

Would you rather run a profitable business or one that creates value?

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It sounds like a trick question. But in corporate finance, it's not.

A **profitable business** is one that generated earnings clearly reflected in its income statement through metrics such as revenue, margins, EBITDA, and net income. These measures provide a visible and consistent signal that the business is “working”.

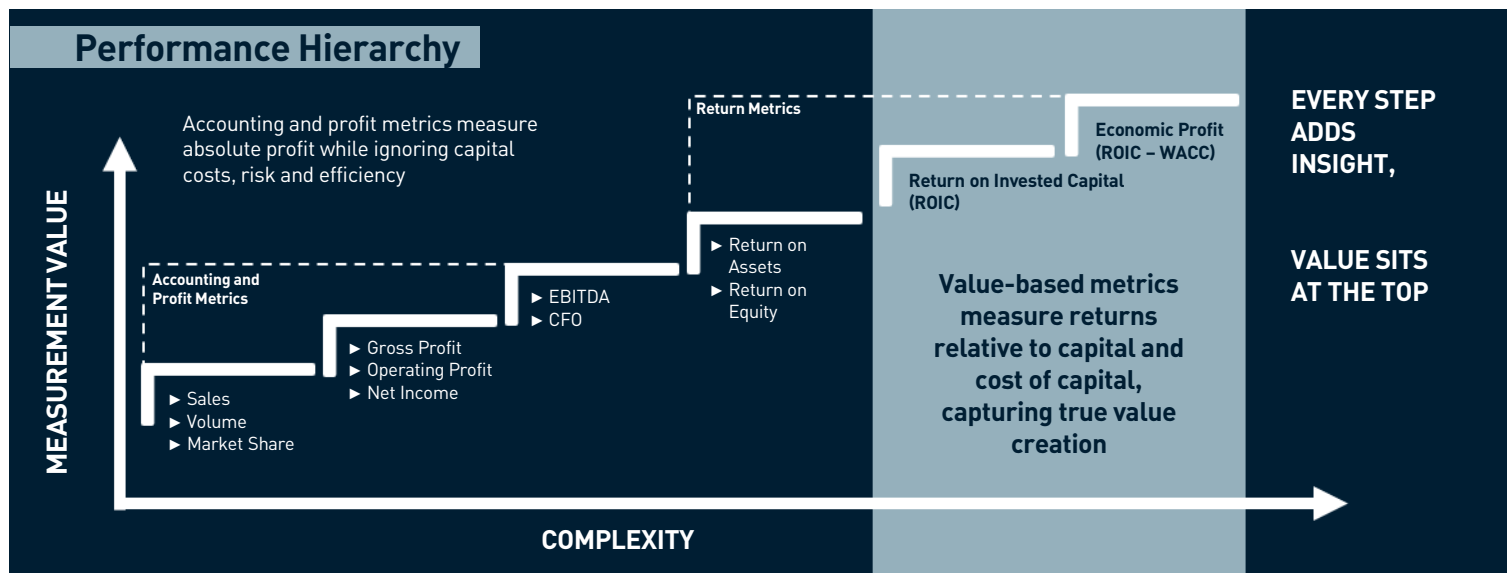
But a **value-creating business** is one that goes a step further. Value is driven by cash flows, but those cash flows require capital, and that capital comes at a real cost.

As a result, true performance is not defined by profits alone, but by whether those profits are sufficient relative to the capital deployed to generate them.

In other words:

- **Profitability** measures whether a company makes money
- **Value creation** measures whether it makes enough to justify the capital it consumes

If profitability is not the endpoint, what prevents companies from taking the final step?



Why Companies Get Stuck in Profitability?

Most organizations successfully move from scale metrics (sales, volume, market share) to profitability (EBITDA, net income), but profitability sits in the middle, not at the top, of the performance hierarchy.

Few make the leap to true value-based evaluation. Several factors explain why:

Starting with the most straightforward, **Value-based metrics are simply harder to measure.**

**HARD TO
MEASURE**

**EASY TO
IGNORE**



Metrics like ROIC and economic profit demand a different lens on performance:

- Define real capital at work – not just accounting assets
- Estimating the cost of capital, including the often-ignored cost of equity
- Returns vs cost – focus on spread, not just absolute profit

More importantly, these metrics require judgement and discipline, not just calculation.

Unlike revenue or margins which are standardized, widely understood, and consistently reported, value-based metrics:

- Are less intuitive
- Require alignment across finance and operations
- Are harder to communicate across the organization
- Vary based on industry, business model, and situation

As a result, organizations tend to default to what is easier to measure, easier to explain, and easier to manage even if it provides an incomplete view of performance.

While value-based evaluation is more involved, it enables more informed decisions through deeper insight into value drivers. Stepping back to a high-level perspective simplifies the concept and clarifies what truly drives value.

Core Value Creation Framework

At its core, it comes down to one simple equation:

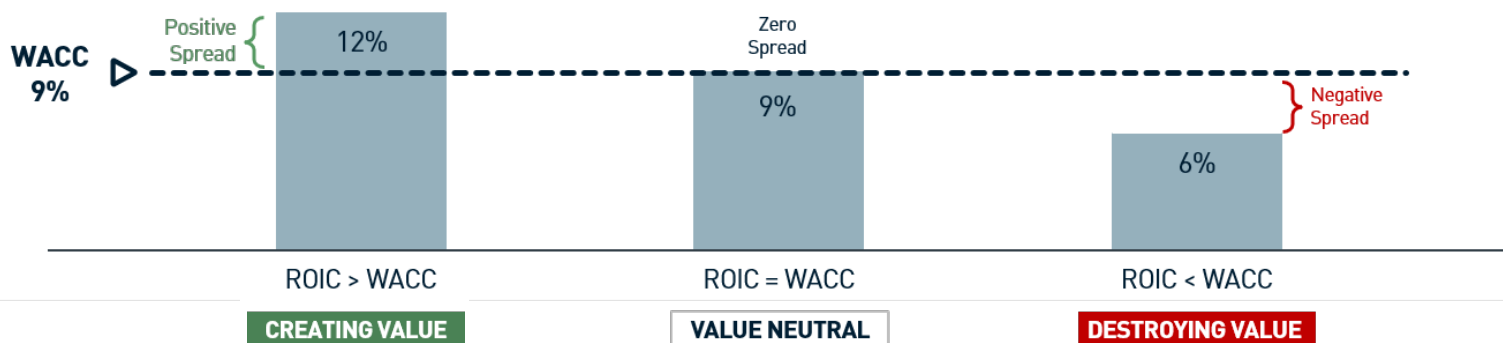
$$\text{Economic Profit / Loss} = (\text{ROIC} - \text{WACC})$$

Where:

Return on Invested Capital (ROIC) – *Profit per dollar invested in the business*

Weighted Average Cost of Capital (WACC) – *Minimum return required by capital providers*

Where ROIC stands relative to WACC determines whether value is created or destroyed.



Economic profit reframes performance from “how much did we earn?” to “was it worth the capital required?” the line between value creation and destruction.

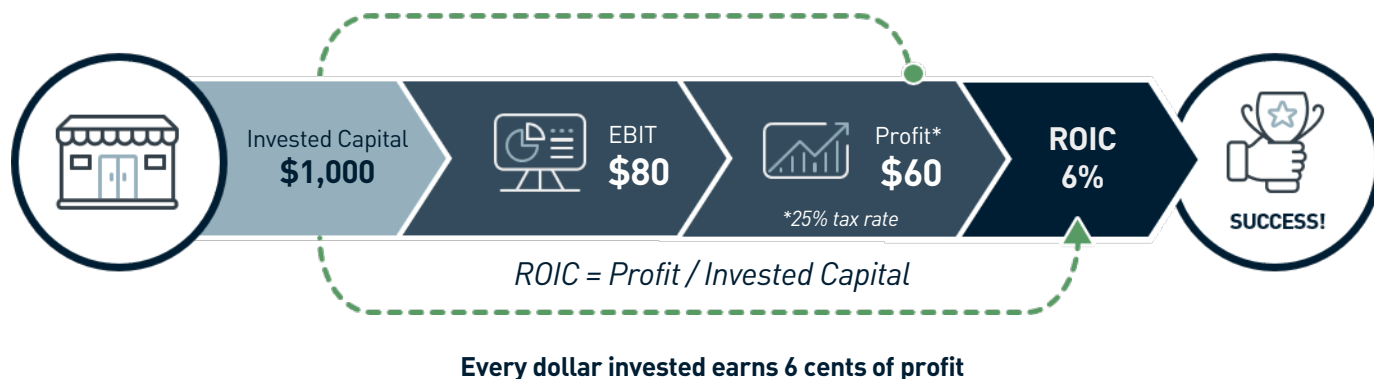
Another factor that keeps companies stuck is *the tendency to view profitability as the ultimate measure of success. Overlooking the risk that it can coexist with value destruction.*

The Profitability Trap

Many companies treat profitability as the endpoint of performance. Once margin targets are met, earnings grow, EBITDA improves, results are rewarded. Reinforcing the perception of success.

But that sense of success can be misleading.

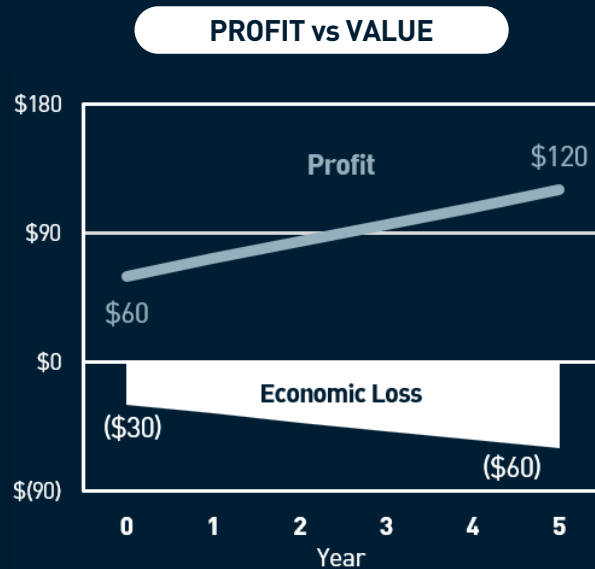
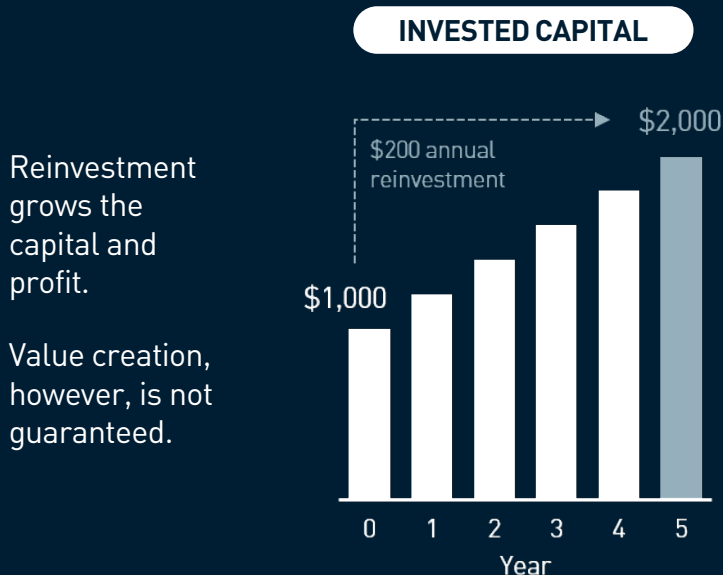
Consider a company with strong margins, growing earnings, and positive cash flows.



On paper, performance looks solid and the business is seen as successful. To sustain this growth, *this company reinvests \$200 back into the business each year.*

But the capital fueling this profit and growth comes at a cost. With a 9% required return (WACC), *each dollar invested and reinvested in the businesses loses 3 cents in value.*

The company continues to grow earnings while reinvesting at sub-economic returns, creating the illusion of success as value quietly erodes over time.



Understanding the concept is only the starting point. Applying it is where it becomes powerful.

How Value Creation Drives Better Decisions

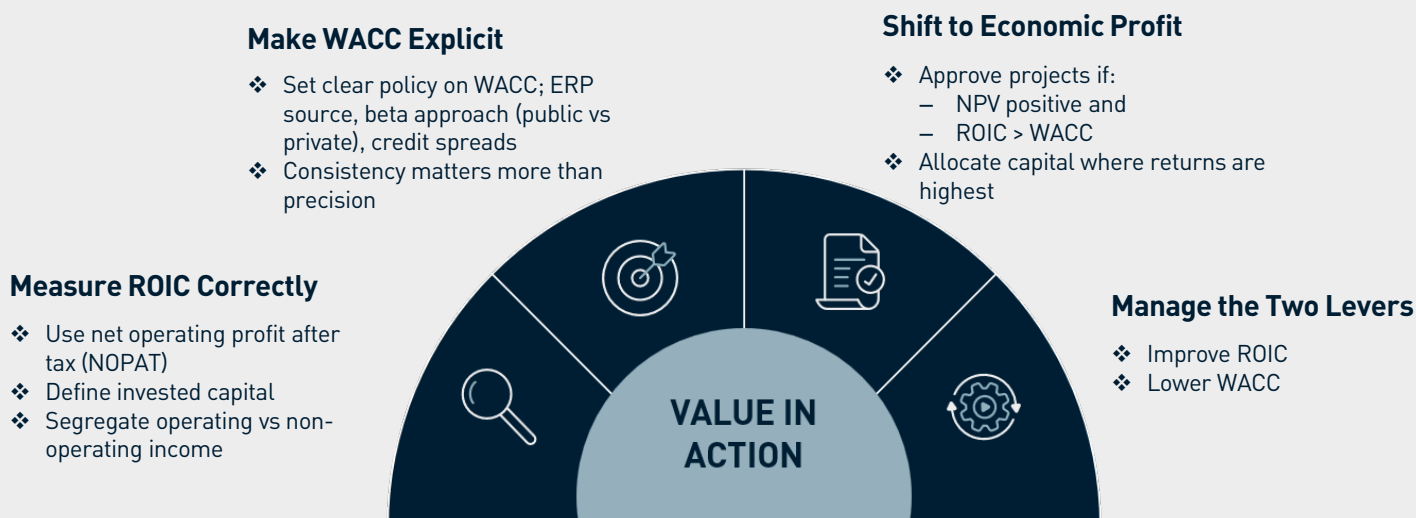
Beyond measuring past performance, the value creation measure is a practical decision-making tool. The same framework that measures performance also guides better decisions.

Use Case	Key Question	Application	Decision Anchor
Capital Allocation	Where to invest?	- Prioritize high positive spread - Avoid funding sub-economic return projects	Capital flows to the highest value-creating uses, not just the biggest or fastest growing
M&A / Growth Strategy	Is growth worth it?	- Evaluate deal / project ROIC vs corporate WACC - Include synergies, M&A costs, and time horizon	Reject deals if returns do not exceed cost of capital, even if earnings accretive
Business Unit Management	Grow, maintain, or deprioritize?	- Rank business units by ROIC – WACC spread - Identify positive, zero, and negative spread	Reallocate capital from value-destructive to value-accretive businesses
Management Evaluation	Is management creating value?	- Evaluate performance via economic profit - Focus on returns, not just earnings growth	Hold management accountable for capital efficiency and value-creation
Investor Communication	How to tell the value story?	- Frame performance as ROIC vs WACC - Highlight economic profit generation	Shift narrative from earnings growth to value creation

Importantly, the inputs behind ROIC and WACC are not one-size-fits-all; they require clear definitions and thoughtful calibration to ensure consistent application across the business.

The “Value Creation Operation System”

The value creation operating system translates the ROIC – WACC concept into a practical set of disciplines ensuring that the capital is deployed with purpose, performance is evaluated correctly, and value creation becomes part of everyday decision-making. Here’s a practical approach:



Profitability is easy to measure, but value creation is what separates winners from the rest. The framework provides clarity, but its impact depends on how rigorously it is applied.

Organizations that consistently create value don't just understand the rules; they embed them into how they operate.

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 Consultative, product agnostic approach	 Working Capital Analysis Identifying opportunities to unlock cash flow through working capital efficiencies	 Liquidity and Capital Structure Assess optimal capital structure that provides appropriate liquidity, aligns with risk tolerance, and funds corporate & shareholder goals
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