CEO Wealth Creators... and Destroyers

In the first annual *Chief Executive*/Applied Finance Group Wealth Creation Rankings we size up the best and worst performers of the S&P 500 over the last three years.

VALUE. Creating and sustaining it is what CEOs are supposed to do. Creating a lot of value makes shareholders happy and justifies fat paychecks and big bonuses. Losing it angers shareholders, creates tension with the board and generates skepticism about CEOs' strategies, their team's effectiveness or both. When value creation eludes a CEO, his or her days are numbered.

To get a sense of how the S&P 500 CEOs were faring at wealth creation, *Chief Executive* partnered with the Applied Finance Group, creators of the Economic Margin (EM) value metric, and with Drew Morris, CEO of Great Numbers!, a results-improvement consulting firm. His framework for maximizing results, which includes EM, appeared in our January/February and March 2008 issues.

As we have seen with the recent meltdown in financial markets, value isn't always what it appears to be. And traditional accounting measures do not count what really counts. Earnings per share (EPS) and price/earnings (P/E) ratios are based on accounting profit, which is prone to distortion and has no real relationship to wealth creation. Trying to grow earnings or EPS in the belief that the stock market will reward you with a higher share price no longer works, as investors really seek to understand the company's underlying economic performance.

To state the obvious, navigating with instruments that mislead is dangerous. CEOs need to look at their businesses with the same wealth-creation measures that, for example, private equity and institutional investors use. Investors want to know how good a company and its leaders are at preserving and growing their capital.

Many companies have moved from accounting to economic approaches to measuring this. A few, such as EVA, are good because they reckon with the true cost of capital, but none are perfect. Our rankings rely on Economic Margin, a measure with which executives can readily manage wealth creation, and which is applicable at all levels of a company. EM is calculated as the difference between operating cash flow and an appropriate capital charge, all divided by invested capital. EM is suitable for both private and public companies and useful for making comparisons with competitors, as it's an economic-profitability percentage, not a monetary amount.

The ranking method we used (see sidebar, opposite) also considers management's demonstrated ability to protect shareholder wealth and create truly valuable assets. Our intent is to advance the art, science and practice of creating wealth for a company's owners and the associated results-creation skills of its executive team.

10 BEST WEALTH CREATORS

	CEO	COMPANY
1.	J. Christopher Donahue	Federated Investors
2.	Jeffrey P. Bezos	Amazon.com
3.	Robert W. Selander	Mastercard
4.	Mark Donegan	Precision Castparts
5.	Hugh Grant	Monsanto
6.	John W. Rowe	Exelon
7.	John C. Martin, Ph.D.	Gilead Sciences
8.	Daniel P. Amos	AFLAC
9.	Andrea Jung	Avon
10.	Clayton M. Jones	Rockwell Collins

10 BEST WEALTH DESTROYERS

	CEO	COMPANY
1.	James R. Tobin	Boston Scientific
2.	Robert J. Coury	Mylan
3.	Gary C. Kelly	Southwest Airlines
4.	Herb M. Allison, Jr.	Fannie Mae
5.	Eli Harari, Ph.D.	Sandisk
6.	Glen F. Post, III	Centurytel
7.	Larry L. Weyers	Integrys Energy
8.	Steven R. Appleton	Micron Technology
9.	John A. Luke, Jr.	Meadwestvaco
10.	Lynn Laverty Elsenhans	Sunoco

Ranking CEO Wealth Creation BY

DREW MORRIS AND MICHAEL BURDI

The ranking focuses on the performance of companies (and their CEOs) in the S&P 500 index for three years ending on Sept. 1, 2008. It's based on reported results during that period and estimates for the next 12 months.

CEOs whose tenure did not coincide for the full three years were not ranked. Also not ranked are the 14 REITs in the S&P 500 and companies that have been acquired or no longer exist.

The four components of the ranking, explained below, were developed and calculated by the Applied Finance Group (AFG), an independent equity-research advisory firm, using proprietary metrics and data. A weighted combination of each company's component rankings is used to produce an overall score: 100 is awarded to the best wealth creator; 1 to the worst. The component rankings are shown as letter grades with companies in the top 20 percent of each component metric receiving an A grade; the bottom 20 percent receiving an F.

Market (or Enterprise) Value/Invested Capital (MV/IC)

This measure shows the degree to which investors consider the company's assets valuable, relative to their cost. Market value is what a buyer would have to pay to buy the company outright, that is, to purchase all of the stock and pay off all of the loans, leases and other obligations. Note that market value depends on the stock price. Invested capital is the inflation-adjusted total of all of the investments in the business. It does not depend on the stock price. So by its nature, MV/IC reflects the market's take on the value of the investments made in the business.

The Average of the Past Three Years' Economic Margins

Economic Margin (EM) measures the degree to which the company is making money in excess of its risk-adjusted capital cost. It's expressed as a percentage of invested capital.

Overall Ranking	Score (best=100)	MV/IC	3 Yr. EM	EM Change	Mgmt. Quality Score	Company	CEO
1.	100	A	A	A	A	Federated Investors	J. Christopher Donahue
2.	100	A	A	A	A	Amazon.com	Jeffrey P. Bezos
3.	99	A	A	A	A	Mastercard	Robert W. Selander
4.	98	A	A	A	A	Precision Castparts	Mark Donegan
5.	98	A	B	A	A	Monsanto	Hugh Grant
6.	97	A	A	B	A	Exelon	John W. Rowe
7.	96	A	A	A	A	Gilead Sciences	John C. Martin, Ph.D.
8.	96	A	A	A	A	AFLAC	Daniel P. Amos
9.	96	A	A	A	A	Avon	Andrea Jung
10.	96	A	A	B	A	Rockwell Collins	Clayton M. Jones
11.	95	A	A	B	A	McGraw-Hill	Harold W. McGraw, III
12.	95	A	A	A	A	Microsoft	Steven A. Ballmer
13.	94	A	A	A	A	MEMC Electronic Materials	Nabeel Gareeb
14.	93	A	A	C	A	C.H. Robinson Worldwide	John P. Wiehoff
15.	93	A	A	B	A	Schlumberger	Andrew Gould
16.	93	A	A	B	A	Intuitive Surgical	Lonnie M. Smith
17.	92	A	A	A	C	Express Scripts	George Paz
18.	91	A	A	C	A	Autozone	William C. Rhodes, III
19.	90	A	A	A	C	Lorillard	Martin L. Orlowsky
20.	90	A	B	A	A	FirstEnergy	Anthony J. Alexander
21.	90	A	A	A	C	Paychex	Jonathan J. Judge
22.	89	A	A	B	A	Apple	Steven P. Jobs
23.	88	A	A	B	A	Ecolab	Douglas M. Baker, Jr.
24.	88	A	A	C	A	Smith Int'l.	Douglas L. Rock
25.	88	A	A	C	A	Franklin Resources	Gregory E. Johnson
26.	88	A	A	A	C	Charles Schwab	Charles R. Schwab
27.	87	A	C	A	A	Fluor	Alan L. Boeckmann
28.	87	A	A	C	A	Linear Technology	Lothar Maier
29.	87	A	B	B	A	Lockheed Martin	Robert J. Stevens
30.	87	A	A	D	A	Questar	Keith O. Rattie
31.	86	A	A	C	A	Sigma-Aldrich	Dr. Jai P. Nagarkatti
32.	86	A	B	B	A	C.R. Bard	Timothy M. Ring
33.	86	A	D	A	A	Jacobs Engineering Group	Craig L. Martin
34.	84	B	B	B	A	Int'l. Flavors & Fragrances	Robert M. Amen
35.	84	A	B	B	A	State Street	Ronald E. Logue
36.	84	A	B	B	A	Yum! Brands	David C. Novak
37.	83	A	D	A	A	Celgene	Sol J. Barer, Ph.D.
38.	83	B	C	A	A	Deere	Robert W. Lane
39.	83	A	A	D	A	Expeditors Int'l.	Peter J. Rose
40.	83	B	C	A	A	Gamestop	Daniel A. DeMatteo
41.	83	A	B	C	A	Waters	Douglas A. Berthiaume
42.	82	A	A	D	A	American Express	Kenneth I. Chenault
43.	82	B	C	B	A	Aon	Gregory C. Case
44.	82	B	B	B	A	Emerson Electric	David N. Farr
45.	82	B	B	B	A	Ensco Int'l.	Daniel W. Rabun, J.D.
46.	82	B	B	B	A	DuPont	Charles O. Holliday, Jr.
47.	82	A	C	A	A	McDonald's	James A. Skinner
48.	82	D	A	A	A	Manitowoc	Glen E. Tellock
49.	81	A	A	D	A	IntercontinentalExchange	Jeffrey C. Sprecher
50.	81	B	C	A	A	Tiffany	Michael J. Kowalski
51.	81	A	A	D	A	Varian Medical Systems	Timothy E. Guertin
52.	81	B	B	B	A	SYSCO	Richard J. Schnieders
53.	80	B	C	A	A	Cummins	Theodore M. Solso
54.	80	B	B	B	A	Genuine Parts	Thomas C. Gallagher
55.	80	A	A	D	A	Google	Eric E. Schmidt, Ph.D.
56.	80	A	A	F	A	Western Union	Christina A. Gold
57.	80	C	B	B	A	Occidental Petroleum	Dr. Ray R. Irani

The (sortable) list is online at http://www.chiefexecutive.net/AFG/AFGIndex.aspx

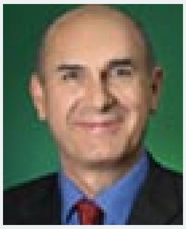
Three Top Wealth Creators—

Jeff Bezos, Amazon.com

Score: 100

The market values Amazon's assets (brand, customer base, warehouse and distribution capabilities and IT infrastructure). The company generates healthy cash flow exceeding its cost of capital (and it's expected to improve). Bezos has grown Amazon's asset base while continuing to produce returns above its cost of capital. That's just the numbers side of the story. Amazon's fanatical attention to the design of its customer experience, and passion for improving it, serves them well. Their customer-value proposition (including the thin margins that made analysts apoplectic in the past) continues to drive revenue growth. Amazon sees few limits to what it can offer customers. It's true that much of the cost of creating its IT and warehouse infrastructure is behind them, so it's easier to make money. But Amazonians still have their foot on the gas, continuing to bring on third parties, which drives sales and margins with low-to-modest impacts on its infrastructure. None of this seems like an accident. There's a lot to admire here.

Hugh Grant, Monsanto



Score: 98

Monsanto has created a business that's specifically designed to help its customer (the farmer) win. It makes substantial R&D investments that have led to products that both increase and protect crop yields. So farmers can produce a higher-quality end product at lower cost, with less effort and with reduced risk of crop failures from droughts and other threats.

Wall Street seems to appreciate Monsanto's dominant market and intellectual-property position, as reflected in its strong MV/IC score. In 2005, Monsanto substantially increased its R&D spending. Between 2004 and 2007, Monsanto's Economic Margin grew from 4 percent to 8 percent, while revenues rose 36 percent.

Andrea Jung, Avon Products

Score: 96

Avon shares many high-performance characteristics with Amazon, but Jung did something else right. In 2006, when Avon's profitability slipped, she restructured the company, fixing profitability and operational issues before resuming growth. This preserved shareholder wealth and is reflected in Avon's management-quality score.

There's much to like about Avon's business model: high (international) scalability, low costs, an established, trusted brand, and a pay-for-performance direct sales force. But in 2005, some of the wheels looked like they might come off the car. Avon's management dug into the situation and recognized a handful of things, its best shots, that it needed to work on. These included delayering an unwieldy management structure; globalizing product development, supply chain, direct sales and technology infrastructure; focusing Avon's marketing efforts where they'd bring the most benefit; and adding compelling new products at higher price points, which enhanced its brand's value. A lot of heavy lifting. But Jung and her team have a lot to show for it. In addition, Avon pushes hard on good governance and good citizenship, such as giving women in the developing world a path to a better future.

—and Destroyers

James Tobin, Boston Scientific

Score: 1

For disregarding shareholders' welfare, this company wins the prize. Overpaying for Guidant increased Boston Scientific's invested capital markedly (along with its capital charge). The market's reaction was severe, depressing the stock price. Guidant's product recalls led Wall Street and physicians to view Guidant's stent line as damaged goods. Both of these factors hurt its MV/IC score. And the reduced demand, and sales, hurt cash flow and EM.

Gary Kelly, Southwest Airlines

Score: 6

Southwest's low score may come as a surprise considering it's arguably among the best-managed airlines. But it's an airline; the only one in the S&P 500. That means planes, airport fees and lots of competition. The market is far from wild about the value of its assets. In the EM sector rankings, Southwest was grouped with other transportation companies, all of which performed better. Southwest's EM ranged between -.5 percent (-.005) and -0.9 percent (almost -1 percent) over the 2005-07 period. While its SEC filings show a profit during this time, when Southwest's off-balance sheet leases and other adjustments are accounted for, the picture reverses. For example, applying those adjustments to Southwest's 2007 results increases its invested capital by $5.9 billion, or 35 percent. The $1.7 billion capital charge on this amount exceeded its $1.5 billion operating cash flow, resulting in a negative Economic Margin.

Steve Appleton, Micron Technology

Score: 13

Micron makes commodity memory (DRAM) chips, which require huge investments in wafer fabrication plants. The extreme price competition in this sector limits Micron's ability to earn the margins needed to recover these investments and turn a profit. So Micron's assets are not exactly Wall Street's favorites, leading to a low MV/IC score. Also, Micron has not earned an economic profit since 2000. Yet in 2006, the company elected to enter another memory-chip market (NAND) which has roughly similar economic characteristics, so it could leverage its very expensive wafer-fab assets. Micron also entered image sensors for cell phones and cameras that is slightly higher margin. Result: Micron continued to grow its assets before correcting its negative EM, destroying even more wealth.

There's a lesson here about CEOs' portfolio-management role and the degree to which a wide range of choices gets considered. IBM over the years took a different approach than Micron. IBM looked for high-margin businesses they could add to their portfolio (services) and got the low-no margin ones (making PCs) out of their portfolio. We wonder whether Micron considered such options.

Finally we wanted to highlight a company that failed to manage its risk—big time. But we weren't able to find any that were still standing and that met our other criteria for CEO tenure: Fannie Mae (still operating, but with a new CEO as of September, Lehman (bankrupt), Washington Mutual (acquired by JPMorganChase) and Wachovia (acquired by Wells Fargo). The popular old song asks, "Where have all the cowboys gone?" Now we know.

—D.M. and M.B.

How to Move Up

At the corporate level:

- Use EM to measure wealth-creation company-wide.
- Manage your portfolio of businesses from a wealth-creation perspective. This includes entering lucrative or fast-growing businesses as well as putting businesses making sub-par contributions into other hands or shuttering them.
- Get all you can out of your assets, including the often underleveraged intangible assets (see "Do Intangibles Matter?" *CE* July/August 2008).
- Ensure that the company's capital structure is right. This affects the capital charge and invested capital. Equity is more expensive than debt, but leverage adds more risk.
- Overpaying to buy back stock is another danger.

At the business-unit level:

- General managers need to find their best ways to boost operating results, as Avon (page 32) did.
- Finally, manage risks throughout the company. Really.

Drew Morris is founder and CEO of Great Numbers! LLC, a NJ-based results-improvement consulting and training company. He has no stake in any of the companies mentioned, save those that might be in long-held mutual funds' portfolios. For more in-depth information on boosting results, contact *drew.morris@greatnumbers.com*.

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