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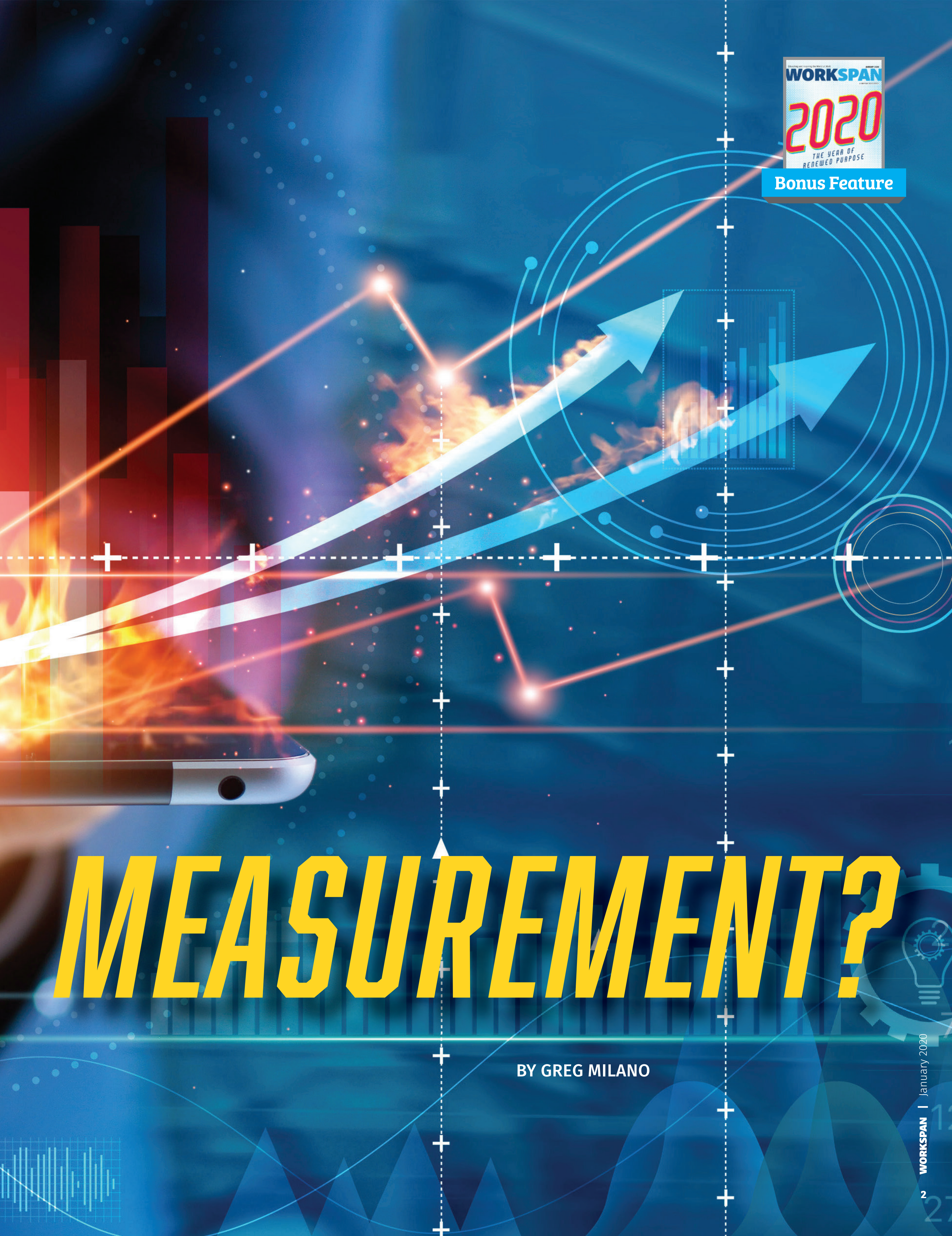
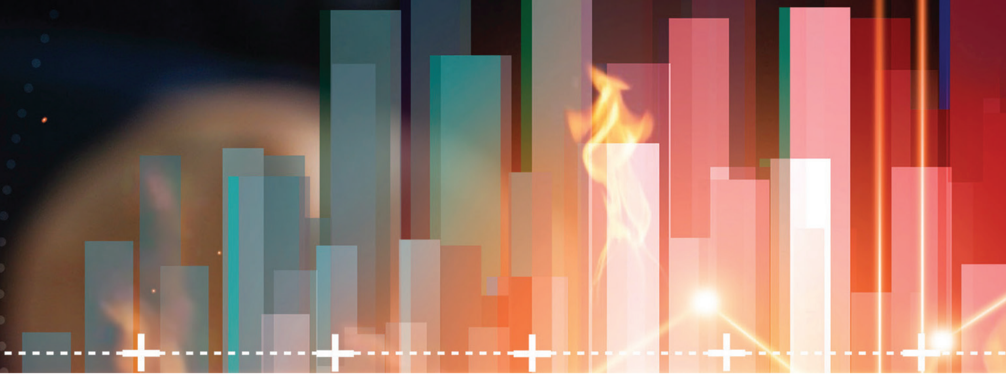
THE NEXT GAME CHANGER IN PERFORMANCE



MEASUREMENT?

BY GREG MILANO

THE NEXT GAME CHANGER IN PERFORMANCE MEASUREMENT?



When it comes to executive compensation, organizations want the approval of investors. And, securing that approval is much more likely when incentive compensation plans are viewed favorably by proxy advisory firms like Institutional Shareholder Services (ISS) and Glass Lewis. To be sure, there are mixed feelings on the roles these advisors play and the influence they wield; nonetheless, their views matter to investors.

In 2018, ISS acquired EVA Dimensions, an equity research firm that uses economic value added (EVA) to measure corporate performance as a proxy for value creation. Following this acquisition, ISS also announced that in 2019, EVA would be featured in its research reports along with GAAP-based measures. Furthermore, it would consider incorporating EVA into its standard pay-for-performance model in 2020.

Though many applauded the news, not everyone was as enthused about this resurgence of EVA. This became clear during the WorldatWork 2019 Executive Compensation Forum in Colorado, where many speakers insisted that managers and directors should be troubled by this trend. Many spoke of the complexity of EVA and how operating managers struggle to understand it. Yet perhaps even more troubling, others suggested that EVA creates a systemic bias in favor of short-term results at the expense of long-term growth.

During my tenure at Stern Stewart from 1992 to 2002, I implemented EVA for scores of clients all over the world. I can say with confidence that EVA is a more effective way of guiding and motivating corporate managers to create value than traditional performance measures. It was a substantial improvement in that it attempted to balance considerations about both quantity (size and growth) and quality (rate of return and profit margin) within a single measure. However, EVA does have crucial flaws, which will be discussed below, along with solutions. But it was a major advancement in the field when it was first launched in the 1980s.

The Shortcomings of EVA

EVA is calculated by determining the net operating profit after taxes (NOPAT), less a capital charge to reflect the expected return on capital of shareholders and lenders. Although in principle the pursuit of higher EVA motivates managers to balance growth and profitability, in practice it often fell short and was replaced by more traditional performance measures after a few years.

I was fortunate to have several briefings from corporate executives on their rationale for abandoning EVA. By far, the most common reason was that their employees didn't understand the measure and how their decisions would affect it. This is largely a result of EVA's computational complexity and all the required accounting adjustments. According to Wikipedia, more than 160 potential adjustments can be applied to EVA. Though most organizations I worked with only incorporated five to 10 such adjustments, even sophisticated financial analysts still struggled with the complexity.

Some of these failures also rested on the shoulders of management, for there were many organizations that introduced EVA with far too little communication and training. The fact is, implementing unfamiliar performance measures and compensation designs takes a lot of training and conditioning of behaviors to work successfully. How can we expect managers to know how to apply a new financial measurement framework to everyday operating decisions if we don't train them on how it works and what is expected of them? One of my clients in the '90s, for example, originally embraced our recommendation for a full day of EVA training, but by the implementation phase, those being paid incentives based on it had only received a 30-minute briefing call and a four-page brochure. It also was too common for this EVA training to be more about the measure and how the accountants would be calculating it, and much less about the important implications for strategic and tactical decisions that the measure encourages.

While working with another client, the CEO consistently downplayed the need for detailed training, often claiming, "You cannot find a way to pay me that I cannot figure out." That may have been true for him, and perhaps that's why he rose above others to become CEO. But for most of us mere mortals, training and communication are essential to understand what amounts to an entirely new measure of success. In the absence of

clear guidelines on how behaviors should change, managers tend to keep doing what they have always been doing — they just get paid less since the new measure is driven by a different set of performance characteristics.

Potentially worse, even when managers understand how to use EVA, it often motivates suboptimal decisions. As I explain in detail in “Beyond EVA,” published in the Journal of Applied Corporate Finance in the fall of 2019, EVA — and pretty much all rate-of-return measures — tend to penalize performance when assets are new and inflate it as those assets depreciate away over time. This often leads managers to underinvest to avoid driving down their near-term EVA, and thus their bonuses. Instead, many managers realize they could milk old, depreciated assets to boost EVA. It is of little concern to them that doing so undermines the long-run growth of the businesses they oversee, since they still get their bonuses in the near term.

Some may point out that this is why many organizations provide long-term compensation through vested shares and stock options. Yet, from my experience, many managers consider long-term compensation to be, to a large extent, out of their control, and will focus much more on maximizing annual bonuses. Unsurprisingly, many clients’ CEOs have confided in me that they dropped EVA because they couldn’t get their managers to invest sufficiently while their compensation was linked to the measure.

Getting Managers to Think More Like Long-Term Owners

When we founded Fortuna Advisors in 2009, it was clear that the business world needed a simpler measure of value creation. But even more important, we also wanted to find a way to better balance the motivation to improve capital efficiency and to invest in future growth, which is essentially the balance between delivering results now and later. And, in a business climate where decision making has become increasingly motivated by short-term considerations — due in part to a heavy emphasis on quarterly earnings — solving this performance measurement problem seemed of the utmost importance for our clients, their shareholders and the economy at large.

RCE CASE STUDY

VARIAN MEDICAL SYSTEMS

For 70-plus years, Varian Medical Systems has helped lead the fight against cancer by innovating cancer therapies and is currently the market leader in radiation therapy. The No. 1 priority of Varian’s management is to find new and better ways to increase access to cancer care for more patients across the globe. Historically, Varian’s competitive advantage has derived from a culture of innovation premised on and supported by significant R&D investment.

After a long run of innovation that both extended Varian’s therapeutic reach and resulted in strong growth through the mid-2010s, the organization’s TSR began to sag, partially due to a slowdown in the release of new, innovative products to drive the market. As management dug deeper into the organization’s investment decision making and compensation processes, it became clear they were subtly — and inadvertently — reducing management’s motivation to invest in critical R&D and innovation.

As the centerpiece of a new way of thinking and running the business, Varian’s management decided in 2017 to adopt a customized version of RCE known internally as Varian value added, or “VVA.” One of the most important benefits of VVA is that it treats expenditures in R&D as investments rather than period expenses, as is the case in standard accounting.

In parallel with the launch of new incentive designs, Varian embarked on several layers of communication and training and continues to reinforce these messages frequently. Top and upper-middle managers have begun to think about all sorts of investments, including R&D spending, in a different and more productive way; and every major investment is now evaluated using VVA. Whether growing current business lines or funding innovation for future products and services, managers seek 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 profit and loss statement with the balance sheet, and from the reinforcement of incentives that are no longer tied to budgeted goals.

To be sure, linking compensation to a more reliable performance measure helps — but it’s not enough in order to instill a strong culture of accountability. VVA would never have worked so well for Varian if it was used only for incentives. Organizations must actively use and discuss the measure and incorporate insights from the analysis in all important decision-making processes. By taking these steps, corporate leaders can make a performance measure like RCE the focal point in motivating better planning and investment decision making — and, ultimately, developing an ownership culture that yields more long-term value.

The goal for our new measure was to get corporate executives and managers to behave more like owner-managers. We want managers to drive current profitability, but not by cutting expenditures that could compromise long-term growth. We rarely see an owner achieving short-term goals by slashing investments in the future like R&D, marketing or training expenditures. Yet, we constantly see these behaviors in corporations run by employee-managers.

We conducted extensive capital market research to optimize a formula that would be both simple and encourage owner-like behavior — without the adverse effects of EVA. The result was residual cash earnings (RCE), which has a maximum of three potential accounting adjustments.

And, for those interested in the math, the most important computational difference between EVA and RCE is that RCE doesn't include the cost of depreciation of assets. This may sound like a trivial detail that would only seem important to accountants, but it has an enormous impact on behavior and is at the crux of why EVA leads to short-term decision making. As fully described in the aforementioned article, "Beyond EVA," new investments tend to drive down EVA, and milking old assets gives the illusion of value creation as they depreciate over time. On the other hand, the RCE of a new investment tends to be positive sooner and it doesn't rise over time as assets age. So, there is more willingness to invest and managers are motivated to think more like long-term owners.

What's more, even with RCE's simpler formula, it actually relates better to total shareholder return (TSR) than EVA in all 20 industries we examined in a comprehensive study based on the current members of the Russell 3000, excluding the financial, insurance and real estate industries. So, we can be confident that when managers take actions to drive RCE, it's likely that improvements in TSR will follow. In most cases, this linkage is strong enough that our clients have set target RCE each year at a level equal to the prior year actual RCE; and at that level of performance, target bonuses are paid.

To understand the importance of setting targets based on the prior year, consider how compensation committee discussions would be different if there were no negotiation of performance targets. And within the organization, imagine how the dialogues between corporate leadership and the heads of segments and business units would change. If a CEO asks a business unit general manager whether they can incorporate into their plan a new strategy that is believed to deliver $5 million more RCE, the manager may or may not agree. But before answering the question, the manager would know that they stand to earn more if the plan works — as would the CEO. So they are on the same side of the table, like partners. This is in stark contrast to the endless negotiation, gamesmanship and sandbagging that occurs at most organizations. Indeed, some believe the best reason for adopting RCE may simply be to have a credible approach for separating incentive targets from plans and budgets.

RCE: Well Worth Consideration

EVA was a game changer in the field of performance measurement as the first measure to successfully combine aspects of both quantity and quality into one "all-encompassing" financial measure. Yet for all of its benefits, EVA's success was limited by its complexity and the unintended incentive it provides to underinvest. Many may have wished to forget about EVA, but, alas, the acquisition of EVA Dimensions by ISS signals a revival for measures like EVA.

But more than three decades after EVA's unveiling, there appear to be better options. One such option is RCE, a measure that is arguably simpler, more accurate and more comprehensive than EVA, all in the pursuit of better performance measurement and more value creation — not just for shareholders, but for all stakeholders and society at large. Organizations should consider a customized version of RCE to help improve the quality of their incentives and how they relate to the organization's business management processes. Many indicators point to better financial outcomes when organizations motivate their managers to plan, decide and behave like long-term owners. **WS**

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