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ENTERPRISE VALUE ENHANCEMENT – 2
THE FINANCE FUNCTION AND ITS RISK MANAGEMENT ROLE

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We outlined in our last Notes a 3-part agenda for building a finance function that can help with risk management. This Note provides further thoughts on the first two agenda items:

Benchmarking enterprise value

Managing risk is about managing change and uncertainty. Amidst uncertainties, it is important to know for certain the initial position where one stands as the first point of reference. Thus the very first step in our agenda is to benchmark the present enterprise value against which future changes can be measured and future positions monitored.

Enterprise value as previously explained can be measured if we know the growth pattern and risk profile of a particular company. The growth pattern of an enterprise is a function of changes in cash flow over a certain period of time. The risk profile is measured with the weighted average of cost of capital ("WACC") which in turn depends on the enterprise's capital structure and the level of return that investors and lenders may expect in the light of specific and market risks peculiar to the enterprise at the time when its risk is measured.

While it is possible to identify comparable companies as relatively objective yardsticks, adjustments are required to improve comparability and subjective assessments are inevitable in the process. However we would suggest it is not necessary to achieve a "perfect" measure, as the purpose of the exercise is to establish a set of benchmarks for relevant parameters that determine enterprise value. Once benchmarks are set, the management can focus on them when contemplating what forces are dictating changes. The finance function can then devise suitable tools to obtain appropriate data for the production of relevant information in support.

Protection of credibility

The importance of credibility cannot be over emphasized, not just because it is a moral issue but also because credibility needs to be consistently maintained in order for an enterprise to attain lower WACC; hence lower risk and higher enterprise value. As mentioned earlier, the value of WACC depends on the particular capital structure, expected return on equity and cost of debt. One may expect, therefore, that a company with an unknown or tainted reputation must offer a much higher return or interest to investors and lenders when raising capital and debt as compared to those with consistently good credit records.

Furthermore, as illustrated in our earlier Notes, enterprise value is more sensitive to risk than growth. Thus, for example, those who artificially inflate sales or earnings in an attempt to boost share value would on the contrary seriously undermine the value when overstretched expectations on growth are not met and investors are disappointed. Building reputation is an endurance test; once the credibility of an enterprise is compromised, it is hard and may take a very long time to recover if at all possible.

Accordingly, high on our proposed agenda is the protection of credibility as the most valuable asset and tool for enterprise value enhancement. This requires senior leaders of the enterprise to set the right tone at the top and implement an effective governance structure to protect this most valuable asset. The finance function can play a significant role in this respect by providing relevant information to alert the management to potential exposures on existing and new businesses.

In the above, we have explained our view on the first two items on the proposed agenda and outlined what the finance function can do when taking on its new role in risk management and value enhancement: provide good and relevant information. Our next Notes will focus on the third item: approach to building a contemporary finance function equipped to do this job.