Turn Strategic Goals into Results Using Economic Profit

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By Frank Hopson and Izabela Rak

Investors have become increasingly concerned with management teams' ability to successfully navigate the rising uncertainty of 2022. After seeing the S&P 500 Total Shareholder Return (TSR) soar 52% and net profits jump 43% in 2021, share prices have recently come under pressure.

To understand this slide in investor confidence, Fortuna Advisors studied the historical ability of non-financial S&P 500 companies to generate Returns on Invested Capital in excess of their Cost of Capital, that is, to produce positive excess returns. We found that investors' concerns aren't entirely unwarranted.

Over the last three years, 20% of observed companies generated returns on invested capital below their cost of capital. The S&P 500 includes some of the most prestigious companies in the US, so it's striking to see one out of five of its companies falling in this bucket.

Naturally, companies with stronger excess returns produce better TSR for shareholders. For example, over the last three years, companies that produced excess returns in the top quartile outperformed the bottom quartile by an annualized TSR of over 20% per year.

On median, all observed companies generated excess returns of 5% over the last three years. While the returns are positive, it's clear that the margin of safety between creating or destroying value is thin for many companies. Top-quartile companies generated excess returns of 26.2%, showing strong differentiation in their business models. While bottom-quartile companies had -1.9% excess returns, showing that even amongst the largest companies generating value can be challenging.

Delivering top-quartile TSR requires management teams to have the capability to turn strategic goals into tangible results. Successfully executing strategies in today's dynamic world requires a clear definition of value and processes for actively reallocating resources across your organization.

Value directs prioritization decisions for your resources and determines what actually gets done. Resources extend beyond cash and include your people, property and equipment, technology and brands, and relationships with outside stakeholders.

Traditionally a successful company could serve customers through a rigid business model. Today, management teams must juggle multiple strategies to effectively reach customers; however, this is where many decision frameworks fail. Management teams need a value lens that can analyze multiple business types while not inherently favoring one model over another. For example, capital light businesses are not in and of themselves better than ones requiring more assets. And targeting different customer types can require very different business models (e.g. B2C vs B2B). Value needs to be defined in a way that the pros and cons of each can be weighed equally to determine the best method of creating value.

Economic profit is designed to capture and relate the *full* value implications of investment decisions. It enhances the excess return framework by expanding beyond efficiency and factoring in growth; it is a dollar measure defined as earnings less an expense for the capital your business uses to generate its revenue. The value contributions of businesses with different margins, capital needs, and growth prospects can all be judged through this singular measure of success.

To move from planning to action, processes must be revised to align with this new value framework. Capital approval requests, the planning process, pricing term sheets and supplier agreements should all incorporate economic profit in their decision models. Processes will then naturally guide resources to the greatest value impact.

However, the imperative to drive value shouldn't be confined to the finance division. Enduring change requires people across the organization to embrace this shared vision and understand how they impact it. End-of-year results are driven by decisions made throughout the year. Therefore, to enact real change, the organization must align decision-makers incentives with its value framework.

Economic profit's comprehensive measure of value provides decision-makers with the strategic flexibility required today to meet customers' needs. Designing incentive compensation focused on improvements in economic profit creates value for the company, its employees, customers, and suppliers.

Resources are provided by the investors and customers who value an organization's products and services. Management teams then allocate these resources to create the most value for stakeholders. In today's rapidly changing world, economic profit provides management teams with the best tool to produce profitable results.

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