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## ***The Conceptual Model of Enterprises' Value Migration*** **Model koncepcyjny migracji wartości przedsiębiorstw**

*The goal of this article is to conceptualize the process of value migration between companies. It takes advantage of A. Slywotzky's three stages of value migration model, which specifies the inflow, stability and outflow stages of value migration. The key issue is the discrimination of frames of the stability stage in terms of the volume of value migration as well as its timing.*

**key words:** *value migration, three stages of value migration model, value inflow, value stability, value outflow.*

### **1. Introduction**

Value based management combines strategic management with financial management directed at maximizing corporate value in the long term. The goal of increasing corporate value may be realised by generating a return on invested capital above the weighed average cost of capital ( $ROI > WACC$ ). In consequence, this leads to an inflow of value into a company due to a respective increase in market value of capital equity in relation to book value.

From the financial viewpoint, the general premise of value management concept results from the belief that all capital invested in the current business activity has its cost. Traditional measures used for evaluating company profitability, based on net profit, only take into account the cost of debt capital. In the theory of value management, value creation comes as a result of gaining returns on investment higher than the capital invested, so that the claims of the creditors and shareholders can be satisfied, and the cost of debt and equity capitals covered. Shareholders only gain extra value if the company makes extraordinary profits, after the cost of equity capital has been accounted for.

The processes of value migration, which can be observed on the capital market, sanction the need to measure them accurately. Value migration is the shirting of value-creating forces<sup>1</sup>. The starting point is the construction of a framing for value migration model.

Value mapping consists in assembling the data concerning changes in generated value in relation to capital invested for individual companies over time. Such a value map makes it possible to identify companies going through an inflow or outflow phase.

The goal of this article is to present the three stages of value migration model, as well as to characterize specific migration framing. This model may work as a theoretical and methodological basis for the measurement of value migration processes, as well as for an analysis of their stability in time.

## **2. The three stages of value migration model**

A proposal for a method of measuring value migration is the three stages of value migration model by A. Slywotzky<sup>2</sup>. The methodological basis of this model is the assumption that at a given point in time a company may be going through one of the three migration stages:

- value inflow;
- value stability;
- value outflow.

It is worth noting that while the inflow and outflow phases are obvious and intuitively comprehensible, the stability phase is a kind of a theoretical construct.

The three stages of migration model was derived from the concept of product lifecycle. Companies' business designs, as well as their products or services, go through lifecycles, from entering a specific market to reaching maturity to leave it, and, in the final phase, to disappearing altogether.

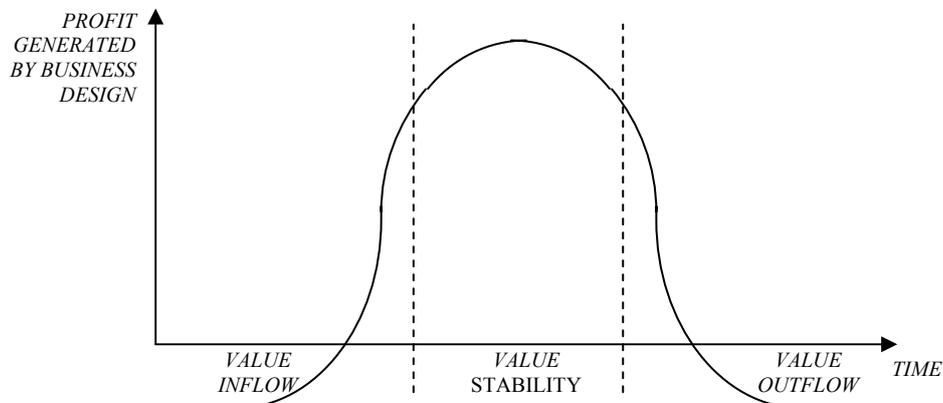
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<sup>1</sup> P. Phillips: Time to Revisit Value Migration. Business Corner. Strategies & Analysis. Rodman Publishing, July 2012, p. 36.

<sup>2</sup> A. Slywotzky: Value Migration. How to Think Several Moves Ahead of the Competition. Harvard Business School Press, Boston, Massachusetts 1996.

A. Slywotzky notices that the three stages of a company's value migration „describe its relative value-creation power, based on its ability to satisfy customer priorities better than competitors do and thus to earn superior returns”<sup>3</sup>. The specific framing of migration puts emphasis on the ability of a company to meet customers' needs better than its competitors, to generate return on invested capital, and, in consequence, to change the value of the capital belonging to the company's shareholders.

The starting point of the three stages of value migration model is the curve presenting the profit generated by a business design in relation to time, as shown in Picture 1.



Picture 1. Conceptual model of the curve presenting profit generated by a business design

Source: A. Slywotzky<sup>4</sup>

It should be noted that the two basic parameters of the presented model, that is, the amount of profit generated (the Y axis in Pic.1) and the period of time needed for value to migrate between particular stages (the X axis in Pic.2) may differ between various economic sectors and various business designs. This may lead to an instability of value migration over time.

“As a business design moves through these three phases, its ability to generate profit rises and falls as well. A business design's profit curve is a fundamental driver of its value curve. After an early subsidy period characterized by operating losses, operating profit grows rapidly. As the business design matures into stability, profit growth slows. As the design

<sup>3</sup> *Ibid.*, p. 6.

<sup>4</sup> A. Slywotzky: *Value Migration. How to Think Several Moves Ahead of the Competition*. Harvard Business School Press, Boston, Massachusetts 1996, p. 49.

becomes obsolete and enters value outflow. Finally, most business design that are part of a corporate portfolio tend to be subsidized at the end of their lifecycle, destroying value until they are shut down or replaced”<sup>5</sup>.

A business design can be defined as a unique combination of tangible and intangible assets because of which a company creates or loses value<sup>6</sup>, or, “business models describe, as a system, how the pieces of a business fit together”<sup>7</sup>. A business design determines the ability of a company to gain competitive advantage and sustain it (i.e. to sustain the period of its growth).

The period when a company possesses competitive advantage is a time when it generates a return on invested capital above the weighted average cost of capital<sup>8</sup>. In consequence, this leads to value creation for shareholders. This period comes to an end when, due to competitive processes taking place on a market, the cost of capital matches the rate of return. At that point, value starts flowing out of the company and into those investment opportunities which guarantee gaining a competitive advantage and, consequently, a superior rate of return on the capital invested.

The competitive advantage period may last for a number of years. It can be divided into two sub stages: the hold and the fade periods. According to the research and observations of J.B. Madden i S. Eddins<sup>9</sup>, carried out on American market, the average period of sustaining competitive advantage lasts between 7 to 8 years.

After this time, the fade stage begins. In other words, the rate of invested capital falls to a level at which it matches the weighted average cost of capital. In some cases, the fade stage may take several years.

A company’s competitive advantage consists in the ability to create value for all stakeholders<sup>10</sup>. Thus, it is possible, through accurate analyses,

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<sup>5</sup> A. Slywotzky: Value Migration. How to Think Several Moves Ahead of the Competition. Harvard Business School Press, Boston, Massachusetts 1996, p. 48.

<sup>6</sup> R.E.S. Boulton, B.D. Libert, S.M. Samek: Odczytując kod wartości. Jak firmy tworzą wartość w nowej gospodarce. Wig Press, Warszawa 2001, p. 186.

<sup>7</sup> J. Magretta : Why Business Model Matter. Harvard Business Review. May 2002, p. 91.

<sup>8</sup> R. W. Mills: Dynamika wartości przedsiębiorstwa dla udziałowców. Zasady i praktyka analizy wartości strategicznej. Ośrodek Doradztwa i Doskonalenia Kadr Sp. z o.o. Gdańsk 2005, p. 285.

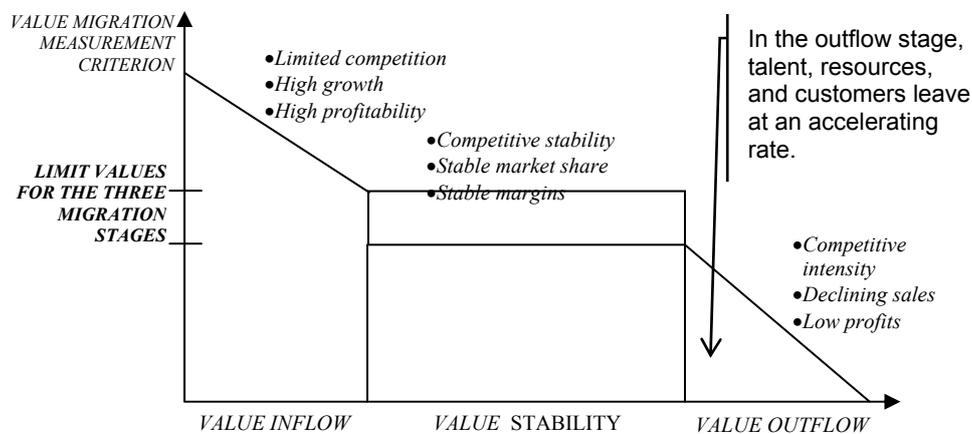
<sup>9</sup> J.B. Madden, S. Eddins: Different approaches to measuring the spread of return on capital in relation to the cost of capital, Valuation Issues, vol. 2 no. 4, July-August 1996.

<sup>10</sup> M. Siudak: Zarządzanie wartością przedsiębiorstwa. Oficyna Wydawnicza Politechniki Warszawskiej, Warszawa 2001, p. 47.

forecasts and decision-making, as well as skilful restructuring of a business design when needed, for the period when the competitive advantage is sustained to last for many years at a stretch.

J. Schumpeter's concept of creative destruction may be adduced at this point. In the place of economically ineffective business designs in the outflow stage, there appear new designs, ones which create value added for shareholders. If the shift in the business design takes place internally, the company may return to the value inflow stage. If necessary changes are not conducted, value will migrate to other companies which, as a result of value capture, remain either in the inflow or the stability stage.

On the foundation of old or inefficient business designs new ones are devised. These new models have the ability to maximize value for shareholders. A continuous process of value migration is started at this point, and its temporary acceleration leads, in consequence, to an instability of value migration in time. Each of the specified value migration stages has its own characteristics. They have been presented in Picture 2, which illustrates A. Slywotzky's model of the three stages of value migration.



Pic. 2. The three stages of value migration model

source: A. Slywotzky<sup>11</sup>

A more detailed characteristic of each of the value migration stages has been presented in Table 1.

<sup>11</sup> A. Slywotzky: Value Migration. How to Think Several Moves Ahead of the Competition. Harvard Business School Press, Boston, Massachusetts 1996, p. 50.

Table 1. Characteristics of the three value migration stages

PHASES OF VALUE MIGRATION	CHARACTERISTICS
Inflow stage	Companies increase their competitive advantage in a given sector or on the market. Both return and the growth dynamics are very high. This leads to gaining more competitive advantage and to an disproportionate growth in the market value in relation to the capital invested. As a consequence, solid ground is created for optimal allocation of capital by investors. Companies in this phase capture value from other companies (operating in the same or different economic sectors), or capture value flowing from a positive balance of value migration of the considered set of enterprises.
Stability stage	Due to competitive processes on the market as well as a lowering of barriers to entering a given segment, the competitive position of a company becomes more stable, which leads to a stabilisation of its market share and return. Companies are still able, through their business operation, to generate value allowing for the coverage of the cost of capital provided by all investors. Swings in market value which can be seen in the short term as well as minor fluctuation in the longer term lead to slight changes in the relation between the market value and the capital invested in business operation.
Outflow stage	Companies going through the outflow stage lose their competitive advantage. Their revenue on products and services drops, which leads to a low return on invested capital and makes it impossible to cover the cost of capital. An inefficient or old business design is the reason why customers' purchasing power gravitates elsewhere. In consequence, investors begin to withdraw the capital out of the business activity and transfer it towards alternate investments which are more likely to provide expected return while remaining at the same risk level. A process of value outflow is started. At first, its pace is slow; as time goes, however, unless appropriate restructuring activities are undertaken, the outflow pace accelerates. The market value erodes faster than the value of the capital invested in the basic business activity.

source: own

Value migration in companies happens as a result of investors' search for capital allocation options. Capital, in turn, flows towards those companies which have gained competitive advantage by means of an efficient business design which has the ability to maximize value for shareholders. Value outflow, on the other hand, results either from an ill-devised business design, or from a lack of appropriate reaction on the part of the management to an ever-changing business reality (which leads to a lowering of return on investment projects in the company). Shareholders transfer their investment to other allocation opportunities. If the above-mentioned happens in a very short time, it leads to a lack of stability of value migration processes within a given period, in which a company can quickly move from inflow to outflow stage, and vice versa.

Generally speaking, each of the specified value migration stages can be seen as a challenge in terms of decision-making, organisation, structure and economy. Depending on which value migration stage the company is in, the decisions taken by management will be different. The accuracy of

the decisions as well as of their timing will eventually be verified by the capital market itself.

As the company moves between the different phases on the value migration map, its management goals change also. A. Slywotzky<sup>12</sup> lists six basic types of actions undertaken by a company's top management in the context of value migration processes:

1. construct a business design that will create and capture value;
2. maximize the ability of that design to perform during inflow phase;
3. adjust investment intensity as the design moves to stability phase;
4. optimize the profitability and sustainability of the stability phase;
5. identify the requirements of the next generation design before competitors do;
6. manage creatively the transition to the new business design as value begins to flow out of the obsolete one.

### **3. The framing of value migration stability stage**

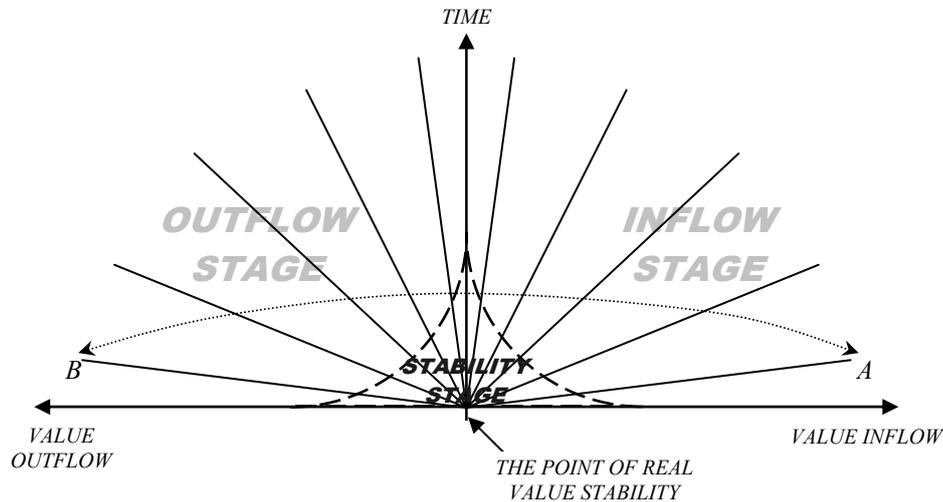
The stability stage is a theoretical assumption and causes major problems for accurate value migration measurement. The stability phase in the context of ongoing value migration processes has been presented in Picture 3. It includes short-term changes (on the X axis) as well as minor changes in company value in the longer term (on the Y axis). These changes possess their own levels of development stability, and make it difficult to measure the stability stage accurately. The stability stage has been marked in dashed line, and the curves present the hypothetical lines for value outflow and inflow stages respectively, taking place in strict relation to time.

Undoubtedly, the processes of value migration in companies are strictly connected with value inflow and outflow. In real life, seldom can one observe a lack of one of the two, unless a very short time is taken into account. At such a point, a company is truly at a point of value stability (i.e. a company has not seen a flow of value in any direction, as shown in Picture 3). On the other hand, as a result of an instable value migration process in time, there may be a considerable flow in value and, as a result, a crossing from an inflow to an outflow stage (or vice versa) in a very

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<sup>12</sup> A. Slywotzky: Value Migration. How to Think Several Moves Ahead of the Competition. Harvard Business School Press, Boston, Massachusetts 1996, pp. 55-56.

short period of time. This has been illustrated as a fluctuation from point A towards point B (or vice versa) in Picture 3.



Picture 3. The stability stage in the context of the three stages of value migration

source: own

There remains the issue of the limit at which the observed fluctuations within a certain period of time, which often cancel each other out, result in a relative stability of a company's market value in relation to the capital invested in its business activity.

Pointing at companies in the stability stage becomes cumbersome due to practical complexity of the process of value migration measurement. It is necessary, although not pragmatic, to introduce the stability stage so that the inflow and outflow stages can be distinguished.

Companies in outflow and stability stages should undertake actions aimed at preventing current or future value outflow.

There remains the issue of companies in the inflow stage. The main goal of those entities should be to further multiply the invested capital. The management should either focus on increasing business activity while sustaining the existing competitive advantage, or on increasing competitive advantage while stabilizing the size of the company's business operations.

In both instances, the growth in market value added will lead to an inflow of value (i.e. there will be an increase in the ROI-WACC ratio while

sustaining the value of capital invested, or, if the surplus of ROI over WACC is kept steady, the amount of the capital invested will be increased). Otherwise, in case of a change in the market value at a comparable level in relation to the capital invested, the company may soon find itself in the stability stage. Consequently, a sharp decline in the market value added in relation to the capital bases will put the company in the outflow stage.

„To remain competitive, a company must understand its business design’s ability to capture value in the inflow phase, its sustainability in the stability phase, and its vulnerability in the outflow phase”<sup>13</sup>.

#### **4. Conclusions**

It must be noted that it is difficult to list even the general factors which influence value migration and the final classification of companies into one of the specified three stages of value migration. Such a list must be modified depending on macro- and microeconomic conditions. The only, and at the same time a very broad, determinant of the ongoing value migration processes is a systematic evaluation of company value by the capital market resulting from a constant search for capital allocation opportunities on the part of shareholders. Shareholders, in turn, take investment decisions based on subjectively perceived expectations concerning the rate of return and the risk involved.

This factor is constant and independent of economy structure, financial market architecture, or the relations between those two. Despite the unquestionable evidence supporting a lack of efficiency of the capital market, investors still look for suitable investment options in line with their strategy for capital multiplication, which is reflected in value migration among companies.

The three stages of value migration model presented above may be used to measure and qualify companies as well as economy sectors appropriately within the value migration framing. The knowledge of the specific point and phase to which a company belongs at a given time, as well as its position on the value migration map, may be used as a crucial item of information for carrying out its economic and financial analysis.

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<sup>13</sup> A. Slywotzky: Value Migration. How to Think Several Moves Ahead of the Competition. Harvard Business School Press, Boston, Massachusetts 1996, p. 48.

The three stages of migration model may also be used as a tool for an identification of an instability of value migration processes, which is reflected in sudden transfers from an outflow to an inflow stage (and vice versa) taking place in subsequent phases of the analysis.

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### **Sterszczenie**

W artykule podjęto próbę konceptualizacji procesu migracji wartości przedsiębiorstw. Do tego celu wykorzystano zaproponowany przez A. Slywotzky'ego model trzech faz migracji wartości, wyróżniając fazę przyływu, stabilizacji i odpływu. Kluczową kwestią jest określenie zakresu fazy stabilizacji wartości, względem wielkości przepływu wartości i czasu jego zaistnienia.

słowa kluczowe: migracja wartości, model trzech faz migracji wartości, przyływ wartości, stabilizacja wartości, odpływ wartości.

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