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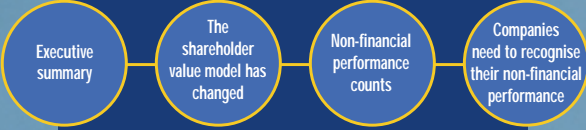
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Measures That Matter™

An outside-in perspective on
shareholder value recognition



Executive summary

The shareholder value model has changed

Non-financial performance counts

Companies need to recognise their non-financial performance

Measures That Matter



"In today's volatile markets, a company's non-financial performance, namely its ability to identify, demonstrate and communicate value in its intangibles, future growth platforms and strategic options, is a key differentiator for investors almost irrespective of short-term cashflows and tangible assets. And the greater the uncertainty, the greater the significance of non-financials to investors' decision-making as leading indicators of future financial performance."

Andrew Tivey, Head of Strategic Finance, Ernst & Young



Executive summary

The shareholder value model has changed and non-financial performance has become increasingly important...

How shareholder value is defined, created, and in particular recognised by the capital markets, has fundamentally changed with the connected economy.

Intangibles, new business models and optionality are increasingly significant to corporate valuations. As investors become more concerned with future growth prospects than dividends, non-financial performance indicators which inform how companies derive competitive advantage, become more influential. And, the more volatile and uncertain the environment, the more these indicators count.

...but by how much?

Research by Ernst & Young adds even sharper focus to the significance of non-financial performance and confirms the global nature of this change. Research during 1999-2000 has confirmed an earlier US study that fund managers attribute at least 35% (and sometimes much more) of their consideration surrounding an investment decision to non-financial performance. Critical areas of non-financial performance that are relied on or measured when assessing the scale and riskiness of future expectations were also identified. We call these areas, which have a significant bearing on investors' valuation and thus PE ratings, the Measures That Matter ("MTMsTM").

“Quality and execution of strategy go hand in hand. The company needs a good strategy that can be executed, and communicated well.”

Buy-side analyst

So what should companies be doing about this?

Managing shareholder value requires understanding not only a company's internal economic value creation model, but also how investors recognise and measure performance from an external perspective. Why? Because investor portfolio decisions are influenced by other non-financial factors neither reflected in internal economic models nor communicated through traditional financial reporting requirements. Key insight into why a market may attribute a higher value to one company within a peer group when short-term financial performance expectations may be similar can be gained by examining what performance the markets are actually measuring. And more importantly, how it impacts on valuation.

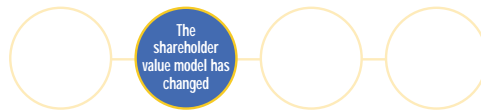
Ernst & Young's research learnings applied through its Measures That Matter – Investor Exchange diagnostic can significantly help companies address value gaps and refocus investor communication on what matters. It also informs potential solutions for strategy and execution by closer alignment with actual market drivers.

“To be successful, a company must stay ahead of its competitors. It must beat them through gaining first mover advantage in any way it can. Either by getting to market in different ways, or introducing new innovative strategies.”

Sell-side analyst

Summary of Key Findings of Measures That Matter Research

- *Non-financial performance drives at least 35% of investors' portfolio allocation decisions; the greater the uncertainty, the greater this proportion*
- *The more non-financial information analysts use, the more accurate their forecasts*
- *In the absence of any established framework for non-financial performance, a common hierarchy emerges of critical Measures That Matter that analysts and buy-side investors respond to. This is consistent in both the UK and US*
- *The influence of specific non-financial performance, or Measures That Matter varies from industry to industry*
- *Rating in one aspect of non-financial performance influences perceptions in other areas of non-financial performance*



The shareholder value model has changed

“They are all telling us their glowing strategies. It is, however, the quality of the management and their past record that dictates whether they can execute it and hence get a higher rating.”

Sell-side analyst

The connected economy...

The connected economy is redefining the shareholder value paradigm. Tangible assets and forecasted cashflows are no longer the primary sources of value. Today, intangible assets and new business models which focus on achieving platform dominance and nurture multiple growth options appear key.

Despite recent corrections and market uncertainties, the valuations of many “new economy” companies such as eBay, Amazon, Yahoo, Freeserve and other stocks particularly in the Telecoms, Technology and Media sectors remain high and provoke controversy. The capital markets, through investors, appear to be valuing these companies on future expectations and with this shift comes higher levels of volatility and risk. Increasingly we see a widening disconnect between current financial performance and value, and market values driven more by future promise and intangibles than historic performance. But why is this?

...has given rise to new sources of competitive advantage

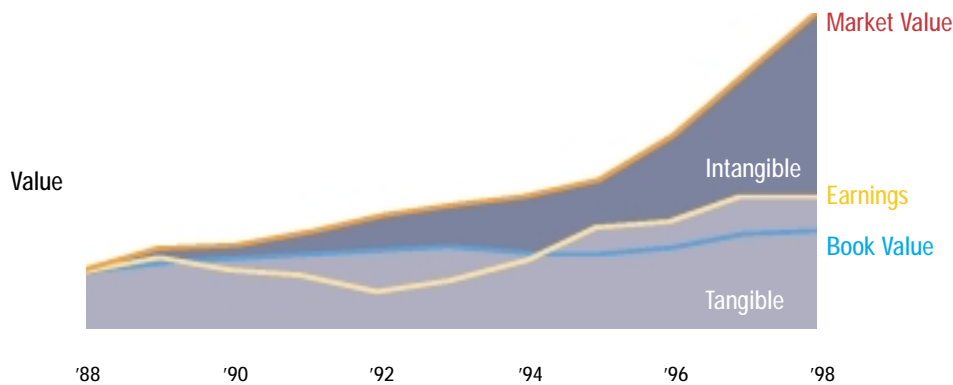
First, the transformation to the connected economy from the industrial by harnessing the power of the internet and other new technologies is creating potential for new growth opportunities and economies of scale. The internet for instance has slashed the cost of, and ease of access to, a prime resource requirement – information. But more than that, the internet is also a means of exchange, a market place and a distribution channel. It has thus enabled new types of growth previously unthought of for those able to identify and exploit new digital business opportunities, or recognise how their existing businesses can be transformed or even reinvented.

“Investors need to feel confident in the management’s ability to perform in the future and trust that what they are being told will be executed. Track record can act as a guide to future performance.”

Sell-side analyst

Intangible measures are increasingly important

S&P 500 (10 year example)



Secondly, the basis of competition has changed. Advantage is now achieved by those who through innovation and excellent execution rapidly seize these new opportunities, and demonstrate sufficient flexibility in their business models and speed of managerial decision-making to exploit network effects. This not only impacts on new economy companies. Old economy companies who are slow to recognise the markets’ expectations for change in their industries are losing market support and value to e-competitors, as the market is attracted to newer stocks with higher growth prospects. And in a low inflation environment, investors are more willing to value promises of profits tomorrow.

Finally, as information about assets and their future value becomes more readily available through traded markets where risk can be transferred, risk properly managed, becomes a source of opportunity rather than a threat.

“A target of employer of choice within the industry, and a capability to attract the best management is key to achieving a competitive advantage.”

Buy-side analyst

“Strategy execution is the most important non-financial factor because in an environment where investors are prepared to discount longer and more aggressively business models, sometimes between ten and twenty times revenue, progress in relation to milestones is all investors have to make an assessment. Failure to meet even a small short-term target will often have a disproportionate effect on investors’ perceptions as to the long-term viability of the model.”

Sell-side analyst

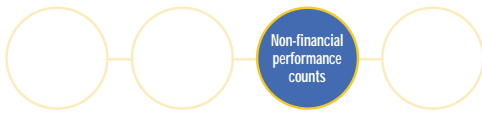
..that challenge traditional models of performance measurement and shareholder value

Traditional financial performance measures such as sales growth, profits, cashflow and return on investment still matter of course. But higher valuations, intangible levels and the rapid pace of change has decreased their significance.

As planning horizons become shorter and more uncertain, higher proportions of corporate value now accrue beyond any reasonable forecast interval. Past performance no longer guarantees future performance. But the traditional approach to valuation of discounting expected future cashflows at a single risk-adjusted rate assumes all future cashflows attract the same degree of risk, irrespective of management’s ability to exploit future upside (option) potential and manage downside risk.

Understanding performance in this environment therefore requires investors to discriminate on other more qualitative non-financial factors. These factors are more leading indicators which inform on growth prospects and become proxies for why certain companies trade at a premium to others.

And this phenomenon is not just limited to e-commerce and an on-line world which is still in its infancy. As the distinctions between companies in the on-line and off-line world become more blurred, so the relevance of non-financial performance to future expectations extends to the old economy as our research shows.



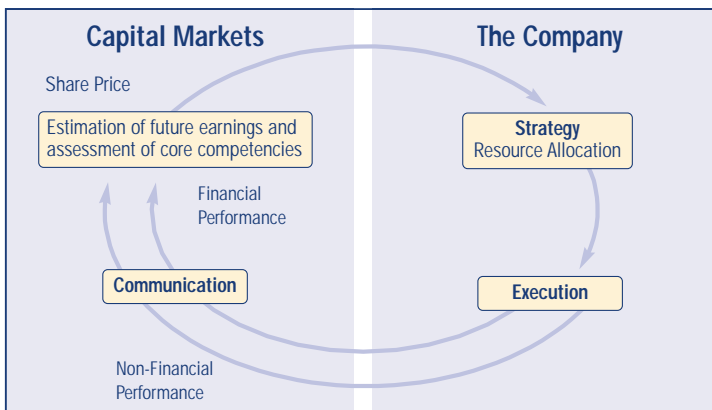
Non-financial performance counts

Ernst & Young’s Capital Markets Feedback Loop

Ernst & Young’s Measures That Matter research focused on how value was defined and measured in the exchange between investors and corporates, illustrated below in Ernst & Young’s Capital Markets Feedback Loop.

This feedback loop depicts the forward-looking perspective of investors. To assess value and the core competencies of a company, information on the company’s strategy and where it chooses to allocate its portfolio of tangible and intangible assets is assessed from a variety of sources, principally company announcements, reports and presentations. Periodically, when the company reports results or makes trading statements, insight is gained into how the company is delivering on its strategy. But other qualitative non-financial information is used, either systematically or intuitively, to supplement hard historical financial facts. This information can significantly influence inputs into investors’ and analysts’ financial valuation models, either in how future growth is seen and/or the level of risk associated with it.

The Capital Markets Feedback Loop



Source: Ernst & Young Centre for Business Innovation Survey

“One valuation model we use is a hard EVA model that is purely financial. We forecast cashflows over a 10-year planning period using a growth factor. But some soft measures are worked into this model in calculating the growth rate. Factors such as management performance, strategy and acquisition policy, will all drive a growth rate which is used to determine a company’s rating.”

Buy-side analyst

A clear but often neglected inference of this is that, knowingly or not, companies have a financial brand value associated with their stock – the ability to create and deliver a value promise, and thereby justify a premium rating.

“There are a lot of very bright analysts looking at the sector, and producing excellent numeric models, but they can’t call the shares up or down. I therefore tend to ignore the numbers and rely on the strategy.”

Buy-side analyst

UK Measures That Matter research

Our UK research sought to test the earlier US-based Ernst & Young study involving almost 600 sell-side analysts and buy-side representatives, which demonstrated that non-financial performance drove at least 35% of investor decisions. The table below shows all the 39 non-financial criteria used in the US study grouped into 8 categories and tested across a diverse range of industries including Technology, Pharmaceuticals, Oil and Gas and Manufacturing.

The US study focused on 39 specific non-financial criteria.

Quality of Management

- Execution of Corporate Strategy
- Quality of Corporate Strategy
- Management Experience
- Quality of Organisational Vision
- CEO Leadership Style

Effectiveness of New Product Development

- Research Leadership
- New Product Development Efficiency
- New Product Development Cycle Time
- Percentage of Revenues Derived from New Products

Strength of Market Position

- Innovativeness
- Market Position
- Brand Image
- Strength of Marketing and Advertising
- Global Capability

Strength of Corporate Culture

- Ability to Attract and Retain Talented People
- Quality of Workforce
- Quality of Incentive Performance Systems
- Quality of Employee Training
- Employee Turnover Rates
- Environmental and Social Policies
- Use of Employee Teams

Effectiveness of Executive Compensation Policies

- Alignment of Compensation with Shareholder Interests
- Performance-based Compensation Policies
- Ratio of CEO Compensation to Workforce Compensation

Quality of Investor Communications

- Management Credibility
- Accessibility of Management
- Quality of Guidance
- Knowledge and Experience of Investor Relations Contact
- Quality of Published Materials

Quality of Products and Services

- Quality of Major Business Processes
- Customer Perceived Quality
- Product Defect Rates/Service Failure Rates
- Product Durability
- Product Quality Awards
- Process Quality Awards

Level of Customer Satisfaction

- Customer Satisfaction Level
- Repeat Sales Level
- Number of Customer Complaints
- Quality of Customer Service Department

We took a further sample of UK industries – Consumer Products, Industrial Products, Technology, Communications and Entertainment – sectors with differing levels of tangible and intangible assets. Our objective was simply to find out how non-financial factors identified in the US research mattered to these industries, irrespective of new or old economy bias, and the way in which they impact corporate value. To do this we conducted 50 interviews and a number of workshops with sell-side analysts and buy-side representatives and investors.

Significantly, our research findings were supported by work undertaken with individual clients, notably in the Pharmaceuticals, Insurance and Communications sectors.

“The winners will be those who reduce their earnings exposure to the existing business and have strong management skills to drive value from alternative income streams.”

Sell-side analyst

“Execution is more important than the strategy itself as investors do not like surprises.”

Buy-side analyst

Key findings

- *Our findings supported the US perspective that non-financial performance drives at least 35% of investors’ portfolio allocation decisions. The original finding followed decision-based simulation in the US with 275 fund managers. We tested this with unprompted questions to analysts and fund managers. The results were unanimous in confirming the importance of non-financials, with no respondents confirming a significance of lower than one-third. In fact the average result from the interviews was nearer 45%. Subsequent studies carried out for clients have confirmed how as uncertainty increases, the dependence on non-financial performance data also increases.*
- *In each sector, the more non-financial information analysts use, the more accurate their forecasts. We tested this observation from the US study by studying the correlation between references made to non-financial measures in analysts’ reports and the accuracy of their earnings forecasts as recognised by the AQ FTSE100 Publication. For the sectors tested, positive correlations as high as 0.72 were observed.*
- *In the absence of any established framework for non-financial performance, a common hierarchy emerges of critical Measures That Matter that analysts and buy-side investors respond to – and these are consistent across both the UK and US with the exception of global capability which did not feature in the US top ten. The overall top ten Measures That Matter reviewed were:*

Note: The top ten list was compiled from three sources: broker reports, and sell-side and buy-side interviews.

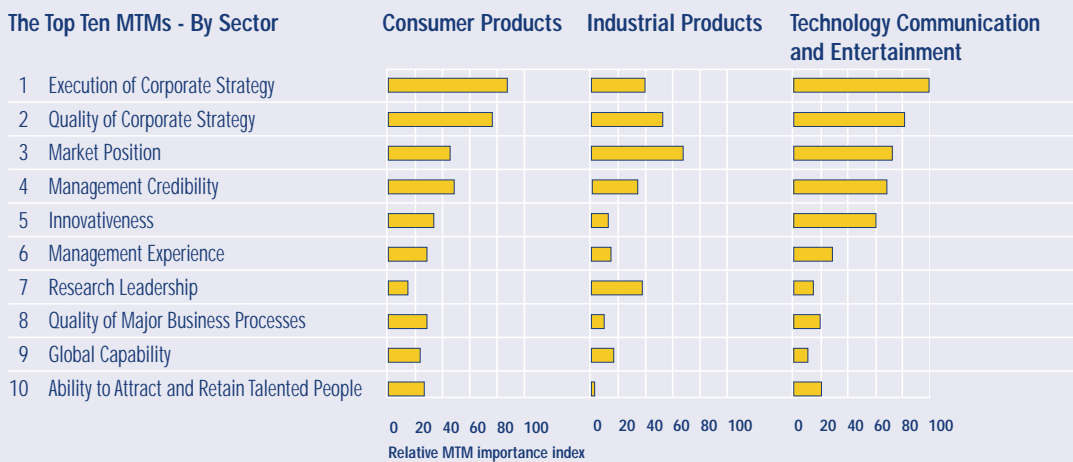
The Top Ten UK MTMs



“A company needs to make clear that the targets it sets will mean it will outperform an identified peer group not just simply outperform IMS quoted industry growth.”

Sell-side analyst

- Execution of Corporate Strategy, Quality of Corporate Strategy and Management Credibility are always among the top five areas assessed, irrespective of differences by industry.
- The influence of specific non-financial performance/criteria varies from industry to industry and indeed can vary from company to company within a given sector, reflecting issues of particular concern for each company.



Underpinning and linked to each area of non-financial performance are specific measures, both quantitative and qualitative. These measures are not only specific to each company but also sector specific. For instance in e:commerce measures of quality of strategy link closely to key areas such as innovativeness and sustainability of business model and value proposition, size of identifiable markets, use of technology, alliance strategy and quality of partners. Similarly strategy execution links closely to traffic (eyeballs) related data i.e number of hits, page views, minutes per page, change in usage and conversion ratios.



Companies need to recognise their non-financial performance

Understanding how the capital markets recognise value...

Our research has major implications for companies dissatisfied with their share price performance or concerned to understand better what drives high PE ratings.

Creating economic value is one thing; but how the market recognises and measures this, draws comparisons with other companies in a given sector and assesses the value of future growth prospects may be another. In almost any given sector, we find inconsistencies between expected earnings growth rates and market multiples. Whilst this may be more pronounced in “new economy” companies because of their higher valuations, it is still relevant to other sectors. Consider the following actual illustration from the engineering sector:

Company	Valuation Multiples				
	EV/Sales 2000	EV/EBIT 2000	EV/EBITDA 2000	P/E 2000	Est 3yr EPS CAGR (%)
Company 1	180%	12.5	9.4	14.1	12.7
Company 2	134%	10.7	8.5	17.2	8.3
Company 3	188%	10.2	9.0	15.8	8.3
Company 4	99%	8.4	6.7	11.6	12.9

Source: E&Y analysis

“I consider all these factors to be encapsulated under management quality – a good strategy, well executed, with a satisfied customer base and a well aligned set of employees are all functions of a good management team.”

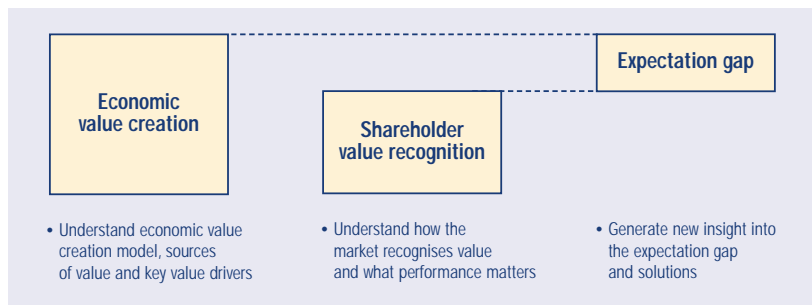
Buy-side analyst

Despite having the highest anticipated earnings growth rate, Company 4 has the lowest market rating. So, is Company 4’s rating deserved given the market’s expectation of its earnings growth? Is the inconsistency in multiples due to differences in relative capital efficiency and risk profiles, or matters related to quality of strategy, its execution or the communication thereof? Are in fact the companies not truly analogous despite the market’s propensity to judge them together? How does market liquidity influence the relative valuations?

...is critical to communicating and managing future expectations

The answer may lie in any one or a combination of these factors but cannot be judged solely from an internal perspective. An “outside-in” understanding of what investors consider to be the Measures That Matter for a company and its peers is fundamental to understanding this issue.

Ernst & Young is using the Measures That Matter study learnings in its Investor Exchange diagnostic tool to help companies investigate valuation issues and identify solutions by recognising value drivers from both perspectives. By adopting a capital markets approach and comparing a company’s internal value creation model to the investment community perspective through the Measures That Matter lenses, powerful insight can be drawn into causal factors of expectation gap differences.



Our fact-based diagnostic process helps companies to understand if expectation gaps are more linked to communication, which can be remedied by aligning disclosures and communication strategy, or if there is a lack of realism by management as to the true position of their business and the markets’ acceptance of their strategies. Measures That Matter – Investor Exchange therefore has real consequences for companies seeking to maximise shareholder value in three key areas of management process.

Measures That Matter – Investor Exchange Diagnostic Insights

Investor communication and disclosure	Strategy development and formulation	Execution and performance management
Have the markets got the story right?	How are the markets recognising and measuring quality of strategy?	Do the markets believe the company can deliver?
<ul style="list-style-type: none"> • What are the key elements of non-financial performance that investors most respond to? • How and what information should be disclosed and how often? 	<ul style="list-style-type: none"> • How will the markets recognise and measure new initiatives? • How can the portfolio of tangible and intangible assets be managed to greater effect? • How should the strategy be best financed? 	<ul style="list-style-type: none"> • What areas of execution are critical to investor confidence? • What measures should be built into balanced scorecards that inform how strategy and the value promise is being delivered to meet or exceed investor expectations?

To sustain or create shareholder value and confidence, companies need to focus on what matters. Our Measures That Matter research and Investor Exchange diagnostic confirms that not only does non-financial performance really count, but it is an essential part of the shareholder value management system in the connected economy.

“Demonstrating a breadth and depth of management experience across the business creates investor confidence in the firm’s ability to execute.”

Buy-side analyst

Ernst & Young's shareholder value model for the connected economy

Measures That Matter is a key element of Ernst & Young's model for shareholder value in the connected economy – FutureWealth expectations™.

FutureWealth expectations (“FWe™”) is a framework based on rigorous valuation methodologies used by analysts in today's capital markets. It is based on the proposition that wealth creation stems from two sources – cashflow generated from current assets (net present value of existing business model) and future growth options.

“Effective New Product Development is a key driver of revenue growth and can create a first mover advantage in new areas of business.”

Sell-side analyst

FutureWealth expectations™ = NPV of existing Business Model + Value of Future Growth Options		
Certainty/Risk	Higher/Lower	Lower/Higher
Performance Indicators	Lagging/Financial	Leading/Non-financial – (Measures That Matter)
Tools & Techniques	eg DCF, EVA™, ROI	eg Real Options, Simulation, Decision Trees.

Ernst & Young Strategic Finance

Ernst & Young's Strategic Finance group delivers innovative solutions applying the FWe mindset to Boardroom shareholder value issues. The group is a dedicated team of professional business advisers with industry, strategy, valuation and business modelling skills. It helps clients to recognise, create and realise shareholder value.

To find out more about FWe, Measures That Matter – Investor Exchange diagnostic, or other shareholder value services provided by Ernst & Young's Strategic Finance practice, please contact any one of the following:

Jim Eales	020 7951 4566
Remy Schosmann	020 7951 5202
Andrew Tivey	020 7951 3656
Iain Williams	020 7951 6425



