Perspective

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The Root Causes of Value Destruction

How Strategic Resiliency Can Help

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EXECUTIVE SUMMARY

Booz & Company recently analyzed some of the world's biggest companies and found that strategic risks caused the greatest amount of shareholder value destruction during the past 10 years. This finding has profound implications for executive teams, which focus on cost and value considerations when setting strategy but often relegate risk management to their enterprise risk management (ERM) teams. It turns out there is an inherent flaw in this approach to risk: ERM teams do not have the mandate to evaluate the strategic risks embedded in the decisions made by senior management. An ERM team hedges risks associated with a certain strategy, but it rarely weighs in on the riskiness of the strategic decision itself.

To bridge this gap in risk analysis, executive teams must revise their approach to strategic decision making, augmenting traditional cost and value considerations with risk and resiliency considerations. This involves broadening the team's awareness about uncertainty and risk, integrating risk awareness into strategic decision making, and adopting strategic resiliency thinking.

A GAP IN RISK ANALYSIS

The world is an increasingly uncertain and rapidly changing place, and with this transformation comes new risks that companies must anticipate and hedge against in order to survive. Technology development, interconnected global markets, shifting consumer needs, blurring and converging industry ecosystems, and new rules and regulations are just some of the factors ratcheting up business risks and demanding corporate resiliency.

With these performance challenges in mind, Booz & Company recently undertook a research project to identify what kinds of risks destroy the most shareholder value—and how companies can respond. It's an exercise we've gone through before. In 2004, when the Enron, Tyco, and WorldCom scandals were fresh, we surveyed thousands of public companies and determined that, contrary to prevailing wisdom, compliance risks did not destroy the most shareholder value. That distinction went to strategic risks—those risks embedded in the top-level decisions made by the executive team, such as what products and services to offer, whether to outsource manufacturing, or what acquisitions to make.

Our 2012 study, which looked at public companies with at least US$1 billion in enterprise value, confirmed those earlier findings: Strategic risks destroy the most shareholder value. This has profound implications for executive teams, which tend to outsource risk to their enterprise risk management teams. The fundamental problem with delegating risk considerations this way is that ERM teams do not have the mandate to evaluate the strategic risks embedded in the decisions made by senior management. An ERM team must assume that the strategic course set by senior management is sound. For example, an ERM team can identify and hedge risks associated with doing business with manufacturers in Southeast Asia, but it can't evaluate whether the company should be outsourcing to the region in the first place.

This gap in risk analysis is causing companies to overlook or misjudge strategic risks and is destroying significant shareholder value. To avoid this mistake and rein in losses, managements can't simply relegate risk considerations to ERM teams; instead they must take a more balanced approach to strategic decision making, augmenting traditional cost and value considerations with risk and resiliency considerations.

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THE BIGGEST LOSERS

During the past decade, companies have steadily dialed up their focus on risk, in part as a reaction to Sarbanes-Oxley requirements in the United States. But they have usually done so with what amounts to a bottom-up approach. Individual functions such as accounting, finance, and compliance have improved risk controls; meanwhile, ERM teams identify and evaluate interconnected risks. These steps, though important, are not sufficient. Indeed, they overlook a critical element to ensuring risk resiliency: a top-down view of risk.

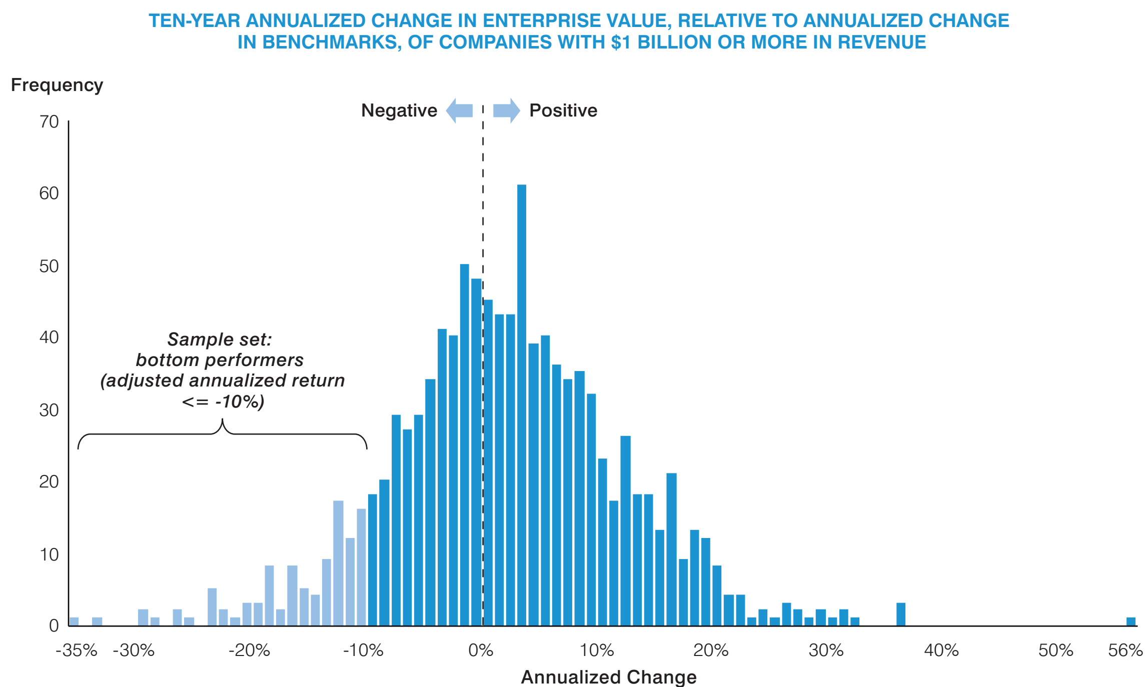
Meanwhile, the risks that senior leaders should be considering continue to increase in scope and complexity. For example, accelerating technology development is forcing rapid adoption of new products, services, and business models; digital information creates vulnerabilities to theft and loss; global supply chain disruptions quickly ripple around the globe, affecting companies and customers; consumer connectivity via social networks can broadcast missteps instantaneously to millions of people worldwide; convergence of established industries, such as technology, financial services, and commerce, upends profitable business models; Asian suppliers that once offered cheap knockoffs can suddenly become robust competitors with improved quality, efficiency, and innovation; and natural, political, or regulatory shocks can reverberate around the globe.

The list goes on, and our research shows that senior management teams' lack of attention to these kinds of risks when setting strategy can destroy significant shareholder value. We reached this conclusion by analyzing companies that were on major exchanges and had an enterprise value of more than $1 billion on January 1, 2002. We found 1,053 companies that met these criteria. We calculated each company's change in enterprise value over the next 10 years, and

then indexed each company's annualized return to that of its industry benchmark to control for industry-specific effects.

This allowed us to zero in on the biggest losers, the ones that experienced the most dramatic losses of enterprise value. There were 103 companies with annualized returns relative to their respective industry benchmarks of worse than -10 percent (*see Exhibit 1*). This corresponds to the bottom 10% of performers in our

Exhibit 1
Changes in Enterprise Value



Source: Capital IQ

sample. We checked to see if the companies on our list were simply the weakest companies in one or two industries in terminal decline. But this was not the case. There was broad industry representation among the bottom performers.

Next, to get at the root cause of this lost value, we conducted an event analysis by going back to company news reports, press articles, and brokerage reports for each of the 103 companies before and after the value declines. We then assigned each company's economic decline to one of four categories:

1. *Strategic:* This category includes major strategic blunders (such as new product or new market failures) or instances when a company was caught flat-footed by a major industry shift (such as digitization of content). We included failed mergers and acquisitions in this category, as well as dramatic shifts in major enterprise value drivers (for example, a major input cost), because these occurrences should have been foreseen. This category, for example, includes Time Warner and its widely criticized merger with AOL.

2. *Operational:* This category includes major operational problems (e.g., supply chain disruptions, customer service breakdowns, and operational accidents) that caused substantial shareholder value destruction. A perfect example is the April 2010 Deepwater Horizon offshore oil rig explosion and leak in the Gulf Coast, an event that wiped out more than $50 billion in shareholder value of BP plc in the days and weeks following the accident.

3. *Compliance:* This category includes fraud, accounting problems, ethics violations, and other failures to comply with laws, standards, or ethics. During the 10-year time frame considered, a few prominent examples included Tyco's accounting and discrimination lawsuits and Tenet Healthcare's improper medical and business practice legal battles.

4. *External:* These situations involved external shocks of a natural, political, or regulatory nature. We narrowed these situations down to circumstances in which the external event could not be controlled or easily anticipated by the company. For example, USEC—a supplier of enriched uranium for nuclear power plants—saw a sudden and sharp decline in enterprise value after the Japanese tsunami and ensuing nuclear leak disaster.

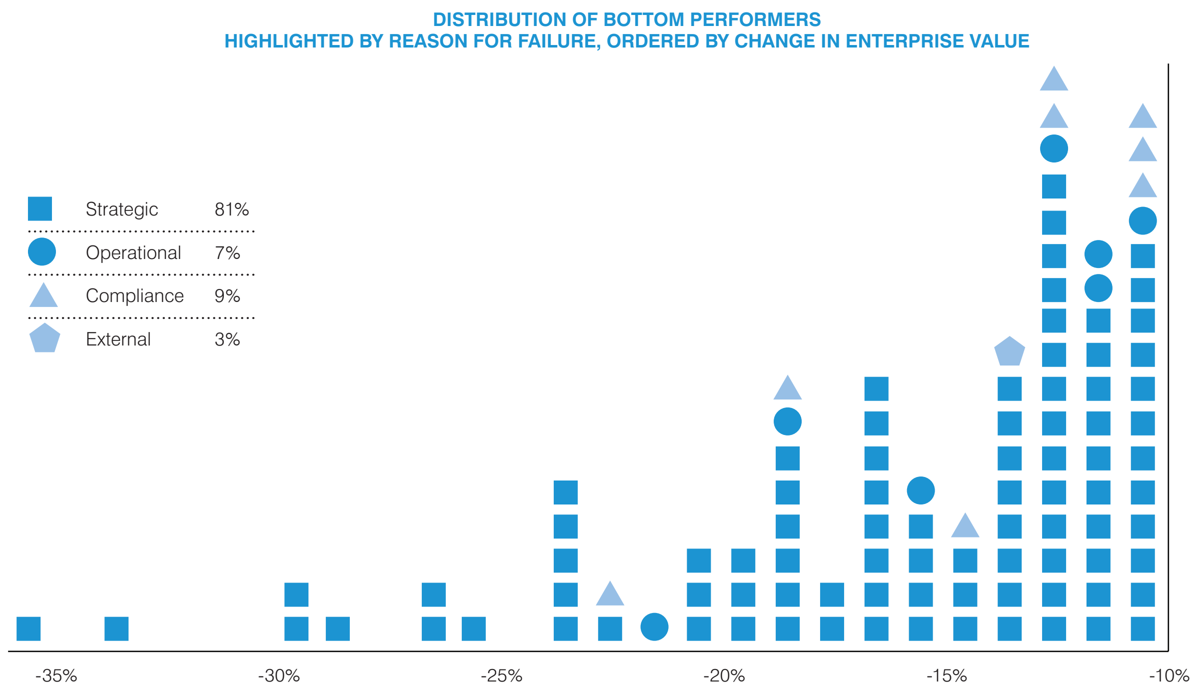
THE CAUSE OF LOSS

The results of our analysis are unambiguous. Among the 103 companies studied, strategic failure was the primary culprit a remarkable 81 percent of the time (*see Exhibit 2*). When we segmented the data by industry and geography, there were some very slight variations (e.g., strategic failures are particularly acute in the financial industry, and Europe has more operational problems than the U.S. or Asia). Nevertheless, strategic failure remains the major cause in every case.

About half the time, the loss occurred gradually—over several months, or even years if the company took too long to grasp a changed strategic environment or lacked the agility to react. The other half of the time, the lost value occurred in a matter of months, weeks, and sometimes even days. Sometimes these sharp shocks were caused by strategic failure (e.g., being caught by surprise when a competitor introduces a superior product), and sometimes by an operational issue, compliance problem, or external event that overwhelmed the company.

Often, of course, there is a confluence of risks that lead to value destruction. To better understand these more complex situations, we segmented loss drivers into primary, secondary, tertiary, and quaternary causes. But even when second-order causes are taken into account, strategic failure caused more than 60 percent of shareholder value destruction.

Exhibit 2
The Vast Majority of Failures Are Strategic in Nature



Source: Booz & Company

BECOMING MORE RESILIENT

If most value destruction is the result of strategic failure, how should management respond? First of all, as noted earlier, leaders must recognize that strategic risk is an issue that management must address itself. Strategic failures are so prevalent, in part, because management teams have unwisely relegated risk management to ERM teams.

Make no mistake, the ERM function is vital at every company. Once handed a strategic plan, these teams identify and quantify risks and then assign people to build continuity plans. Thus, ERM groups play an essential role addressing frequently encountered risks in areas such as compliance, ethics, finance, and accounting, as well as safety. (The research shows that some companies could stand to improve in these areas as well, but in general, most companies have a well-functioning program in place.)

Nevertheless, an executive team can't rely on ERM teams to make the enterprise more strategically resilient because ERM teams do not have the scope to question the strategic decisions that set the company's course and undergird its operations. We believe that executive teams must consider three perspectives on risk in order to preserve and grow shareholder value. All of these are outside the scope of most ERM teams:

1. *Broaden awareness about uncertainty and risk*. We expect change to continue accelerating and uncertainties to increase. Extreme events—with extreme consequences—cannot be predicted, but they can be anticipated. Management teams need to think broadly about what could occur and constantly layer new risks into their calculations as these risks emerge.

2. *Integrate risk awareness into strategic decision making*. By giving risk a seat at the decision-making table, management acquires a full understanding of uncertainties—both upside and downside—inherent in strategic decision making.

3. *Adopt strategic resiliency thinking*. Managers need to consider how strategic decisions can affect resiliency, incorporate resiliency into all decision making, and always be on the lookout for more strategically resilient alternatives in order to build greater corporate agility.

TAKING A BALANCED APPROACH

Executive teams can't outsource strategic risk assessment to ERM teams. They need to embed this assessment in their strategic decision-making process and take a more balanced approach than they have in the past. In addition to considering the typical cost and value factors, leaders must take risk and resiliency into account when making strategic decisions.

Just as managers have advanced tools to analyze cost, revenue, profits, and value, they also need sophisticated tools—such as scenario planning, war gaming, and trend analysis—to judge the resiliency of the decisions they are making before turning the strategy over to the ERM team. Ultimately, companies need both a robust ERM function and leaders willing to evaluate risk at the highest level of strategic thinking.

About the Authors

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