

# WHEN Strategy AND Valuation MEET

## Five Lessons from Return Driven Strategy

BY JOEL LITMAN AND MARK L. FRIGO

**Picture a business strategy expert.** What characteristics come to mind? How does the person behave? What schooling, certifications, and work experience would this person have?

**Now imagine a valuation expert** in terms of characteristics, behavior, or background. How does that person differ from the strategy expert? Is one more likely to have earned the CFA (Chartered Financial Analyst) designation while the other an MBA degree? Is one more likely to be a consultant and the other a money manager?

The goal of this exercise is to raise one significant problem with what we conceive in these differing types of expertise: *There should be no distinction. Great business strategy and great business valuations require the same discipline.*

### SKILLS OF THE BUSINESS STRATEGY EXPERT

A true business strategy expert must have one firm goal in mind that should drive all of his or her analysis and decision making: helping the business maximize the creation of financial value. This overriding concept is often clouded because many other uses of the term “strategy” are bandied about, such as “market strategy,” “channel strategy,” “Internet strategy,” and a list that goes on and on. Yet if we are to focus on true business strategy, then we must also focus on the purpose of the business—to

## THE RETURN DRIVEN STRATEGY INITIATIVE

The Return Driven Strategy Initiative is an ongoing research study that has screened thousands of companies, public and private, and identified, documented, and benchmarked the strategic activities that separate the best performers from the worst and what lies in between. Involving multiple avenues of research and application and a consortium of academic and professional research, it has resulted in the creation of the Return Driven Strategy model (see Frigo and Litman, “What is Return Driven Strategy?,” *Strategic Finance*, February 2002), which describes the strategic activities great companies have demonstrated over a sustained period of time.

Return Driven Strategy is a framework and set of guidelines for evaluating, developing, and refining executable strategy that is firmly aligned with the goal of maximizing financial value. Mark L. Frigo and Joel Litman have led the ongoing academic, clinical, and real-world research and development of the framework over the last several years. The Return Driven Strategy model is being used in the Center for Strategy, Execution, and Valuation at DePaul University’s top-ranked MBA program and Executive Seminars in Chicago. One of its key differentiators is the use of CSFB HOLT’s ValueSearch database of cash flow performance and valuations of tens of thousands of companies in 20 or more countries.

Return Driven Strategy is being used successfully by executives in strategic planning retreats, at board meetings, as a platform for balanced scorecard initiatives, and by investment analysts. It has also been used successfully and adopted by privately held companies and nonprofit organizations. The Return Driven Strategy model is the subject of articles, executive seminars, and a forthcoming book.

generate more cash flow than the cash flow it uses up. Any other concept would suggest strategy for something other than a business, such as a hobby or a not-for-profit organization with other delineated purposes. While those organizations certainly require strategy, we would not deem it *business strategy*.

Financial value maximization is an overriding tenet of business strategy. That means any expert in business strategy must have a superior understanding of what drives financial value creation in the first place. Such a strategy expert must thoroughly understand the differences and nuances between relative valuations and discounted cash flow analyses. That expert also must be able to understand how any strategic initiative considered by a company ultimately affects that company’s ability to generate financial value. In short, he or she must be an expert in business valuations.

For instance, what effect would a new branding initiative have on long-term sustainability of business returns? How might a new partnership or innovation strategy create value for the shareholders or owners of the existing business? In what ways would an initiative to improve execution, such as use of the balanced scorecard, drive future return on investment (ROI)? If they are considering a publicly traded company, how will investors react to any major strategy change or initiative? As higher valuation is the goal of business strategy, any initiative considered must be credibly linked to its impact on long-term cash flow generation. Without this comprehension, how could someone ever be called a “business strategy expert” in the first place? The core valuation skills of any strategy expert must go far beyond a rudimentary MBA-level understanding of finance. Expertise in one area is a prerequisite for expertise in the other.

### SKILLS OF THE BUSINESS VALUATION EXPERT

What are the necessary competencies of a business valuation expert? If the valuation expert’s methodology favors a relative valuation approach (using multiples like P/Es), that person would need to understand the nuances of relative valuation calculations. He or she must fully understand the potential impact of any particular business initiative on valuation multiple expansion or compression. Valuation multiples “expand” or increase as the expectations of a company’s future performance improve. Multiples “compress” or decrease when forecasted financial performance drops. On the other hand, if the valuation expert prefers the discounted cash flow methodology, he or she would need to understand how to adjust near-term

and long-term cash flow forecasts in meaningful ways based on activities the business is engaging in today and plans to engage in tomorrow.

For example, how would new spending in research and development, while a near-term cash loss, lead to higher valuations for a business long term? How might a new employee benefits program lead to higher personnel performance, higher ROI, and thereby higher value creation for shareholders? Regardless of the valuation approach, the need to better understand strategic activities is paramount. Any valuation expert must possess an intimate understanding of the strategies of the business being valued. He or she must also be capable of linking those strategies back to the valuation models by understanding the impact of those activities on long-term financial performance.

### WHEN STRATEGY AND VALUATION MEET

While disparate images of these two separate practitioners have existed, a convergence is finally forming. No one can be at the top of his/her game at business strategy without also having incredible mastery over the frameworks of business valuation. The reverse holds true as well. Any true business valuation expert must understand the deep levels of strategic analysis regarding the businesses he/she is valuing.

Yet how many valuation practitioners really understand competitive strategy? How often do consultants, touting themselves as “strategists,” fail to comprehend the complexities and errors inherent in the simple-looking P/E multiple or nuances of long-term forecasts in discounted cash flow models? For this reason, strategy consultants are often seen as being too “soft” and with daydreamer mentalities. On the other hand, valuation analysts are often perceived as having “black box” valuations with ridiculously obtuse spreadsheets. We hear them debate endlessly over “peer multiples” or intricate cost of capital calculations. Yet, if we listen into the conversations of true experts in valuation, we hear as much discussion about business strategies as we do the frameworks for valuing them.

Thankfully, the convergence of strategy and valuation is occurring quickly. The Return Driven Strategy Initiative (see sidebar), a research project designed to uncover these insights, resulted in the creation of the Return Driven Strategy framework, which is a set of tenets and foundations that describe what business activities truly maximize financial value over the long term. Here are five lessons from Return Driven Strategy—a few of the insights that stand at the convergence of strategy and valuation.

1. A great product seldom ensures a great business;
2. Being “different” is *not* core to strategy—it’s only a by-product;
3. The difference between a great company and a great stock;
4. Why monopolies are often not great stocks;
5. When and why growth is *not* necessarily a good thing.

To show you how these lessons apply, we include some financial performance charts courtesy of CSFB HOLT, a division of Credit Suisse First Boston. These charts display the financial performance of companies over long periods of time—as much as two decades. They show cash flow returns on investment (CFROI®—a registered trademark in the U.S. and other countries (excluding the U.K.) of Credit Suisse First Boston or its subsidiaries or affiliates), adjusted for distortions caused by flaws in accounting information. The charts also show a company’s real asset growth rate over time—how much capital a business is putting to work over time. And they show relative total shareholder returns (RTSR) against an appropriate major market index. Taken together, this information provides a lens into economic reality that lets us better understand key issues in business strategy, such as these five lessons.

### What’s the Difference Between a Great Product and a Great Business?

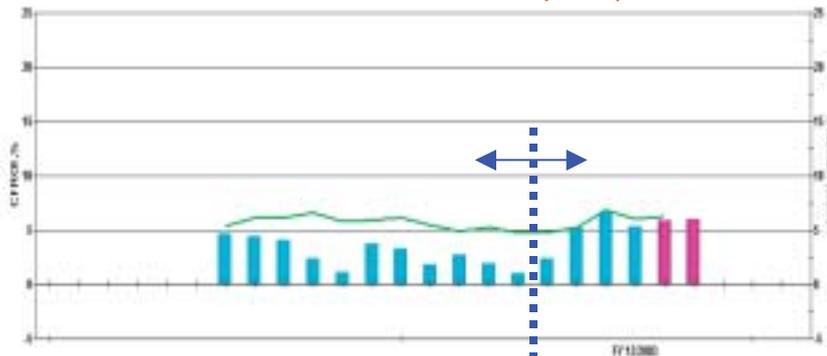
One of the underlying myths held by the layperson in strategy and valuation is that companies with great products that customers truly enjoy must also be great businesses. Nothing could be further from the truth. Time and again, many companies that produce offerings (products or services) that people love are simultaneously terrible businesses with low profitability and poor returns on investment.

One example is BMW. The Bay Motoren Werk Group produces vehicles that are one of the strongest brands with consumers. Car and motorcycle enthusiasts recognize the quality and innovation in BMW’s products. Yet detailed financial performance analysis shows that BMW has had trouble earning its cost of capital for more than a decade. This puts BMW’s ROI distinctly below the average returns of most major industrial companies globally (see Figure 1).

How is it possible that such great products can co-exist in a business with such low profitability? Our research in the Return Driven Strategy Initiative provides a basis for understanding this seeming disconnect. If you view this problem from a converged understanding of strategy and valuation, the explanation must be grounded in both qualitative and quantitative analysis.

**Figure 1: CSFB HOLT Relative Wealth Chart — Historical Company Performance  
BMW (BMWG), Fiscal Years 1989-2003**

**Panel I: Historical Cash Flow Returns on Investment (CFROI®)**



**Panel II: Historical Growth Asset Growth Rate**



**Panel III: Relative Total Shareholder Returns Versus Major Market Index**



CSFB HOLT

**Panel I** shows that BMW's annual CFROI® has barely achieved its cost of capital, despite producing vehicles and motorcycles that people love. Though an important distinction over the last few years shows a move from a low ROI plateau to a higher one, albeit still an average industrial return level at best.

**Panel II** shows that BMW has reinvested in its asset base quite rapidly. Note this reinvestment rate has been quite consistent regardless of the corresponding cash flow returns over time.

**Panel III** clearly highlights that growth accompanied by poor cash flow returns does little for stock price. However, as cash flow returns significantly increase in the last five years, stock performance moves upward dramatically.

*CFROI® is a registered trademark in the United States and other countries (excluding the United Kingdom) of Credit Suisse First Boston or its subsidiaries or affiliates.*

Our research showed that one of the goal tenets of any business is “Fulfill Otherwise Unmet Customer Needs.” As you examine how well BMW achieves this tenet, note that each of these words is loaded with importance.

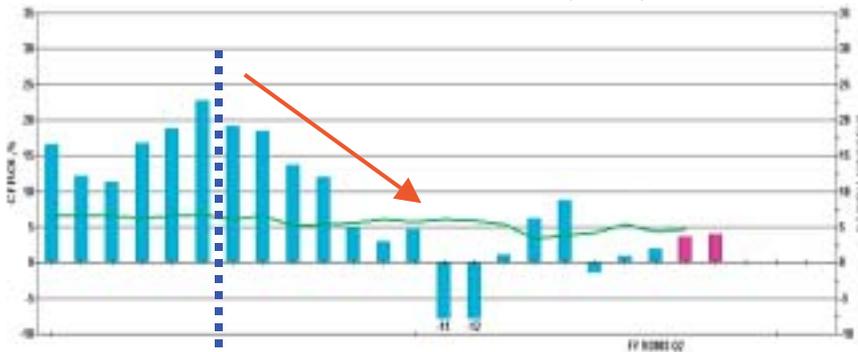
Do customers claim that BMW’s offerings fulfill their needs? Ask a BMW driver, and the answer is probably “yes.” The next question is “Are those needs otherwise unmet?”—meaning that if BMW suddenly began charging double for its 5-series cars, would consumers continue to pay, seeing no suitable substitute? Here the answer would probably be “no.” The problem for BMW is that, while its offerings are superb, there are other ways for consumers to suitably fulfill that need. That means that BMW maintains little in the way of pricing power, so it’s tougher for the company to generate sustained profits throughout its lines of offerings regardless of how great they may be. Of

course, this substitutability may not hold true for every die-hard BMW customer, but it has held true for enough customers to make a difference, as BMW’s long-term, below-average cash flow returns show. Unfortunately, as many consumers see substitutes in Mercedes, Audi, and other brands, BMW’s great product remains trapped by a price point that has not been high enough above its production costs to generate higher profits.

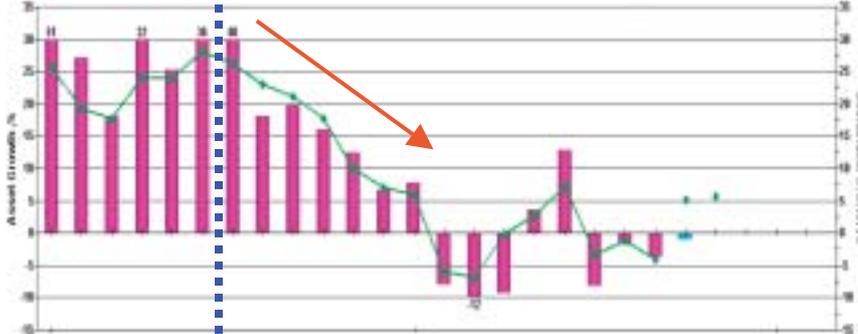
This leads to a deeper quantitative aspect of the analysis. As long as suitable substitutes exist in the minds of a large enough customer base, even the “greatest” product has little ability to combat pricing power—at least not enough to allow BMW to price up its goods sufficiently to deliver revenues to more than just adequately cover its operating costs and capital investments. The benchmark for this justification is a cash flow return on investment

Figure 2: **CSFB HOLT Relative Wealth Chart — Historical Company Performance**  
**Apple Computer (AAPL), Fiscal Years 1983-2004**

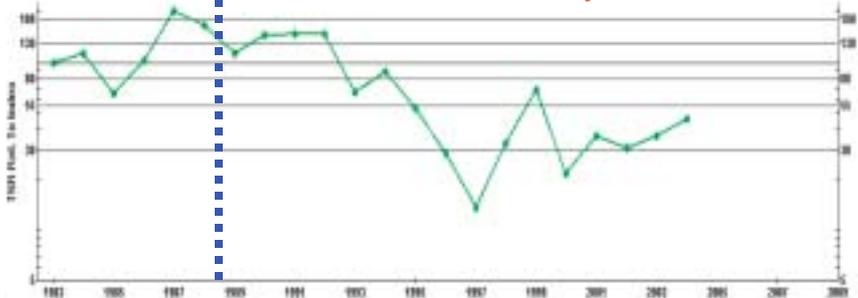
Panel I: Historical Cash Flow Returns on Investment (CFROI®)



Panel II: Historical Growth Asset Growth Rate



Panel III: Relative Total Shareholder Returns Versus Major Market Index



CSFB HOLT

Panel I demonstrates Apple's inability to generate adequate returns on investment in most years over the past decade. Clearly, Apple has created an image of being different - from its 1984 launching of the Macintosh to the recent marketing messages. Nonetheless, being different has not led the firm to excess returns over the last decade.

Panel II shows Apple's asset growth, its reinvestment rate over the last two decades. Beginning in 1989, Apple's high asset growth rates accompanied a steep drop in cash flow return levels—a drop the firm has not been able to recover from. This asset growth has been in investments that have created products that have been undoubtedly "different." Though, being different is not core to strategy—strategy is about fulfilling otherwise unmet customer needs.

Panel III highlights Apple's poor and volatile stock performance, greatly underperforming the S&P 500 over an extended period. Apple has been successful at being different, yet has failed to execute on great strategy as the financial results show. Being "different" is a by-product of great strategy, not a driver.

calculation (CFROI). That calculation must be at least as high as the opportunity cost of capital, a measure of how well that capital could have been employed on average elsewhere. This problem has persisted for BMW for more than a decade, as you can see from Figure 1.

**Being "Different" Isn't Core to Strategy... It's Only a By-Product.**

There is a too-common notion that being "different" is core to business strategy. This idea holds that competitive strategy can be achieved only through different activities producing different products. Our research shows that it does appear that companies with superior financial performance truly tend to be "different" in the way described, but was being different the goal of the high-performing businesses or simply a natural by-product of

their activities?

Again we refer to an ever-important tenet of business strategy. When companies create products and services that fulfill consumers' needs that would otherwise be unmet, we see an incredible relationship with higher-than-average cash flow returns on investment. In other words, these companies, given the same relative level of cash resources, are able to generate much higher levels of profit. Of course, the businesses will naturally look different since they have unique business models, but this is far more a natural by-product of fulfilling other tenets of business strategy and must never be considered the goal. During the Internet bubble period, plenty of Internet businesses looked extremely different, but they lacked focus on customer needs and cash flow that can be derived from fulfilling customer needs. Great companies—

high performers—definitely do things differently, but companies that are different are by no means necessarily great performers. The first implies the latter, but the latter by no means implies the first.

Apple Computer, Inc. is a company that projects itself as being different. Like BMW, Apple's offerings have some of the most die-hard customers. Despite this difference, however, the company is unable to reach enough consumers who would see no substitute for Apple. That failure leads to what we see in Figure 2, a chart that shows some incredibly poor performance in ROI and the subsequent effect on stock price over the last 10 years.

### What's the Difference Between a Great Company and a Great Stock?

You might ask why BMW has been a tremendous stock over the last few years, outperforming major market indices. The answer lies in another great insight when the discipline of strategy converges with the world of valuation: Great stocks are not always the most profitable businesses, and the most profitable businesses are not always great stocks.

For about 10 years, BMW's ROI hovered around a low 2%-4%. Suddenly, in the year 2000, an uptrend began that has brought the business's returns to cost of capital levels for the first time in years. These levels approximate merely corporate average levels. The key here isn't the absolute level but the dramatic change in returns and thereby a change in investors' long-term expectations of future financial performance.

This concept requires deeper investigation. Bill Miller of Legg Mason is one of the most respected mutual fund managers in the investment industry. His money management skills and those of his team have delivered to their investors market outperformance for 13 years straight. On the heels of his 12th consecutive year of achieving returns in the funds he managed that were superior to the market indices, Miller commented in his 2002 fourth quarter commentary:

*The first duty of the investor or analyst is to figure out what is embedded in the price, what is discounted. The failure to address that question is the main source of the poor relative results of most money managers and the general lack of value provided by the opinions of analysts.*

In BMW's case, real annual performance changed dramatically, and the changes drove investors' expectations. The company's cash flow generating abilities were much lower years ago and higher in 2001, 2002, and 2003,

though still relatively low—average at best. That change, however, drove large valuation increases and stock market outperformance. It's important to understand that this didn't result from BMW suddenly producing products that people began to be happy with—customers have certainly been pleased for years. The result is from a change in ROI level, even if it is only reaching an average level now. The dramatic change in longer-term expectations has driven the stock's incredible rise.

Gillette provides us with a flip side to this example. In Figure 3, you'll see incredibly high cash flow returns on investment coupled with stock market performance that fails to meet its prior peaks by a long shot. In 1996 and 1997, Gillette was trading at all-time stock valuation highs, but over the next several years the stock price dropped, and now, even seven years later, the market still hasn't rewarded Gillette with its previous valuation level.

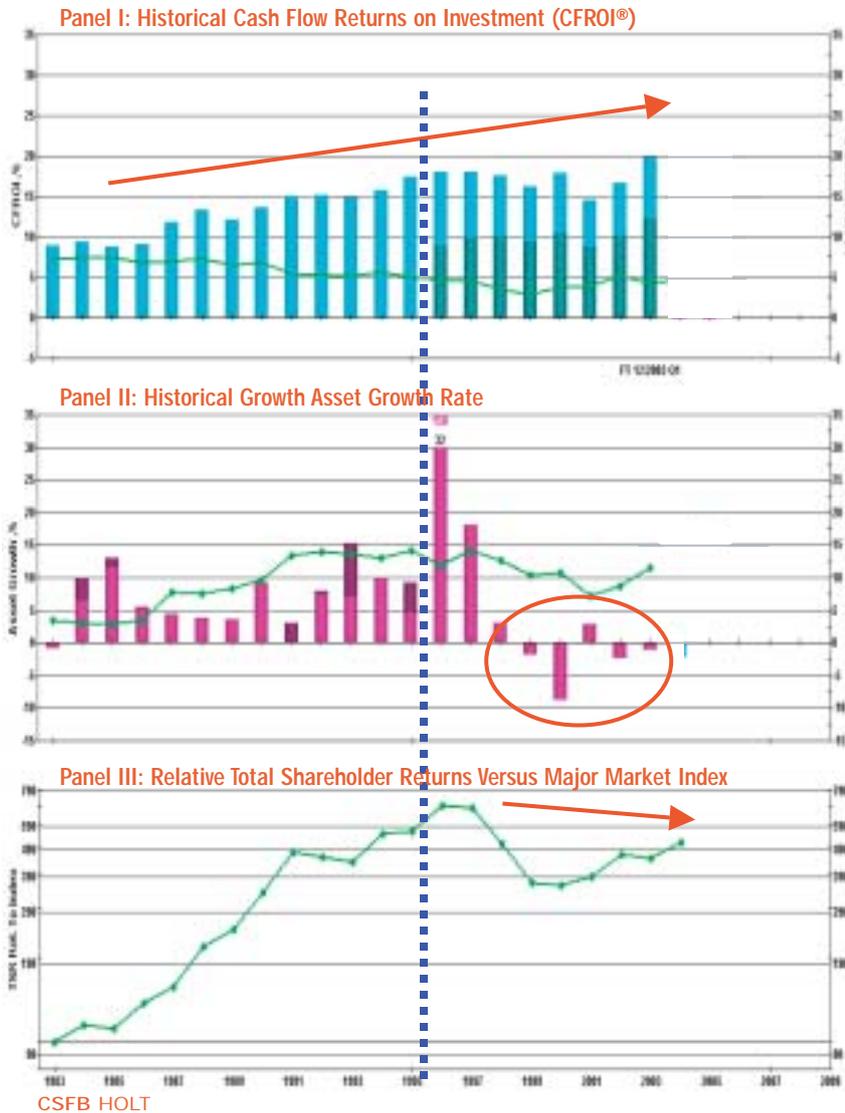
Too often, inexperienced analysts, managers, and consultants assume that such a drop in stock price must signal the company's fall into corporate average or below-average performance in terms of profits or cash flow generating ability. Yet Gillette still generates massive operating cash flow—as the CFROIs show—with phenomenally high returns that are well above its cost of capital or market averages.

This analysis tells us that something else must be at work. Specifically, changes in investor expectations, not problems with the business's absolute cash flow generating ability, have driven stock price. When Gillette's stock reached its 1997 peak share price, you had to presume an embedded expectation level of performance that was far too high—much greater than the company could actually achieve. So, while Gillette's performance remained solid on an absolute level, its performance didn't meet previous expectation levels. Gillette will only enjoy those valuation levels when expectations increase again. And this can happen only when investors see the potential for even higher performance based on strategies in place. Great business models aren't always great stocks.

### Static Monopoly vs. Ongoing Monopolization

Notice Gillette's extremely high ROI levels in Figure 3. You could argue that the company is certainly fulfilling otherwise unmet customer needs. People will pay higher prices for Gillette's Mach 3 blades than others because customers feel there is no real substitute. As discussed, it isn't enough that an offering is enjoyed and appreciated by customers. In order to achieve pricing power and the opportunity for higher returns, the product or service

Figure 3: **CSFB HOLT Relative Wealth Chart — Historical Company Performance**  
**Gillette (G), Fiscal Years 1983-2004**



**Panel I** shows Gillette's incredibly high returns on investment. Over the last twenty years, G's CFROI have been well above its cost of capital or industry average. Gillette fulfills otherwise unmet customer needs, commanding higher pricing power and contributing to significant returns on an increasing basis over almost two decades.

**Panel II** displays G's asset growth over the last twenty years. As the company was able to grow its investment basis with the accompanying high cash flow returns, it massively outperformed the markets. Over the last decade, however, Gillette has maintained its category dominance, but not expanded it—note the low if not negative asset growth rates over the last six years. Despite the high ROI levels, the stock has under-performed the market from 1996 to 2003 on a cumulative basis.

**Panel III** illustrates the change in investor expectations over time. From 1997 onwards, Gillette continued to deliver high CFROIs but the valuation peak assumed expectation over and beyond what the company could actually deliver to push the share price further upwards, leading to subsequent stock under-performance, though the stock has had a good run over the last few years.

must be the only one that provides that particular enjoyment or need fulfillment. Gillette's blades, among its other products, have that characteristic as its high cash flow returns have exhibited year after year.

In fact, Gillette strives to have product dominance on a category-by-category basis, effectively creating monopolies in the areas in which it competes. These economic monopolies are created by the uniqueness of the offerings and by customers freely choosing those products over others.

So shouldn't a monopoly be a great investment? Wouldn't an investor snatch up the chance to own part of a business with offerings that lack substitutes? Our research shows that, despite monopoly-like cash flow returns to the company, the company's stock price still dropped precipitously from 1996 to 2000. The stock's recovery over the last few years hasn't made up for the

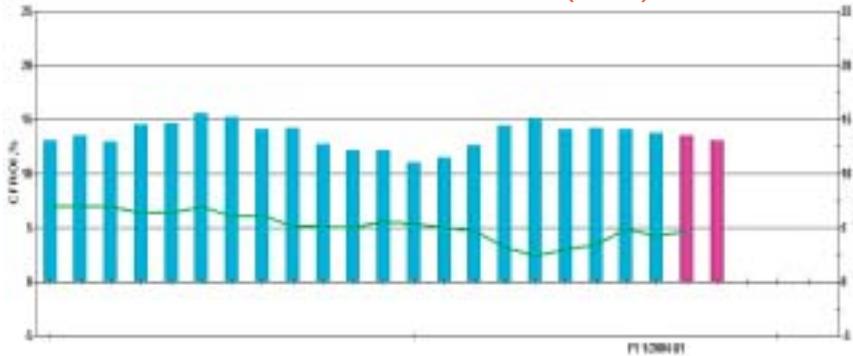
losses of that period.

Now let's examine Wal-Mart, a company that has created a business that has drawn consumers at amazing growth rates for decades (see Figure 4). Its cash flow returns are high, as you would expect. Also notice the asset growth line. Wal-Mart didn't merely create dominance in one category and try to secure it. The company has succeeded in providing offerings in terms of price and convenience that have no adequate substitutes. More importantly, in relation to the asset growth line, Wal-Mart has been able to repeat this in category after category—from toys to jewelry to groceries and many others. On top of that, the company continues to grow in the number of stores, square footage, and geographic region.

Wal-Mart achieves both high returns and high reinvestment rates (asset growth). This powerful one-two combina-

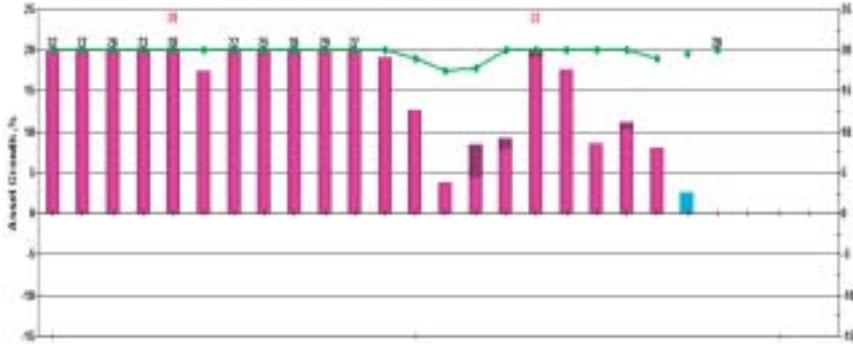
**Figure 4: CSFB HOLT Relative Wealth Chart — Historical Company Performance  
Wal-Mart Stores (WMT), Fiscal Years 1983-2004**

**Panel I: Historical Cash Flow Returns on Investment (CFROI®)**



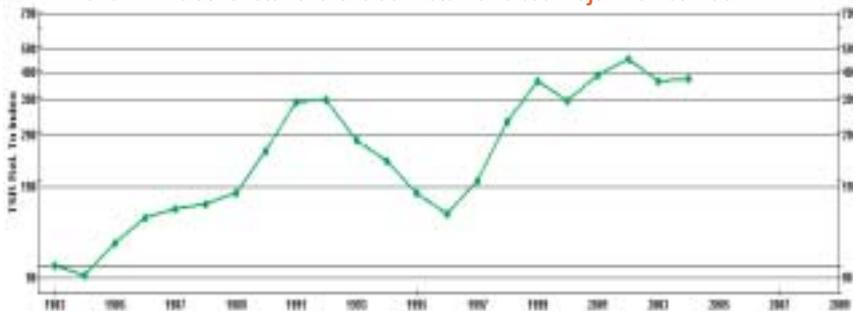
**Panel I** displays WMT's returns over the last twenty years. A testament to its ability to create an offering without real substitute, WMT attracts customers in droves. Through superior asset efficiency coupled with reasonable margins, WMT has delivered sustained high returns over a long period of time.

**Panel II: Historical Growth Asset Growth Rate**



**Panel II** shows WMT's significant asset growth rates showing its high reinvestment rate into its businesses. WMT has grown its asset base by moving into new business areas to meet customer needs and into new geographies. WMT's category dominance areas such as toys, jewelry, grocery, to name a few, has delivered a powerful combination of high cash flow returns and growth.

**Panel III: Relative Total Shareholder Returns Versus Major Market Index**



**Panel III** illustrates WMT's stock price performance relative to the S&P 500. Ongoing monopolization achieved by delivering an offering customers freely flock to is clearly powerful in driving stock price performance. In fact, the stock's poor performance between 1992 and 1996 accompanies the only period where asset growth and ROIs reached decade lows for the company.

tion, together with its exceptional stock price performance, supports the idea that ongoing monopolization is the key.

### Why Growth *Isn't* Necessarily Good

When examining the differences in financial performance of companies like Wal-Mart and Gillette, some people might overly stress the importance of revenue and asset growth in great stock performance. Too often, companies believe that growth is always good. Driven by metrics such as sales revenue, sales per share, or customer growth rates, management teams can do incredibly value-destroying things.

Take International Paper, for example (see Figure 5). Over the last 10 years, the company has increased revenue from \$15 billion to \$25 billion. Surely a company that has increased its sales levels by a whopping \$10 billion must be doing something right.

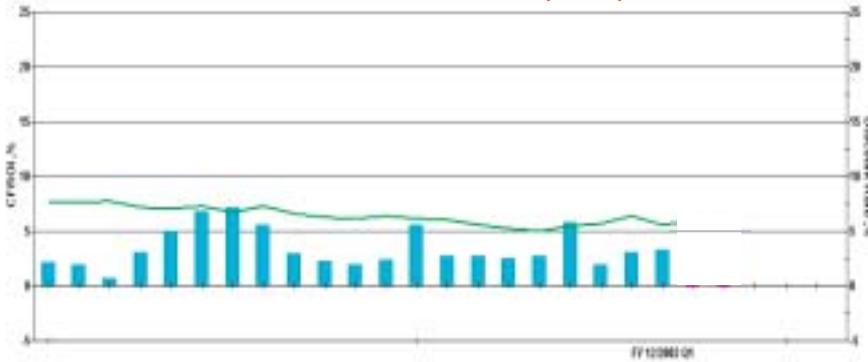
Yet, over that same time period, the IP stock has underperformed the market with stock returns less than half those of a major market index like the S&P 500. Why? Much of the massive sales growth increase was accompanied by cash flow returns that only reached a corporate average (cost of capital level) twice in the entire 10-year period. What does this tell us? Growth *isn't* always good, even the venerable top line. The cash flow returns achieved are at least as important as the sales growth, if not more so. Growing sales or assets without adequately growing cash flows can lead to troublesome stock price consequences.

### FIVE LESSONS OF THIS CONVERGENCE

What insights come from the convergence of strategy and valuation, and who will benefit from this convergence?

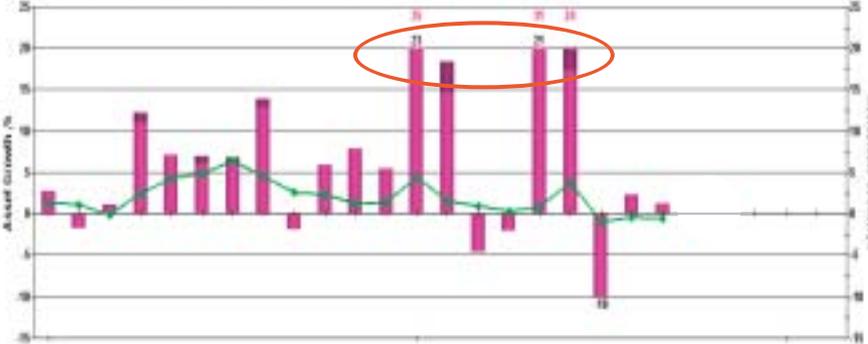
Figure 5: **CSFB HOLT Relative Wealth Chart — Historical Company Performance International Paper (IP), Fiscal Years 1983-2004**

Panel I: Historical Cash Flow Returns on Investment (CFROI®)



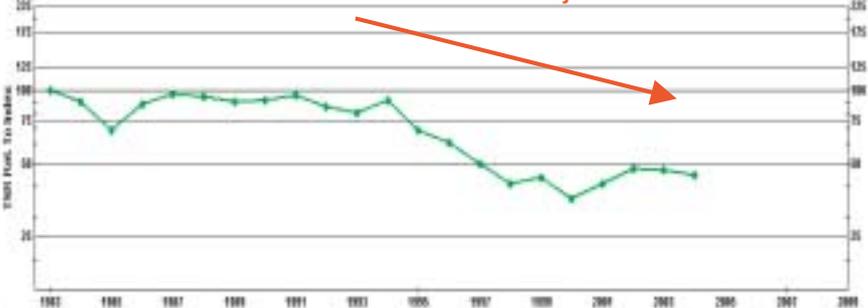
Panel I shows International Paper's poor CFROI history. Over the last ten years, it has only met its cost of capital twice. Its cyclical return activity has averaged in a low 3% to 4% range.

Panel II: Historical Growth Asset Growth Rate



Panel II displays IP's very high asset growth rates, mainly through acquisitions. Over the last ten years, International Paper increased revenues by a whopping \$10 billion dollars.

Panel III: Relative Total Shareholder Returns Versus Major Market Index



Panel III illustrates the importance of generating a decent cash flow return when growing sales and assets. IP's inability to translate high growth into high returns – or possibly low returns as a result of massive growth – explains much of the stock's underperformance. Over the last ten years, IP's share price return has been less than half that of the S&P 500.

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The insights are critical to investment analysts, corporate executives and managers, consultants, and anyone else who needs to better understand a company and its value.

Superior finance leads to superior strategy and vice versa. Knowing when to grow and when not to must dispel old myths about the overimportance of the “top line.” Monopoly-like businesses may generate high returns, but no assumption can be made for long-term, sustained stock price outperformance. Great companies may not be great stocks. Being different is ancillary to—not the driver of—successful strategy.

We must engulf ourselves in this significant convergence of thought between valuation and strategy if we are to move forward in our decisions regarding our businesses. As the convergence enhances our understanding, it

should also enhance our decisions. ■

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