Fortuna Advisors LLC

MAY 2022

2022 Fortuna Advisors Value Leadership Report

Every company should strive for top-quartile TSR

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Thank you to Chris Moore, Jason Gould, Michael Chew, Michael Morris, and Izabela Rak of Fortuna Advisors for their contributions to this report.

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.
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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.

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Driving Sustained Shareholder Returns

In our second annual Fortuna Advisors Value Leadership Report, we analyze the performance of companies in the Russell 1000, excluding financials,[1] to help executives better identify insights, make decisions, and drive behaviors that unlock their companies' long-term value creation potential.

Total Shareholder Return (TSR) combines share price appreciation and dividend yield to reliably and comprehensively reflect value creation.

We evaluate value leadership in markets based on Total Shareholder Return (TSR) and, inside companies, using Fortuna's customized measure of economic profit, Residual Cash Earnings (RCE), along with other key financial measures. The findings help explain capital market trends and can aid management teams in charting their own roadmaps to top-quartile performance.

Top-quartile TSR performance over the five-year period ending February 2022[2] implied nearly a quadrupling of share price. With top-quartile companies creating $14 trillion in market capitalization versus $700 billion lost in bottom-quartile companies, this illustrates the immense value created by market outperformers—and underscores the importance of focusing capital and human resources on your very best business units.

As part of this year's report, we examine how common financial measures, which are often used to measure and incentivize performance, related to shareholder returns over the period. The insights provided are vital for managements and boards that are charged with selecting performance measures that are most likely to drive top-quartile performance.

We will also apply Fortuna's RCE and "Five Tools of Value Creation" framework to unpack the impressive performance of Thermo Fisher, which achieved top-quartile TSR in back-to-back five-year periods—no small feat!

Lastly, we highlight some of the obstacles to achieving top-quartile TSR that managements should strive to overcome.[3]

VALUE CREATION HIGHLIGHTS

1 **SIZE OF THE PRIZE**
The members of the Russell 1000 created over $19 trillion in market capitalization over the five-year period, with the top quartile accounting for nearly $14 trillion, a whopping 72% of the market gains. Top-quartile "value leaders" delivered median annual TSR of 30.1%, implying nearly a quadrupling of share price over five years.

2 **ECONOMIC PROFIT AS A VALUE CREATION LENS**
Analysis of key drivers of TSR over the period reinforce the value of economic profit (EP) in explaining market value creation. Our analysis shows Fortuna's cash-based EP measure, Residual Cash Earnings, better relates to TSR performance than commonly used measures.

3 **INDUSTRY SPOTLIGHT: RETAIL REINVENTS ITSELF**
Retailing had the second highest median annual TSR of the industries in our study, at 19.8%, and created $1.8 trillion in market cap over the period. While past reports focused on sleek technology companies, these results show that any business in any industry can outperform the market by thinking outside the box (store) about value creation.

4 **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.

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.

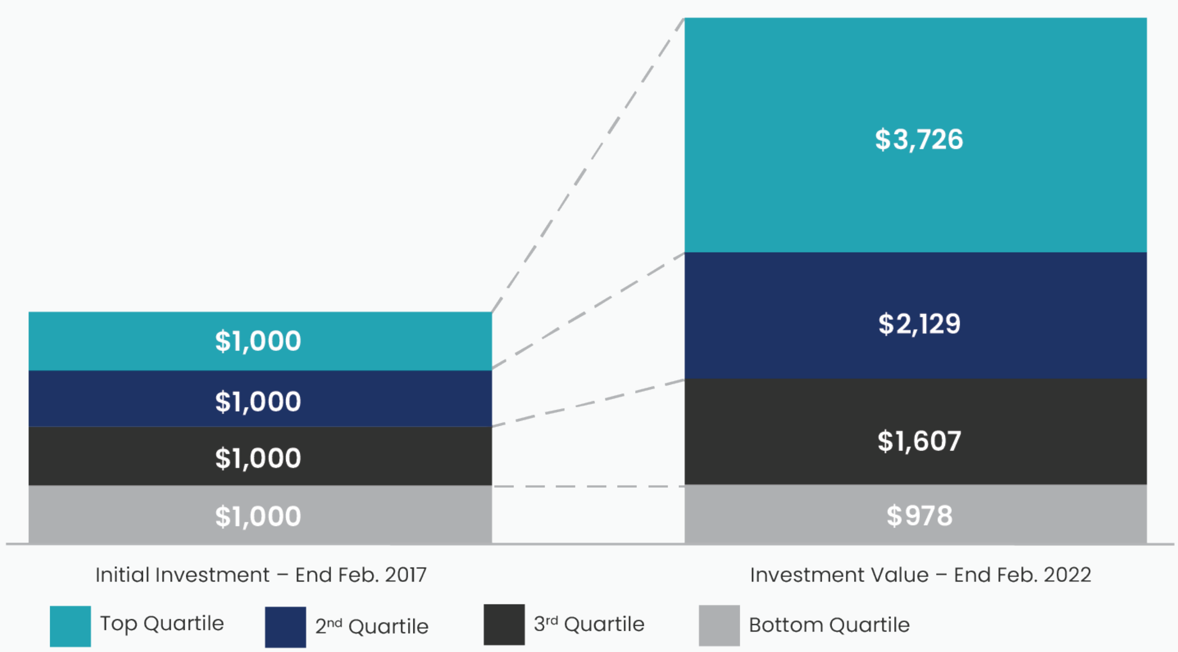
What Does it Take to Produce Top-Quartile TSR?

Achieving top-quartile TSR is easier said than done. But the results are well worth it. Over the five-year period, the median annualized TSR of the top quartile of our Russell 1000 sample was 30.1%. At this rate, a one-thousand-dollar investment would have been worth $3,726 after five years, almost quadrupling in value, as shown in Figure 1. The period studied was end of February 2017 through February 2022, in order to reflect company financial information released in early 2022 for the end of calendar year 2021.

The scatterplot in Figure 2 shows company TSR percentile rankings over successive five-year periods, with each dot representing a member of the Russell 1000. For instance, CarMax's dot, highlighted in red, is in the 48th percentile over the first period, on the horizontal axis, and in the 44th percentile over the more recent five-year period.

There is a relatively even distribution of datapoints across the chart, which is the point. Past performance is not a reliable indicator of future performance—virtually any company is capable of reaching the top quartile over the next five years. Some companies, and indeed some industries, shift due to business and economic cycles. But there is also a broader influence of market disruption where companies meaningfully gain, or lose, competitive advantage, which can profoundly influence both performance and valuation multiples, and in turn, TSR.

FIGURE 1
Five-Year Ending Value of $1000 Invested in Median of Each Quartile[4]



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 47 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 Tesla to NVIDIA. Serial leaders focus on improving year over year and constantly re-evaluate, 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 Target, Chipotle, and Deere & Co. Either by riding a wave of changing consumer and business behaviors, improved operations, or continued growth, recovery is often also accompanied by an increase in future expectations, which increases the valuation multiple.

Fallen Angels are the 31 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 for the second year in a row. Interestingly, this industry group also had the third most representation in the top quartile during the most recent five-year period. The COVID-19 pandemic certainly played a role in creating a wide dispersion for the industry.

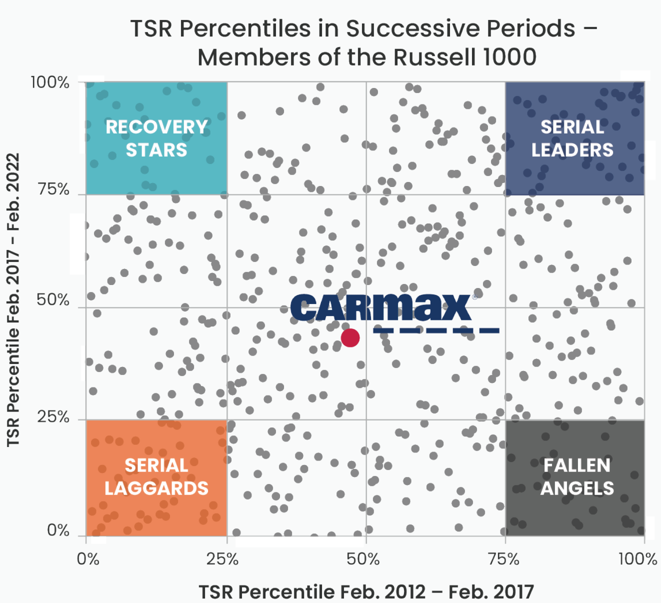
Serial Laggards are the 43 companies that generated bottom-quartile TSR over the two successive periods. The meaningful and sustained drop in commodity prices caused the energy industry to be overrepresented in this bucket.

Companies with multiple business lines 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 anticipated 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

AutoNation
Bio-Techne
Bruker
CF Industries Holdings
Chipotle Mexican Grill
Darling Ingredients
Deckers Outdoor
Deere & Company
DICK'S Sporting Goods
FMC
Fortinet
Freeport-McMoRan
FTI Consulting
GameStop
Intuitive Surgical
Lululemon
Marvell Technology
Mirati Therapeutics
Molina Healthcare
Novavax
Penn National Gaming
Plug Power
QUALCOMM
Quidel
Target
Tempur Sealy International
The Estée Lauder Companies
Williams-Sonoma
Wolfspeed
Zynga



SERIAL LEADERS

Abiomed
Adobe
Align Technology
Alnylam Pharmaceuticals
Amazon
Amedisys
Applied Materials
Axon Enterprise
Broadcom
Builders FirstSource
Chemed
Cheniere Energy
Churchill Downs
Cintas
CoStar Group
DexCom
EPAM Systems
Fair Isaac
HCA Healthcare
Horizon Therapeutics
IDEXX Laboratories
L3Harris Technologies
Lam Research
Lithia Motors
Live Nation Entertainment
Louisiana-Pacific
Lowe's Companies
Manhattan Associates
Monolithic Power Systems
Netflix
Nexstar Media Group
NVIDIA
Old Dominion Freight Line
Pool Corporation
Repligen
Take-Two Interactive Software
Tesla
Texas Pacific Land
The Sherwin-Williams Company
Thermo Fisher Scientific
TransDigm Group
Trex Company
Tyler Technologies
United Rentals
UnitedHealth Group
Visa
West Pharmaceutical Services

Residual Cash Earnings (RCE)

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**. 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 has been found to discourage long-term growth investment. To arrive at a simpler measure that 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 for accounting 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.

FIGURE 3
RCE Calculation

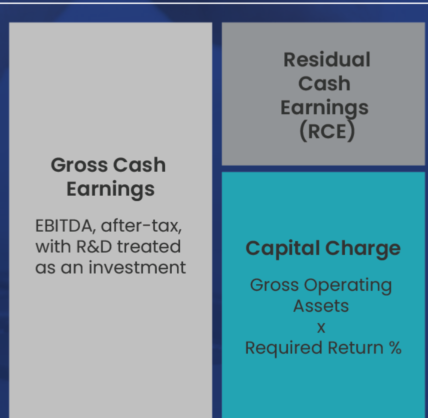
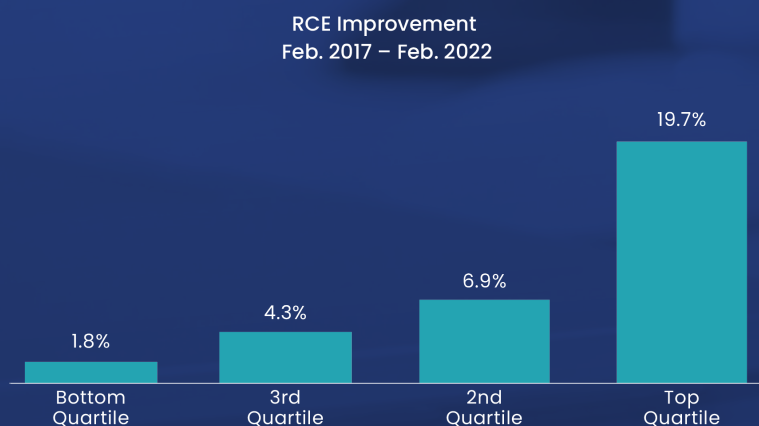


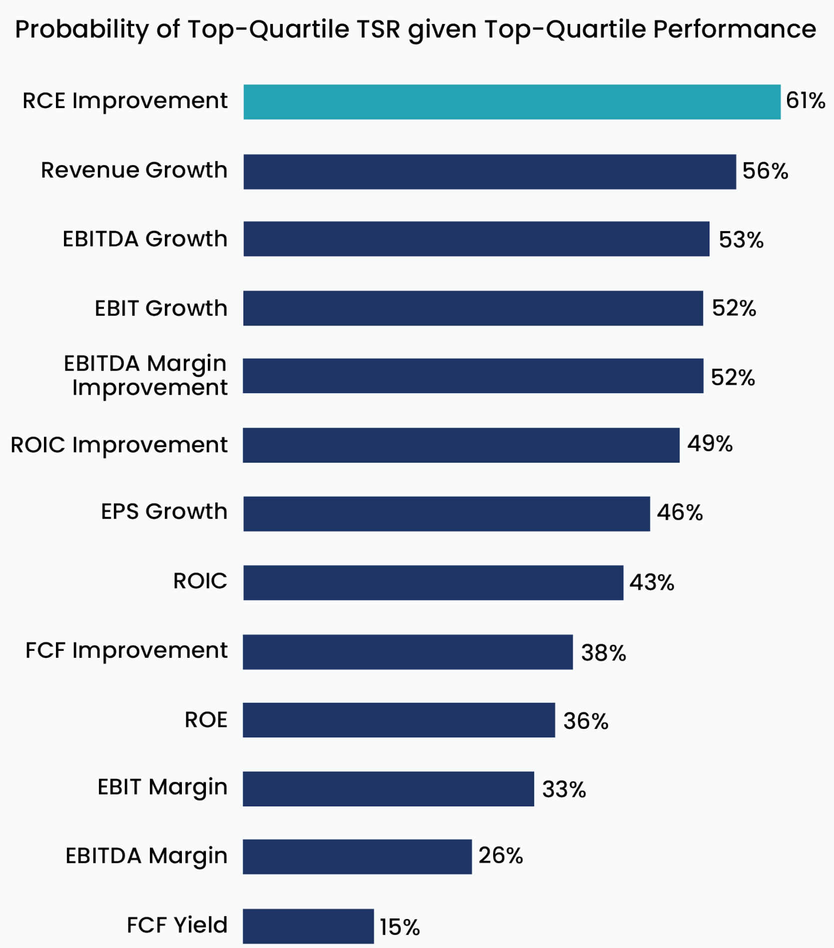
FIGURE 4
Improvement in RCE Relates to Higher TSR[5]



How Common Performance Measures Relate to TSR

Companies adopt performance measures to reward employees for creating value for shareholders. So the holy grail of performance measurement is a metric that accurately predicts market value creation, or TSR. With this in mind, we set out to analyze how the many common performance measures we see in company executive incentive plans actually relate to stock market performance.

FIGURE 5
How Performance Measures Relate to TSR[6]



Methodology

To identify the characteristics of top-quartile TSR performers from 2017 through 2022, we measured the Total Shareholder Return performance of the Russell 1000 companies in our study. We then looked at companies that performed in the top quartile in each of the studied performance measures and calculated their TSR quartile distribution to understand the likelihood of landing in each TSR quartile. We then compared the probability of top-quartile TSR given Top Quartile performance in each measure to understand which measures best explain TSR.

Results & Discussion

On the left side of the chart, we see the metrics that were the best indicators of TSR outperformance. Among these are improvement in Revenue, EBITDA, EBIT, EBITDA Margin, Return on Capital (ROIC), and Earnings Per Share (EPS)—which we might have expected. After all, these are some of the most common corporate performance measures. But the metric that most reliably predicted top-quartile TSR performance was Residual Cash Earnings (RCE)—Fortuna's customized economic profit measure.

A company that achieved top-quartile RCE improvement was 61% more likely to fall in the top quartile in terms of TSR—a full five basis points ahead of the next-best metric, Revenue Growth. The reason for this is simple: RCE is designed to comprehensively factor all aspects of performance. So, in cases where Revenue Growth increases, but overall profitability declines to the point of value destruction, RCE would have been a more reliable indicator of performance. Likewise, a company that focuses on ROIC might sacrifice so much growth that even as ROIC improves, its market value declines. And the higher ROIC goes, the higher the bar jumps for new investment, which discourages growth further.

Companies tend to have too many performance measures and fail to adequately understand how they relate to each other, and to overall value creation. To optimally run their businesses, corporate leaders should determine the measure(s) that, when improved, are most likely to drive shareholder value higher over time. When such measures are incomplete, this leads to adverse decision-making and financial outcomes. And perhaps worse, when measures conflict, this can lead to indecision and "*analysis paralysis*." As a comprehensive measure, RCE sends an incontrovertible signal on value creation.

Problems with Common Measures

We often see that metrics like ROIC and *Free Cash Flow* (FCF) stifle long-term investment, since they encourage short-term cost-cutting to key drivers of long-term value such as training, brand-building marketing, and R&D. This harms shareholders and stakeholders alike as companies underinvest and their competitive edge fades. Indeed, a company that achieved top-quartile ROIC improvement had a 49% chance of achieving top-quartile TSR, while FCF improvement indicated only a 38% likelihood of top-quartile TSR.

A company that achieved top quartile EPS growth had a 46% chance of top-quartile TSR. One drawback of EPS is that management can feel pressured to maximize EPS over short-term cycles to the extent that they forgo good investments that may pay off handsomely over time. Additionally, GAAP EPS requires R&D investments be charged as an annual expense. So unless the lion's share of the benefits of R&D are expected during the current fiscal year, which is typically not the case, this distorts EPS by making it look worse. Unfortunately, this tends to encourage R&D cutting for public companies looking to meet earnings expectations—often at the cost of future earnings.

Another problem stems from the fact that share repurchases create the appearance of earnings improvement when looking at profitability on a per share basis. So using EPS as an incentive may unintentionally encourage managements to prioritize share repurchases over investing in their businesses to build earnings power.

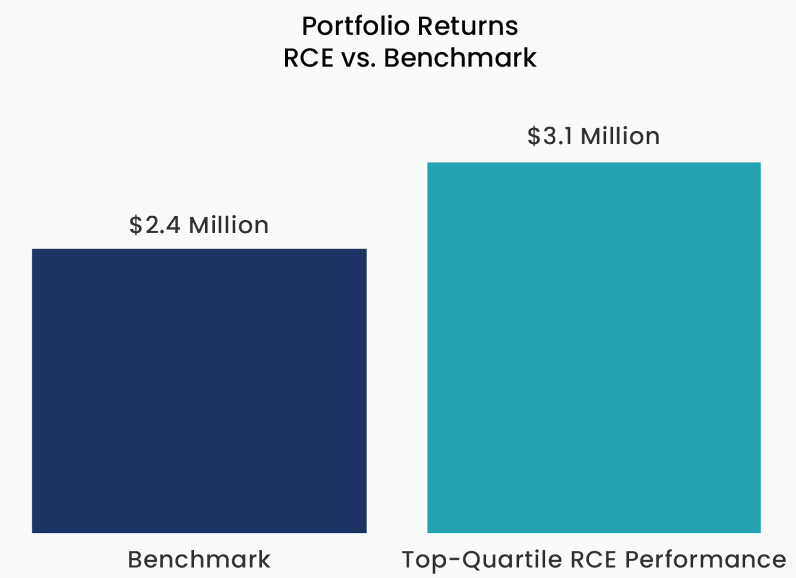
Given the many short-term pressures corporate managements face, it is not surprising that companies are concerned with maximizing results over the near term, and this can lead companies to trade off future growth to maximize current profits. In this sense, many companies would benefit from a measure that helps elucidate this tradeoff between profitability and growth. As a measure of economic profit, RCE factors growth, profitability, and capital productivity, which also ensures management is thoughtful about the opportunity costs of deploying capital to any given opportunity—and about capital allocation choices broadly.

Don't see your company's performance measure(s) on this list? Reach out and we'd be happy to take a look for you. (info@fortuna-advisors.com)

An RCE Portfolio Significantly Beat the Market

RCE is a strong predictor of TSR and can serve as a reliable value creation signal for corporate decision makers. But the measure also has important implications for investors. The below study shows that a portfolio of stocks selected based on RCE output generated an annualized alpha of 6.3% above the broader market over the five-year period ending February 2022.

FIGURE 6
Five-Year Ending Value of $1 million Invested



Methodology

The back-test was conducted on the Russell 1000 companies in our study by calculating each company's one-year improvement in RCE for the past 20 quarters (five years). Each quarter, the companies were grouped into a quartile based on their RCE performance. Corresponding quarterly TSRs were calculated for each company. The top-quartile-RCE-performance portfolio each quarter was comprised of companies that had achieved top-quartile RCE improvement over the previous twelve months.

Results

The RCE portfolio achieved an annualized return of 25.0%, which was 6.3% higher than the benchmark portfolio. If an investor had been using RCE to pick stocks, their ending portfolio increased in value by almost 50% more than if the investor held an evenly balanced position of the companies comprising our study.

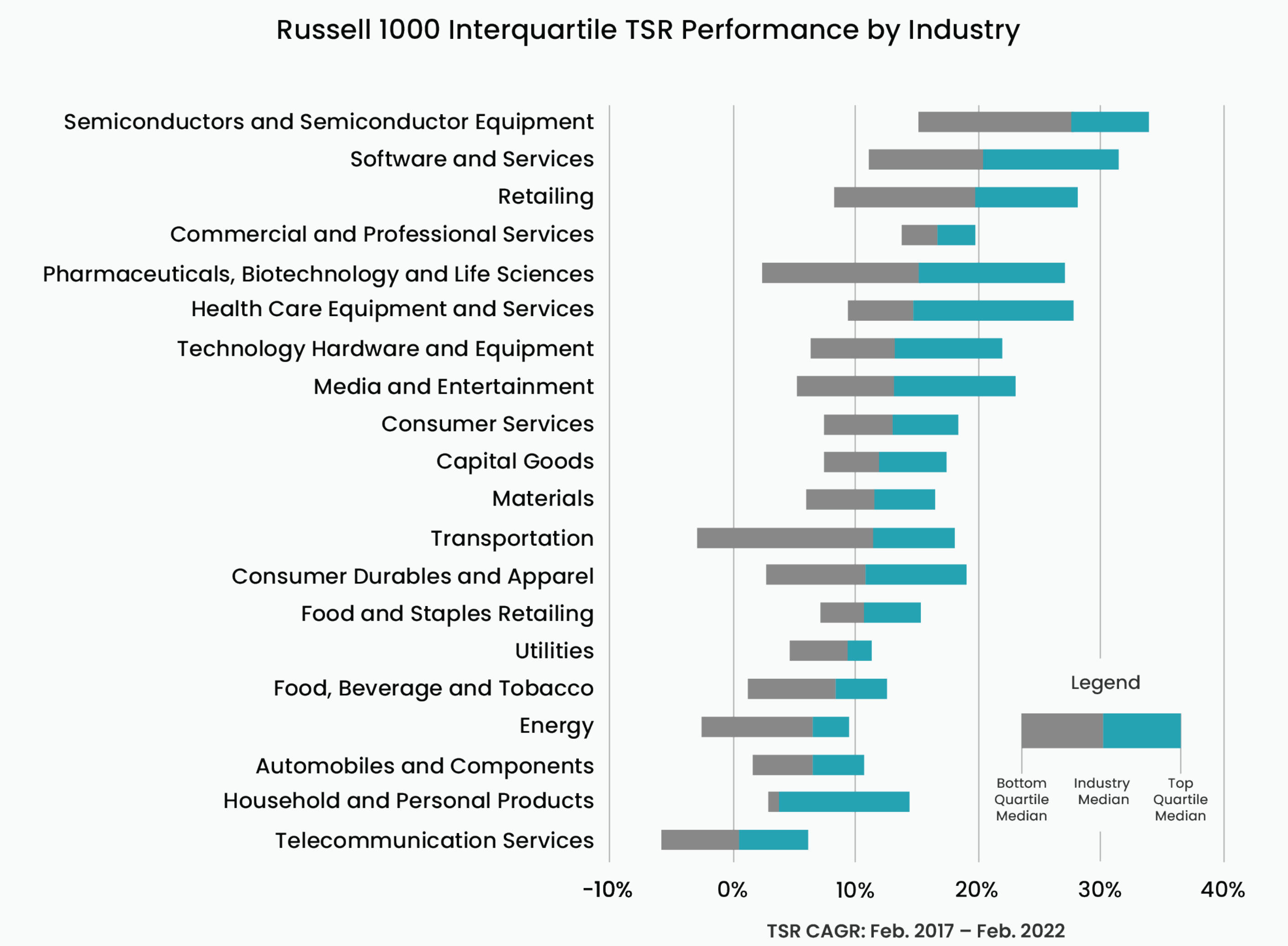
The portfolio study illustrates how RCE can be used by investors to make investment decisions—but the same concept can also be applied to managements overseeing their business portfolios. The best management teams think of resource allocation the same way investors do, except they benefit from knowing significantly more about each of their business segments' ability to generate returns. In the same way an investor can build a portfolio of investments based on RCE generation, a management team should be allocating their resources based on future RCE generation—with confidence that, if they improve their RCE, their share price is likely to follow.

The TSR of Industries

As to be expected, shareholder returns varied by industry. As in last year's report, Semiconductor companies once again led the pack. At the tail end, last year's biggest laggard, Energy, was replaced by Telecommunications, which brought up the rear in this year's report. In some industries, such as Transportation and Pharmaceuticals, Biotechnology, and Life Sciences, we see a much larger performance spread than in others, as denoted by the interquartile range (the gap between the 75th percentile and 25th percentile industry performers). This suggests that these industries had more varied performance, likely at both the subindustry and individual company level; whereas other industries like Food and Staples and Utilities showed relatively consistent performance across industry constituents. Figure 8 shows the Russell 1000 industries, excluding financials, ranked by median TSR with the interquartile range shown.

As usual, innovation left its mark throughout the top performers in most industries in this study. This is unsurprising given the shifting consumer and demand dynamics created by the pandemic and the subsequent reopening of businesses. Notably, Retailing made a strong comeback as many companies adopted a larger digital presence. See our *Industry Spotlight* for more on retail's outperformance.

FIGURE 7
Industry Performance and Quartile Distribution of Russell 1000[7] Feb. 2017 – Feb. 2022



Indeed, the strongest companies continued to leverage technological advances to generate excess returns over their competition. As evidence of this, we note that 57% of Semiconductor and Semiconductor Equipment companies in our sample achieved top-quartile TSR, along with 45% of Software and Services companies. In particular, Adobe, Amazon and NVIDIA were effective in reinvesting their capital to generate profitable growth to remain as Serial Leaders.

Pharmaceuticals, Biotechnology and Life Sciences had the largest interquartile range in our study. This was reflected by 25% and 45% of companies falling into the bottom and top quartiles, respectively. This is not unexpected given the volatility of the industry and long R&D lifecycle. As mentioned above, Transportation was also notable for its large interquartile range, likely driven by differences in subindustries and modes of transport.

On the opposite end of the spectrum, we saw stable industries like Food and Staples Retailing, Consumer Services, Capital Goods, Materials, and Utilities with less than half the internal quartile range of the Pharmaceuticals industry. Interestingly, Commercial and Professional Services fell into this group as well, which includes companies like Booz Allen Hamilton, Equifax, LegalZoom, Clean Harbors, and Waste Management. The industry performed well, despite the pandemic, with the third highest median TSR.

The Energy and Food, Beverage, and Tobacco industries were among the worst performing industries in our study that contained at least 25 companies. Cheniere Energy and Texas Pacific Land Corporation (TPL) were the only two Energy companies to achieve top-quartile TSR over the past five years. TPL's TSR performance has been remarkable, given the performance of other Oil & Gas companies over the past five years. TPL has been around since 1888, and following the bankruptcy of Texas and Pacific Railway, it operates by receiving royalties on oil & gas extraction from the land it leases in Texas, including in the Permian Basin. So it appears this unique business model enabled investors to value the company's ability to capture the upside of the market without facing much downside risk, given it has no need to invest capital to generate income.

Industry Spotlight: Retailers Thinking Outside the Box Store

An unexpected bright spot that emerged over the last few years has been the performance of the Retail industry. Retailing had the second highest median annual TSR of the industries in our study, at 19.8%, and created a whopping $1.8 trillion in market cap over the period. In part, retail's reinvention was driven by the rapid adoption and rollout of digital platforms, and tailwinds relating to increasing demand for household goods and products.

Among the top performers was Lithia Motors, an automotive retailer that offers new and used vehicles, as well as a host of related services. The company was highly successful in acquiring new customers through its e-commerce presence, which enabled substantial market share gains without meaningful new capital expenditure. Other notable retail performers include the likes of e-commerce juggernauts like Amazon, Etsy, Target, and Wayfair.

Retail's outperformance is significant, given that it is not historically an industry that has delivered excess market returns. But the industry's transformation should be a signal to companies everywhere that even the most discounted industries and companies are capable of top-quartile performance. While the industry clearly benefitted from COVID-related tailwinds, it is still remarkable what can be accomplished when managements think outside the box, and adopt new paradigms for producing shareholder returns.

Serial Leader Spotlight: Thermo Fisher Scientific—Pandemic Darling, or Intrinsic Value Juggernaut?

New to the Serial Leader field this year is the healthcare tools and services giant, Thermo Fisher Scientific (NYSE: TMO). Over the past five years, Thermo Fisher produced an annualized TSR of 28.4%—a rate that would have turned a $1,000 investment into almost $3,500 over the period. Thermo Fisher created an excess return over 16% above the median TSR of companies in this study.

Headquartered in the bio-pharmaceutical hub of Waltham, MA, Thermo Fisher offers advanced technology products and services to the health care industry. The company operates in four segments: Life Sciences Solutions, Analytical Instruments, Specialty Diagnostics, Laboratory Products, and Biopharma Services. Thermo Fisher has been one of the major contributors to, and beneficiaries of, the COVID-19 vaccine development, as their products and services have been critical in supporting the entire value chain of this endeavor. By the company's own estimates, revenue related to the COVID-19 response has totaled $13 billion in the last two years.

Breaking down Thermo Fisher's performance into what we call the "*Five Tools of Value Creation*" offers a glimpse into how the company was able to achieve such spectacular results. To understand what these metrics measure, and how to calculate them, refer to Figure 8.

FIGURE 8
Five Tools of Value Creation

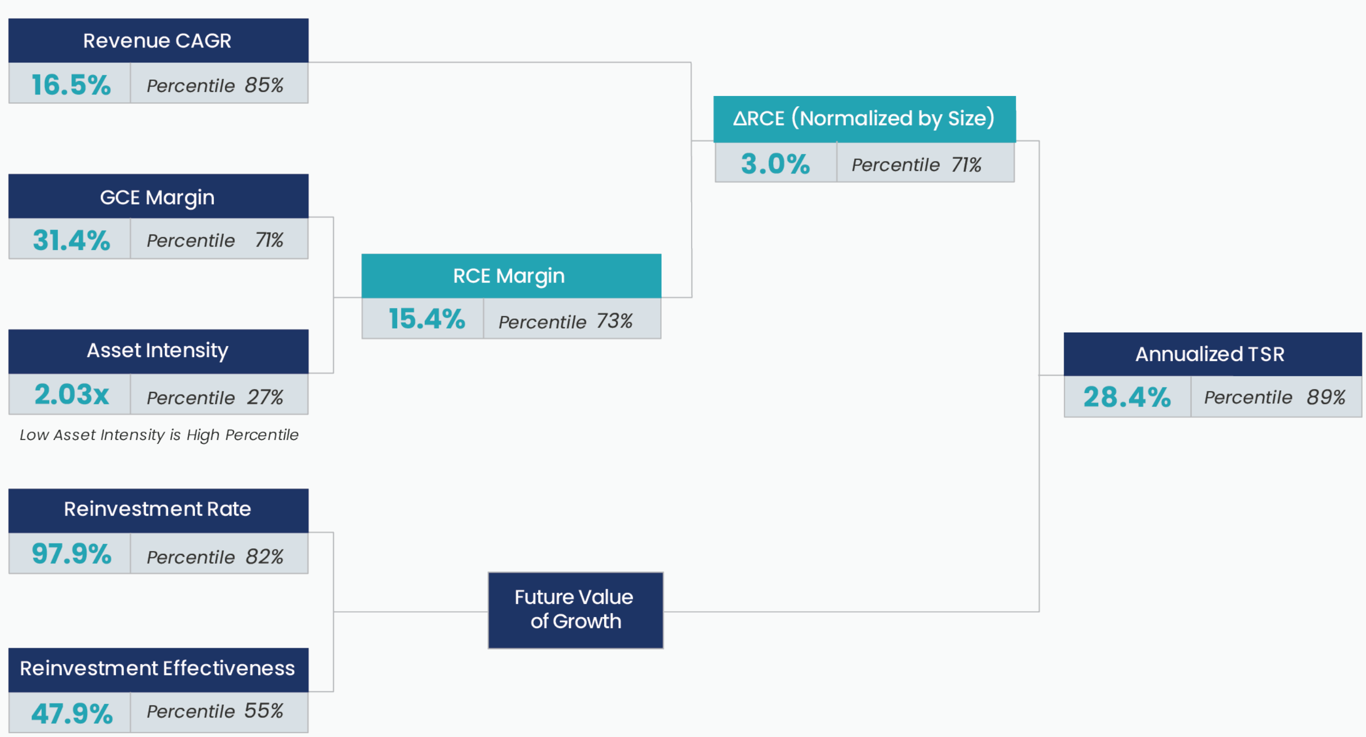
		MEASURE	DESCRIPTION	CALCULATION
Current Performance	Growth	Revenue Growth	Reflects a company's ability to grow, as measured by the percentage change in sales over a specified period.	Revenue Compound Annual Growth Rate (CAGR)
Current Performance	Profitability & Efficiency	Gross Cash Earnings Margin	An 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

Over the last five years, the company achieved an annualized rate of almost 17% **Revenue Growth**—with the bulk of this growth occurring in the last two years. Additionally, Thermo Fisher is quite active from an M&A perspective, and much of their growth in 2021 was related to the $22 billion acquisition of the drug services company, PPD, Inc. Over the same period, they also continuously improved profitability, with their **Gross Cash Earnings Margin** expanding by 5.3% since 2017, making each dollar of revenue over 20% more impactful to their bottom line. Thermo Fisher's average Gross Cash Earnings Margin over the last five years was 31.4%, putting them in the 71st percentile among companies in this study.

With an **Asset Intensity** of 2.03x, Thermo Fisher is fairly capital-intensive, falling in the 27th percentile on this metric versus the study sample. Since a higher asset base results in a higher *capital charge*,[8] high asset intensity raises the bar for value creation. But we want to highlight two important points about Thermo Fisher's Asset Intensity. First, they are highly profitable and can absorb a higher capital charge than most companies. Second, their Asset Intensity declined by 10% over the last five years, even with the aforementioned acquisition of PPD. So they have demonstrated a track record for consistently converting investment into incremental revenue and profit.

This is a good segue into the last two levers of value creation—Reinvestment Rate and Reinvestment Effectiveness. We define Reinvestment Rate as the percentage of Gross Cash Earnings a company chooses to reinvest in the business. Many readers may be in the practice of looking at capex and R&D as a percentage of sales. The reason we look at this differently

FIGURE 9
Thermo Fisher's Five Tools of Value Creation[9]



is simple—a large portion of sales (COGS, SG&A) is not available for reinvestment, but most of a company's Gross Cash Earnings is. So the proportion of Gross Cash Earnings is a better representation of a firm's rate of investment, and also normalizes for varying levels of profitability.

Thermo Fisher's financial statements indicate a lofty **Reinvestment Rate** of 98% of Gross Cash Earnings (82nd percentile). Their average Reinvestment Rate over the last five years, however, is inflated by their 2021 acquisition of PPD, which accounts for 44% of their total reinvestment over this period. When we focus on organic reinvestment (Capex, R&D, working capital), Thermo Fisher has held their reinvestment quite stable at around 35% of Gross Cash Earnings. But we don't want to lessen the importance of this transaction—quite the opposite. Successful M&A can be a critical component of value creation, and can be one of the biggest levers of value creation as companies grow.

Reinvestment Rate requires a companion measure, Reinvestment Effectiveness, to fully make sense of a company's reinvestment profile. Thermo Fisher's **Reinvestment Effectiveness** over the last five years was 0.48x—meaning every dollar of reinvestment produced $0.48 of incremental revenue, placing them in the 55th percentile on this metric. In isolation, this performance is not stellar, but with their strong profitability one can see how their reinvestment has created substantial value.

Overall, Thermo Fisher's performance was a portrait of sustained value creation, which is not an easy feat over multiple business cycles. Their success is a testament to management's ability to continually seek out new sources of growth and performance improvement, whether through organic or acquisitive growth, or through continued efforts at improving profitability. Thermo Fisher most certainly benefited from tailwinds in their customer base that were related to the COVID-19 response. But their track record for M&A integration indicates there could be more runway, especially if PPD's lower margins converge to TMO's—as has been the case with their previous acquisitions. Additionally, if the COVID-19 vaccine marks the infancy of an mRNA revolution, few companies are better positioned to ride this tide. Congrats to the Thermo Fisher team, and to all of their stakeholders, for the repeat top-quartile performance!

Overcoming Obstacles to Sustained Value Creation

The 2022 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. The following are some of the common obstacles to TSR outperformance facing company managements.

- ***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.*** Many managements overspend because it's "in the budget." In turn, this can lead to underinvestment in new attractive ideas that arise between budget cycles.
- ***Risk aversion.*** Company culture matters. Excessive risk intolerance can prevent experimentation and innovation, which harms long-term competitiveness.
- ***Misguided incentives.*** Using too many, or incomplete, performance measures means constant negotiation of budget targets. Worse, it often leads to suboptimal investment decisions.

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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.

CONTACT US

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NOTES

[1] Some of the measures we use, such as EBITDA and Residual Cash Earnings, are not suitable for financials companies, where interest cost is thought of as a cost of goods sold and funding debt is generally not considered to be part of long-term capital.

[2] The period studied was end of February 2017 through February 2022. The reason for this was to reflect company financial information released in early 2022 for the end of calendar year 2021.

[3] All analyses performed in this report use data from Capital IQ.

[4] Analysis excludes Banks, Diversified Financials, Insurance, & Real Estate Industries

[5] Note: RCE improvement is normalized by size, by calculating the change in RCE divided by Gross Operating Assets at the beginning of the period.

[6] Note: Fortuna Advisors analysis using data from Capital IQ. FCF Improvement is calculated as change in FCF divided by sales to normalize the metric for size. RCE improvement is normalized by size, by calculating the change in RCE divided by Gross Operating Assets at the beginning of the period. Growth measures are calculated as CAGRs over the five-year period. EPS Growth is calculated according to GAAP methodology. ROIC is calculated as NOPAT/Net Invested Capital.

[7] Analysis excludes Banks, Diversified Financials, Insurance, & Real Estate Industries

[8] Capital charge refers to the cost of capital (required return) multiplied by a company's operating asset base. See section on *Residual Cash Earnings* (RCE) for more detail.