Better Performance Measures

The following article by [Cliff Weight](), **Director of** [MM & K]() was published in the March 2011 edition of [Executive Compensation Briefing]().

My Eureka moment!

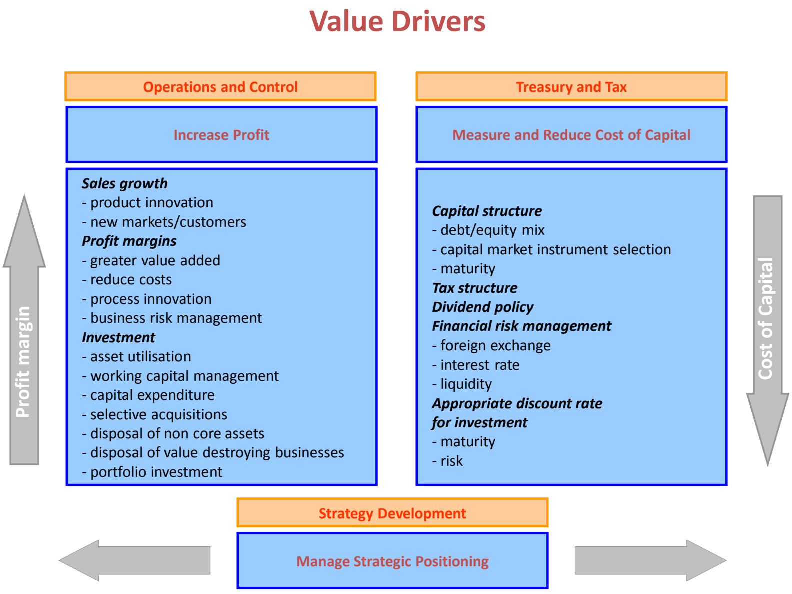
Rio Tinto's announcement, that its profits had risen from $5 bn to $14 bn, made me ask whether they had done well? Profits were up. But were they ahead of budget? Was the budget set realistically? Had they done better than their competitors? In this article I will examine these questions about performance, review the traditional measures and propose a promising new paradigm for practical performance measurement.

Commodity prices affect profits in the mining industry. Also, the ability to be able to increase production when demand rises is a key driver of profits, but such wise business positioning is often a result of investment decisions made several years before. The decisions that come good in one year's results could have been made by different managers several years before.

The general state of the world economy affects commodity prices. World GDP growth has bounced back after the reverse the previous year.

So then I asked myself what was the profit definition? Was the prior year affected by a fair value adjustment to assets? Were there exceptional items in one year but not the other? And that was when I concluded …

Performance Measurement Principle 1. Distinguish between operational and financial performance



When measuring performance, distinguish between measures of operational performance and measures of financial performance. See Diagram 1. Both are important. Line management are tasked with managing the operational performance (growing sales, making pricing decisions, brand and product development, improving productivity, discovering new reserves and bringing them on-stream).

The finance function, the CEO and the board make the key financial decisions such as raising debt or equity finance, setting dividends, managing treasury, tax and risk hedging strategies. Finance decisions are often difficult to evaluate in the short term, as there may be fat tails and or long tails associated with them and future economic circumstances are always uncertain. There are numerous examples of companies who have boosted short term profits by increasing risk.

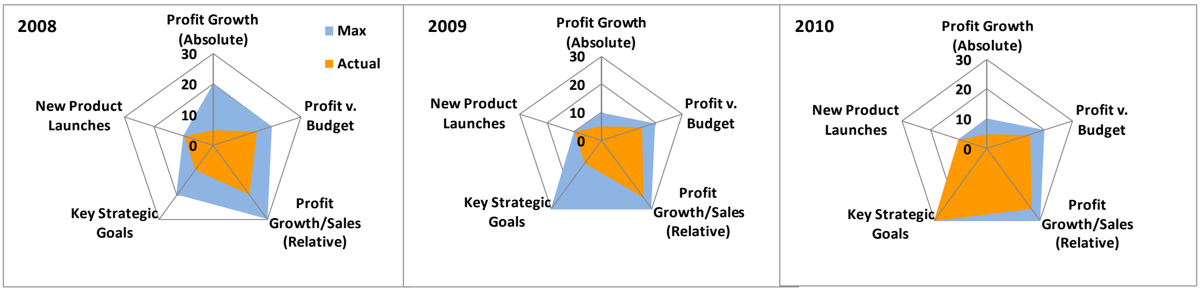
Performance Measurement Principle 2. Measure lagging and leading indicators of performance

Profit is a lagging indicator of performance. It measures how well the company has done in the accounting period. It gives no information about whether profits will grow or decline in the future, nor about the risks in the business model.

I favour the balanced scorecard as it contains a range of measures. A company may measure itself with, say, a 50% weighting of profits, but it also needs to measure key indicators of future success, e.g. sales growth, customer satisfaction, customer retention and new product pipeline.

Performance Measurement Principle 3. Performance metrics may change over time

At different stages of a company's strategic development, it should change the focus and weighting of its performance metrics. I use Performance Radar Charts to keep track of changes in measures and performance against different measures. You need good graphical presentation to enable people to see and assimilate lots of information quickly.



Performance Measurement Principle 4. Understand the impact of acquisitions

Acquisitions can be a key part of a company's growth strategy. I like to distinguish between small acquisitions and large ones.

Small acquisitions are usually in related business areas and offer natural synergies. For example exploiting the existing client base to increase sales by selling a wider product range, cost savings of moving production to fewer sites, provision of additional resources to speed up the acquired company's growth and exploit its growth opportunities.

Large acquisitions generally do not work - the academics tell us that 60 to 70% fail to achieve their objectives. Not all fail. Sometimes they are essential such as to create global scale (e.g. Smith Kline with GlaxoWelcome). Sometimes they add product and enable cost savings (e.g. Smith Kline and Beecham; Glaxo and Welcome; Marsh and Sedgwick, which was a brilliant example of a purchase of an underperforming company where the acquiring company was able to raise the performance of the acquired company up towards its own standards where sales/employee were two to three times higher).

Some large acquisitions fall into the "bet the shop" or "bet the bank" category. The RBS acquisition of ABN Amro was a classic case of this. As was the earlier RBS acquisition of NatWest.

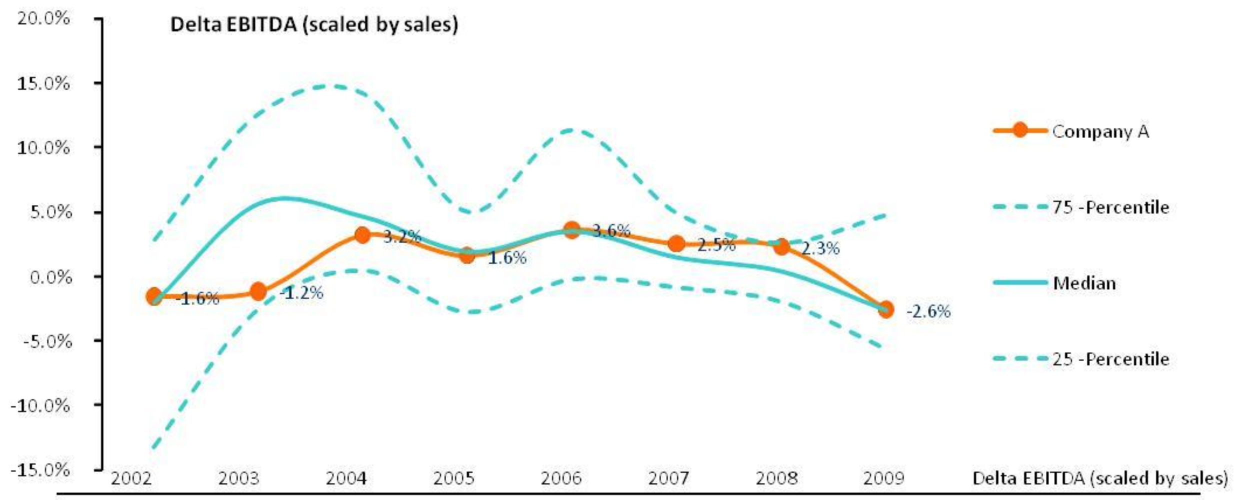
Large acquisitions require a huge increase in debt and/or the issue of additional equity. They also offer the chance to arbitrage tax, through the structuring of the location of debt. By increasing the financial gearing, the future profits will increase (but at the cost of increased foreseeable and unforeseeable risk, i.e. a potential fat tail). These are important aspects of measuring financial performance.

However there are dangers that expected synergies will not be realised and differences in cultures will lead to a drop off in operational performance.

Performance Measurement Principle 5. Measure operational performance relative to peers

I had my own personal Eureka moment when I suddenly understood this. Archimedes saw the water rise in the bath when he got in. I saw profits rising in most companies when the economic backcloth was favourable!

Hermann Stern, the CEO of Obermatt (see www.Obermatt.com for further information), came up with the ground-breaking idea that you can only measure management's performance when you take out the effect of the business cycle. You can do this by comparing performance with a group of companies that follow the same business cycle. The graph below, showing the cycle over a 10 year period and the performance of company A against such a 'cycle peer group', demonstrates this approach.



The Obermatt approach involves first choosing a performance measure. In this example I have chosen the change in EBITDA over the previous year. Then, in order to compare companies of different size this measure is 'normalised', e.g. divided by some dimension of company size. I have used sales revenue in my example. Companies in the cycle peer group are then ranked on this measure. The graph shows both the value of the normalised measure for the company in question and its relative ranking.

I first met Hermann in 2009 and have been promoting his ideas ever since. But before the "knockers" start to trash this idea, I will admit that it is not perfect. (See the box below where I discuss openly some of the limitations).

My central point is that this is a much stronger conceptual basis on which to evaluate performance than any other I have seen. It beats TSR hands down. Stern Stewart's Economic Profit was extremely popular and still has its advocates, but it is not as widely useful as relative operating performance.

Relative operating performance is not the perfect performance paradigm because:

- "Only measures EBITDA". This criticism is not valid as the Obermatt methodology can be applied to other metrics than Delta EBITDA (scaled by sales). Companies choose the most appropriate metrics.
- Annual results can depend on where you are in the cycle. If you have just had an awful year then the bounce back the next year can mean it is easy to come towards the top rank next year. In such cases judgement is required when interpreting results.
- Capital expenditure and investments may take some time to pay back and will not show through into EBITDA for some time. Likewise brand investment, marketing and advertising. All financial metrics are backwards looking. The balanced scorecard is needed to cover all the key measures that executives must manage. (We tend to agree with this criticism, but would recommend a high weighting to relative operating measures in the scorecard.)
- Some companies are more highly geared than others. In many cases such variations are of the second order of magnitude and the Obermatt approach will take out most of the cycle effects. It also prompts further analysis and discussion about true performance. Concepts such as Beta and tracking error can be used for more detailed analysis. When analysing share prices, a share that moves up 11% when the market moves 10% has a Beta of 1.1. When analysing fund managers performance tracking error is essential: it measures the standard deviation of daily performance relative to an index– if manager A has tracking error of 4% and manager B tracking error 2% and both achieve 3% returns above the index, then manager A has done considerably better. Similar approaches could be used for reviewing operating performance metrics.

Performance Measurement Principle 6. Measure non-operating performance by a combination of TSR relative to other companies, absolute TSR and by ROCE, EPS, etc.

As noted above, operational performance is only part of the picture. In the long term shareholders want increases in share price. But they also want companies to outperform - in many cases the shareholders are themselves fund managers who can only retain and attract more funds if they can demonstrate to their investors that they are doing a better job managing their funds than their competitors. Their pay is strongly driven by relative performance which has influenced their view of how to measure and incentivise managers of the companies in which they invest.

TSR (share price changes plus dividends) measured relative to comparator companies or an index is still the most favoured measure of long term performance (in large companies). However it has a number of problems in practice. It is difficult to find a good robust group of comparator companies.

Acquisitions and disposals can change the nature of a company and make it no longer such a good comparator. Also acquisitions and disposals can change the gearing of a company and make it more or less reactive to changes in the business cycle, so that its relative performance is more due to its gearing than to the operational performance of the management.

Technological changes can mean the comparator group can bifurcate. For example the media company who found its performance was well ahead of the old media newspaper companies but well behind the new media companies. Its strategy was to diversify away from old media to have a balance of newspapers and new media investments. The strategy was executed well but the relative TSR measurement failed to recognise this.

The use of a general index e.g. FTSE100 or FT250 avoids the problems of one or two companies changing and unduly affecting the end result. However the FTSE100 (in particular) has been heavily influenced by sector issues which has meant it is difficult for companies from other sectors to keep up or too easy to outperform in other periods, e.g. Telecoms and IT wonderful in 1998-2001 then awful since then, Banks wonderful in 2002 to mid-2007 then awful, Mining up to 2008 were wonderful then declined and then bounced back sharply.

Two other problems about relative TSR are the Median to Upper Quartile typical scale and a mere 3 year measurement period create a dysfunctional bias in the relative TSR metric. No payment below median and maximum vesting at upper quartile creates a perverse incentive for volatile performance (10 years of steady growth produces a lower payout than a nil growth 10 year yo-yo performance of upper quartile followed by lower quartile results – ironically relative TSR performance share plans can be more volatile than the share option plans they largely replaced).

Such problems with relative TSR suggest it should only have a low weighting and more consideration should be given to absolute growth in TSR, EPS and ROCE. Each however has problems of calibration.

Performance Measurement Principle 7. Calibrate Performance

Calibration of incentive plans is one of the main, if not the main, problem in operating incentive programmes. Remuneration Committees are asking the question 'how do we know if we are setting bonus targets which are stretching against our competitors?' and the heads of reward do not currently have an answer. Major companies do want to get this right.

I think the focus should be on operating performance (relative TSR has been done to death in the UK).

Looking at the business cycle shows how much external factors affect results. You should take out the cycle if you want your incentive programme to reward for true performance rather than for external factors. (You can have profit-sharing as well, but make the distinction).

So you need to index. The way to do this is to choose a benchmark of CYCLE PEERS (not just direct competitors). This makes the index larger and more robust.

Since 2009 the international financial reporting standards have required full divisional performance reporting which gives the opportunity both to index to other companies' divisions and to measure your own divisions.

Readers may be familiar with the so called 'Obermatt Bonus Index' which the voting advisory agency Manifest and other commentators have used to question whether executive bonus pay outs are appropriate. This index, which is used by shareholders and for Obermatt publicity, considers just normalised growth in EBITDA. It is important to realise that the measure does not have to be EBITDA - companies who use Obermatt use a variety of relative metrics .

Obermatt's USPs as an analysis house are that it is an external provider, trustworthy, accepted by shareholders, and a cost efficient way of collecting and analysing data.

Summary: Cliff's 7 Performance Measurement Principles

1. Distinguish between operational and financial performance
2. Measure lagging and leading indicators of performance
3. Performance metrics may change over time
4. Understand the impact of acquisitions
5. Measure operational performance relative to peers
6. Measure non-operating performance by a combination of TSR relative to other companies, absolute TSR and by ROCE, EPS, etc.
7. Calibrate performance using the Obermatt approach

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