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Corporate as an Investor

By Gregory Milano

Most companies wrap their annual planning processes in December or January after spending hundreds or even thousands of hours preparing, analyzing, discussing and negotiating said plans and budgets. As these proceedings conclude, most everyone involved cannot wait to get back to their real jobs. And in all too many cases, the business unit staff come away feeling like children grilled by their counterparts in corporate.

Having reviewed scores of these processes at clients over the last 30 years, I have witnessed countless problems that are viewed as unavoidable. "It's a process that everyone must go through every year," they all say. One such problem is that companies may miss the vital opportunity to properly evaluate where in their portfolios they create economic value, and to disproportionately shift resources to these promising areas. Instead, far too many companies indiscriminately allocate resources across the portfolio with only marginal differences in investment as a percentage of sales (or some similar rubric).

Consider a company that invests in two business units, A and B, at 8% and 10% of revenue, respectively. Management explains that B is the more favorable business, thus the difference. The problem is that the percentage of revenue tells us little about the relative reinvestment rates. If Business A generates cash earnings at 16% of revenue, then they are reinvesting fully half of what they generate back into the business. If B has a 40% cash earnings margin, it is only reinvesting 25% back into the business. It is critical to evaluate investment rates in comparison to cash earnings generated, not revenue, in order to understand the true reinvestment dynamics—and to avoid underinvestment in the most valuable businesses.

Successful investors will carefully concentrate their investments in companies where the stock price is expected to rise and harvest capital away from those where expectations are flat or down. Similarly, to think and act like investors, corporate leadership should aim to have higher reinvestment rates in the parts of the business that create more value. You may be allocating resources across a portfolio of businesses, products or geographies, but in each case, you want to overweight allocations to the best businesses.

The question remains, however, "How do we determine value creation?" Modern corporate finance suggests we use the net present value (NPV) technique. In other words, we forecast free cash flow and calculate the present value. If the NPV exceeds what has been invested in the business, value is created.

I believe strongly in this NPV approach, but there are two practical problems with this application. The first is that the assessment of value creation depends on a forecast, and we all know how subjective that can be. If we ask 10 experts to forecast something, we're likely to get 10 different answers. And we often see "hockey stick" forecasts where the first year is down, so it's easy to achieve success in the annual bonus plan; and then in following years performance improves dramatically, to justify all the requested funding.

The second problem is that it's hard to hold people accountable to a forecast of free cash flow. If it is lower next year, perhaps that signals poor performance—or maybe it's such good performance that we are investing more than the plan. As good as free cash flow is for determining NPV, it is a terrible performance measure. In my firm's 2022 Fortuna Advisors Value Leadership Report, my team showed that only 15% of the companies in the top quartile on free cash flow yield were also in the top quartile on total shareholder return, or TSR. Even if we instead measure the improvement in free cash flow, we only get 38% in the top TSR quartile.

My experience with clients and capital markets generally has demonstrated the value of economic profit: a single, comprehensive measure that incorporates growth, margin and capital intensity. Traditional economic profit, often known as EVA (economic value added), is based on net operating profit after taxes (NOPAT) less a capital charge based on the net capital invested multiplied by the weighted average cost of capital.

My firm developed a simpler, cash-based version of economic profit called residual cash earnings, or RCE. To demonstrate its efficacy in proxying value creation, my colleagues and I

showed that it relates to TSR better than EVA in all industries in a research paper titled "Beyond EVA." The value leadership report shows that 61% of companies in the top quartile on RCE improvement were also in the top quartile on TSR. With RCE, there is a better relationship to TSR than with any measure tested, including revenue growth, EBITDA margin, ROIC and EPS growth.

When RCE rises, this means EBITDA has increased enough to cover any increase in taxes plus the capital charge on the investment in increasing gross operating assets. It's a simple and effective period performance measure.

By comparing the amount of RCE improvement, per dollar of investment, to the reinvestment rate, you arrive at a true "investor-like" method of portfolio evaluation. The key, of course, is to have a meaningfully higher reinvestment rate where RCE shows the greatest improvement and vice versa. This can be done prospectively, to ensure resource allocation is aligned with value creation in a plan. And it can also look back historically at actual performance to validate managements' allocation strategies.

When I explain this to executives, they often look at me like I have four heads. Of course, they know they should invest more where they create more value. Yet in most cases, I find the opposite in my consulting work: Managements often invest too little in their high-value creators, and too much in the weaker ones.

As a new fiscal year begins, now is the time to leverage the recent planning process to drive strategic, investor-like resource allocation. I believe companies that do so will be well rewarded by investors as well as analysts who peer into segment resource allocation.

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Gregory Milano is founder and CEO of Fortuna Advisors LLC and author of Curing Corporate Short-Termism, Future Growth vs. Current Earnings. Read Gregory Milano's full executive profile here.