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The Art of Value Creation and Measurement

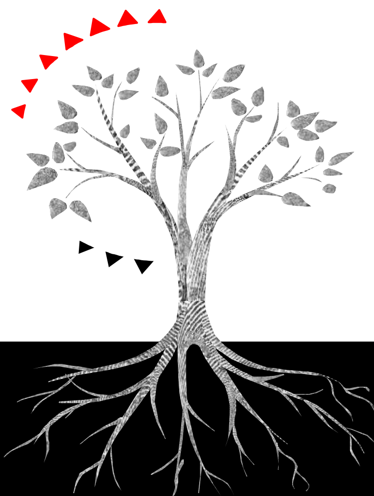
Value creation became the ultimate measure for corporations by which they are judged. During the past years, debates have focused on the question of what is the most appropriate type of value for a corporation to create. There exist different opinions whether it is the value the stock market gives to a company (market value), or the value shown in its balance sheet (book value of its assets minus its liabilities), or if it might be something based on its expected future performance (referred to DCF-Valuations).

During the last decades the shareholder value approach was the preferred one by most executives. Creating value for shareholders, in terms of high dividends, which are related to a healthy financial situation, and growing cash flows was the focus of every company's activities. This was directly reflected by the company's stock price and so an easy to follow and understandable indicator. Everybody could see whether a company grew (i.e. creates value) or shrinked (i.e. destroys value). But it became clear that measures based on stock market values are subject to the same volatility as the market itself. In a "Hausse" all companies raise. But macro-economic changes and generally forced up markets do not lead to the fact that values of individual companies change in the same way.

The market movement isn't caused by the representative values of companies, but by a few individual corporations which have a major impact on their industries and is further influenced by partly ambitioned expectations of institutional and private investors. Hypes like the dotcom bubble at the end of the 1990s proved that investors' expectations can leverage corporate values on very high levels without any assignable basis.

New measurement systems regarding the value of companies were set up. The idea to measure the value of a corporation based on its future prospects was born, but, nevertheless, was not an easily applicable alternative. Very soon analysts ran into the difficulty of quantifying what those prospects are – nothing more than assumptions and leaving the question how they can be justified. The idea that a company is no more than the net present value (NPV) of its future cash flows was based on uncertainty. What is that cash flow going to be in the future and what kind of interest rate is used to discount those cash flows? However, these measures do have one great advantage, which is that they are independent of accounting rules. They can be used to compare companies in different industries and countries and DCF-models are still common for evaluations of companies, projects or investments.

Another measurement system, which was developed by Stern Steward and co., overcomes these problems. It is called EVA® (economic value added) and it is the measure of outputs (taken as operating profit after tax and further adjustments) less input (taken as the annual rental charge on the total capital employed, both debt and equity).



The advantage of the EVA® can be seen on two perspectives. Firstly the managers have all parts of this equation like costs, revenues, debt and capital expenditure on a (nearly) daily basis, to calculate the economic value added on every business activity and their overall organization. Secondly when it increases or decreases they have no one to praise or blame but themselves as these financial positions are directly managed.

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