A Company That Gets Managers to Think Like Owners

How finance and investor relations can lead a cultural transformation that drives long-term shareholder value.

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Varian Medical Systems is the market share leader and an innovator in radiology cancer treatment, but its innovation doesn't stop at research and development (R&D). Over the last 20 months, the finance and investor relations team, in part, has led the company in transforming business management systems and the corporate culture. The goal? To forge a stronger link between strategy and execution and share price performance—all by encouraging managers and employees to think and act like long-term, committed owners.

The centerpiece of the ownership culture is a new internal operating measure of value creation that clarifies where the company creates value and facilitates better strategic resource allocation. Varian value added (VVA) is a customized cash-flow-based measure of economic profit, or EVA (economic value added). VVA was designed to relate well to total shareholder return (TSR), in the form of share price appreciation plus dividends, for companies with Varian-like business models.

Capital market research and direct investor feedback made it clear that innovation was the life-blood for Varian's ability to create value, so VVA was designed to treat R&D as an asset. This is to encourage more investment in R&D and more accountability for earning a return on R&D investments.

The VVA calculation begins by determining gross cash earnings, which is adjusted EBITDA plus R&D less a provision for taxes. From this is subtracted a capital charge, determined as the product of the required return, or cost of capital, multiplied by gross operating assets. Gross operating assets includes undepreciated gross property plant & equipment, net operating working capital, other operating assets, and capitalized R&D, which is the sum of the last eight years of spending. The eight-year period provides the best relationship to TSR for Varian-like companies and seemed consistent with the thinking of the R&D leadership on the average life of R&D.

Effectively, Varian treats physical and intangible assets in the same way investors treat their own investment portfolio. As a result, it wasn't surprising that capital market research demonstrated a strong relationship between TSR and changes in VVA, known as ΔVVA.

More than 50 companies with similar business models were studied over 10 years and in each four-quarter period, companies were sorted into high, medium and low ΔVVA groups. In aggregate, the high group generated median annualized TSR that was 12% higher than those companies in the low group,

whereas similarly constructed groups based on EPS CAGR only showed a 6% difference. This fact-base gave Varian's management and its compensation committee confidence that management's pay would rise and fall with the value of the company — as it should.

Unsurprisingly, according to media reports, an EVA methodology will be adopted in evaluating pay for performance by proxy advisory firm Institutional Shareholder Services, so we expect investors to be more and more interested in the approach going forward.

Since VVA is a comprehensive measure, balancing revenue, cost, and the cost of capital, it can be measured versus the prior year without the need to use budgets to guide goals and objectives. If VVA equals the prior year's, then management has earned the required return on all new investments while maintaining performance on existing assets. In so doing, it would provide an acceptable return to investors. If VVA declines, then performance under-delivers on investor expected returns; if VVA rises, then management over-delivers and creates premium value.

This emphasis on improving performance versus the prior year, rather than beating a budget, encourages managers to own their decisions, results, and consequences of their actions. Management cannot benefit from beating a low, sandbagged budget, and similarly cannot be penalized by falling short of stretch goals that create unrealistic targets. Behaviorally, this is important. It discourages target negotiation and instead emphasizes continuous improvement in operating and financial performance, just as an owner would.

Compensation Payoff

For Varian, the adoption of VVA for executive incentive compensation has been a welcome change. It allows management to focus on a singular comprehensive measure that balances the tradeoffs of traditional measures to inform better value-creating decisions. In conventional incentive systems, managing to a basket of metrics often leads to managing to none. VVA provides the balance in a balanced scorecard, as an arbiter of sorts that resolves the conflicting signals of other measures. In many instances, by managing to VVA Varian has achieved simultaneous improvement in growth, profitability, asset efficiency, and returns.

The ability to set incentive targets independent from budgets and strategic plans has been liberating. It has also discouraged potential short-sighted decisions to underinvest or cut R&D at the expense of mid- and long-term sustainable performance. As stated in the company's 2018 proxy, "Economic Profit aligns with a key component of Varian's growth and value creation strategy, which is to drive innovation over relatively long product cycles through ongoing investments in R&D."

Because executive management's pay is no longer dependent on budgets, but simply based on the improvement of VVA, planning is evolving to become a search for unfettered value creation. That search is only limited only by the management team's creativity. The process changed from a negotiation to a truly strategic exploration that simultaneously encourages line managers to drive long-term value by making all good long-term investments, while not relaxing the emphasis on delivering outstanding period-by-period performance.

Planning at Varian balances both the short and long term through its "run-the-business" and "change-the-business" frameworks. These frameworks strategically allocate resources to the most productive users and uses of capital — whether growing current business lines, laying the foundation for future products and innovations, or both.

Meanwhile, VVA provides the analytical framework to evaluate both organic and inorganic investments against a consistent standard so that capital isn't simply spread evenly across opportunities. Rather, it is disproportionately directed towards those investments that generate the greatest value for shareholders. And with R&D treated as an investment, VVA also provides the fact-base needed to make the tough decision of prioritizing and diverting resources towards those products and R&D initiatives that will produce the greatest value.

Achieving a cultural change requires discipline, communication, training, and constant reinforcement, all of which take time and effort. But once achieved, an ownership culture creates a competitive advantage that is difficult to replicate. For Varian, adopting VVA has reinforced the pursuit of growth, profitability, and cash flow, balanced with the required return on new investment. Thus far, it has led to superior TSR.

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