Fortuna Advisors LLC

APRIL 2021

2021 Fortuna Advisors Value Leadership Report

Every company should strive for top-quartile TSR

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ABOUT FORTUNA ADVISORS

Fortuna Advisors LLC is a strategy consulting firm that collaborates with corporate leaders to design and implement value-based analytics that improve strategic decisions and align organizational behaviors to deliver superior Total Shareholder Returns.

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Driving Top-Quartile TSR over the *Long Term*

In our inaugural Fortuna Advisors Value Leadership Report, we analyze the performance of companies in the Russell 1000 (excluding financials) to help executives better identify insights, make decisions, and drive behavior to unlock their long-term value creation potential. We evaluate value leadership in the markets based on Total Shareholder Return (TSR) and, inside companies, using our Residual Cash Earnings (RCE) and Five Tools of Value Creation framework. The findings help explain and validate capital market trends, and can help management teams chart their own roadmaps to top-quartile performance.

"'Look, when the stock is up 30% in a month, don't feel 30% smarter. Because when the stock is down 30% in a month, it's not going to feel so good to feel 30% dumber.' … I never spend any time thinking about the daily *stock price."*

— JEFF BEZOS

Median top-quartile TSR over the last five years was relatively high versus historical norms, and implied a quadrupling of share price. We will show what it took, in terms of growth, margin, asset intensity, and various aspects of reinvestment, to achieve such top-quartile TSR.

We discuss a changing stakeholder landscape in which value creation increasingly benefits all stakeholders; and show how a company's contributions to environmental, social, and governance (ESG) issues, along with its ability to empathize with employees and consumers, provides quantifiable benefits for shareholders.

We will apply RCE and our Five Tools of Value Creation to analyze the top-performing industry, highlight a "Serial Leader," (company with repeat top-quartile performance), and a "Recovery Star," (one that went from bottom- to top-quartile in the latest period measured).

Lastly, we highlight some of the obstacles to achieving top-quartile TSR that managements should strive to overcome.

Total Shareholder Return (TSR) is a comprehensive metric that combines share price appreciation and dividend yield, and is a more reliable indicator of value leadership than share price appreciation or dividend yield alone.

VALUE CREATION HIGHLIGHTS

1 **GROWTH IS THE MOST IMPORTANT DRIVER**
Revenue Growth and Reinvestment Effectiveness were the strongest drivers of top-quartile TSR. Many value leaders also had below-median profitability, suggesting the heightened importance of growth during the period.

2 **SIZE OF THE PRIZE**
Our value leaders delivered 35% higher median annual TSR than the bottom group, and the market capitalization of the value leaders increased by over $10 trillion versus a decline of over $1 trillion for the bottom quartile.

3 **PAST PERFORMANCE IS NO GUARANTEE**
Value leaders in the prior five years were as likely to drop to the bottom quartile in the recent period, as they were to remain top-quartile. Winners cannot rest on their laurels, and current underperformers should never count themselves out.

4 **INTANGIBLES INCREASINGLY DRIVE VALUE**
Increasingly, value-driving investments appear on the P&L, not the Balance Sheet. Think R&D, brand building, and training expenses, for example. Companies need a reliable measure that treats these as investments.

5 **GREAT COMPANY OR GREAT STOCK?**
So-called great companies are often large, profitable and cost-efficient, but their share prices stall without sufficient growth. Great stocks expand markets through innovation and invest aggressively in value-adding projects. Investors prefer great stocks.

Achieving Top-Quartile TSR Isn't Easy

Achieving top-quartile TSR is easier said than done. Over the five-year period ending 2020, the median annualized TSR of the top quartile of our sample was 33.5%, a high bar. At this rate, a one-thousand-dollar investment would have been worth $4,250 after five years—a more than quadrupling of value, as shown in Figure 1.

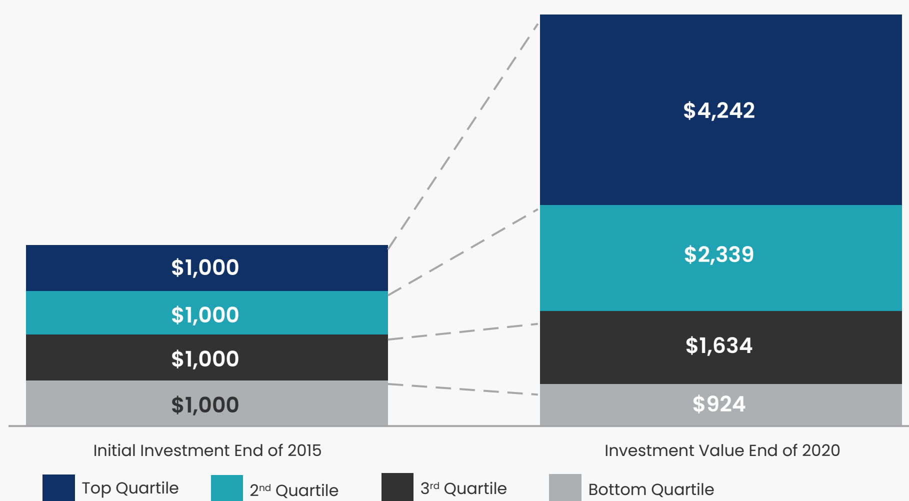
The scatterplot in Figure 2 shows the TSR percentile rank over successive five-year periods for all non-financial Russell 1000 companies. Each dot represents an individual company's TSR rank over the two five-year periods ending in 2015 and 2020, respectively. For instance, Marriott's dot, highlighted in red, is in the 45th percentile over the first period, on the horizontal axis, and in the 55th percentile over the more recent five-year period… impressive for a travel company over a period ending in a travel lockdown.

The dots appear to be randomly distributed across the graph, which is the point. Past performance is not a reliable indicator of future performance. Some companies, and indeed some industries, such as energy, shift due to business and economic cycles. But there is also a broad influence of market disruption where some companies meaningfully gain, or lose, competitive advantage, which can profoundly influence both performance and valuation multiples, and TSR in turn.

Managements should act like long-term investors, CONCENTRATING RESOURCES WHERE VALUE IS FORECAST TO MEANINGFULLY RISE OVER TIME, **and "harvesting" capital from businesses expected to be flat or down.**

FIGURE 1

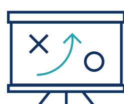
Five-Year Ending Value of $1000 Invested in Median of Each Quartile



*Excluding Banks, Diversified Financials, Insurance, & Real Estate Industries

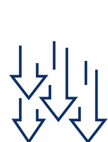
Source: Fortuna Advisors' analysis using data from Capital IQ

We've developed four TSR archetypes for the companies that start *and* end in either a top- or bottom-quartile position over the two successive five-year periods:



Serial leaders are the 34 companies that remained in the top quartile for both periods, which represent a wide range of industries. Many would be considered trailblazers, from Amazon to Domino's Pizza to Dexcom. Serial leaders focus on improving year over year and *constantly* reevaluate, and reallocate resources to, their best strategies and opportunities. Simply put, they are never satisfied with the status quo.

Recovery Stars are the 30 companies that languished in the bottom quartile in the first period, but leapt to the top over the most recent period, including Best Buy, Caterpillar, and VMware. Though this is often the result of meaningful improvements in financial results, it is often also accompanied by an increase in future expectations, which increases the valuation multiple.



Fallen Angels are the 43 companies that generated top-quartile TSR, during the first five-year period, but then fell to the bottom quartile during the most recent five-year period. The largest industry constituents of this group were Pharmaceuticals, Biotechnology and Life Sciences, where the pace of new drug launches has slowed, in relation to the commercialized base, affecting both results and expectations.

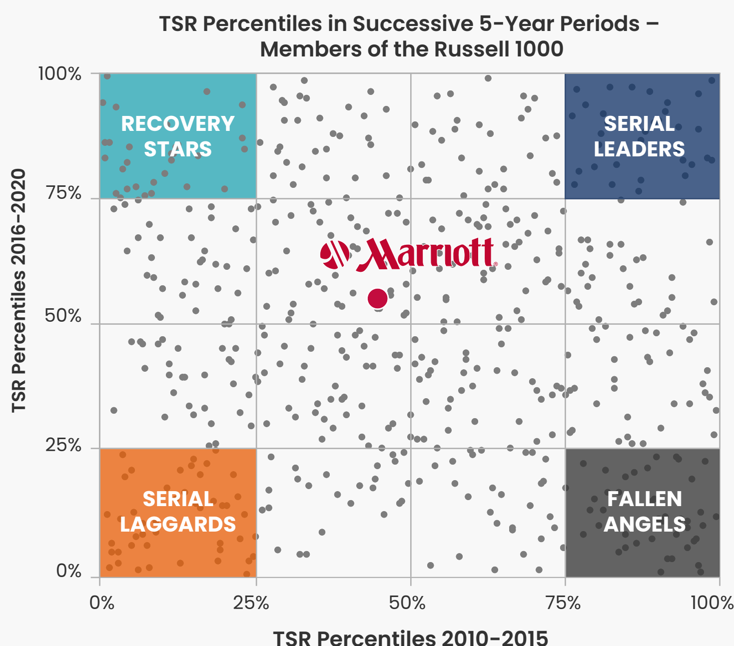
Serial Laggards are the 46 companies that generated bottom-quartile TSR over the two successive periods. The meaningful and sustained drop in commodity prices caused the energy industry to be overrepresented in this bucket; with over 60% of energy companies falling into this archetype.

Companies with multiple businesses should consider where each business would fall on this chart, if each had their own share price, and where they expect them to be in five years. Understanding value creation trends and opportunities is critical to effective strategic resource allocation. Managements should act like long-term investors, concentrating resources where value is forecast to meaningfully rise over time, and "harvesting" capital from businesses expected to be flat or down.

FIGURE 2
TSR Percentile Rank in Successive Five-Year Periods

RECOVERY STARS

COMPANY
Advanced Micro Devices
Amedisys
Marvell Technology Group
Inphi Corporation
Iovance Biotherapeutics



SERIAL LEADERS

COMPANY
Align Technology
Axon Enterprise
Generac Holdings
Tesla
Trex Company

Source: Fortuna Advisors' analysis using data from Capital IQ

Residual Cash Earnings Drives TSR

There are many business attributes that lead to high TSR. So when it comes to performance measurement, executives are often tempted to layer measures on measures. But this introduces **unnecessary complexity**, and worse, creates **adverse incentives**. So how can management teams effectively balance performance drivers to maximize long-term TSR?

Economic Profit, whose most well-known iteration is Economic Value Added (EVA), was developed to serve as a comprehensive performance indicator that balances growth and rate of return.

Fortuna's partners spent many years implementing Stern Stewart's EVA and applying Credit Suisse HOLT's cash flow return on investment (CFROI). In different ways, these two frameworks aimed to combine growth, profitability, and capital productivity to relate performance to valuation and share price performance.

Unfortunately, both of these measures are fairly complex, and EVA also has been found to discourage long-term growth investment. To arrive at a simpler measure that better balances growth and return, Fortuna conducted extensive capital market research to create Residual Cash Earnings (RCE).

More than any other performance measure, RCE provides a reliable value signal. To put it simply: up is good, down is bad. And most important, it shows a stronger relationship to TSR than EVA, or generic economic profit (see "*Beyond EVA*").

As shown in Figure 3, RCE consists of Gross Cash Earnings, which is EBITDA less tax costs plus P&L investments like R&D & Rent, less a capital charge based on Gross Operating Assets multiplied by a required return on capital. We use gross assets in the asset base for consistency with not charging depreciation.

Figure 4 shows the median improvement in RCE normalized as a percentage of starting Gross Operating Assets, for the TSR quartiles. The strong relationship gives us confidence that, if management drives RCE higher over time, TSR will follow.

> *"The ideal business is one that earns very high returns on capital and that keeps using lots of capital at those high returns. That becomes a compounding machine."*
> — WARREN BUFFETT

FIGURE 3
RCE calculation

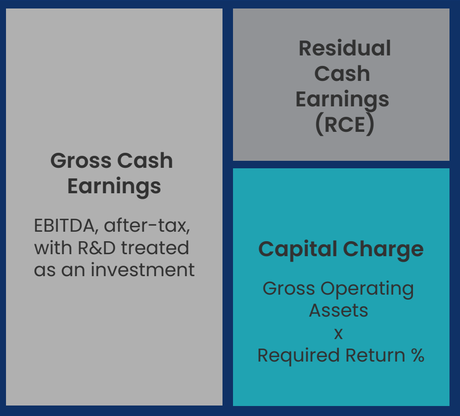
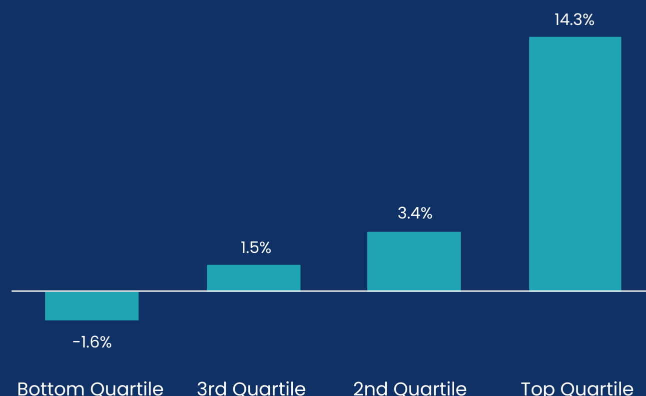


FIGURE 4
Improvement in RCE relates to Higher TSR



Note: Change in RCE (Normalized by Size) is calculated as the change in RCE divided by Gross Operating Assets at the beginning of the period.

Source: Fortuna Advisors' analysis using data from Capital IQ

Performance Diagnostic: The Five Tools of Value Creation

Most companies have too many key performance indicators (KPIs) and fail to adequately understand how they relate to each other, and to overall value creation. Through extensive capital market research and vetting with clients, Fortuna Advisors developed the Five Tools of Value Creation to provide a short list of metrics that, in aggregate, reliably predict value creation. It is helpful for companies to compare their Five Tools, which are explained in Figure 5, against peers to know where they can improve, and whether their forecasts are reasonable.

By measuring the differential on each of the Five Tool Measures for the top and bottom TSR quartiles of our sample, we were able to estimate the explanatory power of each measure. This analysis indicated that Revenue Growth and Reinvestment Effectiveness were the two most important drivers of TSR, followed by Gross Cash Earnings Margin, Asset Intensity, and, finally, reinvestment rate, as shown in Figure 6.

Performance across the Five Tools of Value Creation was normalized through percentile ranking for comparative purposes. For example, the median rank of five-year Revenue CAGR for top- and bottom-quartile TSR companies was 77th and 25th percentile, respectively, thus a differential of 52%.

FIGURE 5
Five-Tool Playbook for Value Creation

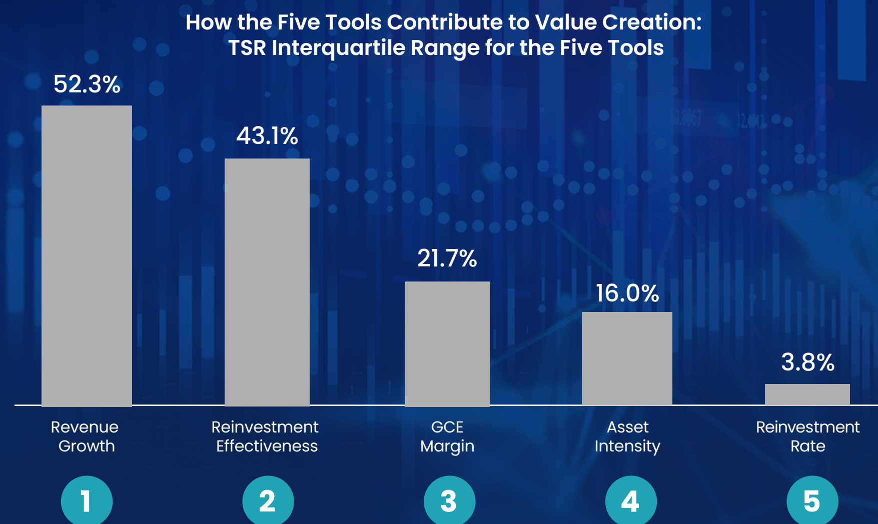
		MEASURE	DESCRIPTION	CALCULATION
Current Performance	Growth	Revenue Growth	Reflects a company's ability to grow, as measured by the percentage change in sales over a specified period.	Revenue Compound Annual Growth Rate (CAGR)
Current Performance	Profitability & Efficiency	Gross Cash Earnings Margin	An indicator of P&L efficiency and pricing power. Gross Cash Earnings (GCE) is calculated as after-tax EBITDA with R&D added back. To arrive at a margin estimate, we divide this value by revenue.	Gross Cash Earnings/Revenue
Current Performance	Profitability & Efficiency	Asset Intensity	Reflects capital productivity. The lower the Asset Intensity, the more capital-efficient a company is. Gross Operating Assets (GOA) refers to a company's undepreciated operating asset base.	Gross Operating Assets/ Revenue
Future Performance	Reinvestment	Reinvestment Rate	Measures the level of reinvestment relative to the cash generated by a business. Includes CapEx, R&D, Net Cash Acquisitions, Δ Net Working Capital, Rent, and Δ Operating Leases.	Reinvestment/Gross Cash Earnings
Future Performance	Reinvestment	Reinvestment Effectiveness	Indicates efficiency of reinvestment by measuring the Revenue generated per dollar of reinvestment.	Change in Revenue/ Reinvestment

Revenue Growth Leading the Way: Given the sometimes excessive focus on profitability over the past decade or so, as demonstrated by the popularity of measures like ROIC and EBDITDA margin, it may seem surprising to see Revenue Growth as the top TSR driver. Admittedly, the effects of Covid-19 on market dynamics enhanced the importance of growth, as growth became a stronger indicator of TSR at the end of 2020; though it has typically been the top performance driver in past studies as well.

Reinvestment Effectiveness - A Close Second: It's not enough to invest a lot; the investment has to lead to growth! At the end of 2020, the Reinvestment Effectiveness of the top- and bottom-quartile TSR companies was 0.45x and 0.01x, respectively. This whopping gap means that the median top-quartile TSR company got an additional $0.44 in revenue for every dollar reinvested. So, companies should focus on growth, but also growing profitably.

Gross Cash Earnings Margin - A medium-strong TSR Lever: The Gross Cash Earnings Margin gap between top- and bottom-quartile TSR companies was 8.2%, a sizeable gap, though not as significant as Revenue Growth and Reinvestment Effectiveness. Interestingly, the five-year median Gross Cash Earnings Margin at the end of 2015 was 18.3% for the top-quartile group of companies and 21.6% for the bottom-quartile group. This trend did reverse by 2017, but it does highlight the importance of growth over profitability. The five-year top vs bottom TSR differential expanded on average 230 basis points between 2015 and 2020. For companies that want to reach top-quartile TSR through margins, it's not enough to have high margins—they need to expand over time.

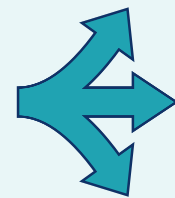
FIGURE 6
Russell 1000 Through the Five-Tools Lens



Source: Fortuna Advisors' analysis using data from Capital IQ

Asset Intensity - Importance Varies by Profitability: The five-year Asset Intensity differential between 2015 and 2020 has been declining and rising depending on the mix of companies in the top and bottom quartile. Despite this, and to be expected, the top-quartile TSR companies had lower Asset Intensity. The median five-year Asset Intensity of the entire Russell 1000 has risen roughly 0.20x between 2015 and 2020; and unsurprisingly the Asset Intensity for the top quartile has risen from 0.96x at the end of 2015 to 1.29x by the end of 2020. This shows that, while capital productivity is important, rising Asset Intensity doesn't always equate to low TSR.

Reinvestment Rate is least important: In our study, Reinvestment Rate alone has not been a strong indicator of top-quartile TSR, since it's not enough to know how much is invested; we must know how effective those investments are at driving growth. At the end of 2020, there is only a 3.6% five-year Reinvestment Rate differential between the top- and bottom-quartile TSR companies, making it the least important of the Five Tools of Value Creation over the period. It is important to note, though, that for companies with high reinvestment effectiveness, the reinvestment rate does matter, and can be a tool to drive higher TSR.



Revenue Growth and Reinvestment Effectiveness were the

TWO MOST IMPORTANT DRIVERS OF TSR

Stakeholder Value Drives Shareholder Value

In 2019, the Business Roundtable updated their definition of the role of the corporation to recognize the need to deliver value to *all stakeholders*, not just shareholders. This wasn't simply an observation of a greater social role for corporations; it was also a reflection on how the nature of value creation has changed. Prior to the digital era, value was largely created from tangible assets—factories, assembly equipment, vehicles, etc.—requiring large investments. Since shareholders funded these assets, it made perfect sense that management would be beholden to the shareholder, giving way to TSR as the primary yardstick for management performance.

But as the economy developed in the late 20th century, there was a growing recognition of the value contributed by different stakeholders: the customers, suppliers, employees, communities *and* shareholders that have a relationship with a corporation. This began in the early 1980s, but didn't accelerate until the 90s; and it wasn't until the 21st century that the importance of the shareholder and the stakeholder began to converge.

Intangibles Increasingly Drive Value Creation: What changed? The nature of investment in the economy changed. You no longer needed to build a factory to launch a business; you only needed to clean out your garage. Investment shifted from creating tangible assets like assembly lines to creating intangible assets like patents, customer relationships, brands and organizational capabilities. A patent follows years of research & development; a brand grows from years of product innovation and marketing; organizational capabilities are developed through years of management learning and training. The accumulation of value occurs in the minds of the people that conduct the research, market the brand, codify learned best practices, or commit to remaining a loyal customer—that is to say, it occurs with the stakeholder. Thus, it's a two-way street and building intangible value *means* building stakeholder value.

Quantifying Returns on Purpose and Stakeholder Value: Clarifying corporate purpose is an important step toward creating stakeholder value, by specifying the impact a company has on its stakeholders. In October 2020, Fortuna Advisors published *The Return on Purpose: Before and During a Crisis* in collaboration with Chief Executives for Corporate Purpose (CECP), showing that companies that scored high on Purpose outperformed low-purpose companies on common financial, valuation, and value creation measures. Perhaps it should be no surprise that there is strong alignment between doing good for customers, employees, the communities and other stakeholders, and the creation of shareholder value.

Building intangible value means building stakeholder value.

"Companies that scored high on corporate purpose metrics outperformed their low-scoring counterparts on common measures of financial performance, market valuation and shareholder value creation."

The Return on Purpose: Before and During a Crisis

CEO Investor Forum

Fortuna Advisors LLC

Research report by Fortuna Advisors and Chief Executives for Corporate Purpose

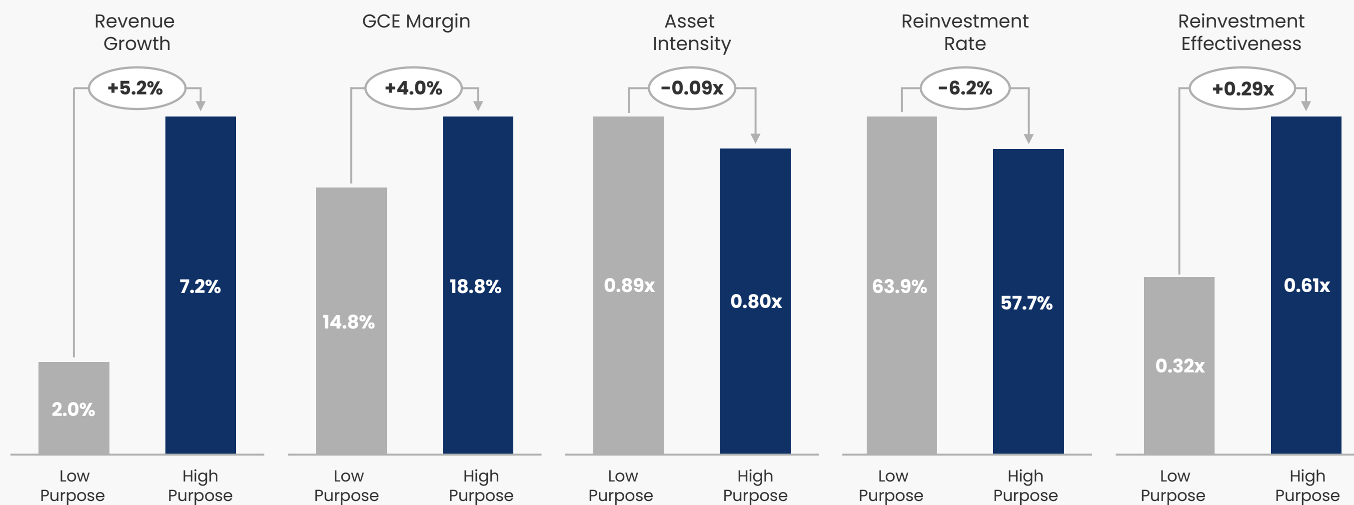
We have updated and extended this research to analyze the Five Tools of Value Creation of high- vs. low-purpose companies. We found, for example, that high-purpose companies had higher reinvestment effectiveness, enabling high-purpose companies to deliver higher revenue growth at a lower rate of reinvestment, as shown in Figure 7.

As another data point on the alignment of stakeholders and shareholders, high-TSR companies also generate more employment growth. For the five-year period ending in 2020, corporate employment data in Capital IQ shows that companies with above-median TSR grew employment by 14%, while those below median TSR shrank employment by 2%.

There is much more work to be done, but it's clear that the most valuable assets of a company are often the communities and employees that form its stakeholders. Being a value leader requires careful management of all intangibles, including relationships with stakeholders.

For the five-year period ending in 2020, corporate employment data in Capital IQ shows that COMPANIES WITH ABOVE-MEDIAN TSR GREW EMPLOYMENT BY 14%

FIGURE 7
Five-Tools Performance of High-Purpose and Low-Purpose Brands



Source: Fortuna Advisors' analysis using data from Capital IQing data from Capital IQ

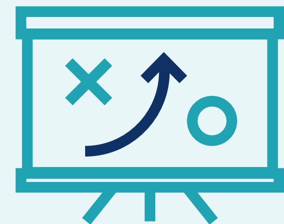
The TSR of Industries

Value leadership varied considerably by industry. Over the last five years, investment in Semiconductor companies fared far better than that in Energy companies, for example. The range of outcomes also varied with the interquartile range (the gap between the 75th percentile and 25th percentile industry performers), which was well over twice as wide in Transportation versus in Utilities, as another example. Figure 8 shows the non-financial industries ranked by median TSR with the interquartile range shown.

Innovation left its mark throughout the top performers in most industries in this study, which, again, may be related to shifting (or perhaps accelerating) trends driven by the COVID-19 pandemic. Not only were three of the top-five-performing industries pure plays on technologies, but digging into the top performers in other industries reveals the importance of capitalizing on trends such as digital platforms, ecommerce, and the cloud. In the Retailing industry, for example, Amazon, Etsy, and Wayfair were among the top performers—hardly your traditional brick and mortar companies. The same can be said for Media & Entertainment, where Netflix, Zillow, and video game publisher, Take2Games, achieved top-quartile TSR performance within the industry.

> It is not enough to decide if a business is a good business with strong growth and high returns or a bad business with weak growth and/or low returns.

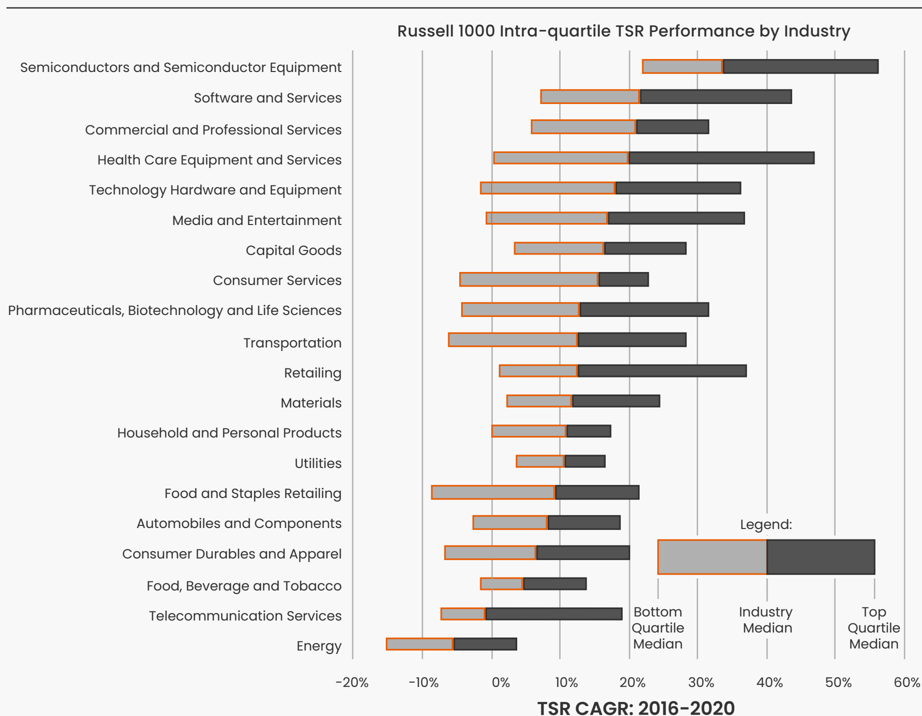
CAN VALUE BE ADDED?



Is it Time to Prune the Portfolio?

GREG MILANO, FORTUNA ADVISORS

FIGURE 8
Industry Performance and Quartile Distribution of Russell 1000 from 2016-2020



Source: Fortuna Advisors' analysis using data from Capital IQ

Semiconductors Are Top of the Heap (#1 of 20)

Fully 24 of 29 semiconductor companies achieved top-quartile TSR versus the Russell 1000—none were in the bottom quartile. And the top performer, Enphase Energy, achieved annual TSR of nearly 119%. Stunning!

The Five Tools, shown in Figure 10 below, reveal that Revenue Growth and Reinvestment Effectiveness were key drivers of high semiconductor TSR, which is consistent with most industries. But it was more pronounced for semiconductors, with top-quartile performers achieving 13% more revenue growth and *ten* times more revenue per reinvestment dollar.

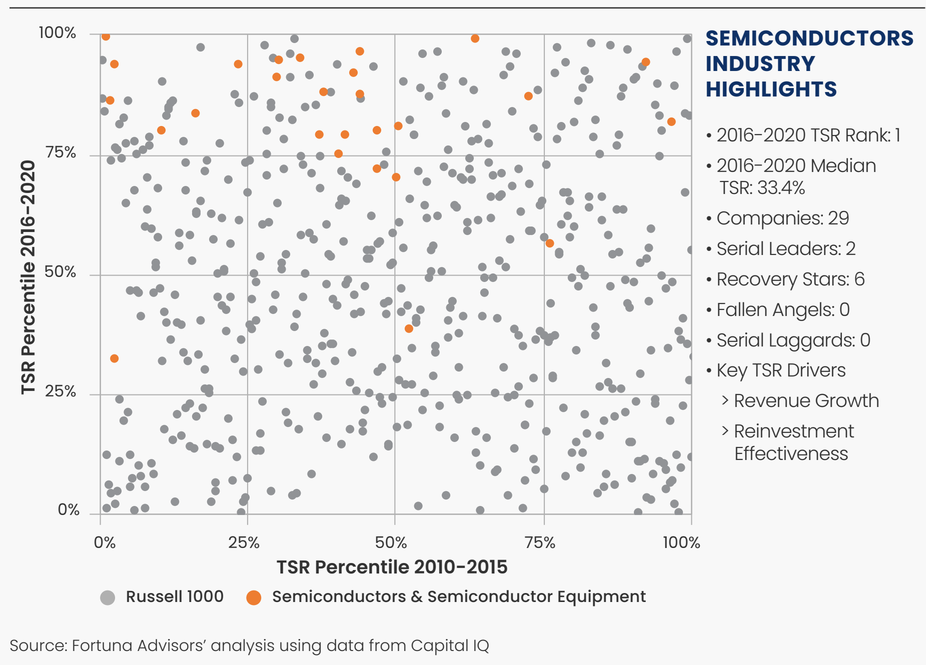
Margins had an inverse relationship, as semiconductor companies with lower margins outperformed. It may seem counterintuitive, but this is why we have *Five* Tools of Value Creation. Profitability itself provides little insight without more context on the investment and assets required to drive it.

The top-quartile companies had much lower asset intensity, and this exceptional capital productivity offsets their low margins to varying degrees.

What makes this particularly interesting is that, in 2020, NVIDIA paid $38.6 billion to acquire ARM Limited, and Advanced Micro Devices purchased Xilinx for $36.8 billion. Since acquisition accounting records any premium paid above net book value as a goodwill or intangible asset, if this acquisition trend continues, then we should start seeing Asset Intensity increase if Revenue Growth does not accelerate to overcome the expanded assets on the balance sheet.

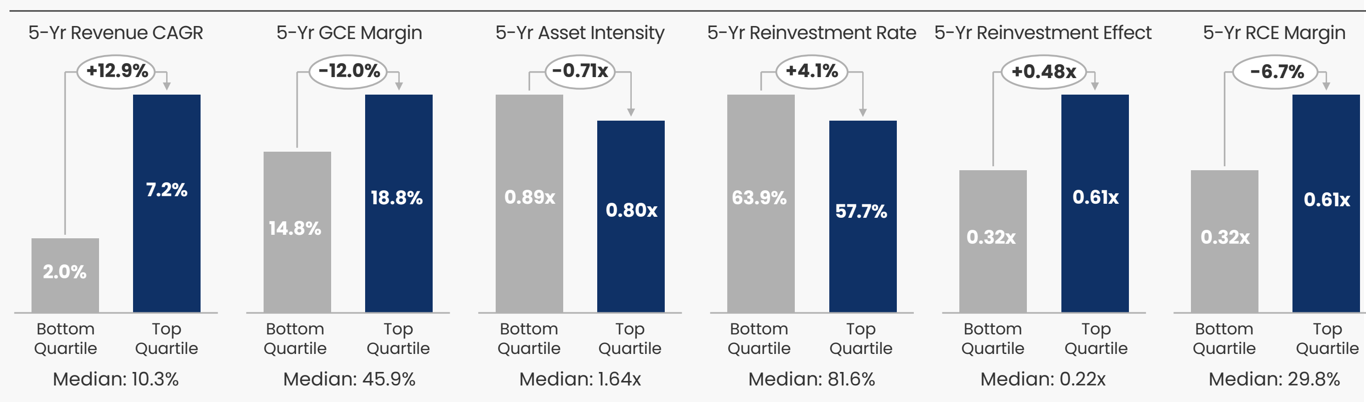
There is a difference between being a great company, and a great stock, and the semiconductor industry shows this well. When we see high margins we say, "that's a great company"; but if they delivered lower TSR, they were not "great stocks." Once a company can beat the required return on investment, as most semiconductor companies do, revenue growth and effective reinvestment are the main drivers of new value creation, and these, in turn, are fueled by innovation, especially in such a dynamic industry.

FIGURE 9
Semiconductors TSR Distribution and Highlights



Source: Fortuna Advisors' analysis using data from Capital IQ

FIGURE 10
Semiconductor Five Tools of Value Creation



Serial Leader: Is Tesla a Darling of Wall Street?

Ranked 8th in our sample, with annualized TSR of 71.2% over the five-year period, Tesla grew its market capitalization by the end of 2020 to $669 billion. Tesla's added market cap exceeded that of the other nine members of the Value Leadership top ten combined. For years, many experts have questioned Tesla's valuation, such as in 2018 when a *Car and Driver* article asked, "Why is Tesla So Loved by Wall Street?"—and went on to quote numerous skeptics.

Is it Irrational—Or Does Tesla's Performance Justify its Returns?

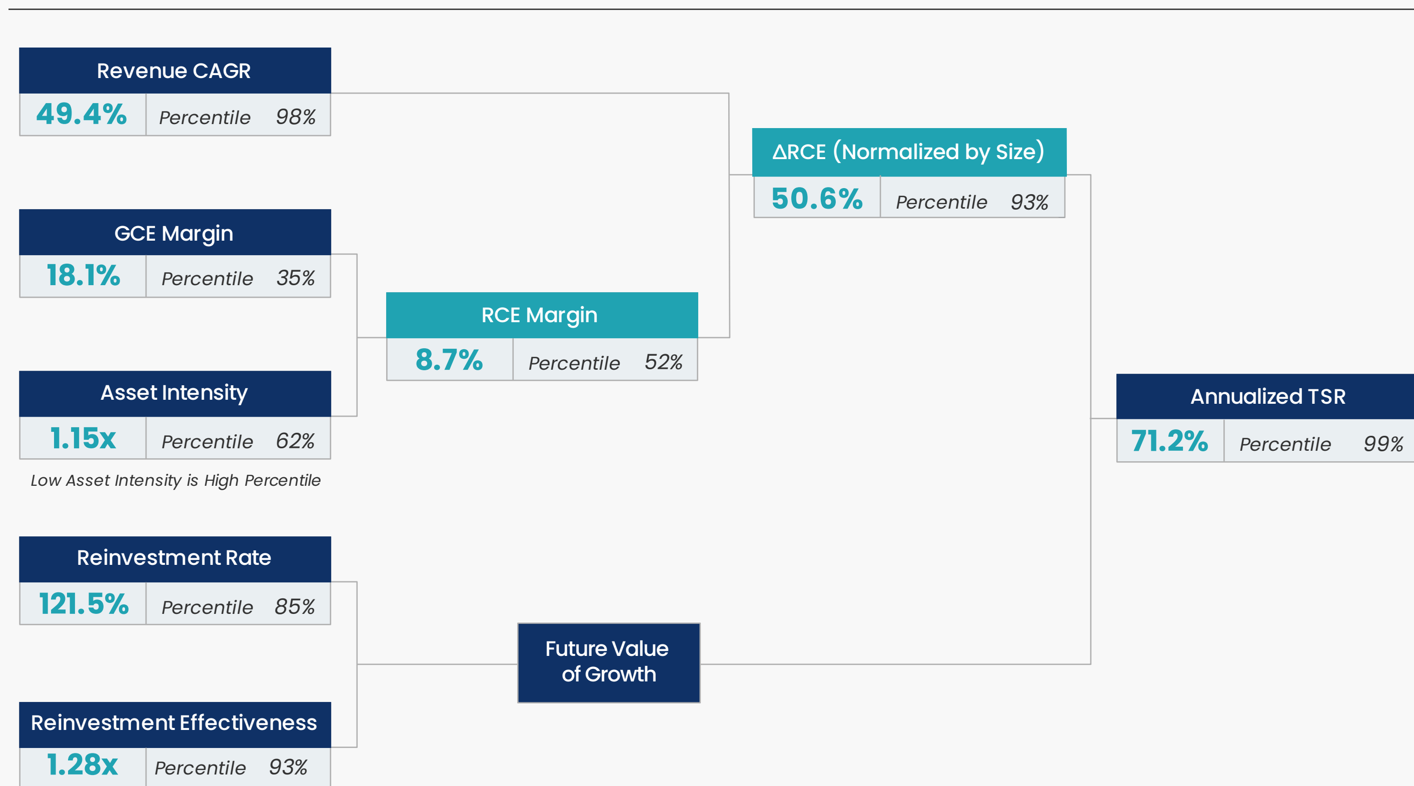
It's true, with total enterprise value at over 150 times trailing EBITDA in the fourth quarter of 2020, Tesla's valuation paints a pretty lofty future. But how did performance during the five-year period inside the company relate to the TSR outside the company? In 2017, Tesla began production of the Model 3, a low-priced, high-volume electric vehicle; and then they launched the Tesla Semi, a truck designed to save fuel costs; the Model Y, a mid-size SUV; and the Cybertruck, which Tesla claims will have better utility than a traditional truck and more performance than a sports car. It's clear they have been innovative across multiple vehicle categories, which expands their headroom in terms of the eventual number of vehicles they might sell.

But how many vehicles has Tesla been selling? They produced and delivered about 180,000 vehicles in the fourth quarter of 2020 and about 500,000 for the full year. This is only about 3% of global 2020 vehicle sales, which seems paltry; but it also shows the potential upside is huge. Versus the fourth quarter of 2015, when they sold 17,400 vehicles, the recent quarter represents a compound annual growth rate of 60%! The revenue growth rate is lower, at just under 50%, since the mix of vehicles now includes a large number of the lower-priced model 3s.

With all this great news on innovation and growth, how does Tesla look on the Five Tools of Value Creation? See Figure 11.

Overall, it's a pretty impressive profile, with the only exception being Gross Cash Earnings Margin (profitability) of 18.1%, which is only 35th percentile. But decent capital productivity lifts the RCE Margin above the median at 8.7%. For

FIGURE 11
The Five Tools of Value Creation for Tesla



Source: Fortuna Advisors' analysis using data from Capital IQ

RCE Margin comparisons, GM and Ford were at 10.8% and 9.5%, respectively. So Tesla is a bit lower, but their profitability through the RCE lens doesn't look as bad as with GAAP accounting, because RCE is cash-based and treats R&D as the investment that it is. But near-median RCE Margins don't drive top-ten TSR on their own.

The story, again, is about growth. Plenty of profitable growth. Tesla's 49.4% annualized revenue growth is 98th percentile, and this resulted from a Reinvestment Rate of 121.5%, which is 85th percentile, and Reinvestment Effectiveness of 1.28x, which is 93rd percentile. Tesla's increase in RCE over the five years was a remarkable 50% of their beginning Gross Operating Assets, which is impressive given the low accounting profits. There really are no comparisons to GM and Ford on these dimensions, since both suffered declining revenue and RCE over the period, and each had below median TSR.

Where does such performance come from? Value creation always comes from differentiation, and Tesla has plenty of it. In the past we felt we had to drive a boring car to be doing something *good* for the environment, and Tesla changed all that. No longer do we need to choose between "eco-friendly," "high performance," and "curb appeal." Tesla has them all. So, their demand is strong, and likely to stay strong for a long time.

Embedded Investor Expectations

We did some quick math to understand investor expectations. With the consensus estimates of brokerage analysts for sales and EBITDA, we estimate Tesla's 2022 RCE Margin will rise to about 18.5%. If they can hold that level, their growth rate is expected to fade down to about 18.0% by 2030. If that happens, sales at that point will be about seven times the estimate for 2021. That would be a pretty big jump in market share, but not unlike what they've been doing. In short, if innovation keeps coming, why would we expect anything else? And this analysis doesn't even consider the potential value of autonomous cars, batteries and chargers, solar panels, etc.

So why have GM and Ford been fading while Tesla is doing so well? They have electric vehicle programs now, but both companies hesitated while Tesla jumped in with both feet. When GM got around to it, they launched the Chevy VOLT, which lacked Tesla's performance and curb appeal. Now they seem to be on a better path to launch new innovative vehicles, but it's not clear how well they are executing the new plan.

Industry Disruption

This is a classic case of industry disruption. Couldn't GM have launched a line of cars just like Tesla? Sure, they could have. But, if back in 2003, someone had proposed the idea and had credible plans, would the investment have been approved? It may seem like a slam dunk, of course, in retrospect. But imagine GM's leadership, at the time, pondering a long duration of weak accounting earnings while, on top of that, cannibalizing their own existing profitable product lines.

It's not enough to invest a lot; Tesla's 49.4% annualized revenue growth is 98th percentile, and this resulted from a REINVESTMENT RATE OF 121.5%, which is 85th percentile, and REINVESTMENT EFFECTIVENESS OF 1.28X, which is 93rd percentile.

From this perspective, it's easy to see why sustaining top-quartile TSR is such a tough ask: it often requires breaking away from the status quo in a way that many large, established companies, and their management teams, find difficult. It requires a constant focus on reallocating capital, but also on how internal processes and incentives drive management behavior over the long term.

Recovery Star: FMC Corporation

The Philadelphia-based agricultural sciences company, FMC Corporation, returned a TSR of 0.5% from 2011-2015, ranking them well down in the bottom quartile. From 2016 through 2020, their TSR skyrocketed to 29.5%, fully 14.1% above the "IWB" ETF that tracks the Russell 1000.

Founded in 1883, FMC is one of America's most enduring companies, with 6,400 employees, 26 manufacturing sites, 22 R&D facilities, and operations spanning across three segments and five continents.

Effective Reinvestment

How did this storied company achieve Recovery Star status? First, as shown in Figure 12, they grew revenue over the five years through 2020 at 7.5%, outpacing almost 75% of the companies in the materials sector. In the prior five-year period through 2015, FMC grew revenue at just 1.5%. How did their Reinvestment Rate and Reinvestment Effectiveness enable this jump in Revenue Growth?

From 2011 to 2015, FMC reinvested heavily—more than 120% of their Gross Cash Earnings—placing them in the 90th percentile in terms of Reinvestment Rate for the Materials sector. But they didn't get much from it. Their Reinvestment Effectiveness for this period was a meager 0.05x, meaning they grew revenue less than $0.05 for every dollar of reinvestment. In their sector, 73% of companies were more effective with their capital deployment.

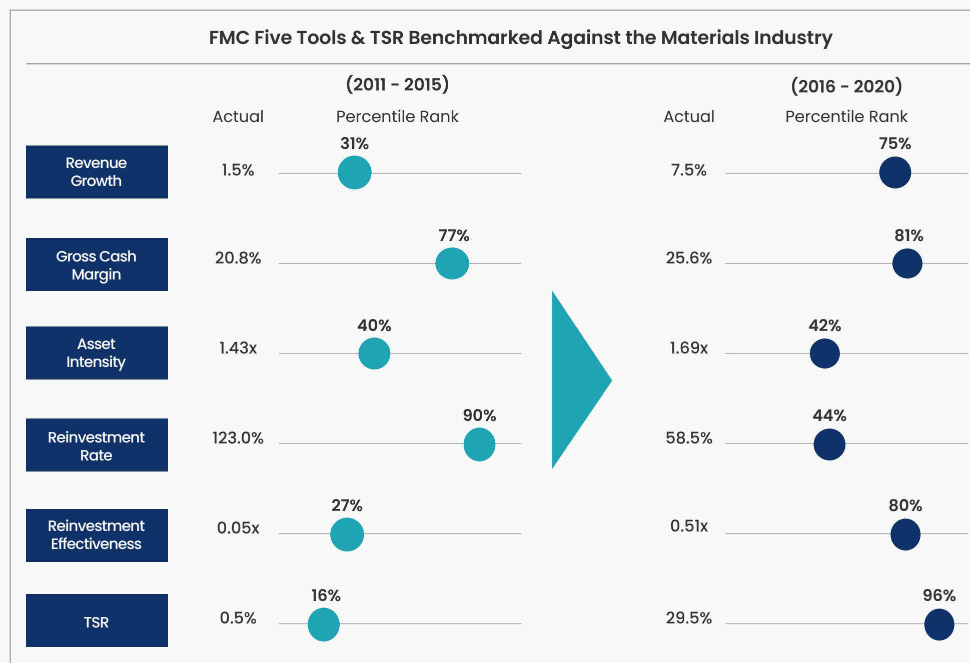
FMC Company Snapshot

Global Headquarters: Philadelphia, PA
Founded: 1883
Ticker: FMC (NYSE)
Employees: 6,400
Stock Price: $104.82
Industry: Materials/Fertilizers & Agricultural Chemicals

Market Cap: $13.6B
2020 Revenue: $4.6B
2020 EBITDA: $1.3B
CEO: Mark Douglas (2020)
CFO: Andrew Sandifer (2018)

Business Overview: FMC develops, manufactures and sells commercial agricultural chemical products focusing on crop protection, health, and yield, with operations in North and South America, Europe, the Middle East, Africa, and Asia

FIGURE 12
FMC Corporation Five Tools Analysis



Source: Fortuna Advisors' analysis using data from Capital IQ

From 2016 to 2020, FMC embarked on new strategy and invested far less … but got much more for it. Their Reinvestment Rate fell to 59% of Gross Cash Earnings (44th percentile), but their Reinvestment Effectiveness soared to 0.51x (80th percentile), *ten* times the Revenue Growth per dollar of investment versus the prior period. The recent five-year period saw $350 million less in capital expenditures and over $600 million less in cash acquisitions, but they reinvested about $550 million of this into increased R&D spending. Again, innovation is often the key to driving growth and returns.

During a recent investor call, FMC Chief Financial Officer Andrew Sandifer emphasized the importance of new products and organic growth in their market and affirmed that there were few M&A opportunities, given the recent consolidation in the industry. Mr. Sandifer also conveyed expectations that FMC will commit to spending 6-7% of sales to enable organic growth.[1] This guidance is in line with the trends we observed. From an efficiency standpoint, FMC was able to steadily improve profitability over the five years through 2020, as Gross Cash Earnings Margin improved from 20.8% to 25.6%, placing them at the 81st percentile among companies in the materials sector.

Don't Forget Working Capital

Working capital management can be an important source of capital productivity, but is often left unattended or used as a buffer to manage the P&L. From 2011 to 2015 FMC's working capital as a proportion of its Gross Operating Assets increased from 15% to 28%. After that, management reduced this balance to less than 18%, with improved working capital metrics, such as days sales outstanding (DSO) and days inventory outstanding (DIO) declining by 33% and 13% respectively from the peak in 2017 through 2020. And days payable outstanding (DPO) increased from 60 at the start of the ten-year period to a high of 127 at the end of 2020. These working capital management improvements added over $240 million of cumulative RCE from 2016 to 2020. In the eyes of long-term investors, all capital is created equal—they make little distinction between capex and lenient payment terms intended to boost short-term sales.

Portfolio Management

These improvements in Gross Cash Earnings Margin and Asset Intensity may have been as much about the changing mix of businesses in the portfolio as they were about tactical and operating decisions. In the first five years, they acquired Cheminova and Epax Norway, while selling what became PeroxyChem and Tronoix Alkali. In the more recent period, they acquired crop protection assets from DuPont and spun off Livent corp. The total value of these six deals was $9.7 billion, about $5.8 billion in acquisitions and $3.9 billion in divestitures.

Portfolio management can be an effective way to focus management on areas where they can create incremental value

WHILE EXITING BUSINESSES THAT AREN'T LIKELY TO OFFER MUCH IN TERMS OF PERFORMANCE IMPROVEMENT

Portfolio management can be an effective way to focus management on areas where they can create incremental value while exiting businesses that aren't likely to offer much in terms of performance improvement. Some of these businesses may well be great companies, but if they don't offer much potential for future value creation, the capital devoted to these businesses would be better spent growing more promising businesses in the portfolio.

1 FMC Company Conference Presentation, December 10, 2020.

Overcoming Obstacles to Long-Term Performance

The 2021 Fortuna Advisors Value Leadership Report aims to help executives and investors better understand the factors that influence TSR performance. Our goal is to inspire companies to commit to long-term value creation, and resist the temptation to sacrifice profitable investments in order to meet short-term expectations. This requires a commitment to understanding the sources of value creation, prioritizing the allocation of scarce resources to those sources, and reliably measuring value creation inside the company to drive the desired management behavior. In essence, the goal is for managements to think and act like long-term, committed owners.

Seems easy, right? The following are some of the common obstacles to better TSR performance.

- ***The team doesn't think it's possible.*** Visualizing and charting a roadmap for achievement is the first step.
- ***Lack of Aspirational Goals.*** Aiming high is unwittingly discouraged at many companies where performance is measured against plans and budgets. Such companies pay managers to plan for mediocrity, and that's what they get.
- ***Insufficient portfolio optimization.*** Companies often stay in businesses where they cannot add value and don't commit enough resources to building and growing businesses with significant untapped potential.
- ***A use it or lose it mindset*** leads to overspending because it's "in the budget." In turn, this leads to underinvestment in new attractive ideas that come up between budget cycles.
- ***Poor risk management*** leads to either excessive risk or, potentially worse, an excessive intolerance of risk that prevents experimentation and innovation.

Our goal is to inspire companies to commit to long-term value creation,

AND RESIST THE TEMPTATION TO SACRIFICE PROFITABLE INVESTMENTS

in order to meet short-term expectations. It's not enough to invest a lot;

THE INVESTMENT HAS TO LEAD TO GROWTH!

ABOUT FORTUNA ADVISORS

Fortuna Advisors collaborates with leaders to transform decision-making throughout their business to achieve exceptional results. Our management playbook delivers measurable outcomes through:

1. **BETTER INSIGHTS:** See the truth about where value is created or destroyed.
2. **BETTER DECISIONS:** Drive faster, better, and enduring results.
3. **BETTER BEHAVIORS:** Align incentives and processes to drive execution.

We serve as a catalyst to create a culture of ownership, where everyone from the board to management and employees embraces a long-term investor perspective to unlock the organization's full value creation potential.