

# HOW VALUE PATTERNS SHAPE PRIORITIES FOR VALUE CREATION

**H**OW DO SUCCESSFUL COMPANIES make the right choices in order to create attractive shareholder value? There is no one simple or universal formula. Companies as different as the North American retailer of high-end yoga and exercise clothes Lululemon Athletica, the Korean automaker Hyundai Motor Company, and the U.S. industrial supplier W.W. Grainger all delivered shareholder returns over the past five years that were strong enough to earn them a spot in our top-ten rankings in their respective industries. But they illustrate the diversity of company starting positions, and each achieved superior performance following quite different paths.

In last year's Value Creators report, we introduced the idea of *value patterns*—distinctive company starting positions that cut across industry boundaries and shape the range and types of strategic moves most likely to create value.<sup>1</sup> This year, we use the stories of these three quite different companies to explore the wide range of contexts in which leaders must find strategies for value—and how they can use the value patterns concept to unlock new sources of value.

## Four Factors Underlying Value Patterns

In recent years, BCG has been conducting a major proprietary research effort to analyze

the quantitative factors that define a company's starting position, as seen from an investor's point of view. Our research has focused on four underlying factors that define the context for any company's investment thesis: the health of its portfolio, the degree and quality of its growth exposure, the nature of the risks it faces, and the expectations of its investors, as expressed by the company's valuation. Let's consider each of these factors in turn.

**Portfolio Health.** Although delivering returns that are above the cost of capital has long been a fundamental principle of value management, it is striking how many executives still think of value creation in terms of earnings, margins, or growth rates. As long as earnings are growing, these executives think they are creating value. But an earnings- or profit-growth agenda is not necessarily a value agenda. More than one-third of the \$8 trillion of invested capital in the S&P 1500 does not earn the cost of capital. A business with a low return on invested capital has yet to earn the right to grow. Therefore, the first question any senior executive team must ask itself is: Where do we enjoy competitive advantage in our business that can drive attractive returns on invested capital?

**Growth Exposure.** For market segments and positions with attractive returns, the next challenge is to find attractive growth expo-

sure. Although the vast majority of companies are expected to grow at modest rates, most companies aspire to break out from the pack and deliver above-average growth. In doing so, however, the challenge is not simply to grow—for growth can create no value and, in some cases, can even destroy value. The key question is: How much growth exposure do we have, and how can we find profitable and sustainable growth?

**Risk Profile.** Highly leveraged, turbulent, or fast-changing businesses require different actions to defend and increase value. Debt leverage is highly visible because companies with stressed balance sheets have weak credit statistics and ratings. Companies with too much debt must focus on restructuring and liquidity. Businesses with significant commercial risk—those facing turbulent markets, rapid competitive shifts, or unusually high uncertainty on key business drivers—typically have volatile market values because investors are not sure whether today’s earnings will be around tomorrow. For some companies, the degree and types of risk will be the dominant value-creation issue they face.<sup>2</sup> Investors will want to know how the company intends to protect itself against a significant deterioration in the franchise value of the business. So executives must ask:

What are our key risks and how should we manage them?

**Investor Expectations and Valuation.** Most companies most of the time trade in a range that is consistent with their fundamentals and their future prospects. But sometimes, companies find themselves with a valuation that is considerably outside this range—with implications for future value creation that have to be managed. An unusually low valuation can be a tempting target for activist investors and threaten the breakup of the company. And while everyone likes a high stock price, too high a valuation can seriously penalize a company’s future TSR potential. The final question in formulating an investment thesis is: What expectations do our investors have, and does our valuation match our outlook?

Understanding a company’s profile along these four dimensions is a critical first step in developing a sound investment thesis to guide strategic priorities. But depending on a company’s starting point, any one of these factors may carry a special weight. BCG’s research on roughly 6,000 companies in 60 countries has identified ten distinctive value patterns that combine these four factors—portfolio health, growth exposure, risk profile, and valuation dynamics—in different ways. (See Exhibit 3.)

