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THE ESSENTIALS FROM STRATEGY&

Total Shareholder Returns

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Total Shareholder Returns

This measure of business performance is the best indicator of corporate success.

by Ken Favaro and Greg Rotz

For the past 20 years we have been working with the CEOs and CFOs of large, global public companies, helping them implement management approaches and capabilities, with the explicit objective of generating superior total shareholder returns (TSR). Total shareholder return is a measure of corporate performance. But as we shall see, it is also a system of management, grounded in a set of metrics and practices for running a company to maximize its value creation, over both the short term and the long haul.

There are many ways to start working with this system. You could simply change your top-tier metrics and incentive compensation (for example, adding TSR to the scorecard and linking the pay rates for your top 50 executives to TSR). Or you could adopt a better way to run the company, incorporating new performance goals, strategies, management processes, and organizational behaviors. You might choose this type of action for a variety of reasons — for example, to return to industry-leading performance and valuation, to get the most out of a new organizational structure, to strive for strategic distinction, to improve the company's resource allocation, or to make the company more than just the sum of its parts.

When starting down the TSR path, it is helpful to begin with two questions: How broad or narrow should we make our focus on TSR? What issues and opportunities are we seeking to address by adopting a sharper focus on managing for TSR?

Primary TSR Metrics

These are the four primary metrics to use when managing for top-tier TSR.

1. Total shareholder return. This is the change in a company's stock price for a given period, plus its free cash flow over the same period, as a percentage of the beginning stock price. For example, if a company has a stock price of US$100 at the beginning of a year, free cash flow of $3 during the year, and a stock price of $110 at the end of the year, its TSR for that year is 13 percent. TSR can be measured only for publicly traded companies because it requires observable stock prices.

In any given year, a company's TSR doesn't mean all that much. But when measured over time, it is the single best indicator of success. This is because it reflects how well a company has created long-term value in highly competitive capital, labor, and product markets — markets that are often very short-term-oriented (or that at least feel that way).

2. Free cash flow (from a shareholder perspective). This is the difference between earnings and retained earnings (sometimes called *equity cash flow*). At the company level, it is the portion of earnings paid out to investors. In a year when a company neither issues nor

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repurchases equity, free cash flow is simply the dividends paid to shareholders. At the operating level, it is the portion of an operating unit's earnings that are available to be paid to investors after it takes care of all its other investment needs. In any year when an operating unit's investment needs exceed its earnings, its free cash flow is negative.

3. Economic profit. This is the difference between earnings and the cost of invested capital for a given period of time. A business that is earning at least its cost of capital is generating positive economic profit; a business that is earning less than its cost of capital has negative economic profit, even if its earnings are positive. For example, if a company has $15 of earnings, a 10 percent cost of capital, and $100 of invested capital, its economic profit is $5 (15 minus 10 percent of 100). But if its earnings are only $8, it has $2 of economic loss (8 minus 10 percent of 100).

4. Warranted value. This is the current value of a company or an operating unit based on the best estimate of its expected free cash flow (or economic profits) under a particular future strategy. This metric is sometimes called *intrinsic value.* Warren Buffett defines it as "the present value of the earnings power a business has over its remaining life."

There are two important points to be understood about warranted value. First, a company (or operating unit) has as many warranted values as there are valid alternative strategies for it to pursue. Second, warranted value is not the same thing as market value, nor is warranted value per share the same thing as stock price.

The Relationship among Metrics

Although a company's stock price can and often does diverge from its warranted value per share, the company's market value still tends to track its warranted value over time. Hence, the impact of strategic and investment decisions on your company's warranted value per share will ultimately have an equivalent impact on your stock price. Therefore, choose your strategies and make investment decisions based on your warranted value — not on your stock price or, for that matter, any other single financial metric such as revenue growth, return on capital (ROC), or earnings per share (EPS).

If your TSR is driven largely by a change in stock price, and if that price is ultimately determined by warranted value per share, it follows that your company's TSR is driven largely by the change in its warranted value per share. Hence, if your company operates in a way that maximizes long-term warranted value per share over time, it is managing in a way that also maximizes long-term TSR over time.

Likewise, when added to invested capital, the present value of future economic profits will yield exactly the same estimate of warranted value as the present value of free cash flow. Working to maximize economic profit growth over time is thus the same thing as working to maximize long-term value creation and TSR.

A company's P/E ratio is obtained by dividing its stock price by its annual earnings. Over time, your company's P/E and stock price are determined by the same thing: its warranted value per share. A P/E does not determine stock price; it's the other way around.

Using TSR Metrics

In practice, you should not rely on any one measure or criterion to make strategy choices and investment decisions. If you did, the single best measure for such purposes would be warranted value. No other measure can capture the trade-offs between growth and profitability, short term and long term, and risk and reward better than warranted value.

But in itself, this metric is inadequate. Do not use warranted value (or metrics derived from it, such as total business return) for performance management or incentive compensation. It is based on a forecast of expected future results, not on actual delivered results. Instead, use a combination of three measures — revenue growth, economic profit, and free cash flow — to set business targets, track strategy execution, and evaluate management performance. These three measures capture virtually all the high-level financial information that is important for an operating unit. As long as internal management reporting processes are designed to report these measures accurately, they provide excellent feedback on whether the value creation expectations of a particular strategy are being met. Moreover, they are good indicators of which questions to ask and where to look for answers when performance is off track.

Managing for Top-Tier TSR

Managing for top-tier TSR means always choosing the course of action that has more warranted value (per share) than any other alternative. This approach to management involves a continuous search for strategies, ideas, solutions, and opportunities that can increase the company's warranted value per share. It does not mean "putting shareholders first," nor does it focus on managing for shareholders' expectations or short-term stock price.

When understood and used appropriately, managing for top-tier TSR will produce high-quality, sustained EPS growth and a premium multiple. In large part, this is because a greater portion of your investment (financial resources, management time) goes into value-creating activity, and this gives your company more competitive and financial strength. It also enables you to invest in your future and in building the right capabilities as your markets inevitably evolve.

Although managing for top-tier TSR is not about maximizing earnings per share — short term or otherwise — it will produce consistently superior EPS growth. Chasing quarterly EPS will not. As Yale University executive-in-residence Peter Kontes shows in his book *The CEO, Strategy, and Shareholder Value: Making the Choices That Maximize Company Performance* (Wiley, 2010), companies that consistently manage for economic profit growth not only produce twice the TSR, but also one-third higher earnings growth than companies that are dominated by an earnings culture.

Many CFOs and their CEOs have used the framework and process of managing for top-tier TSR — in whole or in part — in order to transform their companies' strategic direction, organizational capabilities, and performance. This includes Coca-Cola under Roberto Goizueta, Alcan under Travis Engen, Barclays under Matthew Barrett, Gillette under James Kilts, and Roche under Franz Humer.

These companies used a variety of "value-based" metrics, tools, processes, and strategies to increase the capacity of their people to create long-term value and generate sustainably superior capital and product market performance. For these executives, changing the operating model and strategies was as important as changing the metrics. They were concerned with all parts of their operating model and strategies, including setting goals, communicating with investors, setting priorities for their top team, allocating financial and nonfinancial resources, and managing performance, as well as strategy development, financial planning, the role of the corporate center, and rewards for operating staff.

Common Pitfalls

Many companies set out to maximize their long-term value creation without success. There are a few important reasons for this. One is the all-too-common practice of managing for shareholder expectations. This is the tail wagging the dog, and often leads to pursuing overly aggressive short-term EPS targets at the expense of profitable investment in the future. Recall that warranted value per share drives stock price over time, and fundamentals, not shareholders' expectations, drive warranted value per share. Put another way, managing for shareholder expectations will almost always lead a company into a course of action that depresses its future multiples, thus undermining its TSR.

Another common pitfall is tying incentive compensation, such as annual bonuses, to performance against a predetermined plan or budget. This inevitably leads people to restrain their aspirations for the business in order to make it easier to "beat plan." In turn, this is interpreted as sandbagging by corporate headquarters or investors. The end result is a time-consuming, soul-destroying, and ultimately unproductive gaming of the planning and budgeting process. Instead, your plan should drive resources and actions that help you realize the full potential of your best strategy. Your budget should be a tool for controlling costs relative to revenue. Neither should be used for determining annual bonuses.

Nor should annual value growth or its closest cousin — total business return (TBR) — be used to determine annual bonuses. These are based on forecasted results, not on delivered results. Annual value growth and TBR are just measures of how the performance forecast for a business has changed over the course of a year. This forecast is highly sensitive to small changes in assumptions about the future performance of the business over an infinite horizon. As we mentioned earlier, annual bonuses should be based on delivered results, not on a forecast of results.

Perhaps the most insidious pitfall, though, is to introduce new measures but then fail to operate differently. The old adage "you manage what you measure" is time-tested, but changing what one measures will not automatically change how one manages, or how well.

The processes that govern strategic planning, resource allocation, performance management, and incentive compensation are the most important factors that determine your company's ability to maximize long-term value creation. Companies that change the metrics used with these processes, but don't change any other aspect of them, have seen very little impact on their capacity to deliver superior TSR. Introducing new management metrics — such as free cash flow, economic profit, warranted value, and TSR — does not, in and of itself, change the way a company, management team, planning process, or corporate center operates.

What to Get Right

Only two factors determine the value creation path of any company: the distinctiveness of its strategies and the execution of those strategies. We often hear statements such as, "A great strategy is worth nothing without great execution" or "I'd rather have great execution with a mediocre strategy than the other way around." The reality is that strategy and execution are two sides of one coin. Is Southwest Airlines or Tesco or Wells Fargo the product of great execution or of great strategies? *Yes.* Both are needed to produce consistently superior shareholder returns.

What, then, will enable your company to have and sustain distinctive strategies and execution? In our experience, this achievement requires proficiency in both the formal and the informal aspects of a company's management. On the formal side are corporate strategy, business strategies, strategic planning, resource allocation, performance management, incentive compensation, organizational design, and role of the corporate center. On the informal side are leadership behaviors, peer-to-peer networks, teaming norms and skills, nonfinancial motivators, pride, and a strong sense of the business's purpose.

Your Company's Purpose

Many business leaders and their organizations struggle with the idea that their company's purpose is to maximize shareholder value. This is understandable. Business is a multipurpose human activity. Through the customer's eyes, the purpose of business is to provide products and services that make their lives better; from an employee's perspective, it is to provide meaningful work and opportunities. A capitalist might say that the purpose of business is to create wealth; a politician might say it is to create employment. For every Peter Drucker who declares that the primary purpose of business is "to create and keep customers," there is an Alfred P. Sloan (whom Drucker studied and greatly admired) who says the purpose is "to make money." In the 1980s, Michael Porter argued that the purpose of business was to maximize profit; today, he writes about "creating shared value." (See Porter's article, coauthored by Mark R. Kramer, "The Big Idea: Creating Shared Value," in the January–February 2011 issue of *Harvard Business Review.*)

Business leaders need to give purpose to their people, and most employees do not find purpose in maximizing shareholder value. Finding meaning and purpose is a personal quest rooted in one's daily work and experience, not in statements of purpose from corporate headquarters. Thus, the context is important. Managing for top-tier TSR will not solve the meaning of life or work for your people. But it is a powerful approach that can create and sustain a high-performance, agile company with high-quality growth. Most employees (and other stakeholders) are highly motivated to be associated with such a company. +

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