



32nd National Conference

Contemporary Governance

Shaping the future



Driving Long-Term Value Creation

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Two Types of Company

Long-term Value Creators

- Build enduring institutions
- Long-term intrinsic value uplift
- Focus on customer value and shareholder wealth
- Put company and long-term shareholder interests first

Short-term Share Price Managers

- Try to maximise share price
- Short-term market value uplift
- Strong focus on short-term Earnings and EPS growth
- Can be hostage to short-term capital market players



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Three Topics to Cover

Recognising the
Drivers of
Short-termism

Establishing
the Correct
Understanding

Driving
Long-Term
Value Creation



What's Driving Short-termism?





The EPS Myth

- EPS and P/E determine value and EPS growth and P/E drive value uplift. **Not true**
- Earnings and EPS are good indicators of product and service market performance. **Not true**
- Better short-term capital market outcomes stem from better short-term product and service market performance (better EPS outcomes). **Not true**



Exploding the EPS Myth – Step 1

EPS growth does not drive value uplift and is a poor indicator of management performance – because it can be bought at any price

	Base Year				Earnings Growth	Growth in Equity	Year 5			
	Equity Capital Employed	Earnings	Cost of Equity	Economic Profit			Equity Capital Employed	Earnings	Cost of Equity	Economic Profit
Company A	100	10	10%	0.0	15%	10%	161	20	10%	4.0
Company B	100	10	10%	0.0	15%	15%	201	20	10%	0.0
Company C	100	10	10%	0.0	15%	20%	249	20	10%	(4.8)

Note. All figures are in millions of dollars except for percentages

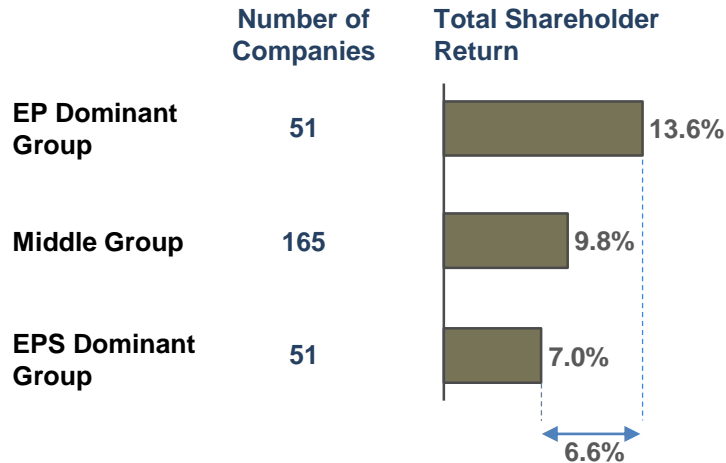
Source. Kontes: *The CEO, Strategy and Shareholder Value*, Wiley, 2010



Exploding the EPS Myth – Step 2

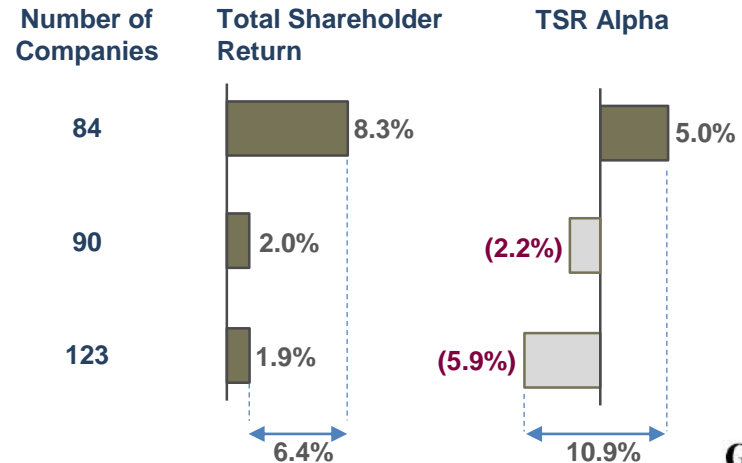
TSR is more closely related to growth in EP/share than to EPS growth

S&P 500 – 10 Years to 31 Dec 2007



Source. Kontes: *The CEO, Strategy and Shareholder Value*, Wiley, 2010

ASX 300 – 5 Years to 30 June 2013

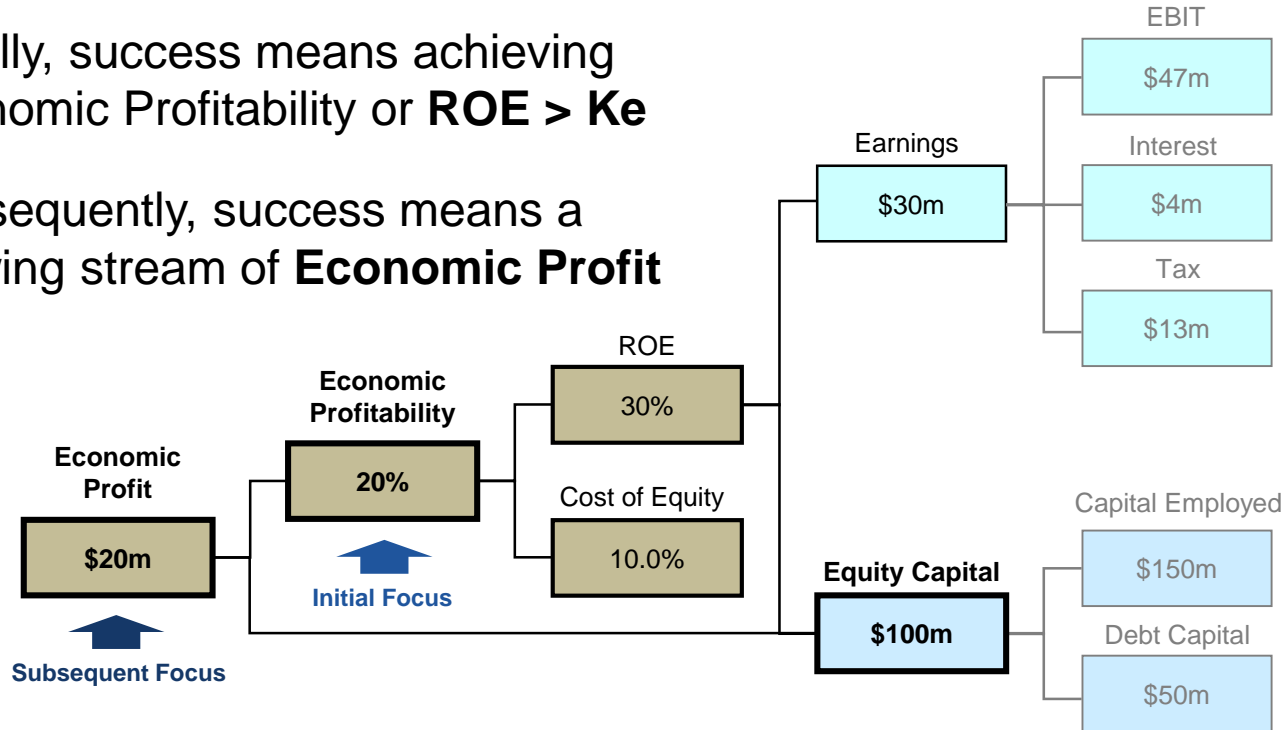


Source. KBA analysis of Bloomberg data



Success in the Product Market

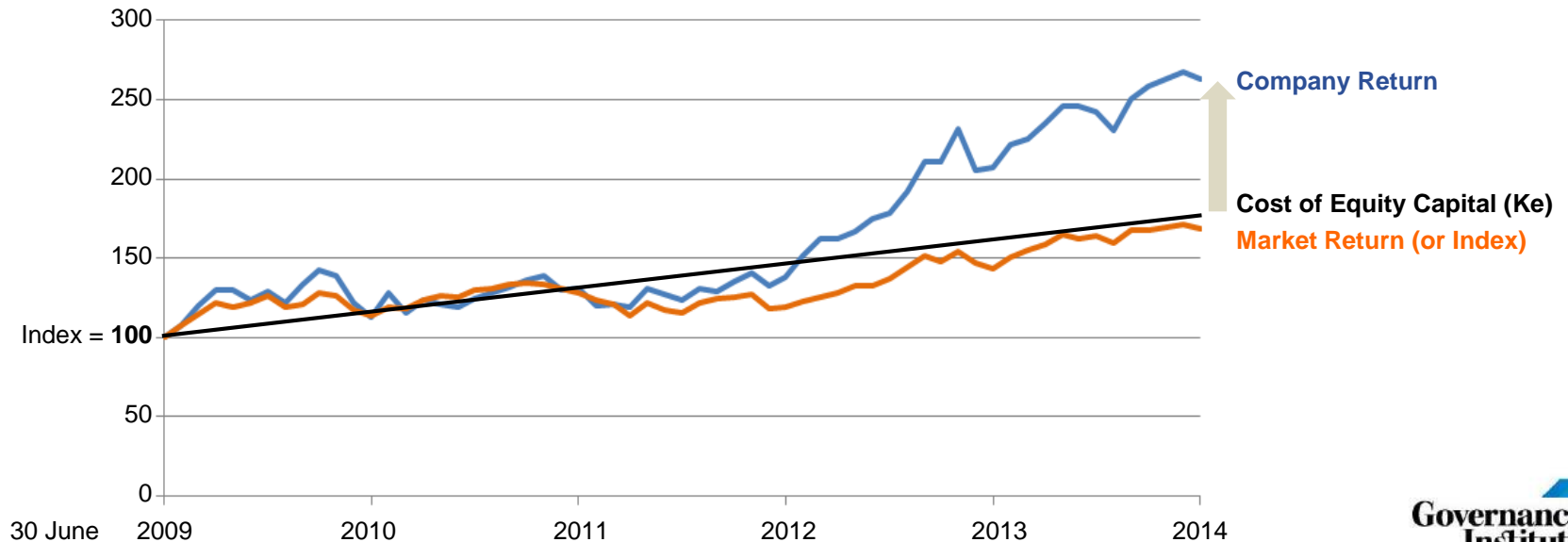
- Initially, success means achieving Economic Profitability or $ROE > Ke$
- Subsequently, success means a growing stream of **Economic Profit**





Success in the Capital Market

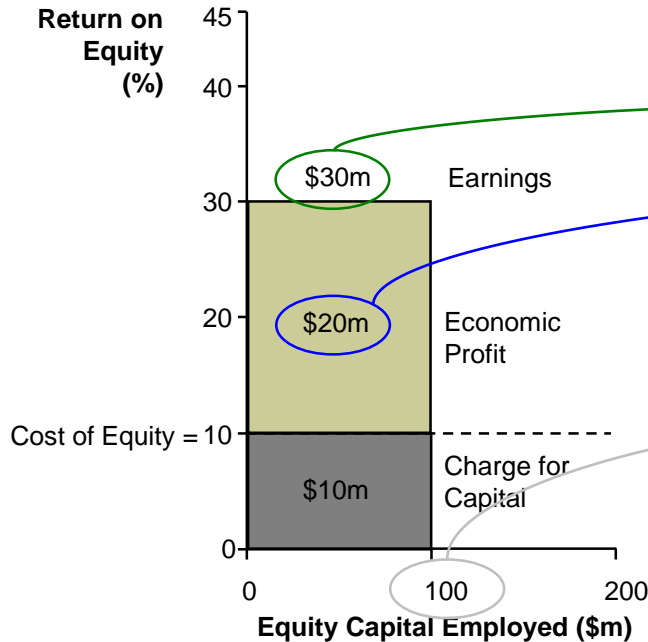
Success in the capital market success means achieving a **TSR > Ke**



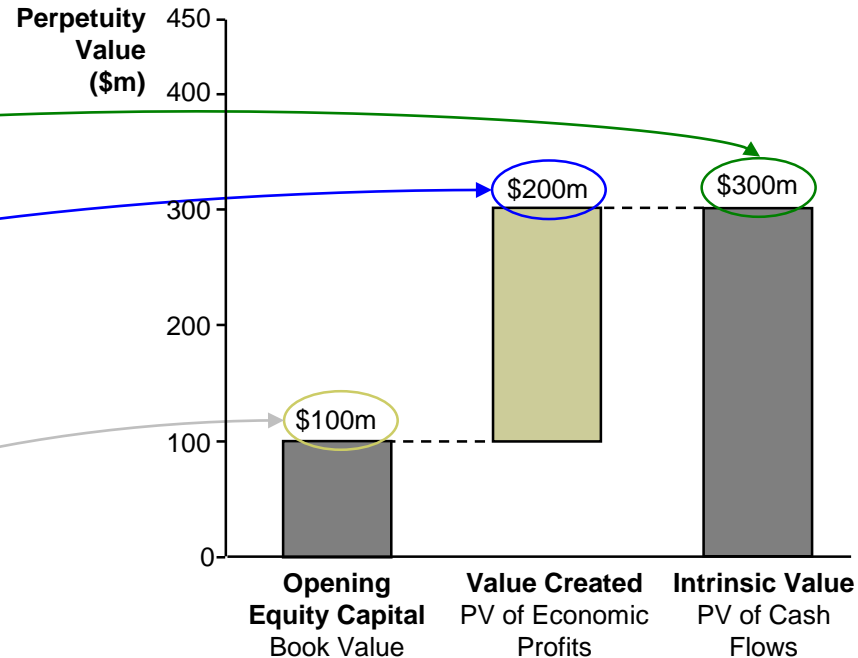


Linking EP and Value

Current EP Performance



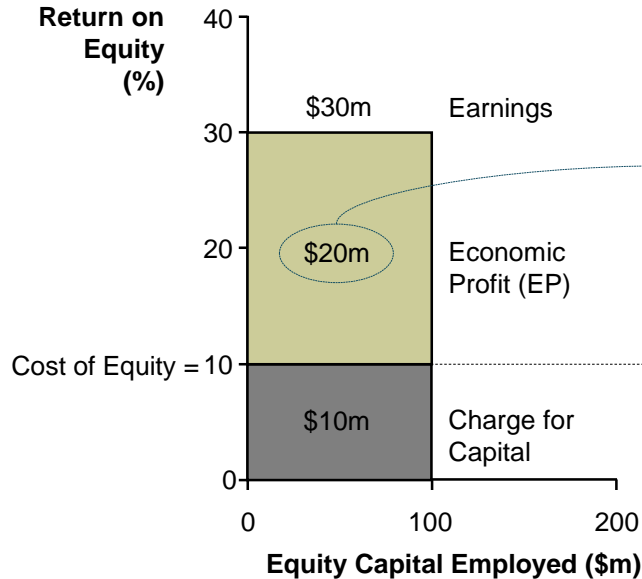
Value if Maintained in Perpetuity



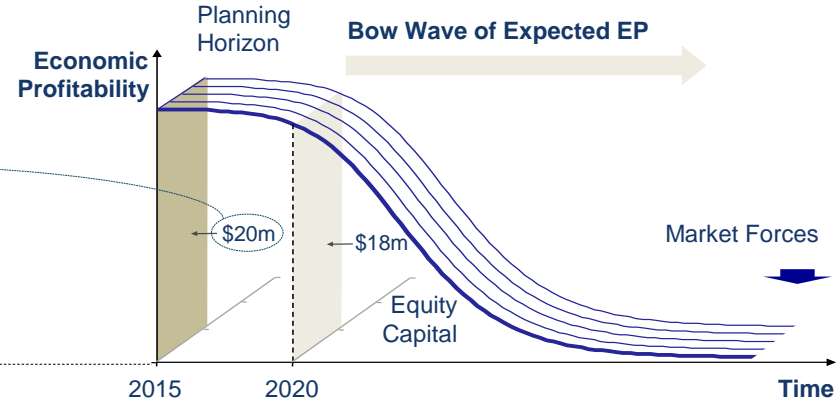


The Bow Wave of Expected EP

Current EP Performance

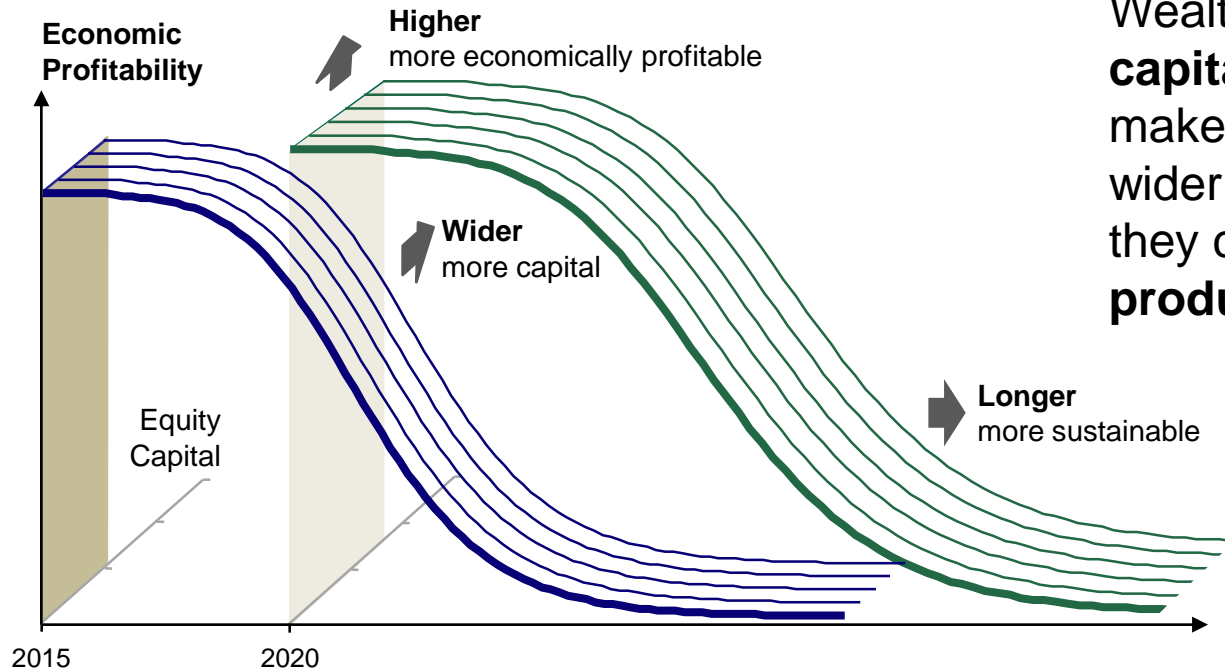


Expected EP Performance





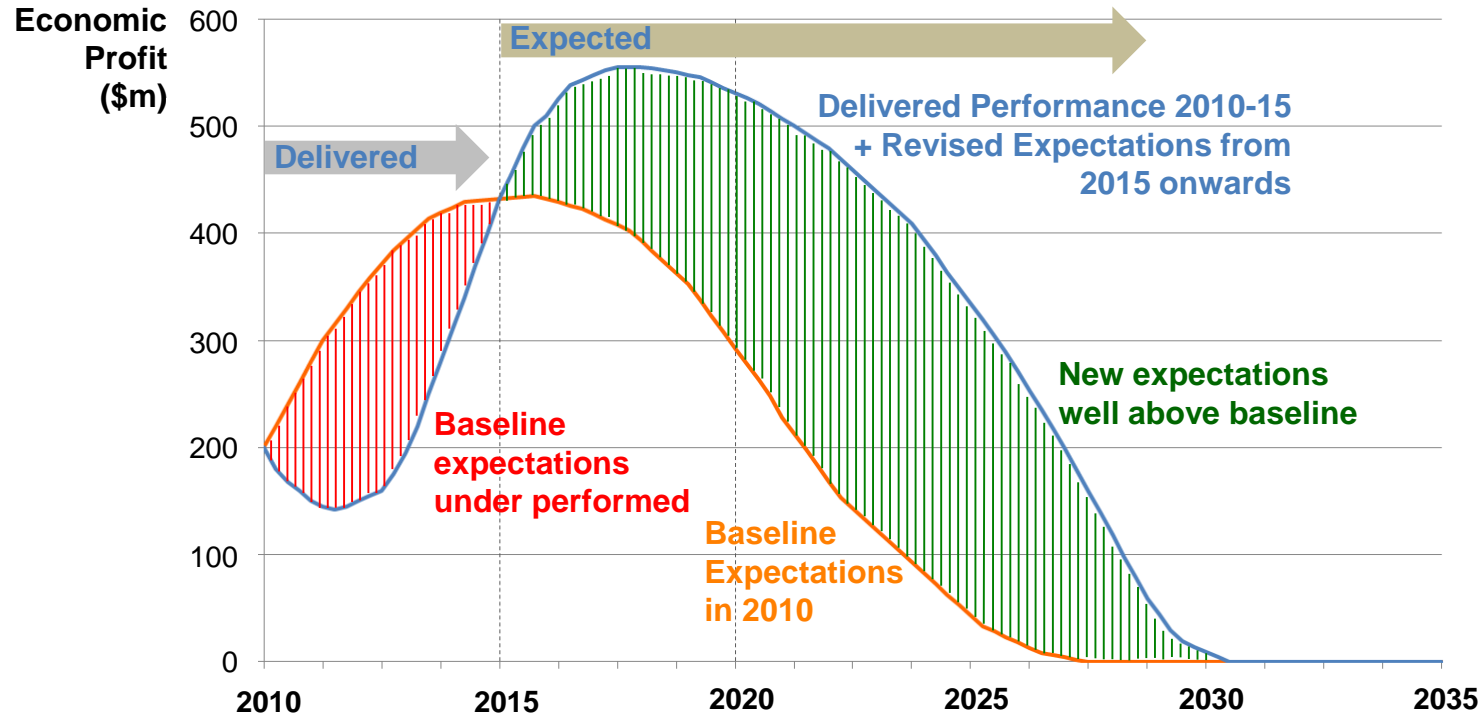
Product & Capital Market Linkage



Wealth will be created in the **capital market** if management make the **EP Bow Wave** higher, wider or longer, through the way they choose to participate in the **product and service market**



The Pair of EP Bow Waves





Two Ways to Create Wealth

	Total Shareholder Wealth Created (Billions of Dollars)	Impact of Meeting EP Expectations (Billions of Dollars)	Impact of Creating New Expectations (Billions of Dollars)	Increase in Bow Wave Length (Years)
Telstra	41.2	(3.7)	44.9	25
Amcor	8.4	(3.8)	12.2	25
Brambles	7.2	(0.9)	8.1	30
Wesfarmers	3.7	(3.6)	7.3	30
REA Group	3.0	0.1	2.9	30
Dominos	2.6	0.1	2.5	20
Carsales.com	1.0	0.1	0.9	20



Short-termism in the ASX 300

		Δ Payout Ratio	Δ Capital Growth	Post GFC 5-year Annualised TSR
All ASX 300 Companies	300			4.8%
Sustainable Growers	75	↓↓	↑↑	17.0%
Sustainable Yield Chasers	40	↑↑	↑	7.1%
Managing for Returns	82	↓	↓↓	1.3%
Unsustainable Yield Chasers	103	↑↑↑	↓↓	(1.8%)

Note. Change in Payout Ratio and Capital Growth means 5-year post-GFC average versus 5-year pre-GFC average.
More details are in *KBA Insights* May 2015



Three Fundamental Capabilities

Value Measurement Capability



Understand where value is being created, where it is being destroyed, and why, under the current strategy

Value Creation Capability



Develop and evaluate alternative strategies that enhance value for both customers and shareholders – and then adopt and commit to a higher value strategy

Value Management Capability



Put in place business processes and systems that encourage the ongoing pursuit of even higher value strategies over time



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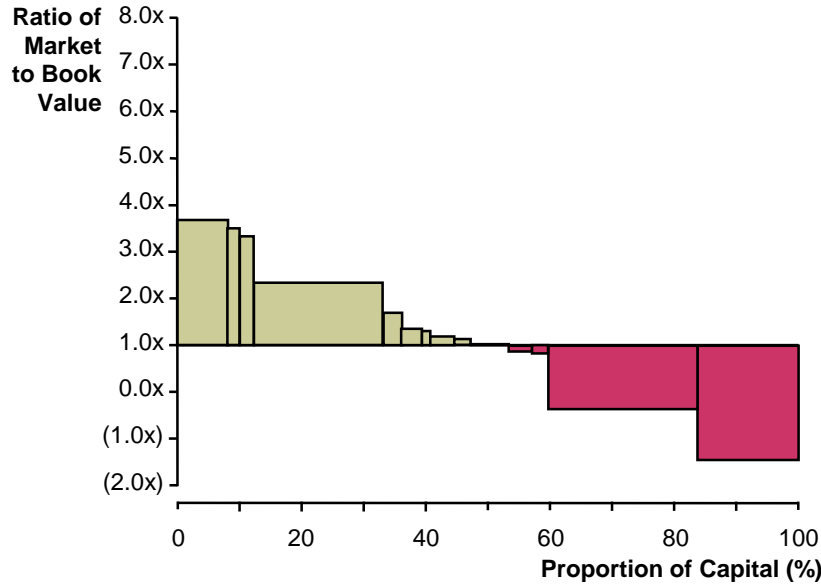


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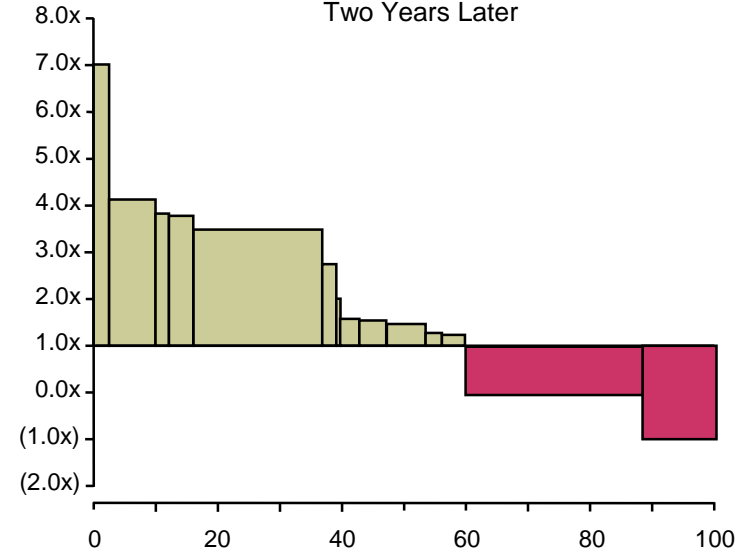


Primary Focus at Segment Level

Initial Value Creation Profile by Segment



Value Creation Profile by Segment Two Years Later





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Aligning Executive Reward

Measuring Wealth Creation in the Capital Market

Wealth created by achieving a positive **TSR - Ke** outcome

=

Value consequences of underlying market movements

+

Value consequences of achieving positive **TSR Alpha** outcome

=

... & in the Products and Services Market

Value consequences of exceeding EP expectations

+

Value consequences of creating new EP expectations



Establishing the Right Mindset

- To improve short-term capital market outcomes, must focus on **longer term** in market for products and services
- It's not about creating wealth – but building an **enduring institution** that can create wealth **on an ongoing basis**
 - A focus on both customer value **and** shareholder wealth
 - A **noble purpose** beyond shareholder value maximisation
 - Seeing stakeholders as **allies in creating value** over the long-term – not adversaries in pursuit of short-term earnings targets