
Creating the future: how creativity and innovation drive shareholder wealth

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Keyword

Creativity, Customers, Shareholders, Value, Wealth

Abstract

Suggests that in many companies that have adopted value-based management, there is a need to shift the focus of management attention from the measurement of value, to the creation of wealth. It argues that shareholder wealth creation is a creative endeavour on the part of the management and employees of a business - and that wealth will only be created for shareholders if management delivers financial performance that exceeds market expectations. This requires the successful implementation of higher value strategies developed from new ideas - not simply the adoption of value-based measurement and incentive systems.

In recent years, increased pressure from investors has caused senior management to focus more and more on the specific goal of shareholder wealth creation. Board members and executives have taken the view that their primary financial responsibility is to maximise the value of the capital with which they have been entrusted by shareholders.

The adoption of shareholder wealth creation as a governing objective for business has in turn led to the emergence of a series of value-based performance metrics. The most well known of these is Economic Value Added or EVA[®] (Registered trademark of Stern Stewart & Co).

Unfortunately, the debate about the relative merits of EVA[®] versus other value-based performance metrics has masked the real issues managers must confront in seeking to build businesses which create wealth for shareholders.

Contrary to what many believe, EVA[®] is not a measure of wealth creation. It is a refined measure of economic profitability. As a stand-alone measure, neither Economic Profit (EP) nor EVA[®] is remotely related to shareholder wealth creation, unless of course shareholders happened to have invested at book value.

The ability to generate a positive EVA[®], and consequently achieve a market value in excess of book value, does not mean that management is creating wealth for shareholders[1]. This is because new shareholders invest at market value, not book value. And every shareholder becomes a new investor every day simply by choosing not to sell their shares.

Wealth will only be created for shareholders if management delivers performance in excess of expectations, or if it convinces the capital markets that it has the ability to do so. This is virtually impossible without the injection of new ideas, or the adoption of a new and higher value strategy.

A higher value strategy means one which will deliver greater long term cash flow than the current strategy. The wealth created by changing strategy is equal to the present value of the expected increase in long term cash flow.

Defining wealth creation in this way makes redundant most of the value-based performance metrics which have emerged in recent years, as well as the business processes which have been built up around them. In so doing, it helps shift the focus of management attention from the measurement value, to the creation of wealth.

To create the future for their businesses and wealth for their shareholders, management must turn away from simplistic value-based management systems which focus on measuring and rewarding wealth created versus book value.

Instead, they must seek to continually exceed investor expectations by identifying and investing in higher value strategies. The key to this is to unlock and harness the creative potential of their organisations. Accessing this potential requires the adoption of a hybrid form of thinking which draws on both creative and analytical modes of thought. Hybrid Thinking lies behind both the development and the successful implementation of most wealth creating strategies.

Wealth creation as a creative endeavour

One of the unfortunate consequences which has flowed from the widespread adoption of value-based management is the belief held by some managers that they will create wealth for their shareholders if they are able to achieve economic profitability and maintain a positive EVA[®]. This is simply not the case.

A positive EVA[®] will ensure a market value in excess of book value. But this is of little consequence to new shareholders who

must invest at market value, or to existing shareholders who have chosen to hold their shares.

All shareholders - whether new or existing - invest at market value, not book value. New shareholders pay market price. Existing shareholders make an investment decision every time they choose not to sell their shares. In effect, they also become new investors every day at the current market price.

The share price of a listed corporation represents the value of the cash that shareholders expect to receive in the future as a result of their investment. Shareholder wealth will be created only if management outperforms the expectations which the shareholders had when they made their investment decision, or alternatively if management is able to convince the capital market that it has put a strategy in place which will enable it to do so.

Either way, management must continually seek to develop and implement new and higher value strategies that can deliver a greater long-term cash flow than the current strategy. This can only be done through the use of innovative thinking or the injection of new ideas.

The key to wealth creation is innovation (see Figure 1). Ultimately, all wealth creation stems from the successful implementation of higher value strategies developed from new ideas - not simply from the adoption of value-based measurement and incentive systems.

The bridge between customer value and shareholder wealth

Shareholder wealth creation is a creative act on the part of the management and employees of a business. It begins with customer value creation.

While measured in the capital markets, shareholder wealth is created in the product markets by using innovative thinking to develop products or devise services that provide greater value for customers. If priced appropriately, these higher value products and services will generate additional revenue. If delivered efficiently, this increased revenue will translate into higher profits and ultimately into an increase in cash flow to shareholders.

While cost management is important, it is rare to find a situation in which stand-alone cost reduction is the only course of action available to management to create wealth for shareholders. It is equally rare to find a situation in which a lower cost structure leading to lower prices is the only way to enhance value for customers[2].

There is a fundamental relationship between the creation of customer value and the creation of shareholder wealth. As is illustrated in Figure 2, to create wealth for shareholders companies must first create value for their customers. They must then deliver that value efficiently.

By focusing in the first instance on the objective of customer value creation, ideas can be generated for new value propositions [3] which, when delivered efficiently to customers, can lead to enormous wealth creation for shareholders.

The role of imagination and belief in the creative process

The creative process through which these ideas emerge has two essential ingredients: imagination and belief. They are equally important. Creativity is as much about believing in new ideas and bringing them into form, as it is about generating the ideas in the first place.

Most corporations employ strategic thinking processes based on sound rational logic, or what some call fact-based analysis. This type of thinking relies almost entirely on data, analysis, argument, debate and criticism. It honours scepticism, and demands proof before there is belief.

The problem is, as inventors, entrepreneurs, and creative thinkers in science and the arts will attest, if you demand proof before you will believe in something, you will never create anything. You must be prepared to believe before you will see (not the other way around).

If you can imagine something, then in a sense, it already exists. Ideas are like new products or services in a very diffuse state. It is belief, manifesting primarily in the form of emotional commitment, which carries an idea from the mind of an inventor to success in the marketplace.

When backed by a strong emotional commitment, an idea gradually becomes less diffuse, gaining in density as it moves first to the drawing board, then into a prototype, and ultimately into a commercially viable product or service.

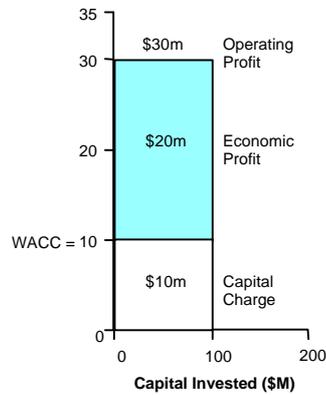
Every product or service begins life as a new idea, just as every city building begins life as a concept in the mind of an architect. Ultimately, all wealth creation stems from such ideas.

Hybrid thinking as the source of higher value strategies

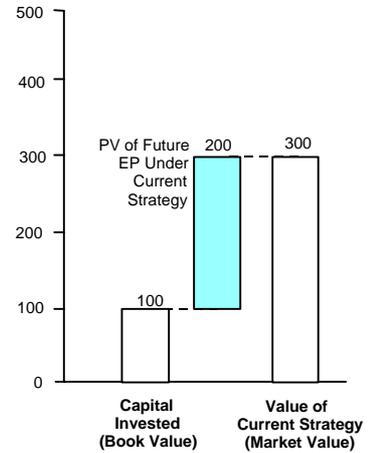
Before a new idea can be incorporated into the strategy development process, it must be given form - in the same way that an architect

Figure 1
 Understanding wealth creation

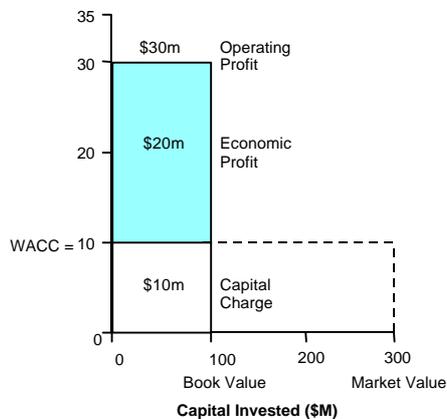
1a An economically profitable business has a return on investment greater than the cost of capital



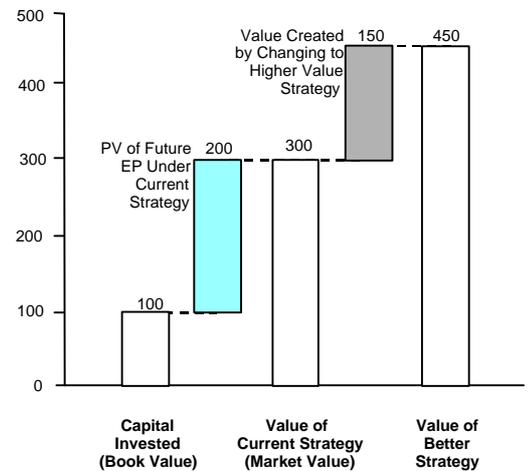
1b If economic profitability can be sustained, the market value of the business will exceed its book value by an amount equal to the present value of the expected economic profit stream



1c All shareholders (whether new or existing) invest at market value - not book value. The return on the market value of their investment is equal to the cost of capital



1d Shareholder wealth will only be created by delivering performance in excess of investor expectations. This requires the injection of new ideas, or the adoption of a new and higher value strategy



must express an idea for a new building as a design concept before a detailed design can be completed and the development process can move forward. A key ingredient during this formative stage of the creative process is a strong belief in the new idea on the part of those responsible for it.

Once the idea has taken form, it can then be exposed to sound logical analysis to prove to others that it has merit. With each step forward the number of people who believe in the idea increases.

The creative process begins with imagination. It is underpinned by belief in the form of an emotional commitment. Passing the

test of logical analysis both strengthens belief and builds commitment.

What is being described here is a thinking process that draws on both creative and analytical modes of thought, while at the same time harnessing the emotions of those involved.

Integrating creative thinking and logical analysis

All organisations make use of both creative thinking and logical analysis. However in most cases they are used in isolation, with

logical analysis having by far the dominant role. This is unfortunate, because when properly integrated they can both be much more powerful.

Logical analysis has an extremely important role to play in the strategy development process. However on its own it is not sufficient.

The decision to raise price in a segment in which the return is below the cost of capital, but in which demand exceeds supply, is a typical example of a strategic initiative developed purely on the basis of logical analysis. As is the case with all initiatives justified in this way, it does not take long for competitors to arrive at the same conclusion. The data is available

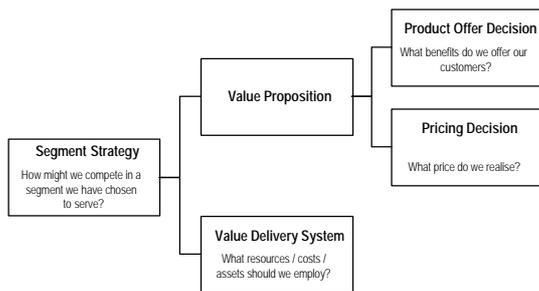
and the logic is usually apparent to all. Consequently, little if any sustainable competitive advantage is achieved.

This is not surprising, since the insights from which all successful strategies evolve are arrived at through a creative process, not an analytical one. Nothing is ever discovered through logical analysis alone. Even when you think you have discovered something analytically, what has really happened is that your mind has created an understanding, and you have simply used logical analysis to prove to yourself what you already knew (or sensed) intuitively.

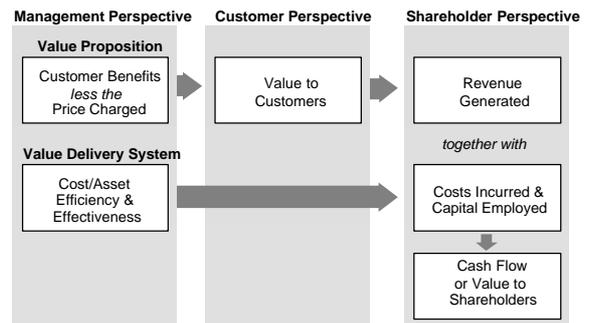
Creative or intuitive thinking has a crucial role to play in the strategy development

Figure 2
 Creating customer and shareholder wealth

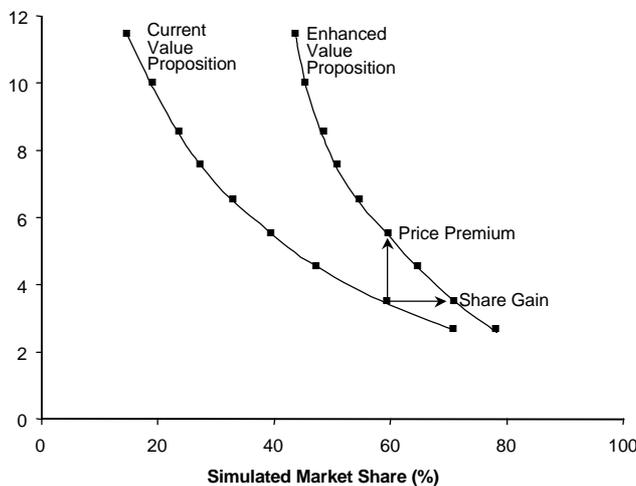
2a Alternative strategies can be expressed in terms of a value proposition and a value delivery system



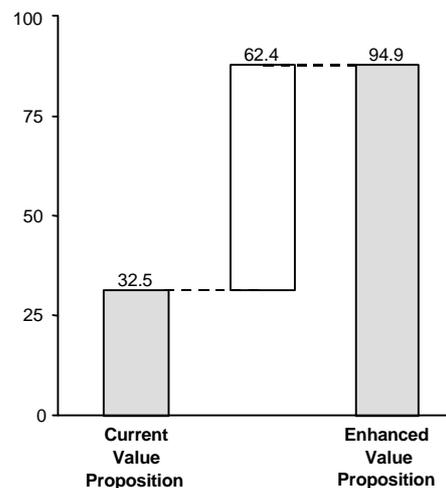
2b To develop a strategy which creates value for shareholders, we must first have a value proposition which enhances value for customers



2c Enhancing a value proposition by creating additional value for customers will result in stronger demand.



2d If priced appropriately and delivered efficiently, the enhanced value proposition can form the basis of a strategy with the potential to create significant wealth for shareholders



Source: [4]

process. However as is the case with logical analysis, on its own it is not sufficient.

Few in the business world would be prepared to invest in a business proposition based solely on intuition. While a brilliant creative idea may have been accessed through an intuitive insight, a solid proof based on sound logical analysis will be required before a board will fund or a team will follow, a strategy developed from such an insight.

Developing new and higher value strategies requires the application of creative thinking and logical analysis in combination - not in isolation.

The best strategies are almost always developed from intuitive insights (or creative ideas) which have been tested and proven with sound, logical analysis. Unlike strategies developed from logical analysis alone, this hybrid form of thinking can lead to breakthroughs which the competition finds difficult to counter.

Defining Hybrid Thinking

"Hybrid Thinking" is the process by which an idea accessed through an intuitive insight, is first given form as a potential value proposition, then tested in terms of customer value creation potential, and finally developed into an alternative strategy and evaluated in terms of shareholder wealth creation potential. It is a higher order thinking process that incorporates both creative and analytical modes of thought.

Hybrid Thinking has its origins in a thinking process first postulated by Plato. Plato's approach had four elements: imagining, believing, hypothesising, and reasoning. The first two (imagining and believing) were creative in nature. The fourth stage (reasoning) was logical or analytical in nature. The third stage (hypothesising) provided a bridge between the creative and the analytical. (Kilroy and McKinley, 1997)

The Hybrid Thinking Process

Most strategy development processes involve three fundamental steps: idea generation, strategy formulation and strategy evaluation. Hybrid Thinking is an enhancement of this process (see Figure 3). It incorporates the same three elements but employs three distinct types of thinking: intuitive thinking, formative thinking and logical thinking.

Intuitive Thinking

Ideas are always generated intuitively. Either the mind creates an intuitive understanding as a result of information acquired from data or analysis, or we simply get an idea.

A powerful symbiosis exists between information and intuition.

Either information stimulates the mind to produce an idea, or it is used in combination with logical analysis to ground a purely intuitive one.

Formative Thinking

As the idea moves to the formative stage, the mind uses both information and insight to mould the idea into a concept that can be communicated to others and evaluated with sound logical analysis. Usually this concept takes the form of a new and innovative value proposition.

Logical Thinking

Once the concept has been formulated as a potential value proposition, it can be exposed to logical analysis by being tested in terms of customer value creation potential. If it passes this test, it can then be developed into an alternative strategy and evaluated in terms of shareholder wealth creation potential.

Customer value analysis is used to test the concept in terms of the benefits which end users will derive. This enables the nature and the strength of the demand for the underlying value proposition to be assessed, leading to an understanding of its price realisation and revenue generation potential. It usually involves the use of choice-based modelling techniques[5].

Once demand and revenue generation potential are understood, the value of the strategy to shareholders can be determined by modelling the value delivery system (ie the costs and capital required to deliver the value proposition) to forecast future cash flow and hence value to shareholders.

Applying Hybrid Thinking

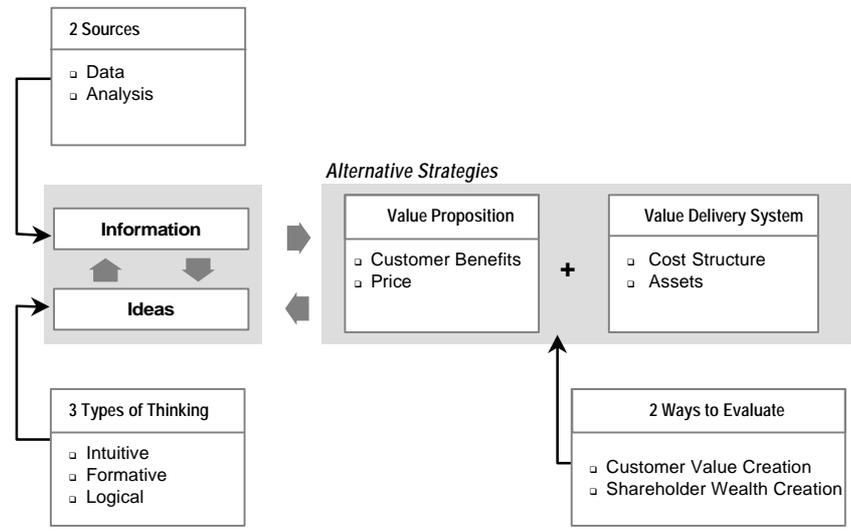
When applied well, Hybrid Thinking generates ideas that can be developed into new strategies with the potential to create significant value for customers and wealth for shareholders.

The following example from the Australian retail banking industry provides a good demonstration of the application of this type of thinking. (Kilroy, 1998a).

Throughout the 1990s, Australian retail banks pursued cost leadership strategies built around new technology-based product delivery systems, aggressive cost reduction programs, and acquisitions aimed at accessing unit cost reductions through greater economies of scale. More recently, competitors have even considered merging their back office functions in an effort to further reduce costs.

These initiatives are classic examples strategies developed from logical, fact-based analysis. However, like all strategies developed

Figure 3
 Hybrid thinking process



from this type of thinking, very little competitive advantage is achieved. This is because the logic behind the strategy is apparent to all players, who ultimately either copy one another, or act in some other way to prevent a competitor establishing a sustainable advantage.

One area in which there has been some real innovation within Australian retail banking over the last decade is the home mortgage segment. The innovation has come in the form of low cost offerings from commodity mortgage originators - offerings which have enabled them to take a significant share of this market from retail banks.

The banks' response has been entirely rational - reduce costs and try to match their new competitors on price.

Had they used Hybrid Thinking, they may have responded quite differently and achieved a far better result for both their customers and their shareholders.

To demonstrate this point, a small workshop group was asked to employ Hybrid Thinking, and focus on the objective of customer value creation in the home mortgage segment. An intuitive understanding quickly emerged within the group which suggested that most of the avoidable cost associated with purchasing housing in Australia arose from the cost of transactions - in particular real estate agent commissions, lawyers' fees, relocation costs and government transaction charges.

Intuitively, the reason for this high cost seemed to be the number of houses many people purchase on the way to getting the home that they wanted. It was felt that this behaviour in turn arose from the so-called

deposit gap (ie the gap between the funds required to purchase a house, and the amount the banks were prepared to lend). The existence of the deposit gap caused people to buy the house they could afford and then continually upgrade until they eventually acquired the house they needed or wanted. In the process, these bank customers parted company with substantial amounts of cash in the form of transaction costs.

The group also sensed that this uneconomical behaviour could be eliminated if it were possible to offer a different form of financing, without the deposit gap. Zero deposit mortgages would be one possibility. Shared equity mortgages would be another. The best option appeared to be a lease with a 100 percent residual or balloon payment. Under this approach, the entire value of the house could be saved in tax sheltered retirement savings accounts if the residual were timed for payment after retirement.

It took less than an hour for this combination of intuitive insight (as to where costs arise for home purchasers) and creative ideas (new financing products) to be tabled. Once on the table, it took approximately two weeks of sound, logical analysis for the project team to prove to themselves that the idea had real merit.

The analysis proved that the lease concept could potentially reduce the total lifecycle cost of home ownership by 40-50 percent for a large proportion of the Australian population. At the same time, it had the potential to accelerate the achievement of the government's retirement savings objectives, and

over time could even result in higher quality housing stock.

For the retail banks, it offered the potential to re-establish a leadership position in the housing mortgage market. The nature of the relationship which a financier would require with the home owner under this approach was likely to disadvantage if not preclude participation by the commodity mortgage originators. However life insurance companies would also be extremely well positioned to benefit from a switch to this form of housing finance.

Creating the future

Many businesses put an enormous amount of effort into analysing their operations in an attempt to unlock insight as to how to improve performance. Often, they place more emphasis on analysis than on creativity, and put more effort into measuring value than creating it in the first place. In the process they discover the world already there, and often convince themselves that cost reduction is the only way to develop higher value business strategies.

It is no surprise to find that few breakthroughs result from this type of thinking. If your only mode of thought is logical analysis, then cost reduction and downsizing would seem to be entirely appropriate ways in which to respond to the rapid change being experienced in many industries. This is particularly true if there is a belief within the management team that they are unable to influence the process of change.

It is possible to create the world we want rather than just discovering the world already there. However this cannot be done with logical analysis alone. It requires Hybrid Thinking.

By using their collective imagination to continually come up with new ideas, and by believing in their ability to bring their ideas into form, a management team can create the future for its business. The role of logical analysis is to prove to themselves and others that their ideas will work.

Conversely, if a management team does not employ creative thinking and logical analysis in combination, it cannot create the future it wants. It must default to simply using fact-based financial and market analysis to try to chart a path forward. At best, this will only enable it to predict a future that has been created by someone else.

Building a creative organisation

If a management team is to create the future

for its business and wealth for its shareholders, it must build a creative organisation. In doing so, it must shift the focus of management attention from the measurement of value to the creation of wealth, and create a climate in which creativity is both encouraged and rewarded. Shareholder wealth creation stems from the successful implementation of higher value strategies developed from new ideas, not simply from the adoption of value-based measurement and incentive systems.

The greatest barrier to successful implementation of a new and higher value strategy is negative thinking - just as the greatest driver of business success is the absence of negative thinking.

Negative thinking manifests primarily in the form of doubts and fears. It undermines belief in the new strategy and weakens emotional commitment. Once belief has been undermined, any new initiative quickly loses momentum.

The seed of doubt is often planted by scepticism on the part of senior managers. Scepticism is not a substitute for good analysis. No new idea should be dismissed until it has failed the test of sound logical analysis.

A creative organisation requires a climate in which new ideas are nurtured rather than suppressed - and in which there are few rewards for scepticism and other forms of negative thinking. It also requires:

- Acceptance of the premise that shareholder wealth creation is a creative endeavour and that ultimately all wealth creation begins with new ideas.
- A broadening of the focus of managers to include the creation of both customer value and shareholder wealth.

Once these conditions are in place, two key business processes can be established which support a more creative orientation.

- 1 A business planning process which uses Hybrid Thinking to generate new and higher value alternative strategies and which requires plans to be developed around that strategy which creates the most wealth for shareholders
- 2 A performance management system which focuses on the delivery of planned performance (ie that forecast performance which caused the chosen strategy to be selected from among lower value alternatives).

Business Planning Process

The business planning process is extremely important in a creative organisation. It provides the mechanism by which new ideas arising from innovative thinking are captured

by the organisation. The process employed is very simple.

First, Hybrid Thinking is used to generate ideas and formulate new value propositions. Once formulated, these value propositions are tested in terms of customer value creation, and then developed into alternative strategies and evaluated in terms of shareholder wealth creation potential. A business plan is then developed around the strategy that creates the most wealth for shareholders.

If a new and higher value strategy is developed during the planning process, then wealth will be created for shareholders if management is able to successfully implement that new strategy. The wealth created will be equal to the present value of the expected increase in long term cash flow.

Performance Management System

The performance management system focuses on two objectives. The first is to ensure that each business is on track with its new and higher value strategy, and therefore that the performance promised in the plan is going to be delivered. The second is to encourage management to continually seek to identify and implement higher value strategies.

At the core of a creative organisation is an Internal Capital Market that allocates capital and other resources to strategies on the basis of wealth creation potential. This market operates in concert with the business planning process and supports a five stage integrated performance management system[6] (see Figure 4).

The business plan becomes a prospectus for capital and other resources from the internal capital market.

In submitting its plan, each business unit commits to a specific level of wealth creation (or increase in future cash flow) in return for the capital and other resources required to deliver that performance. Wealth will be created for shareholders if management succeeds in implementing its new and higher value strategy and delivers the performance it promised in its plan.

If an incentive compensation system is employed, it must also be linked to the delivery of planned performance (Kilroy 1998b) (see Figure 5). In fact, there are really three objectives which the reward system should encourage management to achieve.

- 1 They must continually seek to identify higher value strategies.
- 2 Once a higher value strategy has been chosen and used as the basis of a business plan approved by the Internal Capital Market, they must deliver the performance which they promised in their plan.
- 3 They must create an environment in which creativity is encouraged and new ideas are nurtured so that higher value strategies can continue to be identified.

These three objectives form the basis of a simple yet powerful system of reward built around both a short and a long term incentive.

The incentive scheme must be tailored to the needs of each organisation. While there is no "one size fits all" approach, the Hay concept of annually issued performance units provides flexible building blocks with which to craft a long term incentive that encourages both the delivery of planned performance and the pursuit of higher value strategies. These units are issued annually on the basis of the wealth creation promised in the plan - and paid out after an agreed interval on the basis of the wealth that has actually been created.

To ensure alignment with the chosen strategy, it is important that a sound planning process and a plan-based performance management system are in place before implementing any incentive scheme.

Conclusion

Wealth will only be created for shareholders if management delivers performance in excess of expectations, or if it convinces the capital markets that it has the ability to do so. This is not easy, since the market keeps lifting the bar.

In the case of a listed company, as soon as a new strategy is adopted and communicated to the capital markets, the markets place a value on it. If the new strategy is well received, the company's share price rises.

Figure 4

The performance loop - an integrated performance management system

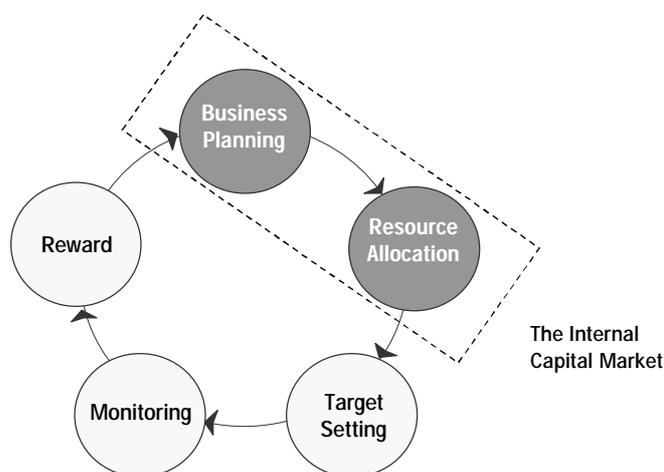
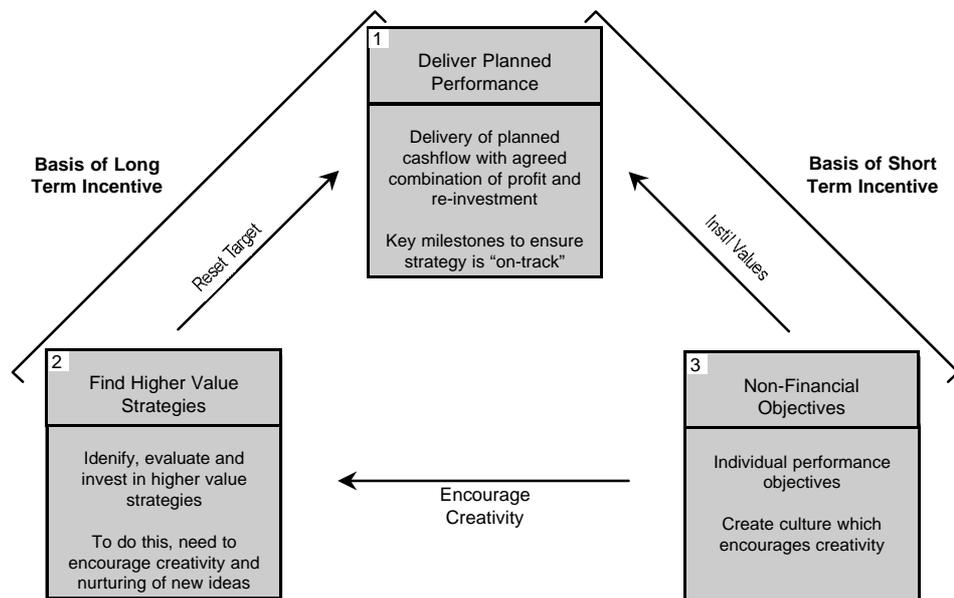


Figure 5
 The plan-based incentive compensation system



While this creates wealth for existing shareholders, the challenge for management then becomes to create wealth for the new shareholders who invested at the higher share price (as well as for the existing shareholders who re-invested at the new and higher price by choosing not to sell their shares).

This challenge can only be met by continually bringing new ideas into play.

Creating wealth for shareholders is a serious creative endeavour - not just a simple analytical process.

Notes

- Value will be created for shareholders if management delivers long term economic profits (or EVA) in excess of market expectations by adopting a new and higher value strategy. The value created by changing strategy will be equal to the PV of the associated increase in expected economic profit. In most cases, this will be identical to the PV of the expected increase in long term cash flow (and it is generally far easier to represent a new strategy with a cash flow stream than with an economic profit stream).
- If we take electricity supply as an example, consumers no doubt appreciate lower prices, but they also value higher reliability and are almost certainly prepared to pay for it.

Application questions

- Are analytical skills or creative skills more important in managing a successful business?

- A Value Proposition is a deliberate combination of end user benefits and price which a company offers to an identifiable customer segment (Lanning and Phillips 1991).
- The demand curves and valuations in this exhibit have been drawn from a recently completed assignment for an industrial component manufacturer. The volume measure in the demand curves is Share of First Choice derived using Adaptive Conjoint Analysis.
- One of the best approaches is Adaptive Conjoint Analysis augmented by either choice-based conjoint or hold-out choices to ensure that the price elasticity of any price sensitive preference segments is calibrated correctly and not understated.
- The Performance Loop was developed in 1991 by James P McGrath who at the time was one of the founding partners of Marakon Associates.

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- What is value in an organisation? Should it be best measured as value added to shareholders; to customers; to employees?