How One Company Balanced Current Performance with Investing in the Future

How a new approach to financial management helped Varian Medical Systems gain clarity into its investment opportunities and tap into its value-creation potential—all resulting in TSR that doubled the market over 18 months.

Gary E. Bischoping, Jr. and **Greg Milano**

According to the Centers for Disease Control & Prevention, cancer was the second-leading cause of death in the United States in 2016, and one in three people will develop cancer in their lifetime. Treatments that benefit cancer patients are invaluable to society.

For over 70 years, Varian Medical Systems has helped lead the fight against cancer by innovating cancer therapies. The company is currently the market leader in radiation therapy. Varian's solutions were used by its customers to treat three million cancer patients last year. The number one priority of Varian management is to find new and better ways to increase access to cancer care for more patients across the globe. According to the Lancet Oncology Commission's 2015 report, an estimated 80 percent of global cancer patients live in low- and middle-income countries where only 10 percent of patients have access to potentially life-saving radiation therapy technology. In the process of providing access to the expertise, information, and technology to cancer care facilities to enable high-quality care globally, the company has also delivered substantial value creation for its shareholders. Over the 18 months ending in March 2019, Varian delivered 40 percent Total Shareholder Return (TSR), including dividends and share price appreciation, twice that of the S&P 500 over the same time period.

Historically, Varian's competitive advantage has been derived from a culture of innovation premised on and supported by significant R&D investment. These investments created proprietary technology that was embedded in advanced equipment, and more recently in software solutions used to help cancer centers better develop treatment plans. Of course, applying radiation to a human body to treat cancer is a very serious endeavor, and the enhanced precision that has come from Varian's research has made the process much less risky and its outcomes more successful by reducing the damage to healthy tissue. These innovations have been applauded by cancer patients, clinicians, and the market alike.

But after a long run of innovation that both extended Varian's therapeutic reach and resulted in strong growth through the mid-2010s, the company's TSR began to sag. The truth was that the stagnating share price was due to a slowdown in the release of new, innovative products to drive the market, and this meant the company's capacity to reach patients was being undermined. As management dug deeper into the company's investment decision-making and compensation processes, it became clear that some of these processes were inadvertently reducing managers' incentives to invest in critical R&D and innovation. To help steer the company back to the success of its old ways, there was a need to look more deeply into the company's different business lines and regions to gain more insight into the most promising areas for resource allocation. And in 2017 Varian management set upon implementing a measure that would reinforce this high-investment strategy while not meaningfully diminishing period-by-period performance.

Diagnosis

Management engaged in meaningful strategic discussions in mid-2017 and identified several opportunities to improve the company's decision-making and compensation processes, which they determined were contributing to its underperformance. Previously, there was a focus on quarterly EPS, particularly in executive compensation. Managers were paid for beating budgeted levels on a mix of measures, including EPS, EBIT, and top-line revenue, as well as a number of strategic goals; and this combination of objectives was not yielding the desired managerial behavior.

In some cases, the demands on management to meet quarterly and annual profit targets interfered with the company's strategic need to invest in the long-term value of the company. This is especially true for investments in R&D, which are expensed in the period in which they are incurred for accounting purposes. As is commonly known, R&D should be viewed as a long-term investment, so treating it as a period expense can lead to underinvestment.

The unevenness or "lumpiness" of earnings and cash flows posed further challenges given the inflexibility of targets. If a few delayed sales contracts caused a profit shortfall in a particular quarter, there was pressure to cut costs. This didn't motivate consistency in taking decisions aligned with driving long-term value. When managers did overcome these adverse incentives, this could mean missing an incentive target and so taking a hit to their own compensation.

Exacerbating this was the design of Varian's budgeting, planning, and goal-setting processes. There was a rigid focus on meeting or beating the annual plan. And this caused frustration in cases where the business performed well relative to its peers and the broader market in a given period, but overly-stretched targets prevented management from achieving the planned goal. This essentially encouraged managers to negotiate more reasonable targets. And managers were effectively discouraged from proposing good investment opportunities; since the expected benefits would be baked into the plan, managers were exposed to significantly more downside than upside. The motivation was to underinvest in all but the most certain of their investment opportunities. Like many companies, Varian was encouraging managers to avoid risky projects. Management wanted to change this paradigm in order to encourage innovative thinking and prudent risk-taking.

Another priority was to better understand the underlying value-creation potential of its business segments and product lines. There was a need for a clear and comprehensive business portfolio evaluation framework that could be used to identify, and invest more resources in, the most promising growth prospects. These insights would allow management to look at each part of the business as an investor would, with the intent of funneling more growth investment to the areas that were likely to earn the highest returns on the investment.

The Solution: A Customized Measure of Economic Profit

As a first step, management enacted several changes to lengthen the time horizon for management decision-making, starting by switching from quarterly to annual guidance to investors. Varian collaborated with Fortuna Advisors to build a fact base linking every aspect of performance to TSR for a large group of peers with business models similar to Varian. This laid the foundation for change and helped guide management as choices were made to improve planning, decision-making, and incentives. This use of data and KPIs to track and compare investments was an important step in not only identifying Varian's most profitable uses of capital, but also generating empirical evidence to demonstrate the value that was achievable, which helped secure buy-in from managers.

As the centerpiece of this new way of thinking and running the business, management decided in 2017 to adopt a customized economic-profit-based metric to better align all aspects of business management with value creation. In June of 2017, Varian met with Fortuna Advisors, a strategic and financial consulting firm that specializes in value-based business management, including compensation systems that simulate ownership. Much of the discussion focused on Fortuna's recent healthcare study, which showed the importance of investing in and driving growth to drive TSR in the industry. With a revitalized growth agenda in mind, and after analyzing the company's financial performance, compensation design, decision-making processes, financing strategy, and payout policy, the team set about designing the ideal measure for Varian.

This new financial performance measure is referred to internally as "VVA," or Varian Value Added, and is a customized version of Residual Cash Earnings (RCE). RCE is a cash-flow based adaptation of economic profit, whose best-known version is EVA, or economic value added. In the proxy statement used to convey compensation practices publicly, the measure is simply referred to as economic profit. And while many are still unfamiliar with how such measures of economic profit work, this appears to be changing. In 2018, ISS, the well-known shareholder proxy firm, announced its acquisition of EVA Dimensions along with its intention to embrace EVA for executive compensation. Unsurprisingly, then, Varian's first proxy after VVA was implemented was well received by ISS and Varian's investors.

The VVA calculation begins by determining Gross Cash Earnings, which is adjusted EBITDA plus R&D less a provision for taxes. From this a capital charge is subtracted, determined as the product of the required return, or cost of capital, multiplied by Gross Operating Assets, which includes undepreciated gross property plant & equipment, net operating working capital, other operating assets and capitalized R&D.

One of the most important benefits of VVA versus traditional economic profit is that it treats expenditures in R&D as investments as opposed to period expenses, as in accounting processes. This removes any incentive to cut R&D to meet a short-term goal, so it promotes investing in innovation. At the same time, since there is enduring accountability for delivering an adequate return on R&D investments for eight years, there is more incentive to reallocate R&D spending away from projects that are failing and toward those that project the most promising outcomes—for patients and shareholders.

In addition, VVA improves on the treatment of capital expenditure relative to traditional economic profit. The traditional treatment of capex burdens performance expectations with the full cost of a capital charge plus depreciation the day an asset is acquired, and then the cost of owning the asset declines each year as the asset depreciates away., This often causes economic profit to be negative for several years, which discourages investments and encourages the sweating of old assets well beyond their useful life. In VVA, depreciation is not charged to Gross Cash Earnings and the capital charge doesn't decline over time, so the benefits of investments tend to show up sooner, and without the illusion of value creation later on as the asset depreciates away.

As a complete metric, VVA also provides insight across investment opportunities and segment (and regional) performance. This can help managers think about how they're going to get incremental returns, which typically involves more revenue growth and increases in operating efficiency to achieve growth and margin expansion. For Varian, three main sources of potential incremental VVA were identified: (1) increasing investment in R&D to drive innovation and ultimately accelerate the profitable growth trajectory of the company; (2) increasing VVA margin through more effective pricing and cost management as well as greater capital productivity; and (3) withdrawing from areas where the required return on capital was not being met—and redeploying the capital to more promising areas.

Implementing VVA and the Results

VVA was implemented near the end of a financial year, so the first priority was to incorporate it in the annual incentive plan for the top 40 executives of the company. One of the most important benefits of VVA is that it is a complete and balanced measure that correlates well with TSR. When VVA equals the prior year's VVA, that means management has delivered a required return on new investments and maintained the returns on previous investments, or some combination of these value drivers. When VVA rises, it means performance has improved and vice versa. With this in mind, annual bonus targets are no longer based on arbitrary budgets, but on year-to-year increases in VVA. Although the compensation committee reserves the right to review targets and to adjust for special items and the like, the intention is that target VVA is always the prior-year actual result.

This has unencumbered the planning process—which is now about planning, not pay; and it freed up managers to consider new and exciting investments in important new innovations and capabilities. If investments pay off well management will be rewarded, and if performance falls short they will be penalized. So before considering any project designed to improve performance, a manager considers whether or not they truly believe it will pay off—they act like owners.

Prior to these compensation changes, an important component of the vesting of Performance Share Units was relative TSR. But such a metric can be fickle due to stock market volatility. The new long-term executive compensation plan includes improved PSUs whereby the performance requirements are tied to a grid of three-year benchmarks for revenue growth and change in EBIT margin, which has proved to be very well aligned with value creation in terms of TSR. There is still a relative TSR overlay that limits PSU vesting when relative TSR is bottom-quartile and sets a floor when relative TSR is top-quartile, but the new PSU design is more driven by internally measurable outcomes, and expected to have more impact on promoting owner-like behavior from managers.

In parallel with the launch of these new incentive designs, the company embarked on several layers of communication and training. At an internal town hall in the fall of 2017, Dow Wilson, the President and CEO of Varian, discussed VVA and how he expected it to help management. Considerable work went into developing a short and straightforward computer-based training module designed to introduce the VVA concepts to employees at almost any level. And for the top managers that would be in the new VVA incentive plan, and their supporting finance managers, a full-day VVA training session was developed and delivered globally. The emphasis was on practical case studies and applications, so the participants wouldn't just hear about VVA, they would learn to use it.

Next Fortuna and Varian collaborated to understand investor expectations that were baked into the share price and to estimate the amount of VVA improvement required to deliver a top-quartile TSR among peers. These top-quartile VVA forecasts were then transformed into reasonable growth, margin, and asset intensity projections, and this in turn was used to decide how much investment would be needed over time. One of the most common causes of growth shortfalls is underinvestment, so this goal-setting process was designed to determine at the outset how much investment may be needed. This led management to think of investments in a different and more productive way while going through the planning process.

Planning has evolved at Varian as well, and is now designed to balance the short and long term through parallel "run-the-business" and "change-the-business" frameworks, which strategically allocate resources to the most productive users and uses of capital. Whether growing current business lines or funding innovation for future products and services, the process seeks to find the best value-creation opportunities and dedicate more resources to these areas. The planning and budgeting processes have benefitted from how VVA integrates the P&L and balance sheet, and from the reinforcement of incentives that are no longer tied to budgeted goals.

Every major investment, including capital expenditures, R&D, and potential acquisitions, is now evaluated using VVA. The NPV of VVA is similar to NPV based on free cash flow, but the benefit is that the methodology directly ties to how management will be measured after the investment. The company evaluates NPV as a percentage of the investment, which is referred to as the VVA profitability index, and this provides "margin of safety" hurdles.

As a demonstration of this investment framework in action, in early 2018 Varian announced that they planned to acquire Sirtex Medical Limited, an Australia-based global life sciences company focused on interventional oncology therapies, for about $1.3 billion. But in May Sirtex received a proposal from CDH Investments, a China-based alternative asset manager, that was offering 20 percent more than the Varian offer. The deal presented strategic synergies, so it was tempting to outbid the rival, but Varian completed a VVA analysis that showed it was unlikely the deal would ever deliver VVA relative to the inflated purchase price. Within weeks the company notified Sirtex they would not raise their offer.

This analytically-informed discipline is an example of the ownership mindset, and has become increasingly intertwined with management's decision-making. By achieving clarity on where the company creates value, the goal-setting, planning, and investment decision-making processes have converged to drive much better resource allocation. And the results are showing: Whereas R&D was less than 6 percent of sales at some points in the past, it has averaged 8 percent over the last three quarters.

The VVA framework also helped Varian identify related or adjacent markets where they could apply their core competencies to provide a lift to their overall business. One such area has been an emphasis on software and data management designed to improve treatment planning and improve patient results. In some cases, these opportunities have led to synergies and vertical integration designed to make greater use of the company's competitive advantage, and in other cases the company has extended their efforts into adjacent areas where new skills or technology is required to be successful.

VVA incentives officially started in October 2017. In the 18 months through March 2019, Varian's TSR was 41.6 percent, more than double the 15.7 percent the S&P 500 achieved in the same period. Varian has shown promising growth in its Chinese and Indian markets, attaining more than half of total market share in both countries (60 percent and 56 percent, respectively) as of 2018. And the benefits of the company's R&D projects are also coming to fruition. In April of 2019, Varian disclosed promising early-stage data for a potentially breakthrough ultra-high-dose rate therapy. Most importantly, in the past year, the company has been able to reach 10 percent more cancer patients, an increase from 2.7 to 3.0 million.

The process of VVA adoption is still in its early stages, but already the company is seeing more efficiency and capital productivity, and at the same time management is making more investments in promising areas with the intent of better serving patients and delivering more VVA growth and TSR.

And as we've seen, the more financial success Varian achieves, the more patients it's able to reach—it's truly a win-win situation. In December 2018, Varian was named for the second time to the JUST Capital and Forbes magazine's *JUST 100* List. This is a testament to the value that Varian has created not only for shareholders, but for society at large and the millions of people who are affected by cancer every year. Going forward, management seeks to take the VVA mindset down throughout the organization and plans to continue making improvements to planning, investment decision-making, and strategic resource allocation processes, with the intent of continuing to drive above-market TSR and reaching more and more patients. The path has been tough at times, but like most things worth doing, the payoff is worth the investment.

Gary E. Bischoping, Jr. is Senior Vice President, Finance & Chief Finance Officer of Varian Medical Systems.

Greg Milano is founder and chief executive officer of Fortuna Advisors and the author of the forthcoming book A Cure for Corporate Short-Termism*.*