

MEASURE AND

IN THE FINAL PART OF A SERIES OF THREE ARTICLES, BEN WALTERS SETS OUT A FRAMEWORK FOR EMBEDDING VALUE CREATION

INCENTIVISE

Corporate finance is most relevant to firms in two areas: first, project and investment appraisal, the familiar 'static' discounted cash flow; and second, balance-sheet management – targeting a desired debt-to-equity ratio in order to minimise weighted average cost of capital (WACC) under the trade-off theory.

But wouldn't it be great if a third item could be added to the list, that of management performance measurement and reward? We all know the old adage: you get what you measure and reward.

If we could directly measure value creation, then this is what we would get. However, the value drivers in corporate finance are risk and future cash – both notoriously difficult to measure.

Well, read on... the rest of this article explains how this can be easily achieved within the existing reporting framework of every firm.

State of play

Performance measurement and reward are currently centred on profit and loss (P&L) reporting. While the sophistication in terms of measurement may have moved on slightly over the course of many years, they remain firmly book based, reflecting historic cost and accruals-based accounting and reporting. There are, of course, techniques out there, such as economic value added (EVA), that attempt to

take reported book numbers and adjust these to derive a value-created metric for a period. However, there are disadvantages. EVA, for instance, can involve a large number of adjustments, sometimes arbitrary in nature, risking miring management and finance teams in a sea of adjustments. Taken to the extreme, more complex incentive arrangements, such as phantom share options schemes, for example, can literally paralyse an organisation.

So, does the firm leave it to the equity markets to decide if value has been created or not? Clearly, metrics such as improving profits, revenue and cash flows are all indicators of value creation, but what are the risks being undertaken to achieve these, how much capital has been deployed to deliver these, and how does this performance compare to the market's assessment

of the value the firm *should be* creating from its strategic position? To answer this, in article one, I introduced the concept of MWACC* – or market-weighted average cost of capital.

MWACC is the hurdle rate a firm must achieve on its investments in order to justify its current value. However, to take things to the next level, that of creating a process against which management can be measured and rewarded, a little manipulation of the reported data is required. The key principles to get to this stage are to:

- accept the principal of working with incremental results; and
- understand the investment horizon of the business.

Incremental results

To take out a lot of the noise around reported numbers and focus on the direct effect management

decisions have had on the business, only incremental results count. Current levels of profit and cash flow made from past investment decisions are 'sunk' items in corporate finance parlance. For many firms, a substantial element of their value comes from the market's assessment of its future, not its past. And, of course, if you want to measure and reward performance over a period, you measure what has changed over the period. Other advantages of thinking in terms of incremental changes are that the effects of inflation haven't taken hold and the distortions of accruals-based accounting adjustments, such as depreciation, amortisation and impairment, are minimal.

The effect of working in incremental results is that you are only focusing on what management is directly responsible for over the period being measured, without distortion from inflationary effects and accounting practices. In addition, it is incredibly straightforward; few, if any, adjustments are required to the reported numbers.

But what precisely should you be measuring? There is an inescapable fact that one of the fundamental assumptions we are taught about corporate finance, that of there being no restraints on capital, is actually not the case at all in the real world. Firms tend to generate their own capital or borrow it. In this capital-constrained world, the hurdle rate for the internal investment decision is always different from the rate of return external investors required, as long as these investors perceive some kind of strategic value in the firm. This is the MWACC hurdle rate, the return required when the firm invests capital internally or acquires new businesses. The firm should measure the incremental return against MWACC. Figure 1

FIGURE 1: MWACC SHOULD BE USED TO DETERMINE MANAGEMENT PERFORMANCE (LOOKING BACK) AND THE PAYOUT/REINVESTMENT DECISION (LOOKING FORWARDS)

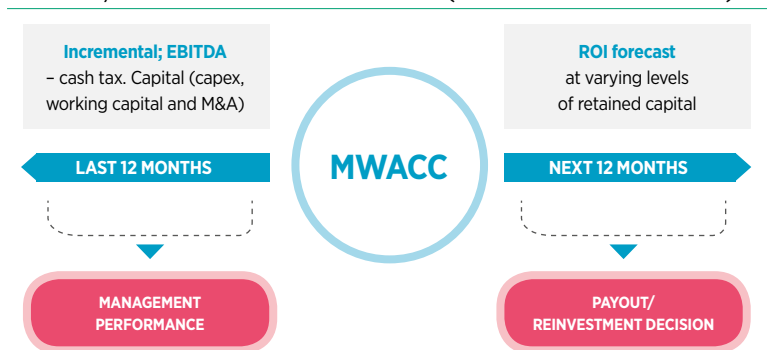
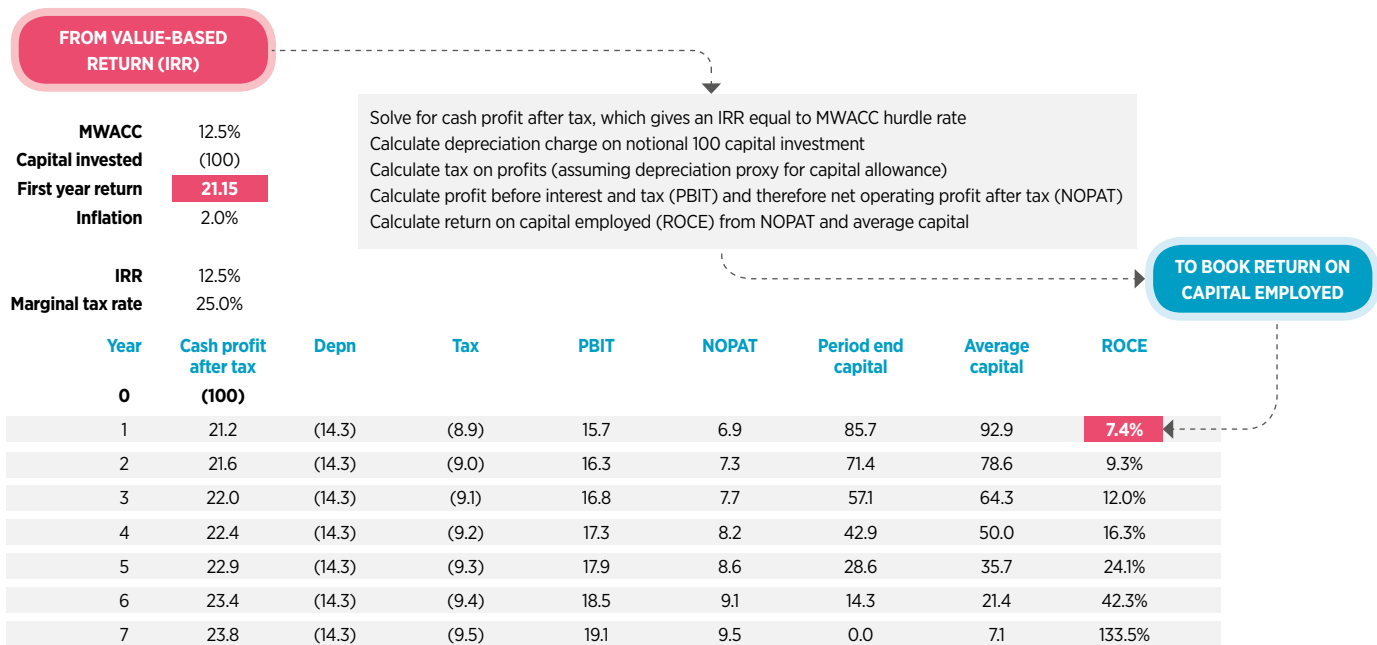




FIGURE 2: SHOWS THAT THE INCREMENTAL ROCE OF THIS FIRM, IE THE CHANGE IN NET OPERATING PROFIT AFTER TAX OVER THE CAPITAL INVESTED IN THE YEAR, SHOULD BE AT LEAST 7.4% FOR MANAGEMENT TO HAVE CREATED SUFFICIENT VALUE IN THE PERIOD FROM THE INVESTMENT DECISIONS IT HAS MADE



From value-based target (IRR) to book-based target; incremental (first year) ROCE

(left) illustrates the two ways in which the firm should be using MWACC: prospectively for its payout decision and retrospectively for measuring management performance.

Linking book numbers to value

A very common and widely understood book-based performance target, such as return on capital employed (ROCE) can be easily derived from a value-based measure, such as internal rate of return (IRR). An IRR equal to the true hurdle rate, MWACC can be converted using simple maths into a target incremental ROCE result. Figure 2 (above) shows how to perform this magic trick. The first step is to back-solve the amount of cash profit after tax (effectively EBITDA less cash tax) that generates the IRR

equal to MWACC. This cash profit number can be worked through to provide a reported ROCE target. Hey presto, you now have a book-based target, universally understood and reported upon, that is truly aligned to increasing the value of the firm.

Target setting

The beauty of being able to translate value creation into a book-based key performance indicator (KPI) is that you have on offer a range of KPIs and can select those most appropriate to your business. For instance, you could use the following targets: revenue, profit before interest and tax (PBIT), margin, cash conversion or capital allocation. I am sure readers can think of many others, but the point is you have a starting

point based on value creation, and the KPIs flow from this. P&L-based KPIs set from a foundation of value creation have true purpose.

Yes, it is true that these KPIs will change as MWACC changes (it is partially a market-based measure). Investors will be sending the firm's management messages about the amount of capital it should retain and invest, and the returns it should be making on this investment. Using MWACC allows management to read these messages and set internal performance targets as appropriate to meet the required response.

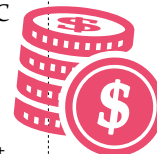
Three further points to make are:

1. By looking at total capital used, management must focus on all aspects, working capital and under-performing assets included.
2. The IRR profile can accommodate the timing of expected cash flows

where this may not be a smooth progression.
 3. The progression of the KPIs used over several years will show a picture of true management performance over time.

Conclusions

This framework for embedding value creation into readily available and widely understood KPIs has applications both for measuring and incentivising management performance.



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* The term MWACC is trademarked to the author

To contact the author about this approach to corporate finance, email him at benwalters73@yahoo.co.uk or join the debate at MWACC_debate#

For parts one and two in this series, please see *The Treasurer*, April 2017, page 34, and *The Treasurer*, May 2017, page 36

MWACC is the hurdle rate a firm must achieve on its investments in order to justify its current value