

## Value Creation Process Chart

The Value Creation Process Chart provides an overview of the value creation process. This chart is a simplified description of the process. A more detailed and accurate description of the value creation process is found in Chapter 5 of *A Theory of Value Drivers: A Grounded Theory Study* (Wendee, 2011) and in Figure 9 of Chapter 5 of *A Theory of Value Drivers: A Grounded Theory Study* (Wendee, 2011, p. 147).

There are three parts to the chart. The first part describes how value is *determined* or *calculated*. It is the part that is shown by the red, green, gray, and blue boxes. If you draw an imaginary line under the two gray boxes, the determination or calculation part of the chart is what is above this line. The second part of the chart consists of the *Primary Value Drivers*. They are shown by the blue boxes in the center of the chart, but also include the variables above the imaginary line that we drew in the previous step; so there is some overlap. Finally, the third part of the chart is represented by the salmon colored boxes at the bottom of the chart that show the *Secondary Value Drivers*.

To understand the value creation process, we must start with the three red boxes (*Value of the Firm's Operations*, *Total Firm Value*, and *Shareholder/Equity Value*) in the first part of the chart. The Value of the Firm's Operation is also known as the *Intrinsic Value* of the firm. It is the objective of every business owner, business manager, entrepreneur, and employee to maximize the value in the red boxes. This also applies to persons working with other organizations, such as non-profits and government organizations. In short, every stakeholder in an organization should be focused on maximizing the value of the enterprise.

The green box in the top, center of the chart represents what I call the *Value Creation Engine*. It provides the calculations necessary to determine or calculate value. This calculation is what is known as the *Discounted Cash Flow Method* of determining enterprise value. It is not the only method that can be used to calculate an enterprise's value, but is a commonly used method and the one that many scholars and practitioners believe provides the most fundamentally sound method of calculating enterprise value.

The two major inputs into the Value Creation Engine are: (1) *Free Cash Flow (FCF)*; and (2) *Weighted Average Cost of Capital (WACC)*. They in turn have a number of inputs that determine their values. In the case of Free Cash Flow, the inputs resemble an inverted income statement. In the case of the Weighted Average Cost of Capital (WACC), the inputs are the cost of equity, the cost of debt and the cost of preferred stock. Each of these inputs to the WACC is weighted by the proportion that each input has in the *capital structure* of the firm. As shown, many factors such as macroeconomic, sector and industry, and company specific factors, influence the values in the WACC calculation. A more thorough discussion of the DCF Method used here can be found in Chapter 5 of *A Theory of Value Drivers: A Grounded Theory Study* (Wendee, 2011).

An important thing to note from the Value Creation Process Chart is that it is necessary to invest back into the business. This is shown by the blue box labeled, *Net Investment in Operating Capital*. As with the other boxes, a more detailed discussion of the calculations for determining

the value in this box is found in Chapter 5 of *A Theory of Value Drivers: A Grounded Theory Study* (Wendee, 2011).

The items in the blue boxes in the center of the chart, as well as the items above the imaginary line that we drew to delineate the determination or calculation section of the chart, comprise the Primary Value Drivers. These value drivers are considered to be primary because they have a more direct link to the actual calculation of the firm's value. It is also easier to put values into these boxes; and the links from sales to FCF, for example, are more readily seen. The same ease of calculation and of seeing direct links applies to the WACC calculation. The Primary Value Drivers are, for the most part, the same for any enterprise under study. They just have different values, of course.

A Secondary Value Driver is any driver of firm value that is not a primary value driver. Secondary Value Drivers are not as easy to quantify as Primary Value Drivers, but they can be quantified, as discussed in Chapter 5 of *A Theory of Value Drivers: A Grounded Theory Study* (Wendee, 2011). There are theoretically an infinite number of Secondary Value Drivers. An *infinite* number of secondary value drivers are, of course, impossible to work with. In practice, there are usually a handful of very important value drivers that should be identified. Identifying and working with more than a handful of secondary value drivers becomes unwieldy and is probably not necessary. What we want to do is to identify the handful of the most important secondary value drivers and focus our attention and efforts on them.

There are several other boxes in the Value Creation Process Chart that should be discussed before concluding the discussion of the value creation process. The first is the blue box labeled *Non-Operating Assets* in the first part of the chart. Non-Operating Assets are such things as investments in marketable securities and non-controlling investments in the stock of non-related companies. The value in this box is usually not very large.

The next box to discuss is the *Debt + Preferred Stock* box. Debt and preferred stock have to be deducted from total firm value to arrive at shareholder (equity) value. The *Debt + Preferred Stock* blue box in the first part of the chart shows this adjustment.

Shareholder returns come in the form of dividends and capital gains or losses. As is discussed in the article on the *Intrinsic Value and the Intrinsic Value Line*<sup>TM</sup>, in publicly traded enterprises stock prices will tend to follow the intrinsic value that is being created. That is one of the primary reasons that we, as investors, are concerned with identifying companies that are creating value. As shown by the gold box labeled, *Shareholder Returns (Dividends + Capital Gains)*, and its relation to the box labeled, *Shareholder (Equity) Value*, there is a loose, but important, linkage between these two boxes. The creation or destruction of shareholder value leads to the increase or decrease in shareholder returns.

The final box to consider is the salmon colored box labeled, *Random Error (Luck)*, at the bottom of the chart. This box asserts that the creation or destruction of value is determined, at least to some degree, by random events, or what some might call "luck". As students of business and management, we have many tools at our disposal to try to mitigate the effects of luck. Many of these tools will be discussed in the sections of this workbook that have to do with management

tools. A more thorough discussion of the random error (luck) phenomenon can be found in in Chapter 5 of *A Theory of Value Drivers: A Grounded Theory Study* (Wendee, 2011).

The purpose for studying the value creation process, as we have done in this article, is to figure out how to create value in the enterprises that we manage; or to see if value has been created in the enterprises in which we may want to invest. As shown in the bottom right part of the chart, the effective use of management tools, along with the effective manipulation of the Primary and Secondary Value Drivers, leads to the creation of value. Management tools provide the link for the exploration of value drivers; the use of value drivers in strategy development; and the solving of specific problems or the addressing of specific issues using value drivers. The use of management tools in the value creation process is discussed in the sections of this workbook discussing management tools.

### **Reference**

Wendee, P. (2011). *A theory of value drivers: A grounded theory study*. Phoenix, AZ: University of Phoenix.