CFO Insights

The value shift: Why CFOs should lead the charge in the Digital Age

First of a four-part series

One glance at any business publication will show that digital business models are increasingly in vogue. Uber, Airbnb, DropBox, and WhatsApp are just a few of the more recent examples of this rapidly growing $10 billion digital start-up trend. CFOs of established firms are taking notice that going digital creates value.

Research by OpenMatters with input from Deloitte & Touche LLP, examining 40 years of data from the Standard & Poor's 500, finds that investors assign higher valuations to organizations that embrace emerging technologies (big data, social media, the Internet of Things, mobile, and so on) to create digital networks. This change is part of a broader trend of corporate value shifts from the predominance of tangible assets, including plant, property, equipment and financial assets, to value from intangible assets.[1] As digital technologies increasingly disrupt age-old sources of value, this issue of *CFO Insights* looks at how CFOs can tap into this value shift through business model innovation.

Four business models driving value

The rise of intangibles as a part of total market and corporate value has occurred in conjunction with the proliferation of new business models. Our research, in fact, shows that almost every company fits into one of four types business models, regardless of industry or function—and each one corresponds to a shift in technology and asset structure. Specifically, companies predominantly fall into one of the following categories, based on the way they create value:

Asset Builders. These companies build, develop, and lease physical assets to make, market, distribute, and sell physical things. Examples include everything from automakers to chemical manufacturers, big box retailers, and distribution and delivery businesses.

Service Providers. These companies hire employees who provide services to customers or produce billable hours for which they charge. Examples include consulting firms and financial institutions.

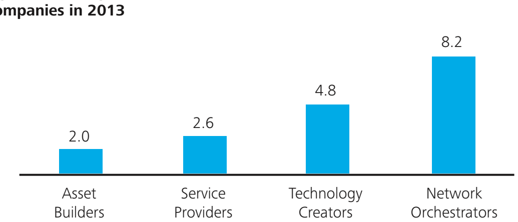
Technology Creators. These companies develop and sell intellectual property such as software, analytics, pharmaceuticals, and biotechnology. Examples include software, big-data tools, and medical-device companies.

Network Orchestrators. These companies create a network of peers in which the participants interact and share in the value creation. They may sell products or services, build relationships, share advice, give reviews, collaborate, co-create, and more. Examples include online financial exchanges, social media businesses, and credit card companies.

The models are differentiated by the underlying technology that was leveraged to develop them. Asset Builders, for example, emerged from the Industrial Revolution, when business was fueled by factories. Service Providers developed in the mid-1970s, when companies started to service what they sold. Technology Creators flourished during the 1990s' information revolution. And Network Orchestrators, the newest entrants, are the companies that have embraced technologies, such as the cloud, analytics, social networks, Internet of Things, and mobile technologies (CASIM), to create value through leveraging unique information, and by orchestrating value generation by network participants. Although a company's business model may not reflect *when* a particular company was founded, it does represent *what* technologies and methods it uses to create value.

The business models are also differentiated by the increasingly lower marginal costs afforded by the technologies embraced. In fact, the OpenMatters research has found that evolving technologies produce a "multiplier effect," increasing market valuation from 1x to 2x revenue as you move along the spectrum from Asset Builders to Service Providers. Above the "digital divide"—meaning companies that either fall in the Technology Creators or Network Orchestrators categories—companies receive valuations 2x to 4x higher than the other two business models (see Figure 1). Moreover, those latter two business models also outperformed on other dimensions, including return on capital employed (ROCE), return on assets (ROA), and earnings before interest and taxes (EBIT) margin in both the short- and long-term.

Figure 1. Average multiplier (price to revenue ratio) for the S&P 500 companies in 2013

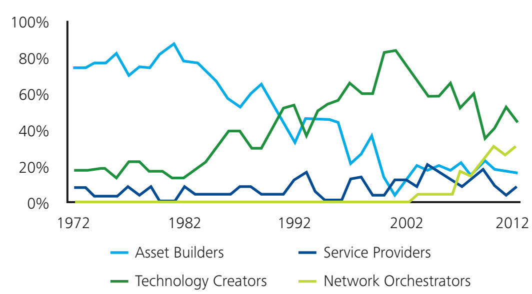


Business models and the value shift

From 1972 to 1992, the most valued 5% of the S&P 500 were mostly Asset Builder companies. From 1992 to around 2010, Technology Creator companies dominated the top valuations. Finally, 2001 to 2012 saw the rise of Network Orchestrator businesses, which are on a trajectory to make up the majority of the top valuations within the next decade (see Figure 2).[2]

Only a few companies, however, are capturing the extra value created by Network Orchestrators. In 2012, less than 5% of the S&P 500 had value multipliers higher than 6x revenue (mostly Technology Creators and Network Orchestrators), while more than 60% had a multiplier less than 2x (mostly Asset Builders and Service Providers). In addition, few companies ever reach beyond established business models to capture the new sources of digital value. In fact, in the Q2 2014 *CFO Signals* report, half of CFOs surveyed said their companies generate all of their revenue from just one business model, and about 80% said they generate at least 70% of their revenue from a single model.[3]

Figure 2. Types of companies constituting the top 5% of the S&P 500 by P/R



For individual companies, the shift to intangibles is also reflected in the slow demise of book value. The major auto companies, for example, maintain enormous real-estate holdings (for example, factories), but managing those holdings may drain cash, dilute focus, and hinder innovation. On the other hand, Apple, which relative to its size has few tangible assets and thus a low book value, is a perpetual innovation machine and has the highest equity value—more than $620 billion—of any company globally.[4] This crucial distinction calls into question the long-accepted belief that ownership of tangible assets is an essential path to sustained success.

Tapping into the value shift

The rise of intangibles—which typically consist of human capital, intellectual capital, and network capital—also has implications for finance and corporate strategy. These forms of capital can create both new cash flows and "real growth options" to enhance corporate value (see W.C Kester, "Today's Options for Tomorrow's Growth," *Harvard Business Review*, March-April 1984[5]). Tapping into this value shift requires CFOs to consider the following:

Shifting mental models. Companies, through their leaders, invest in what they believe has value, and that is driven by the "mental model" of a company's CEO, the CFO, its management team, and board of directors. For example, leaders of Asset Builders believe that value resides in developing and owning (or leasing) hard assets, which can be used for manufacturing, distributing, and selling physical things.[6] On the other hand, Network Orchestrators' top priorities are building and operating social and commercial networks that foster interactions and co-creation with their customers and suppliers.[7] For CFOs, migrating a company's mental model is the first step to capturing the value inherent in intangibles—and a topic we will explore more deeply in a later issue.

Adjusting capital allocation. CFOs would agree that capital should be allocated to where value is created. Yet, while technological and cultural shifts have created opportunities for new, more-profitable business models, many finance chiefs are still allocating capital based on outdated thinking about risks and rewards. Based on our analysis of 40 years of company data and their asset allocations, the findings suggest that most leaders are not allocating their capital to today's sources of value and technologies in order to harness the power of intangibles. For CFOs—who own the capital-allocation process, or at least have a material role in this process as catalysts or strategists (see "The Four Faces of the CFO"[8])—it is important to revisit capital allocation and assess if it taps into the broader value shift. At the very least, we suggest that CFOs allocate 70% to their core business model, 20% to the adjacent business model, and at least 10% to activating dormant networks into value-generating initiatives, including crowdsourcing new ideas.

Rethinking business performance management. Financial data alone is no longer sufficient to convey the value that the new digital business models create (as evidence that more than 80% of today's corporate value is generated by intangible and unreported "assets"[9]). Given this reality, "big data" (which refers to the information gathered on everything from customer transactions to inventory levels, often in real time, and in quantities previously unimaginable) needs to be fused with financial data to constantly measure, monitor, and report the results from these new and often unmeasured and unreported sources of value (customer engagement on websites, for example). For many CFOs, this means finding ways to mine the information new technologies offer in order to help their organizations benefit from today's hyperconnected, flat world.

Adjusting investor relations. Once a company crosses the digital divide, how it measures, manages, and communicates its value to its investor-relations professionals and to analysts also may change. After all, if you are providing more value, you want to be recognized for it. It is not always a linear path, however. First, language has to change: new key performance indicators (KPIs) fueled by big data need to be developed to reflect the value added. And sometimes, audiences have to change. When WWE transitioned its business model to content as a subscription, for example, it also changed how it communicated and as a result, the investment analysts that covered the company changed too.[10] For many CFOs, this means that companies can manage (and report) only what they measure and investors follow suit. So to receive the benefit of today's high valuations, CFOs need to measure what is valuable, report it to their management team and board, and allocate capital to these intangibles to get investor buy-in and support.

CFOs as strategists in the Digital Age

Given CFOs' fiduciary responsibility to deliver shareholder value, it makes sense that they should be leaders in digital business model innovation. When the evidence shows that each marginal dollar can be spent to generate value at a multiplier of 1, 2, 4, or 8 times revenue. CFOs have a responsibility to actively engage as strategists or catalysts for digital business model innovation. They can harness the value shift by actively rebalancing their company's investment portfolio and reallocating capital to create scalable and extensible intellectual property, and consumer, commercial, or financial networks that generate substantial additional value for their organizations.

Endnotes

1 "Intangible asset market value, 1975-2010" Ocean Tomo, LLC Tomo; http://www.oceantomo.com/productsandservices/investments/intangible-market-value.

2 OpenMatters research, http://www.openmatters.com/think.

3 CFO Signals, Q2 2014; U.S. CFO Program, Deloitte LLP.

4 Deloitte's CFO Insights is an independent (publication) and has not been authorized, sponsored, or otherwise approved by Apple Inc."

5 W.C Kester, "Today's Options for Tomorrow's Growth," *Harvard Business Review*, March-April 1984; https://hbr.org/1984/03/todays-options-for-tomorrows-growth/sb1.

6 OpenMatters research, http://www.openmatters.com/think.

7 OpenMatters research, http://www.openmatters.com/think.

8 Deloitte LLP's Four Faces Framework: http://www.deloitte.com/view/en_US/us/Services/additional-services/chief-financial-officer/four-faces-cfo/index.htm.

9 "Intangible asset market value, 1975-2010" Ocean Tomo, LLC Tomo; http://www.oceantomo.com/productsandservices/investments/intangible-market-value.

10 World Wrestling Entertainment, Inc. 10Q, October 2014; http://ir.corporate.wwe.com/doc.aspx?IID=4121687&DID=29667575.

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