



## Show Me the Value: Measuring Value with NPV

by Patricia Ellenburg

Accepting value creation as the primary goal of the enterprise is the first step in an implementation process with four objectives:

1. Understanding *how* firms create shareholder value;
2. Determining measurement criteria for tracking progress in creating value;
3. Establishing guidelines for interpreting the results; and
4. Tying management compensation to the measures, to align the goals of managers and shareholders, and promote value-creating behavior.

Let's take a closer look at the first of these. Firms create shareholder value when they invest in assets that earn returns greater than their cost of capital. These assets come in the form of products, facilities, technologies, or strategies the business will implement, *including its investment in people and training*.

We call all these assets "projects." Projects are funded with capital supplied by *debt* (provided by creditors) and/or *equity* (provided by shareholders). As we've discussed before, capital is not free. Both creditors and shareholders expect a return, so management must earn returns greater than those investors require. Your CFO describes projects that deliver these excess returns as having "positive Net Present Value (NPV)."

A project's NPV is measured using three variables: the *amount* of its future expected cash flows; their *timing*; and investors' *required rate of return*, which compensates them for awaiting payback, and for the *risk* that expected cash flows might not materialize.

Using a process called Discounted Cash Flow Analysis (DCFA), expected cash flows are discounted at the investors' required rate of return. Certain cash flows have a higher NPV: larger cash flows, those that are received sooner, and those with less risk. Conversely, other cash flows have a lower NPV: smaller cash flows, those received later, and those with higher risk.

The value of a business is the composite value of all its projects. Accordingly, as with individual projects, the value of a business is a function of how much cash flow it is expected to generate --





## CLO Institute

with these cash flows discounted at the investors' required rate of return. By investing only in "positive NPV" projects, management creates new shareholder value.

Keep two things in mind:

1. This cash flow model is forward-looking. It is based on expectations of the future, not on what a company has already delivered.
2. This makes sense when you consider investors' motivations: they want to receive cash in the *future*.

However, most performance measures and incentive compensation systems are based on the past, not the future. Herein lies the disconnect: *Capital markets value companies and investments based on future expectations, while managers are evaluated on and paid for results they've already delivered.*

How, then, do we incentivize managers (including those involved in T&D) for identifying and implementing positive NPV projects, and for realizing economic benefits from them?

### ***About Patricia Ellenburg:***

Patricia ("Trish") Ellenburg is the Executive Director of the CLO Institute, responsible for the development of a new series of educational workshops entitled "Business Strategies for Learning" and the qualification of successful candidates for the Certified Chief Learning Officer (CCLO), Certified Learning Strategist (CLS), and Certified Learning Architect (CLA) designations.

The CLO Institute's certification programs are designed to encourage professional excellence and to provide an objective measure and recognition of expertise for learning professionals.

Trish graduated Summa Cum Laude with a Bachelor of Science in Finance degree from Arizona State University. She also received her Masters of Business Administration degree from Arizona State University.

