

A RETURN TO VALUE

Restoring the Discipline of Value-Based Management in an Age of Complexity and Higher Capital Costs



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“Now you’ve got managers who came up in a zero-interest rate world. They haven’t got a clue. They’ve never had to manage with real capital costs.”

— Senior Executive,
WP&C Complexity Summit, April 2025

Executive Summary

For over a decade, companies have benefited from historically low interest rates and abundant, inexpensive capital. These conditions enabled a strategic environment where growth and margin expansion were pursued without sufficient scrutiny of underlying value creation. As interest rates return to historical norms and complexity increases across products, customers, and operations, many firms now find themselves operating without the financial discipline required for long-term shareholder value creation.

This paper argues for a return to Value-Based Management (VBM)—a proven management system focused on aligning strategy, operations, and resource allocation with economic value

creation. We examine the causes of VBM’s decline, the structural challenges companies face today, and the methodologies available to reintroduce it. We also share tools and case examples illustrating how economic profit (EP) and costing techniques like Square Root Costing (SRC) can help firms regain financial clarity and improve decision-making in a world of higher capital costs and greater complexity.

The End of Cheap Capital—and its Implications

Between 2009 and 2022, companies operated in a macroeconomic environment shaped by unprecedented monetary policy: low inflation, low interest rates, and abundant liquidity. During this period, the Weighted Average Cost of Capital (WACC) for companies was unusually low, enabling growth strategies that frequently prioritized top-line expansion and market share over true value creation.

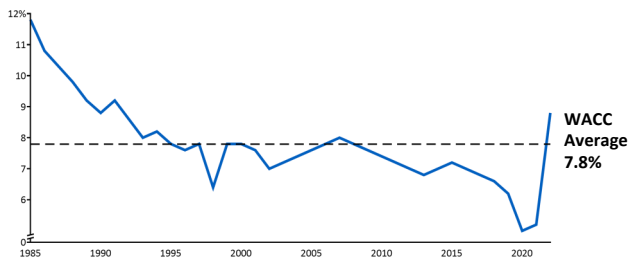
That era may be over.

As shown on the next page in Figure 1, current capital costs have returned to their historical average. For many executives, this shift can feel abrupt. However, from a historical perspective, the recent rise in interest rates is a reversion to the mean—not a temporary deviation.

So leaders face a strategic imperative: stop waiting for a return to lower capital costs and

instead operate under the assumption that **capital will remain more expensive for the foreseeable future.**

FIGURE 1
Interest Rates are Back at Historical Norms
 Russell 3000 Weighted Average Cost of Capital, 1985 – 2022



Source: Morgan Stanley (Companies represented are the Russell 3000 minus financials and real estate)

The Case for a Return to VBM

The good news is, *we already know what to do in this situation.* The tools, concepts, and management disciplines already exist to help companies navigate these conditions. The umbrella for these approaches is Value-Based Management (VBM): a management discipline focused on maximizing the long-term value of a company for shareholders.

VBM was popular in the early 2000s, then fell out of practice in the wake of two trends: 1) declining interest rates and cost of capital, rendering VBM less mission-critical, and 2) increasing complexity, making it harder to properly allocate costs and capital, both necessary to execute true VBM. But the core logic, financial clarity, and entailing disciplines are sound and now more necessary than ever.

In many large organizations, VBM practices have abated and skill sets have atrophied.

Companies must rebuild these skills, re-establish a VBM discipline, and ensure it is robust enough for the levels of complexity in companies and markets that we have today.

Economic Profit: A More Complete Picture

The goal of VBM is to align a company's decisions, strategies, and operations with the goal of creating sustainable economic value. It involves measuring and managing the business with metrics that reflect value creation, rather than just focusing on short-term financial performance. A key metric is Economic Profit (EP): revenue less operating and administrative costs, less the cost of the capital needed to produce that revenue.

$$EP = \text{NOPAT}^1 - (\text{Capital Employed} \times \text{WACC}^2)$$

$$EP\% = \text{ROIC} - \text{WACC}$$

What does EP% tell us? For one, it presents a more complete picture, incorporating both the income statement and the balance sheet. It helps us evaluate alternate strategies, taking into account the capital required to fund a particular initiative. In a world where money is "cheap", that's less important, but in a world with real capital costs, EP can be the difference between value creation and value destruction. Value creation occurs when investments earn a rate of return above the cost of capital (i.e., when $EP\% > 0$).

Consider the client example on the next page (Figure 2): a business wanted to understand their customers' profitability, accounting for complexity costs³ and capital costs. While both

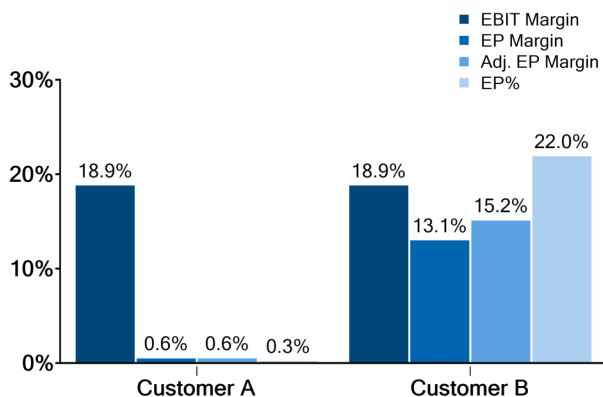
¹ Net Operating Profit After Taxes

² Weighted Average Cost of Capital

³ Complexity costs are costs that grow with variety—products, services, customers, processes, or even IT systems. They don't behave like fixed costs, which stay the same independent of volume, or variable costs, which scale with volume. Complexity costs grow with the increasing number of connections between all the "things" in a business.

customers had the same EBIT margin, Customer A had negotiated terms with our client that resulted in significant working capital and inventory requirements, making them essentially EP-break even. The implication: strategies to increase volume with Customer B would yield far greater value creation than strategies to grow Customer A.

FIGURE 2
Side-by-Side Analysis of Client Profitability (by EP)



To generalize this point, consider what it would mean—in a world where the cost of capital is greater than 0%—to make decisions absent this full picture. What are the implications?

It may mean borrowing money at 10% to generate a return at 7%. Or it may lead to investing to grow a line of business with positive EBITDA but negative EP, and in turn accelerate value destruction. And the long-term impact? A decline in shareholder value.

Growth, EP, and Market Valuation: The Value Mountain

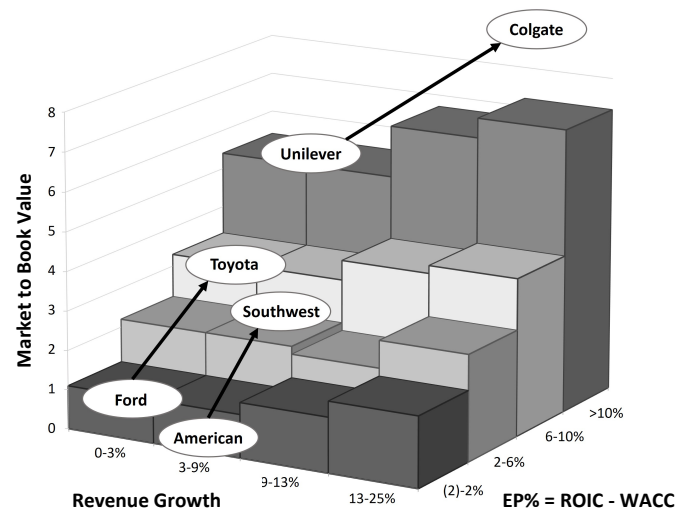
We know this thanks to the “Value Mountain⁴”, shown on the next page in Figure 3. In fact,

EP%, along with growth⁵, is one of the key determinants of share price over the long term. While the data in the graphic needs a refresh, the message is clear. Economic profit and growth rate are core drivers of Market-to-Book Value (the ratio of total market capitalization or value to its book value, or assets less liabilities).

FIGURE 3
The Value Mountain

Premier Stock Price Multiple Strongly Driven by ROIC

Data 1994 to 1998, Copeland's Valuation, ex 5.2 2000 Edition (reproduction)



What the Value Mountain tells us:

1. Growing flat-to-negative EP% businesses destroys value
2. Businesses with lower EP% get bigger bang for their buck growing EP% vs. growing revenue
3. For businesses with higher EP%, top-line growth acts as a powerful accelerator

While this may seem intuitive, much of corporate reporting still focuses on Earnings per Share⁶ (EPS) and beating analysts' estimates, even though EPS is an *unreliable* indicator of

⁴ Source: Conquering Complexity in Your Business, by M. George & S. Wilson

⁵ There is a third, less discussed, factor: Competitive Advantage Period

⁶ Basic EPS = (Net Income - Preferred Dividends) / Weighted Average Number of Shares

value creation. An acquisition may cause EPS to rise, yet destroy value due to the high cost of borrowing. While EPS has long been a dominant metric, the debate about EPS vs. Economic Profit is nothing new. Joel Stern wrote the article “Earnings per Share Don’t Count” in the Financial Analysts Journal some 50 years ago!

How Complexity Undermines Value Creation

While we rarely hear executives discuss EP, most intuitively recognize the link between complexity and its impact on value creation.

We define complexity as the number of things in a business—the number of products, services, factories, processes, even IT systems. At a deeper level, complexity is the interactions between these things, and the business activity required to maintain them. For example, when a manufacturing company adds new SKUs, it requires additional setups on the production line, new raw materials, potentially expanded warehouse space for inventory—all complexity costs.

Complexity impacts both income statements and balance sheets—more labor costs on the production line and more inventory in the warehouse. We’ve made it our mission to help organizations manage complexity better, and the world has only gotten more complex in the 15 years we’ve been serving clients.

Certainly, not all complexity is bad, but too much is bad and most organizations have too much. Part of the challenge is that complexity creeps into organizations, frequently as the result of good decisions made in isolation from

each other. The benefits of complexity are local, while the costs are distributed. So, without an explicit focus on managing complexity, it is highly likely to become overwhelmed by it and suffer the value creation implications highlighted above.

Additionally, complexity creates significant levels of profit and value concentration. Based on our costing analytics work, it is typical for **20–30% of a company’s products, services, customers, etc. to account for 300% of profits.** This means the remaining 70–80% destroys 200% of profits. The same dynamic applies to capital: a small percentage of capital employed accounts for the lion’s share of value creation—in terms of EP-positive products, customers, and business segments.

The Challenge of Visibility: Why Traditional Costing Falls Short

One of the biggest barriers to applying VBM today is the lack of visibility into true profitability, adjusting for both complexity and capital costs.

As we have discovered in the course of conducting many costing studies, companies struggle to unwind cross-subsidizations across a myriad of products, customers, and segments to get a clear view of profitability, let alone build in a view of capital employed. We created our Square Root Costing (SRC) methodology to help address this gap, as a more accurate alternative to Activity-Based Costing, which is not well suited to high levels of complexity. We use SRC to rapidly understand true profitability (OP and EP), correcting for complexity and capital costs.

Without the visibility provided by SRC, companies may follow a disciplined capital budgeting process—but remain blind to the true economics of their operations.

VBM 2.0: Modernizing Value-Based Management

To be relevant today, VBM must evolve. We call this next generation **VBM 2.0**, and it includes five key shifts:

1. Move from EP to Complexity-Adjusted EP

Standard costing hides the cost of low-volume, complex offerings. Use methods like SRC to correct distortions and apply capital charges properly. While for many, moving from earnings to Economic Profit is a significant step, that is insufficient given how complexity has led to significant cross-subsidization in most businesses. Standard costing leads to under-costing low-volume products and customers, and can produce distorted outcomes. The fix is to ensure you are correcting for these distortions (with methodologies such as Square Root Costing) and applying a capital charge.

2. Extend your Competitive Advantage Period (CAP)

CAP refers to how long a business can earn returns above WACC. In today's world of fast-moving disruption, companies must build **systems for repeatable differentiation**—not rely on one-time products or brand moats. In Tom Copeland's *Valuation: Measuring and Managing the Value of Companies*, a classic text for financial analysts, CAP is not much more than a footnote—a third lever for driving market-to-book value, alongside EP and growth rate. However, it's one with growing relevance when product lifecycles are getting shorter.

3. Stretch the discipline of strategic alternatives to accommodate experiments

There is clear value in accompanying every strategy with one or two “challenger” strategies to avoid confirmation bias, becoming too enamored with a particular strategy, or “settling” when there's a higher value-creating option. But all industries are being transformed by technologies such as AI, and there is the very real danger of putting too much emphasis on “completeness” in a strategy definition and not enough on “optionality.” Companies should place bets *and* have discipline around how they manage them.

4. Extend the allocation mindset from strategic to operational questions

Classically, strategy is the allocation of scarce resources, and operations is all about the execution of the strategy. But today, operational leaders must learn how to allocate scarce resources—production capacity, logistics, labor—based on value creation, not throughput.

5. Coordinate strategy execution across distributed models

Organizations are more decentralized than ever. Headquarters must set value-based guardrails, not rigid playbooks—so front-line teams can respond quickly without veering off course. Operating models have become much more complex and distributed over the last decade. In prior years, the “role of the center” vs. the “role of the BU” was more clearly defined. Today, strategy-setting becomes much more about understanding the economic drivers that create value, and then translating it to guardrails that allow for sufficient flexibility for those working at the front line with customers.

Recommendations for Leaders

We are at a unique inflection point. Capital is costly. Complexity is rising. And many leaders no longer have the tools or habits for managing value. Here's what to do:

A. Assess what's at risk without VBM

Which strategies rely on obsolete assumptions? What current strategies are potentially value destroying? What opportunities are being neglected?

B. Measure your capacity for VBM

Assess with an honest eye the maturity level of the VBM capability, perspective, tools, and metrics in the business. What near-term decisions would benefit from a focused application of VBM? Where can they have a quick impact?

C. Reintroduce VBM into the business

Embed EP into strategy, governance, and performance management. Equip teams with the tools to measure and manage value—not just earnings.

Conclusion: An Opportunity to Gain an Edge

“The uncertainties of high interest rates and tariffs, combined with the increasing accessibility of AI, have catalyzed a new wave of creativity and innovation. Just as during COVID, we are having to rethink everything.”

— Jeremy Benedict
Chief Commercial Officer, Acosta, Inc.
WP&C Complexity Summit, April 2025

In the past decade, low capital costs papered over poor investment decisions and bloated complexity. That world is gone. Capital costs are real again. Complexity is rising. Leaders must return to the hard disciplines of value creation.

VBM is not outdated. It's essential. The companies that revive and evolve it—through updated tools like SRC and modern governance models—will unlock disproportionate value in the next era.

Wilson Perumal & Company (WP&C)

is a premier strategy consultancy that helps clients navigate an increasingly complex business environment. WP&C serves multinational corporations, private equity firms, and government entities, supporting their growth agendas.

Our focus is helping organizations develop and execute strategies for successfully competing in the Age of Complexity. We are laser-focused on client value and results—our projects often yield a 20–40% improvement in EBITDA.

Our services range from growth strategy to business simplification—whether that be your portfolio or your business operations—to organizational transformation.

We have published [two books](#) on competing in a complex world: *Waging War on Complexity Costs* and *Growth in the Age of Complexity* (McGraw-Hill). Given our focus on complexity, our employees have deeper knowledge and more experience on this topic than any other consultancy. This translates into faster insights, and ultimately better results.

Learn how we can help:
contact@wilsonperumal.com