For Good Measure: Assessing Financial Performance

By Gregory Milano

For a financial performance measure to be good, it should generally rise when good things happen and decline when bad things happen. And it should motivate high-quality decision-making. This may seem obvious, yet many common measures fail this basic test.

The main problem is that many performance measures are incomplete, designed to capture only one aspect of performance, so companies often pair incomplete measures with other incomplete measures. But even these combinations have gaps, so a third, fourth or even fifth metric is piled on. Many companies, for example, measure revenue growth, EBITDA margin and free cash flow, among others.

Unsurprisingly, this complicates decision-making. After all, there is really no way to balance these different signals. What if revenue growth increases, but EBITDA margin declines? This could be good or bad. So, such scorecards with overlapping, and often conflicting, measures lead to "analysis paralysis," an unfortunate, but all-too-common, corporate phenomenon where decisions are repeatedly deferred.

Consider the development of better performance measures as an evolution. Most companies, decades ago, focused on top-line growth, and this seemed good, because revenue growth is an important driver of success.

But if we were to only reward managements for revenue growth, it's easy to see how things might run amuck, with managers pursuing growth for growth's sake. They would chase all sales, regardless of cost, eroding profitability and dragging the business down.

To counter this, companies might switch to a margin measure, such as EBITDA margin: earnings before interest, taxes, depreciation and amortization, as a percent of sales. But this can lead to unintended consequences. With management laser-focused on expanding margins, they turn down all but the most profitable sales and projects, while aggressively rooting out "unnecessary" costs. This might be good for a while, but as margins expand, it becomes increasingly tough to clear this ever-rising hurdle rate. Top-line growth tends to stall.

The logical next step is to measure EBITDA in dollars rather than as a percent of sales. This way, as margins rise, there is no disincentive to pursue sales with decent margins. The EBITDA margin may decline but the dollars of EBITDA would increase.

Seems great, but what if two equivalent customer sales had very different investment requirements? Maybe one customer is willing to take ownership when the product leaves your facility, but the other wants you to warehouse it until they sell it to their customer. EBITDA ignores the amount of investment required. But, of course, the opportunity cost of capital matters for investors, so it should matter for management too.

One way to deal with this situation is to treat investments the same way we treat costs, which on the surface makes perfect sense. The measure that captures cash inflows less outflows is free cash flow (FCF), which is used to determine net present value in discounted cash flow valuation.

It's tempting to stop here and say FCF satisfies our needs, since it includes growth, margin and investment. Unfortunately, I've found FCF discourages new investment, since any new capital expenditure that does not pay back 100% by year end will reduce annual FCF.

I have encountered pushback when challenging the merits of FCF as a period measure. But consider Walmart from 1981 through 1996, when their FCF was negative in all but one year. According to my calculations based on Capital IQ data, they generated plenty of cash but invested all of it and more in growing their store count, which increased revenue over 50 fold. Despite negative FCF, total shareholder return was more than 4,500% over the period.

Another common measure is return on invested capital (ROIC), which is profit divided by capital employed. Return measures have many virtues, but, as with margins, they discourage growth, especially for businesses that already have a high rate of return.

About 30 years ago, economic profit measures, such as EVA (economic value added), became more widespread as a way of linking performance and pay to value. EVA is simply net operating profit after taxes (NOPAT) less a capital charge based on the amount of capital used in the business, multiplied by the weighted average cost of capital.

Unfortunately, EVA is complicated in practice since there are many adjustments to accounting. This makes it tough to understand and use, even for the financially sophisticated. What's worse, EVA tends to decline with new investment, and rises as assets depreciate away. As with margin measures and FCF, this discourages investment.

With all of this in mind, my firm developed a cash-based economic profit measure known as residual cash earnings, or RCE. To calculate RCE, begin with the gross cash earnings, then subtract the required return times the gross operating assets.

Assets are not depreciated in RCE, so they have the same cost when they are new as when they are old. This means that RCE better encourages new investment, since managers don't get a windfall from letting assets depreciate away. On the other hand, it also holds them accountable for earning an adequate return on the investment over time, so there's no incentive to chase unprofitable growth. On top of this, I showed in a research paper that improvements in RCE relate to share price appreciation better than changes in EVA in every industry.

To get started using RCE, begin by calculating it for your company and your peers, and identify where there are strengths or weaknesses. Then begin using it to evaluate decisions, such as pricing, equipment purchases and innovation projects. Finally, use RCE to track performance and consider embedding it in your incentive compensation program.

Because of the strong linkage to value creation and company share price, I've found there is a tremendous benefit to implementing RCE as the centerpiece of business management. Use it to drive planning and goal setting, capital allocation, and, of course, performance measurement and incentive compensation. It fuels a mindset where managers think and act like owners by treating the resources of the organization as their own—leading to better insights, decisions and behaviors.

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