Rethinking the Value of 3 Common Financial Metrics

Most companies use too many incomplete measures and would benefit from using one complete measure instead, as railroading company CSX has implemented.

By Gregory Milano

At a recent financial training session for railroading company CSX Corporation, CFO Sean Pelkey asked his teammates to list what they considered to be the three most important financial measures. The purpose was to consider both the merits and shortcomings of each measure and ultimately examine how they may lead to suboptimal decision-making.

Pelkey used this exercise to introduce CSX's new financial measure, CSX Cash Earnings (CCE). As the company wrote in its March 2022 proxy filing with the SEC, "The transition to CCE is designed to measure whether returns on new investments exceed an expected rate of return and to encourage investments in growth projects. Based on back-testing of historical data, CCE has shown a high correlation to stock price appreciation."

In simple terms, CCE is a cash-based economic profit measure that starts with operating income, adds depreciation, and subtracts taxes. The result is what we call gross cash earnings, a pre-tax, adjusted version of EBITDA (earnings before interest, taxes, and depreciation), from which a capital charge is subtracted for the use of the assets invested in the business. The capital charge is determined by multiplying the average amount of gross operating assets by the required return on capital, which is an estimate of the aggregate return expected by investors and lenders.

How To Improve Cash Earnings

There are three straightforward ways the company can improve CCE. The first, improve cost efficiency and capital productivity, which have fueled substantial success at CSX in recent years. Second, eliminate unneeded assets to free up capital that can be reallocated to more productive activities, which, again, has been a core competency. Third, invest in new activities that exceed the required return on the capital invested in them. Using this new measure, CCE is helping CSX achieve more growth, without losing its focus on cost efficiency and capital productivity.

Back to the session — 15 measures were listed by the 30 CSX attendees. One by one, Pelkey explained the merits and shortcomings of each. The top metric was free cash flow — unsurprisingly since it had featured in CSX's long-term incentive plan as a way to drive capital discipline in recent years. Free cash flow is a term originally coined in the 1970s by my former partner, Joel Stern. Although the measure has had many definitions applied to it over the years, the original was simply cash in, less cash out, excluding all flows related to financing activities. Stern used to describe it as the cash that is freely available to the debt and equity providers of capital.

When business students take courses in corporate finance, they learn about the so-called discounted cash flow valuation model, which holds that the value of a company is the present value of its expected future free cash flow. We don't need to understand all the math to see that free cash flow would seem to be a pretty darn important performance measure if it is directly linked to the value of the organization.

Yet, as Pelkey pointed out to his colleagues, free cash flow had been a suitable performance measure when the main focus was cost efficiency and capital productivity but would not be as helpful with the increased focus on growth. In fact, free cash flow can be an obstacle to growth since new investments detract from the measure in all cases except when return on investment exceeds 100% in the first year — a high bar. So, while free cash flow is helpful as a period performance measure, a company is unlikely to achieve meaningful growth by maximizing each year's free cash flow. Too many good investments will be turned down.

The second most mentioned measure was revenue growth, which was expected since CSX is seeking to boost growth. And growth is highly important — indeed our 2022 Fortuna Advisors Value Leadership Report showed a strong relationship between revenue growth and share price performance.

But as Pelkey pointed out, growth for growth's sake is counterproductive. And as with free cash flow, one must consider the unintended consequences of incomplete measurement. The stock market is littered with companies that went all-in on growth and lost control of costs, in the end harming their shareholders and other stakeholders alike. CSX is determined to maintain discipline while they grow, maintaining cost efficiency and capital productivity. They realize this approach may slow the pace of growth, but it also reduces the chances of value-destroying investments.

The next metrics were operating ratio and operating income. Operating ratio is measured as cost as a percent of revenue and has been an important driver of success across the railroad industry. And while it drives focus on cost efficiency, it does not factor in growth. Operating income, on the other hand, captures revenue less operating cost, which can benefit from growth, but the metric still ignores the amount of investment needed to produce the income.

Clarifying Decisions and Tradeoffs

At the end of the session, it was easy for the trainees to see how CCE, which combines and balances traditional, one-dimensional measures, would clarify decisions and tradeoffs. For CSX, a measure that strikes a smart balance of growth and efficiency provides greater clarity and conviction in corporate decision-making. And it is helping CSX align the many functions of the organization on a comprehensive metric, supporting the company's efforts to encourage employees to act for the good of the company, often by thinking like investors themselves.

Over the last three decades, I have seen companies quickly transitioning from a heavy emphasis on efficiency and productivity to a growth mindset, and they often lose discipline and earn inadequate returns on investments. Transitioning does not have to be a choice between efficiency or growth. We can have both, and I commend CSX for implementing a solution that encourages growth investments, but only when they earn an adequate return.

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