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Understand, Communicate and Improve the Valuation of Companies

Maximizing Shareholder Value And The Greater Good

By William F. Mahoney

(Subscribers can access the entire Madden monograph by clicking on the link at the end of this article.)

Bart Madden knows the investment process.

Madden has been analyzing the inner workings of the capital markets and especially equity investing his entire career, which, indeed, is distinguished.

His knowledge of stock investing is as a working practitioner. He conceived the life-cycle framework that forms the basis of a comprehensive investing methodology currently being used by numerous professional investors across the world.

He helped refine that framework over two decades while serving as a partner at HOLT Value Associates. The cash flow return on investment (CFROI) methodology pioneered at HOLT was being employed in investment models used by more than 1,000 portfolio managers by the time HOLT was acquired by Credit Suisse First Boston a few years ago.

The Madden monograph builds the case for using an economic framework to understand how companies create and sustain value in benefiting the economy and society.

CSFB has since incorporated the model into its research process and in consulting with corporations.

Thus, when Madden puts his important ideas "to paper" in a book or monograph, it is worth taking some time to "listen." His book, *CFROI Valuation – A Total System Approach to Valuing the Firm* (Oxford: Butterworth-Heinemann) is much more than a primer; it is an investing guidebook.

Madden's new monograph builds the case for using an economic framework to understand how companies create and sustain value in benefiting the economy and society.

Goal: Maximize Shareholder Value

Madden stands tall in saying that the goal of every business should be to maximize shareholder value. Forget about any controversy about the term or the idea of focusing on value maximization.

He even gives the Maximizing Shareholder Value concept a label, MSV. It should take its place among popular short-hand labels, such as EVA, CFROI, EPS, ROE and the like.

Madden argues persuasively that maximizing the value of a business is in the best interests of all constituencies.

"Society benefits when management makes decisions designed to maximize shareholder value because this promotes a market-based process for continually moving resources to their most efficient uses; i.e. the gains to society over time far outweigh the short-term disruptions," Madden writes in his monograph.

He is convinced that MSV should function as the decision-making basis for management. The monograph includes a description of how companies can grow and serve society by using its resources to satisfy customers and grow their customer base as a fundamental way to maximize value.

Competitive Business Environment

A successful company's economic growth typically occurs in a highly-competitive environment. Madden lays out the life-cycle of most companies. He describes the first or startup stage as one of high innovation in which they are earning CFROIs well above their cost of capital, reinvesting funds to continue achieving those high returns.

Competition typically drives fading CFROIs, identified by Madden as the second stage. Economic returns fade toward the average. Companies can reinvent themselves, re-energizing CFROIs. Madden refers to this stage as fading down or fading up. "The rate of fade thus is an indicator of managerial skill," he writes.

His third stage is "mature" and his fourth stage in the competitive life-cycle framework is a "failing business model." Companies in these stages need tough executives and boards to make the right moves, perhaps paying dividends and conducting buybacks in the mature stage and working at improving CFROIs in the fourth stage.

As a champion of business, Madden is rooting for companies in the third and fourth stages to reinvent themselves. In his monograph, he provides a case history of exactly how IBM reinvented itself.

Essentially, Madden is applying the CFROI framework to help explain stock prices. Madden is a strong believer in using an economic, cash-flow generation framework. The CFROI "is a proxy for the firm's economic return. It is an inflation-adjusted (real) metric constructed from annual financial statements to approximate the average real ROI's being

achieved on the firm's portfolio of ongoing projects," he writes.

Earning CFROIs above the cost of capital is the key to creating economic growth. The model focuses on the key variables of CFROIs, asset growth rates (a proxy for reinvestment rates) and investor discount rates (the company's cost of capital).

Charts guide management and investors in understanding a company's economic performance. These charts show and compare patterns of CFROIs, asset growth (capital investment) and stock price returns.

Market Not Driven by Earnings

Madden argues that the market isn't hung up on short-term results based on earnings. Knowledgeable investors make long-term forecasts of net cash receipts, he writes. They also use this analysis to evaluate managements.

For highly-skilled firms clearly earning economic returns in excess of the cost of capital, increased volatility in quarterly earnings, attributable to an expanded investment program, will tend to not hurt near-term stock prices, providing the reasons and underlying strategy are clearly communicated. In fact, stock prices could easily out-perform.

Madden also believes that management focus on short-term accounting earnings contributes to lower-quality research from the sell side. A chapter titled "Overcoming Management's Quarterly Earnings Mind-set" should be a top-priority read.

The following closing paragraph of that chapter should be comforting to corporate executives and IROs: "For highly-skilled firms clearly earning economic returns in excess of the cost of capital, increased volatility in quarterly earnings, attributable to an expanded investment program, will tend to not hurt near-term stock prices, providing the reasons and underlying strategy are clearly communicated. In fact, stock prices could easily out-perform."

Two brief chapters describe the importance of a company's intangible assets in the valuation context. Madden points out that GAAP accounting covers tangibles. He calls for continuing efforts to create a standardized reporting system that covers key intangibles. He also identifies those key intangibles that can be included practically.

"Importantly, the life-cycle framework can illuminate insightful ways of thinking through and clarifying complex accounting issues," Madden

adds.

A highly-useful appendix at the close of the monograph details the CFROI framework in easy-to-understand language. Reading and studying this monograph certainly is time well spent.

[Click here to download the complete Madden work in PDF format.](#)

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