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Partnering with a New CEO to Boost Shareholder Returns

The CFO and the finance team have the skills to help the CEO understand and interpret residual cash earnings signals.

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The success of a publicly traded company can be gauged by its total shareholder return (TSR), which reflects share price appreciation and dividends. TSR is often judged over as little as two or three years. Hence, it stands to reason that a new CEO's main focus should be TSR, but TSR is an outcome, and given the mood swings of the market, many CEOs don't grasp how to drive it higher. Market volatility can make TSR seem like a mystery; we may as well just tell them to "be successful." So where does a CEO start?

Consider a rewording of Albert Einstein's wisdom, "try not to become a [CEO] of success (i.e., TSR), but rather try to become a [CEO] of value." Driving the value of a business higher is what ultimately leads to the success of increased TSR. Not to mention, the mandate to drive value (versus to increase TSR) is much easier to translate into actions that a CEO can understand.

To determine how much value a company has generated for shareholders from one period to the next, look at the improvement in Residual Cash Earnings (RCE), which is a cash based version of economic profit. RCE is simply the after-tax EBITDA (earnings before Interest, tax, and depreciation) generated by a business less a capital charge for the use of the gross operating assets.

To increase RCE, a CEO must simply "act like an owner" by investing in profitable growth, by continuously improving the operations of the business, and by divesting assets that earn inadequate returns — all tasks managers understand. Our research finds that there is a strong relationship between improvements in RCE and TSR, therefore a focus on RCE gives CEOs more insight on how to create value while having confidence that their successes will translate into improved TSR.

RCE effectively "dollarizes" the excess return a company generates above the expected returns of investors. This is comparable to how an investment portfolio manager is evaluated — i.e., based on returns over a benchmark. Naturally, investors should be enthused when a CEO is evaluated as they are. When CEOs are compensated on an RCE basis, "pay for performance" and "shareholder alignment" are no longer platitudes, since RCE provides a strong incentive to act like an owner and treat the company's capital as if it were the CEO's.

Managing to value goes beyond simply evaluating and incentivizing based on RCE improvement. The ultimate objective of driving TSR comes from knowing how to create value, and value comes from knowing where to deploy all capital (human, physical, and financial capital).

A good place to begin is by measuring performance against industry peers. Mapping the RCE impact of drivers, such as revenue growth, margin, capital intensity, reinvestment rate, and reinvestment effectiveness, reveals the pain points for a company that causes its TSR or valuation multiple to trail its peers. Such information provides a prescription on whether it is the right time to reinvest, buy back shares, pay a dividend, decrease leverage, or simply have cash on hand in anticipation of future investment opportunities.

For multi-line companies, the CEO should act like a portfolio manager by assessing the value created in each business unit to ensure capital is invested where RCE prospects are best. Deeper dives by products or service, by geography, and by customer or customer type offer a fact-based foundation for strategic plans that meet or exceed shareholder expectations inherent in the current share price.

For all but the most financially savvy CEO, the CFO is the key to making RCE a way of life. It is the CFO leadership and finance team that has the skills to help the CEO understand and interpret RCE signals. The CFO can insert RCE into strategic planning and budgeting to make sure the CEO reviews and approves capital and operating plans that are integrated and consistent. The CFO can champion the implementation of RCE into all sorts of decision-making. including investment decisions, operating decisions and pricing decisions.

Given how quickly the first two or three years pass, a new CEO must act quickly, deliberately, and boldly. Using RCE to focus their efforts on where and how value is being created provides the confidence they need to develop and execute the strategies that will increase the company’s TSR in a meaningful way.

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