Buona Fortuna!

May 19, 2010

Buona Fortuna! is published by Fortuna Advisors LLC to share views on business strategy, corporate finance and valuation.

Don't Be Too Preoccupied with Return on Capital

Gregory V. Milano

These strategic insights as well as a new improved value-based performance measurement framework can be found in "Postmodern Corporate Finance", to be published in the Spring issue of the Morgan Stanley *Journal of Applied Corporate Finance*.

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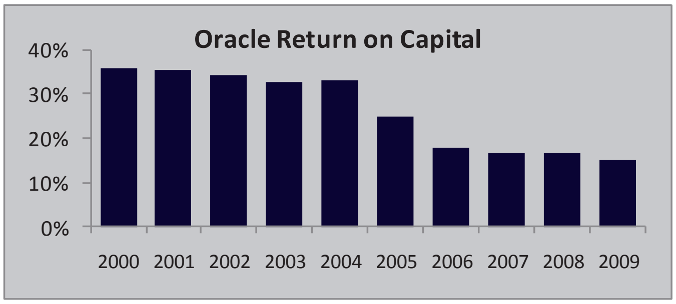
Earning a high and improving return on capital is often reflected in share price appreciation. However, many CEOs are so preoccupied with maximizing returns they limit their valuation upside by turning down growth opportunities, even those earning above the cost of capital, if they fear the investment may dilute the overall company returns. The value-maximizing balance of growth and return appears to have been lost.

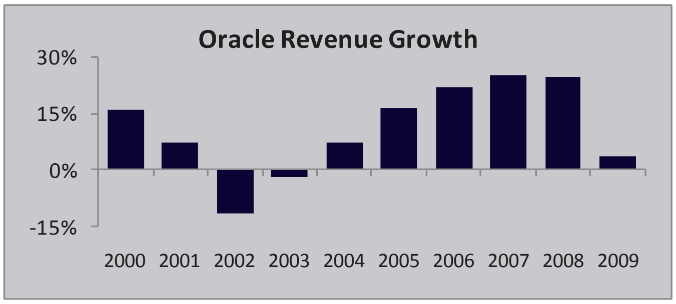
To be sure, pursuing growth to the point of allowing returns to decline while investors often insist on high returns takes courage and persistence.

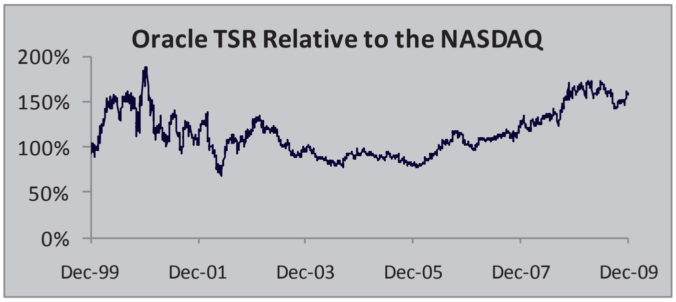
The anthropologist Margaret Mead said, "What people say, what people do, and what they say they do are entirely different things." It is better to go by what investors do than what they, say so we studied large non-financial companies. As expected, most of those that improved returns did well.

Interestingly, sacrificing returns to achieve higher revenue growth worked for most companies too. Although only 14% of the companies had higher revenue growth and lower return on capital in the second half of the decade, 57% of these higher-growth lower-return companies generated total shareholder returns (TSR) above the median. Among these were well-known companies including Oracle, Pepsico, CVS Caremark and Procter & Gamble.

Oracle illustrates this well. During the first half of the decade, Oracle's return on capital hovered between 33% and 36% while growth averaged only 3%. Oracle's TSR underperformed the NASDAQ. During the second half of the decade, Oracle invested heavily







including the acquisition of Peoplesoft, BEA Systems, Seibel and Hyperion, and growth surged to an average of 18% while return on capital collapsed to the 15 to 25% range. This investment in growth delighted investors and TSR outpaced the NASDAQ by 73%.

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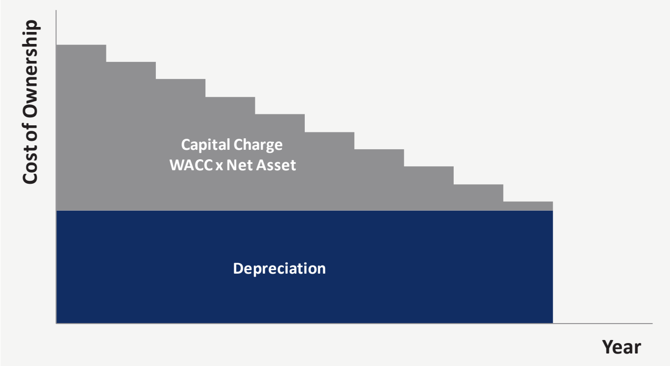
The message to CEOs is clear: optimizing growth <u>and</u> return can avoid what can become a value-limiting preoccupation with maximizing returns.

Proponents of modern corporate finance advocate a long-term "net present value" (NPV) decision-making framework, which most companies include in decision-making. But despite having sound valuation analyses, many executives emphasize near-term returns and turn down promising growth investments.

Furthermore, Return on Capital and similar measures are inherently biased against growth investments. The majority of return and economic profit measures are based on GAAP accounting, with depreciation treated as a period cost and an asset base that is net of accumulated depreciation. Given the cash flow profile of a typical depreciating asset, the return measure starts low and improves over time as the denominator depreciates. New assets appear to have a higher cost of ownership (depreciation plus the cost of capital) and this discourages new investments in favor of old assets.



Beyond these measurement problems, there are managerial behavior obstacles too. Many executives view squeezing returns as less risky than investing in growth. Cost cutting and capital efficiencies seem less uncertain with quicker payoffs than investing in new product development or expanding international marketing. Many CEOs fear the potential personal downside of making investments that turn out bad is greater than the upside if all goes well, given the flock of activist investors ready to circle a company and challenge management if things go wrong.

To ensure the right balance of growth and return, CEOs must take these four steps:

1. Pay more than lip service to long term discounted cash flow
2. Replace return on capital and economic profit with measures less biased against growth
3. Ensure compensation promotes returns <u>and</u> growth down several layers in the organization
4. Encourage sound growth opportunities throughout strategic and operating performance review discussions, and make it clear that under the right circumstances, sacrificing return to step up growth is applauded

By following these steps, a CEO is encouraging his managers to embrace a concept we call *Internal Capitalism*—a culture of explicitly developing strategies, making decisions and assessing performance inside the company to boost efficiency, growth and sustainability over time. Managers will think and act more like long term committed owners. True owners aren't preoccupied with return on capital. They realize it is not just about maximizing return but achieving the right balance of growth <u>and</u> return to maximize value today and over time.

Gregory V. Milano *is the co-founder and Chief Executive Officer of Fortuna Advisors LLC.*

Study is based on the 1000 Largest Non-Financial US Companies as of 12/31/2009, excluding those not public for the entire 10-yr period of the study, yielding 765 companies.