceed the cash generated by sales. This advantage normally applies over a finite period of time; as competitors respond, the advantage will diminish.

Directors are responsible for ensuring that the organisation's economic value is as high as possible. In order to influence the market's valuation of stock prices, it is important to understand the role of economic value compared with that of Earning Per Share (EPS) or sales and profit growth. Directors need to view the organisation through an outsider's eyes, particularly in areas that most heavily influence investor decisions and the market:

- the relative prospects or potential of the company;
- the risk associated with investing in this company versus an alternative investment;
- the amount of cash the investment is expected to return and the period of time over which returns will continue.

Managing a company's financial goals system is a never-ending process in which competing and conflicting priorities must be balanced. At any point, the system is potentially unstable because of the changing corporate environment, shifts in power, and other external and internal influences. Senior management should therefore emphasise the need to achieve maximum corporate value at all times. This involves estimating the value of each strategy in the corporate portfolio. It is also vital that the finance manager take a very active role in the organisation's strategic planning process. Only in this way can the organisation appropriately evaluate all alternatives and assess their long-term viability.

Managing for value is a paradigm that must be absorbed by the organisation. The organisation must ensure that all management levels are committed to the SVA approach and have a good understanding of sound economic concepts.

Although shareholder wealth or value is a result rather than a driver of performance, it should be included in any performance measurement system. Including it ensures that there is continued focus on customer service, market position and the development of products that generate long-term value for the company. This will shift the company's emphasis from short-term measures like gross profit margin and sales growth toward generating future growth. Emphasising shareholder wealth will help managers of individual business units; assess the impact of their strategies on the entire company's wealth.

Financial performance measures indicate whether the company's strategy, implementation and execution help to improve the bottom line. Improved operational performance (e.g., product or service quality, or enhanced productivity) does not guarantee that a company's financial picture will brighten. While managers sincerely believe that these improvements add long-term value, it may be difficult if not impossible for the company to capitalise on them. Not all long-term strategies are profitable ones.

If the company's objective is to create wealth or profit for the company and for its shareholders, then its strategies must be translated into tangible goals and objectives that can be measured and subsequently rewarded. An analysis calculating measures such as return-on-capital-employed and cash flow enable the organisation make short-term informed decisions, while the ability of the company to rely on its forecasts makes it possible for it to reduce historical uncertainty caused by unexpected variations in its performance.