Fortuna Advisors LLC

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2023 Fortuna Advisors Value Leadership Report

Every company should strive for top-quartile TSR

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Thank you to Chris Moore, Michael Chew, and Brian Harte 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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Driving Sustained Shareholder Returns

In our third annual Fortuna Advisors Value Leadership Report, we analyze the financial and share price performance of companies in the S&P 900, excluding financials and real estate,[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 reflect shareholder value creation.

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

To be in the top-quartile on TSR performance over the five years ending in 2022 required nearly tripling your share price. The gap between top-quartile companies, which increased market capitalization by **$7.2 trillion**, and bottom-quartile companies, which lost **$1.6 trillion**, illustrates the immense value created by market outperformers—and underscores the importance of individual companies focusing capital and human resources on their very best businesses.

As in last year's report, we examine how common financial measures, which are often used to measure and incentivize management, 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 motivate strong performance.

Lastly, we highlight some of the obstacles to achieving top-quartile TSR that managements should strive to overcome.[2]

VALUE CREATION HIGHLIGHTS

1 INVESTORS REWARD ASSET PRODUCTIVITY

While revenue growth has been handsomely rewarded in recent years, we observed a significant shift to industries that are asset-efficient, which was likely fueled by rising inflation and interest rates in 2022. Retailing was a prime example of an industry that benefitted from this trend, with TSR 7.2% above the sample median over the five-year period. *Read more.*

2 SHIFTS IN INDUSTRY RETURNS

The recently lagging Energy sector took off in 2022 as commodity prices soared due to geopolitical and other pressures, and "defensive" industries such as Utilities and Food & Staples Retailing gained investor favor; meanwhile Software & Services, Media & Entertainment, and other high-growth industries dropped as pandemic trends began to unwind. *Read more.*

3 THE IMPORTANCE OF STRONG BRANDS, DIFFERENTIATION, AND STRATEGIC RESOURCE ALLOCATION IN INFLATIONARY ENVIRONMENTS

Those with strong differentiation were able to set prices in 2022 that kept up with inflation while others faced margin compression. Those with effective *strategic resource allocation,* emphasized growth in more differentiated areas. *Read more.*

4 ECONOMIC PROFIT PROXIES SHAREHOLDER RETURNS

For the third straight year, Fortuna's unique measure of Economic Profit, Residual Cash Earnings (RCE), tracked TSR better than other performance measures, including EBITDA, EPS, ROIC, and revenue growth. *Read more.*

5 PAST PERFORMANCE IS NO GUARANTEE

Value leaders in the prior five years were as likely to be top or bottom quartile in the recent period. Winners cannot rest on their laurels, and underperformers should never count themselves out. *Read more.*

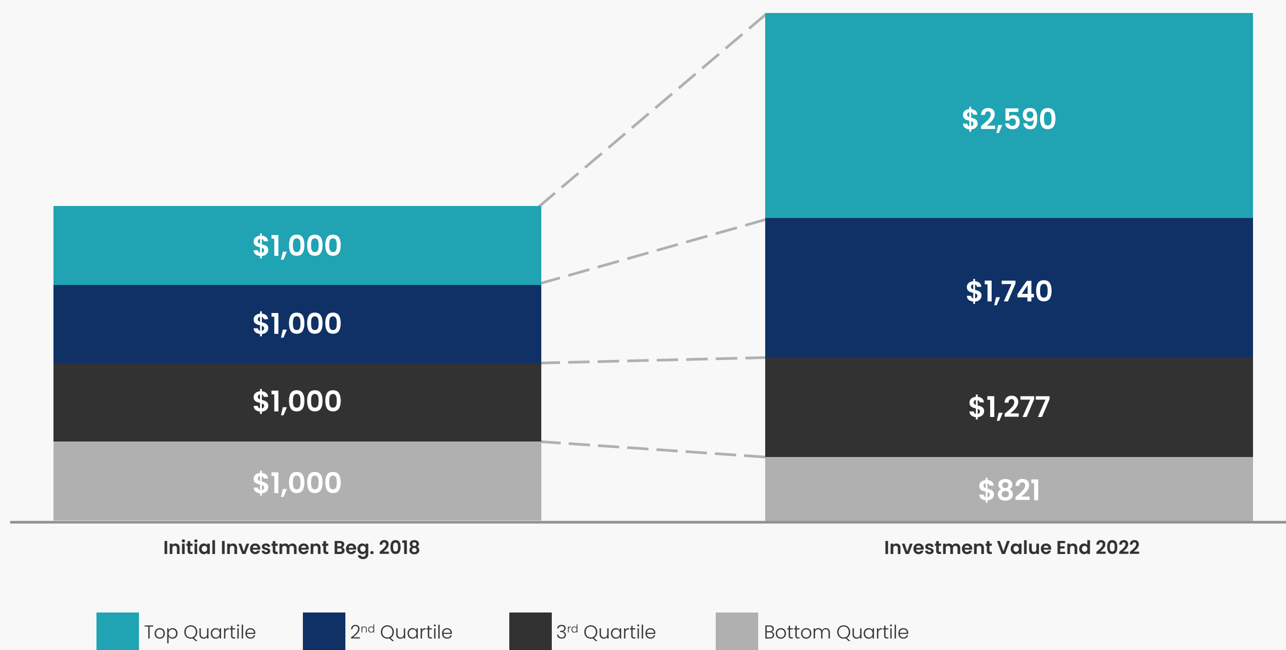
What Does it Take to Produce Top-Quartile TSR?

Achieving top-quartile TSR is by definition no easy task. But the rewards are well worth the effort. Over the five-year period ending in 2022, the median annualized TSR of the top quartile of our sample was 21.0%. At this rate, a one-thousand-dollar investment would have been worth $2,590 after five years, almost tripling in value, as shown in *Figure 1*.

The scatterplot in *Figure 2* shows company TSR percentile rankings over successive five-year periods, with each dot representing a company in the sample. For instance, Advanced Micro Devices is in the 90th percentile over the first period, on the horizontal axis, and in the 99th percentile over the more recent five-year period.

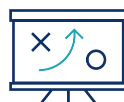
There is a relatively even distribution of datapoints across the chart, which is the point. Past performance is not a reliable indicator of future performance—virtually any company is capable of reaching the top quartile over the next five years. Some companies, and indeed some industries, shift due 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. Unfortunately, we've observed that far too many companies that become consumed with the quarterly earnings cycle underinvest in innovation and creative marketing, which often drive such market disruption.

FIGURE 1
Five-Year Ending Value of $1,000 Invested in Median of Each Quartile[3]



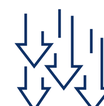
We've developed four TSR archetypes for the companies that start *and* end in either a top- or bottom-quartile position over the two successive five-year periods:

Serial leaders are the 44 companies that remained in the top quartile for both periods, which represent a wide range of industries. Serial leaders this year include Mastercard, The Home Depot, and Advanced Micro Devices. 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 37 companies that languished in the bottom quartile in the first period, but leapt to the top over the most recent period, including Chipotle Mexican Grill, W.W. Grainger, and Merck & 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 39 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.



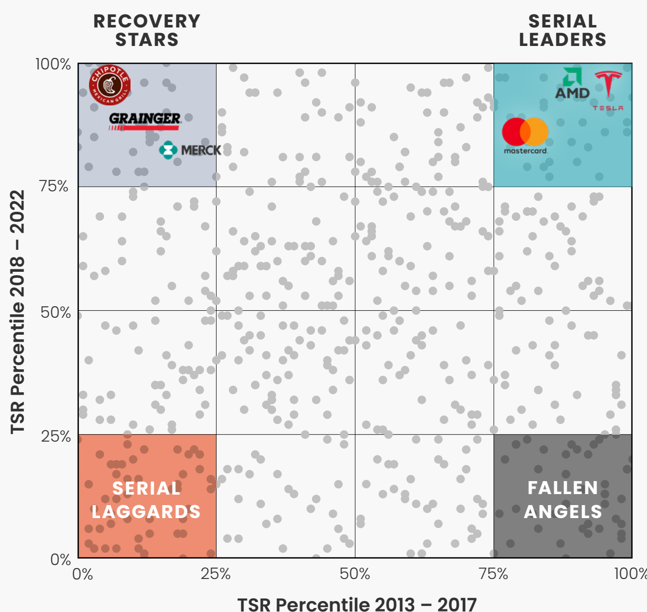
Serial Laggards are the 49 companies that generated bottom-quartile TSR over the two successive periods.

FIGURE 2
TSR Percentile Rank in Successive Five-Year Periods

TSR Percentiles in Successive Periods – Members of the S&P 900

RECOVERY STARS

1. Acadia Healthcare
2. AECOM
3. AGCO
4. AutoNation
5. Calix
6. CF Industries Holdings
7. Chart Industries
8. Chipotle Mexican Grill
9. Ciena
10. Clean Harbors
11. Cleveland-Cliffs
12. ConocoPhillips
13. Crocs
14. Darling Ingredients
15. DICK'S Sporting Goods
16. Enphase Energy
17. Freeport-McMoRan
18. FTI Consulting
19. GameStop Corp.
20. Hess
21. Jabil
22. KBR
23. Lattice Semiconductor
24. Linde plc
25. Louisiana-Pacific
26. Merck & Co.
27. Quanta Services
28. RI RCM
29. Reliance Steel & Aluminum
30. SunPower
31. Synaptics
32. Target
33. Tenet Healthcare
34. The AES Corporation
35. Valmont Industries
36. W.W. Grainger
37. Williams-Sonoma



SERIAL LEADERS

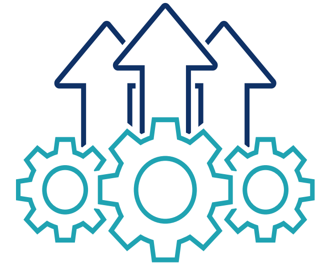
1. AbbVie
2. Advanced Micro Devices
3. Applied Materials
4. Azenta
5. Broadcom
6. Builders FirstSource
7. Cadence Design Systems
8. Celsius Holdings
9. Chemed
10. Churchill Downs
11. Cintas
12. Coca-Cola Consolidated
13. CoStar Group
14. DexCom
15. Elevance Health
16. EPAM Systems
17. Fair Isaac
18. Humana
19. IDEXX Laboratories
20. Insperity
21. KLA
22. Lam Research
23. Manhattan Associates
24. Mastercard
25. Mettler-Toledo International
26. Microsoft
27. Monolithic Power Systems
28. Nexstar Media Group
29. Novanta
30. NVIDIA
31. Old Dominion Freight Line
32. Pool
33. Repligen
34. Saia
35. ServiceNow
36. Steel Dynamics
37. Tesla
38. Thermo Fisher Scientific
39. TransDigm Group
40. United Rentals
41. UnitedHealth Group
42. Vicor
43. West Pharmaceutical Services
44. World Wrestling Entertainment

The Importance of Differentiation, Brand Building, and Strategic Resource Allocation in Inflationary Environments

Despite rampant cost inflation, supply chain issues, and a rising cost of capital, many companies were able to overcome these economic headwinds through differentiated brands and an active approach to reallocating resources across their portfolios to favor businesses that were able to take advantage of pricing power to maintain their profit margins.

Consider PepsiCo, which on October 12 announced revenue and earnings per share that exceeded analyst expectations, with year-to-date revenues up 14% over the prior year, mostly due to price increases. Pepsi's pricing power derived from the company's decades of investment in strong differentiated brands.

For companies that manage multiple brands, products, and geographic segments, now is the time to consider where you believe each business would fall on the chart in *Figure 2*, if each had their own share price, and where you 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.



Residual Cash Earnings (RCE)

There are many business attributes that lead to high TSR. 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).

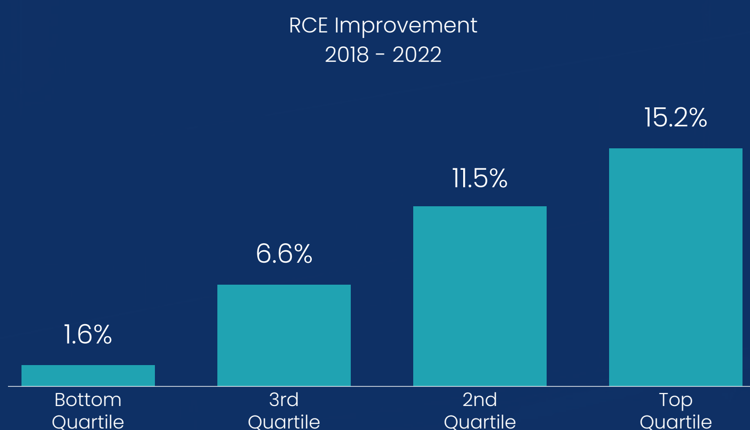
More than any other performance measure, RCE provides a reliable value signal. To put it simply: up is good, down is bad. And most important, it shows a stronger relationship to TSR than EVA, or generic economic profit (see *"Beyond EVA"*).

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 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

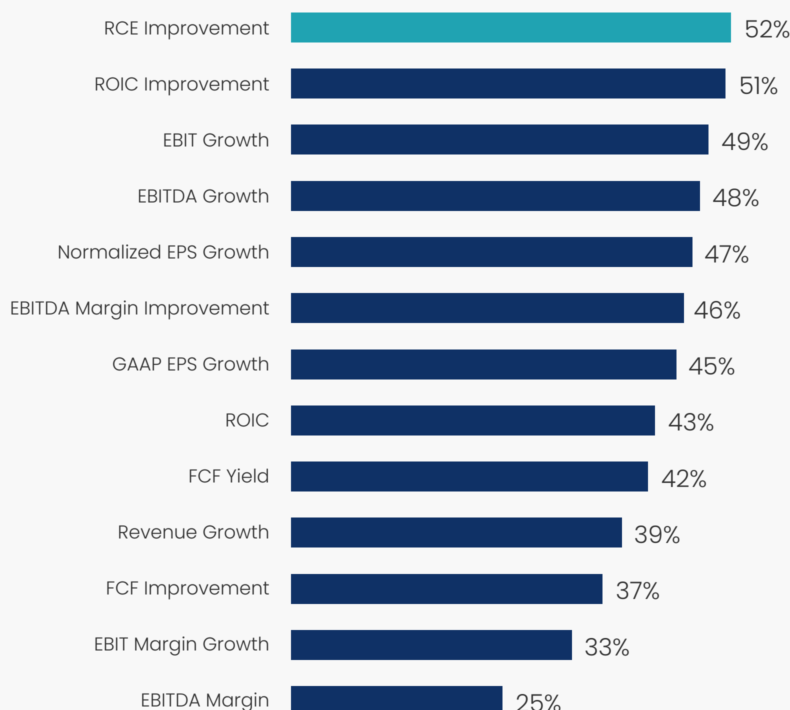
FIGURE 4
Improvement in RCE Relates to Higher TSR[4]



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, so that when managers try to increase the measure, they are more likely to be driving TSR higher over the longer term. 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. Many performed worse than one might think.

FIGURE 5
How Performance Measures Relate to TSR[5]



Methodology

To identify the characteristics of top-quartile TSR performers from 2018 through 2022, we measured the Total Shareholder Return performance of the 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 outperformance.

The reason RCE is a reliable proxy for TSR is that it is designed to COMPREHENSIVELY FACTOR ALL ASPECTS OF PERFORMANCE.

Results & Discussion

At the top of the chart, we see the metrics that were the best indicators of TSR outperformance. Among these are improvement in return on invested capital (ROIC), earnings per share (EPS) and operating profit. What's interesting about this year's results is that most of the top measures indicate strong profitability and efficient use of capital. And whereas revenue growth was second only to RCE improvement last year, it dropped off significantly in this year's report—from 56% to just a 39% likelihood of predicting top-quartile TSR. This underscores the importance of strong margins and capital efficiency during inflationary periods and bear markets, as investors are no longer willing to pay high premiums for growth without sufficient profitability.

While ROIC and Operating Profit are important, the strongest predictor of TSR outperformance over the last five years was Residual Cash Earnings (RCE)—Fortuna's measure of economic profit. The reason RCE is a reliable proxy for TSR is that it 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 reliable measure. Likewise, a company that focuses on and improves ROIC to a very high level might sacrifice any growth that brings down average ROIC, including attractive investments, leading to underperformance.

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 unsatisfactory 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

In recent years, it has become increasingly common to see *free cash flow* (FCF) employed as a period measure of performance. It may seem desirable, since free cash flow over time is used in the discounted cash flow net present value (NPV) model, which is a cornerstone of modern corporate finance. But unless an investment has a return over 100% in its first year, which is fairly unlikely in our experience, FCF will be negative—and may remain negative for several years if a company is in a growth stage, or modernizing older assets over that period. And so free cash flow is liable to motivate underinvestment, which harms shareholders and other stakeholders alike over the long term.

EPS is perhaps the most common measure we see companies focus on. Despite its merits, managements 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 is expected during the current fiscal year, which is typically not the case, this distorts EPS by making it look worse. Unfortunately, this tends to discourage R&D investments 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.

Many companies would benefit from A MEASURE THAT HELPS CLARIFY THIS TRADEOFF between profitability and growth.

Given the many short-term pressures corporate managements face, it is not surprising that they are often concerned with maximizing results over the near term, which can lead companies to trade off future growth to maximize current profits. In this sense, many companies would benefit from a measure that helps clarify this tradeoff between profitability and growth. In short, it encourages strong near-term performance—but not at the cost of long-term value creation. 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)

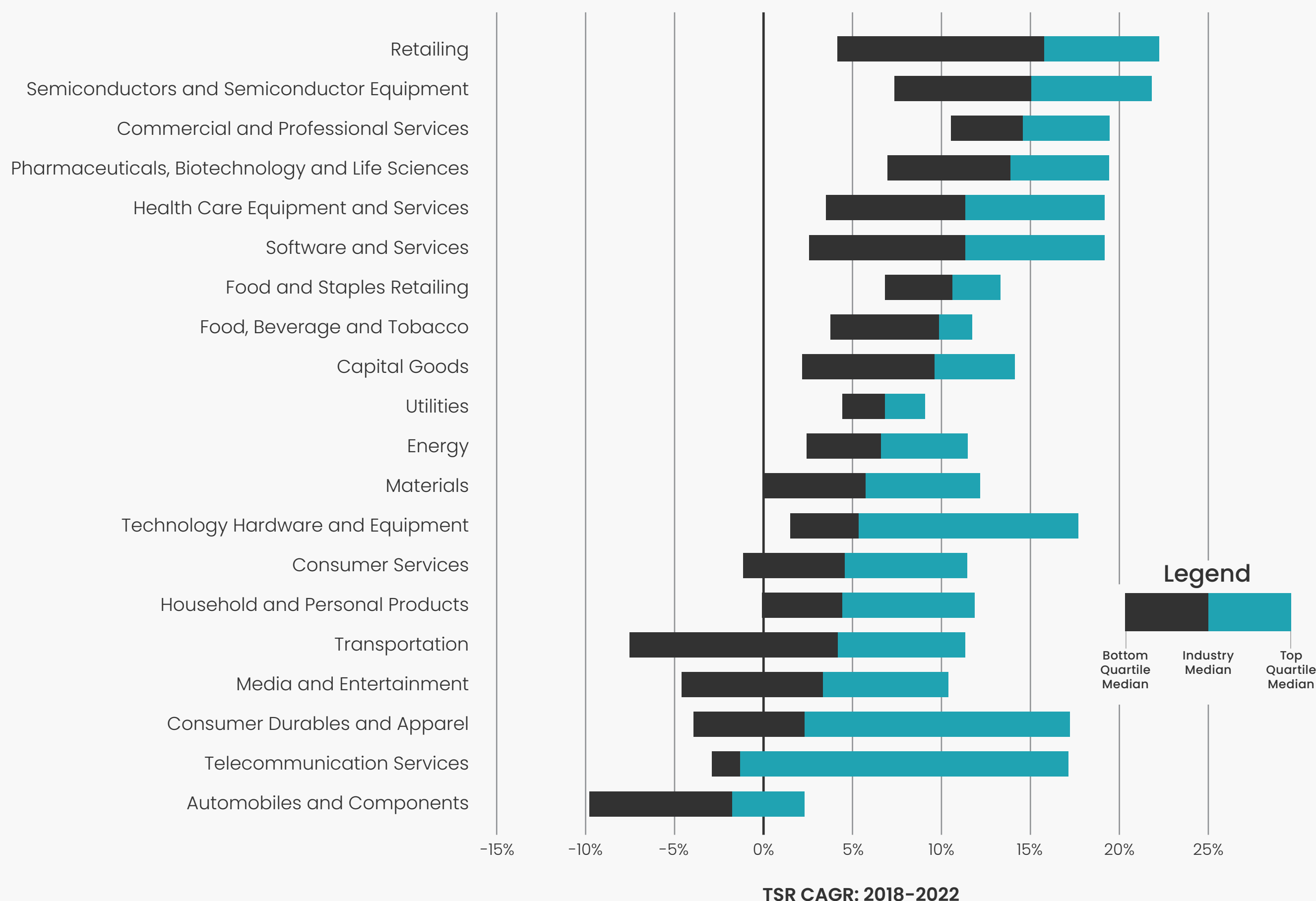
Shifts in Industry Returns

After years of dominance, the semiconductor industry was dethroned in this year's report by Retailing. While still a top performer through the five-year period, returns for semiconductor companies dropped off substantially in 2022 as market valuations cooled. Retailing's strong performance was fueled in part by the rapid adoption and rollout of digital platforms, and tailwinds relating to increasing demand for household goods and products that emerged following Covid-19. Among the top performers in Retailing were Etsy, Dick's Sporting Goods, and AutoZone. While Retail has not historically been an industry associated with significant excess returns, its recent success should be a signal to companies everywhere that even the most discounted industries and companies are capable of top-quartile performance.

Notable outperformers in the past year include Energy companies, which vaulted six spots versus last year's report, from 17th to 11th place among all industries. This boom was sparked by geopolitical and other supply pressures that led to substantial commodity price increases in oil and gas markets. A "flight to safety" mindset in markets may have also boosted returns in non-cyclical industries like Utilities, Food & Staples Retailing, and Food, Beverage &

FIGURE 6
S&P 900 Industry Performance and Quartile Distribution, 2018 – 2022

S&P 900 Interquartile TSR Performance by Industry



Tobacco, which jumped five, eight, and eight spots, respectively. The outperformance of energy and "defensive" industries in 2022 can be traced in *Figure 7*.

But others were not as fortunate. Media and Entertainment as well as Software and Services, for example, dropped precipitously in the industry ranking as pandemic-related tailwinds unwound. Companies such as Salesforce, Netflix, and Disney were significant contributors to the industry downturns.

Asset-Efficient Industries Shine

While revenue growth has been handsomely rewarded in recent years, we observed a paradigm shift toward companies that are asset-efficient, which was fueled by rising interest rates in 2022, which makes capital-intensive businesses increasingly expensive to expand. Retailing, Food & Staples Retailing, and Commercial & Professional Services were some of the sectors that benefited the most from this trend. Retailing, for example, underperformed the median industry return through 2020, but as interest rates jumped in 2022, ultimately achieved annualized TSR that was fully 7.2% above the sample median over the five-year period. Such shifts in the fundamentals investors seek in companies highlight the importance of deploying a *single, comprehensive performance measure*, like Fortuna's *Residual Cash Earnings*, that balances growth, rate of return, and capital efficiency.

FIGURE 7
S&P 900 Five-Year Annualized TSR Trend by Industry[6]

Five-Year TSR Trend by Industry

Industry	2018	2019	2020	2021	2022
Retailing	15.9%	13.3%	13.9%	23.1%	15.9%
Semiconductors and Semiconductor Equipment	21.0%	27.9%	27.3%	34.1%	15.2%
Commercial and Professional Services	20.0%	22.9%	23.7%	25.5%	14.8%
Pharmaceuticals, Biotechnology and Life Sciences	19.9%	19.8%	23.1%	23.5%	14.0%
Software and Services	26.4%	22.3%	23.8%	24.1%	11.4%
Health Care Equipment and Services	25.1%	20.9%	21.5%	20.9%	11.4%
Food and Staples Retailing	18.5%	11.9%	14.1%	13.1%	10.8%
Food, Beverage and Tobacco	12.1%	11.6%	11.6%	10.9%	10.1%
Capital Goods	13.2%	12.7%	16.2%	22.2%	9.8%
Utilities	16.0%	17.3%	8.0%	13.4%	7.0%
Energy	-1.6%	-5.8%	-11.5%	6.9%	6.7%
Materials	10.3%	9.1%	9.5%	21.0%	6.3%
Technology Hardware and Equipment	14.6%	13.4%	16.9%	27.6%	5.5%
Household and Personal Products	14.9%	13.1%	12.9%	8.9%	4.6%
Consumer Services	19.3%	15.8%	15.0%	21.2%	4.6%
Transportation	17.1%	15.4%	8.4%	21.3%	4.3%
Media and Entertainment	21.6%	15.9%	15.6%	14.5%	3.5%
Consumer Durables and Apparel	9.5%	10.4%	8.5%	16.2%	2.4%
Telecommunication Services	7.1%	10.4%	10.5%	8.0%	-1.3%
Automobiles and Components	9.5%	8.5%	12.0%	14.2%	-1.8%

Overcoming Obstacles to Sustained Value Creation

The 2023 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. Shifting cost pressures from inflation, and a rising a cost of capital, only heighten the importance of regular *strategic resource allocation* and portfolio optimization activities.
- ***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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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]All analyses performed in this report use data from Capital IQ.

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

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

[5]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.

[6]Columns show annualized TSR over one, two, three, four, and five years, respectively, from left to right.