Leading Your Business to MAXIMUM RESULTS

Three Questions Every Executive Needs to Answer, *First*—and the Tools for Getting the Answers

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Executives are finding it harder to meet investors' rising expectations. Owners are serious about wanting their companies to produce maximum results. This is about *how* to do that—a *results best practice.*

Delivering those maximum results means that the company's leaders—the CEO, division presidents and the general managers in those divisions—first have to answer three key questions:

1. What are we being scored on?
2. What should we do to maximize our score?
3. What's the most effective way to increase the economic value of our company? For example, is the wealth-creation ability of our current businesses better than that of others we can create, or migrate into? Are we managing with the best value metric?

The new tools described here will let executives find the answers. They underlie *Insight-Based Management*—or first find the *best ways* to boost results, then do them.

1. What are we being scored on?

What type of performance do owners and influential analysts expect? Do their valuation models emphasize:

- Revenue growth?
- Higher profits? (Increasingly, that doesn't mean accounting profit. Investors want to see economic profit, which accounts for both risk and capital costs.)
- Better management of the company's economic value? (Some of the elements that determine value are within management's control, like what the business invests in, the markets it pursues, and the management of its portfolio of businesses. Others, like the stock market's "take" on the company's future cash flows, lie outside it. But for the value elements you do control, what wealth-creation measure should you use? We'll address that in the context of question three.)

For private companies, agreeing on scoring measures requires a discussion with the owners, particularly if the company might be sold or go public in the foreseeable future.

The rest of this section applies to public companies. By analyzing your stock price, you can determine what type of performance the stock market expects. Specifically, you can figure out which will create more shareholder value: adding another percentage point to

your revenue-growth *rate* or adding another point of profit margin? How should you weight the two in setting results goals for your company as a whole and for an individual business within it?

There's an important first question here: Given that you can determine the revenue-growth-versus-profit-margin emphasis that investors expect in aggregate, should you strive to meet it? Good question, especially if your investors are dominated by traders looking for a quick buck.

We've seen cases where management does indeed have a better sense of the type of performance emphasis that will truly create long-term shareholder value. On the other hand, when results expectations are not met, the stock price usually suffers. So at the very least, the market's expected performance emphasis should be taken as important data when management sets results goals.

In the late Nathaniel J. Mass's April 2005 *Harvard Business Review* article, The Relative Value of Growth (RVG), Mass explains how to determine what the revenue-versus-profit emphasis should be for any public company and how to manage its portfolio of businesses from that perspective.

RVG is the ratio of the change in the company's Enterprise Value (EV) brought about by a 1 percent gain in revenue-growth *rate* divided by the EV impact of a 1 percent gain in profitability. (EV is how much it would cost to buy the company, i.e., to purchase all outstanding shares and pay off all of the debt, or market cap plus debt.)

$$\text{Relative Value of Growth} = \frac{\text{Increase in EV Due to 1\% Higher Revenue Growth Rate}}{\text{Increase in EV Due to 1\% Increase in Operating Profitability}}$$

The sidebar *Figuring the Relative Value of Growth* shows the calculations involved.

Once you have the RVG value that applies to your company (and you've decided whether or not to adjust it), the final figure can be used to maximize what you intend to be the value your company derives from its operations.

2. What should we do to maximize our score?

What leaders decide to do largely determines *how well* their businesses will do. If the leaders don't get the "what to do" right, the only thing that will help is to get lucky—even if all the followers follow and they execute perfectly. And luck is like a cat; it doesn't always come when you call it.

Leaders have not had much help in deciding what to do. Most of the leadership advice focuses on *how* to lead—getting followers to follow, once a destination has been determined. Figuring out *where* to lead (i.e., what to do) has received little ink.

What needs to happen to create maximum results depends on your role. CEOs and division heads, for example, will need to ensure that the company's RVG figure is appropriately adjusted for each business and that the resulting values are passed on to general managers. They must also decide whether and when to address the performance of the businesses in their portfolios, i.e., make the needed keep, fix or sell decisions.

General managers of individual businesses must determine what actions they can take to increase the business's RVG-weighted profit and revenue the most, boosting the likelihood of beating senior management's expectations.

FIGURING THE RELATIVE VALUE OF GROWTH

Let's take as an example a company with:

Enterprise Value (Market Cap + Debt)	$5 billion	Cash Flow	$200 million
Revenue	$4 billion	Cost of Capital	7%
EBIT (Profit)	$300 million	Corporate Tax Rate	35%
EBIT-to-Cash-Flow Adjustments	$(100 million)	Profit Margin	7.5%

Revenue Growth Rate Increases

We can understand how important revenue growth rate is to investors by looking at the growth assumption embedded in the stock price. Analysts use discounted cash flow models to determine a company's value. The simpler models are based on a perpetual stream of projected earnings and assume an average revenue-growth rate. For the purpose of illustration, we'll use such a model here, although one with a finite life and varying growth rates might prove more accurate. The only requirement is that the model chosen produce an Enterprise Value using Revenue as one of its inputs. Now we'll find out what the expected revenue-growth rate is, and how the company's value changes if it increases by 1%. We first find the Cash Flow Growth Rate.

The discounted cash-flow model is

$$\text{Enterprise Value} = \frac{\text{Cash Flow}}{\text{Cost of Capital - Cash Flow Growth Rate}}$$

Note: Mass's article assumed that the *Cash Flow Growth Rate* and the *Revenue Growth Rate* were the same. We'll correct that assumption below.

Solving this for Cash Flow Growth Rate gives

$$\text{Cash Flow Growth Rate} = \text{Cost of Capital} - \frac{\text{Cash Flow}}{\text{Enterprise Value}}$$

$$= .07 - \frac{200{,}000{,}000}{5{,}000{,}000{,}000} \quad \text{or} \quad .07 - .04 \quad \text{or} \quad 3\%.$$

Now we have to find the Revenue Growth Rate that corresponds to the Cash Flow Growth Rate. We know:

Cash Flow = EBIT + Adjustments = (Profit Margin x Revenue) + Adjustments. Solving for Revenue gives:

Revenue = (Cash Flow − Adjustments) / Profit Margin

In our example, if we increase cash flow by 1%, holding Profit Margin constant (we'll vary profit under *Profit Margin Increases* below) and assume that the value of the Adjustments (depreciation, capital expenditures) doesn't change, the corresponding growth in Revenue is 0.67%. The Cash-Flow increase that a full 1% Revenue increase would create is 1.5%, lifting the Cash Flow Growth Rate from 3% to 4.5%.

Plugging this Cash Flow Growth Rate into the Enterprise Value equation above gives:

$$\text{Enterprise Value at 1\% greater Revenue Growth Rate} = \frac{\$200{,}000{,}000}{.07 - .045} \quad \text{or} \quad \$8 \text{ billion.}$$

Profit Margin Increases

To get the Enterprise Value of 1% higher profitability, we first find the increase in Cash Flow by multiplying Revenue by .01 (1%) and reduce the result by the Corporate Tax Rate.

$$\text{Cash Flow Increase} = \$4{,}000{,}000{,}000 \times .01 \times (1 - .35) \quad \text{or} \quad \$26{,}000{,}000.$$

Adding that increase into the Cash Flow term in our Enterprise Value equation gives

$$\text{Enterprise Value at 1\% higher profit margins} = \frac{\$226{,}000{,}000}{.07 - .03} \quad \text{or} \quad \$5.650 \text{ billion.}$$

The Relative Value of Growth

$$\text{So RVG} = \frac{\text{1\% Revenue Growth Rate Change}}{\text{1\% Profitability Change}} = \frac{\$8 - 5 \text{ billion}}{\$5.65 - 5 \text{ billion}} = \frac{\$3 \text{ billion}}{\$0.65 \text{ billion}} = 4.6$$

This means that, in this example, *it's worth 4.6 times as much in Enterprise Value to try to grow sales by an additional 1% annually as it is to grow profitability by 1%.*

Background

Progress in the field of management has produced more than 60 legal and aboveboard actions that executives can take to increase profits, grow revenue or both. These *management actions* are the things that executives can do, or set in motion, to improve results—also known as working *on* your business. They include:

- *Optimizing prices.*
- Improving, and competing on, product/service *design*.
- Crafting *a marketing message* that drives sales like no other.
- *Cutting costs* (this is actually a category consisting of several separate actions).
- *Leveraging technological progress* (including, obviously, the Internet) to deliver new or improved products and services for less.
- Designing, then delivering, a killer *customer experience*.
- Creating *high-value business models*, like Dell's ('80s), eBay's ('90s), Google's, etc.

Depending on the particular business, even one of these actions can provide a dramatic uptick. (The trick is to find the best ones for a particular business.)

Management Actions & Strategy

It seems to be necessary to clarify the relationship between the management actions we're referring to here and business strategy.

Strategy has more to do with what position the business seeks to occupy (low-cost provider, etc.), what it will create to defend that position (scale and automation), and what it will and won't do (fly out of hubs or directly between cities). Ideally, the strategy creates *a defensible uniqueness*.

Implementing a strategy and maintaining a strategic position can also require taking management actions. Those actions can be important and should be considered along with management actions like cost-cutting that are simply aimed at increasing results.

Finding the actions that will increase results the most in a particular target timeframe *has nothing to do* with strategic planning or with crafting a solid strategy. They're just *different things*. To deliver maximum results, executives have to get *both* right.

For example, according to a March 27, 2007, front-page article in *The Wall Street Journal*, since Parker Hannifin set out to optimize its pricing in 2002, the effort has boosted operating income by $200 million. In the fiscal year ending June 30, 2006, the gain represented 30 percent of its $673 million total net income. This pricing-related gain exceeds Parker's *entire* net income ($130 million) for FY 2002. As of the article date, Parker's share price was up 88 percent since 2001, compared with a 25 percent rise in the S&P 500. (For details, see: T. Aeppel, "Changing the Formula: Seeking Perfect Prices Tears Up the Rules, Parker's Washkewicz Weighs Market Power of 800,000 Parts." in the Wall Street Journal issue cited above.)

Pricing had a potent effect on Parker's results because it was *appropriate* for the company, as The Journal's article explains. In another company, price optimization might not have had much effect.

Taking Your Best Shots Matters

Getting back to choosing your actions, with your management time scarce (and your sanity sacred) you're not going to tackle 60-plus initiatives. So you need to find the handful that will boost your results the most and that you can really pull off. We'll call this handful of management actions your *best shots*.

The first question an executive can ask is, "Does finding those best shots matter? Can't I just do what seems to make sense to me (to follow my gut)?"

From what we've seen, finding your best shots matters *a lot*. The $22 million U.S. division of a booming traditional marketing and distribution company had gone from 0 to $22 million in annual sales in six years under Roger, its talented president. *(Author note: Roger requested that his last name and company name be omitted for competitive reasons.)*

Roger's business was well run: growing 30 percent per year, with an operating margin of 16 percent.

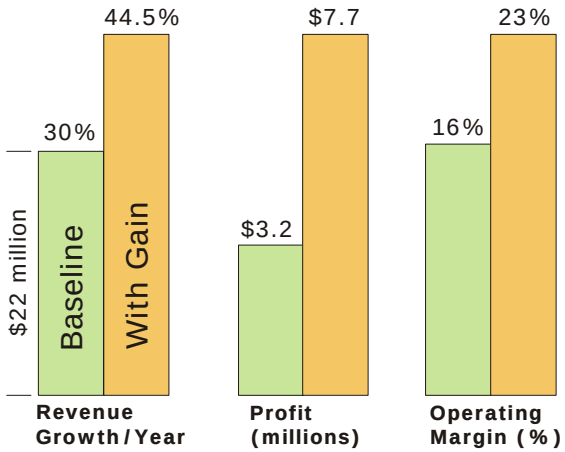
Of the 60-plus ways to increase results, Roger found six that would bring the highest increase in his results and that he could really implement—his best shots.

As shown in the graph, over the next three years, pursuing those best shots would:

- Increase his 30 percent annual revenue growth rate by another 14.5 percent.
- More than double profits.
- Lift operating profit margins from 16 to 23 percent.

These gains would come *solely* from his best shots. *Had he not found them, the gains shown would have been left on the table.*

Results Gains Over 3 Years



The management actions that turn out to be best shots are different for every business, because every business has unique talents, opportunities, constraints and financial characteristics.

A Tool for Finding Your Best Shots—*The Fortune Finder*

The Fortune Finder is designed for working on *a single business*—one that sells a related group of products and/or services to a similar group of customers. This is because, among other things, it focuses on the business's value proposition and how compellingly it's communicated. That can't be done effectively when the attention is on a mix of businesses, like an entire company's or division's portfolio. So we'll assume that the CEO or division head is responsible for managing a portfolio of businesses, and that different people we'll call general managers run each of the portfolio's businesses.

To find the best ways to get that single business's numbers up, the general manager will need to assess the revenue and profit gains that will come from each management action considered, and what it will take to tackle each one.

In this section, we'll use just two management actions as examples:

- Using more compelling and effective ads.
- Harnessing design to both make our products more attractive to customers and to lower the cost of making and supporting them.

To assess an action's gains, we'll need to know how price affects demand and, to figure profit gains, parameters that we call "Profit Power."

Revenue Gains

Revenue = Average Price x Units Sold

Revenue gain is the new average price times the new overall sales volume less the original revenue. For example, if an improved ad campaign boosted unit sales 5 percent, its revenue gain would be 5 percent (because there was no change in average price).

How about design? We'll assume that without a price increase, unit sales would grow 10 percent. But because our product is more attractive, we'll also raise our average price by 2 percent. And we know that historically, demand declines by .5 percent for every 1 percent increase in price.

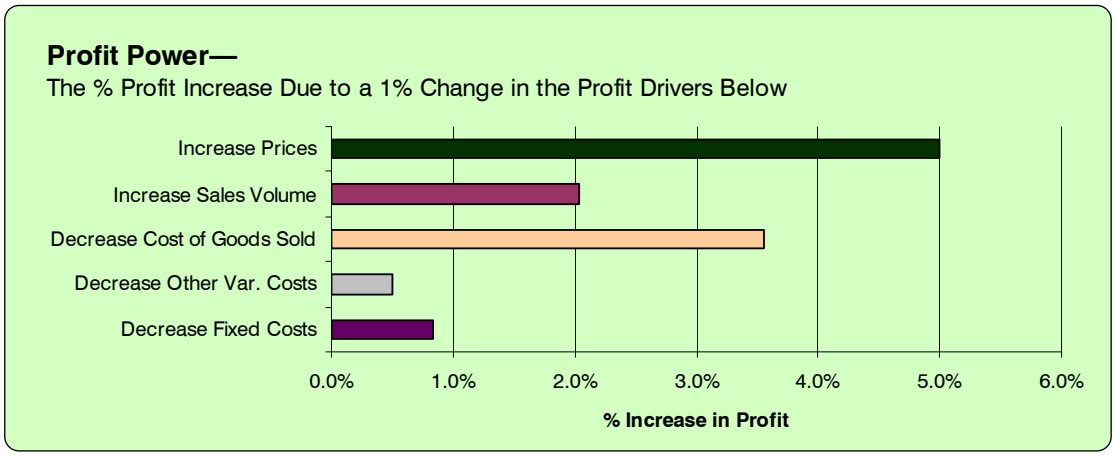
With this data, our revenue would change as shown.

New Sales Volume	x *Sales Volume Adjusted for Price-hike*	x *New Average Price,* or
(100% + 10%)	x *(100% - (2% x .5))*	x *(100% + 2%)* or
110%	x *99%*	x *102%* or
1.1	x *.99*	x *1.02* or
1.11	So the Revenue Gain for the design initiative would be 11%.	

Profit Gains and Profit Power

To assess profit gain, we need to introduce the concept of *Profit Power*. Profit Power is the percent increase in profit that will come from a 1 percent change in each of a business's profit drivers: average price, unit sales, the cost of what's sold, etc. The Profit Power values can be readily derived from the business's operating financials and sales data.

The graph below shows the Profit Power values for the marketing and distribution company discussed earlier, based on a full year's financials. (Corporate overhead costs are not assumed to be under the general manager's direct control, so they're not shown.)



Not surprisingly, the most powerful way for this business to boost profits is to raise prices. The rub is often that a business can't raise prices *that much*. What we call the *range* of a price increase is limited. So the overall profit gain from raising prices might

not be the highest of all the actions they can take. In cutthroat-competitive industries, it can be, well, zilch.

The next highest of Roger's Profit Power values is the cost of what's sold. Often, such costs can be cut to a greater degree than prices can be increased. The resulting profit gain can be larger, even though the COGS Profit Power value is a bit lower than that for price.

Boosting sales volume (unit sales) helps, and it helps more in high-margin businesses. It's *why* marketing is paramount in software companies like Microsoft (2006 gross margin: 82.7 percent).

For Roger's business, other variable costs and fixed costs won't have much impact on profitability unless they can be reduced dramatically, which is unlikely.

Profit Power values in hand, we can move on to assessing the profit gains of improving our ads and of harnessing design. We said that a more effective ad campaign can boost unit sales 5 percent, and that the ad campaign won't affect price nor will it affect cost of goods sold. We'll assume it won't affect other variable costs, as running the improved ads won't cost any more than running the originals. However, we will have to pay an agency for researching and creating the ad. We'll handle that as a 2 percent (one-time) charge to fixed costs.

Factor	Profit Power	x	Range (%)	= Profit Gain (%)
Average Price	5.0			
Sales Volume	2.0		5	10.00
Cost of Goods Sold	3.5			
Other Variable Costs	0.6			
Fixed Costs	.85		-2	-1.70
Total Profit Gain: *More Effective Ads*				8.30

The profit gain of pursuing a more effective ad campaign is the Profit Power of sales volume (2.0) times its range (5%) or 10%, less the one-time fixed cost of revising the campaign. Should you do it? That depends on the other options you have.

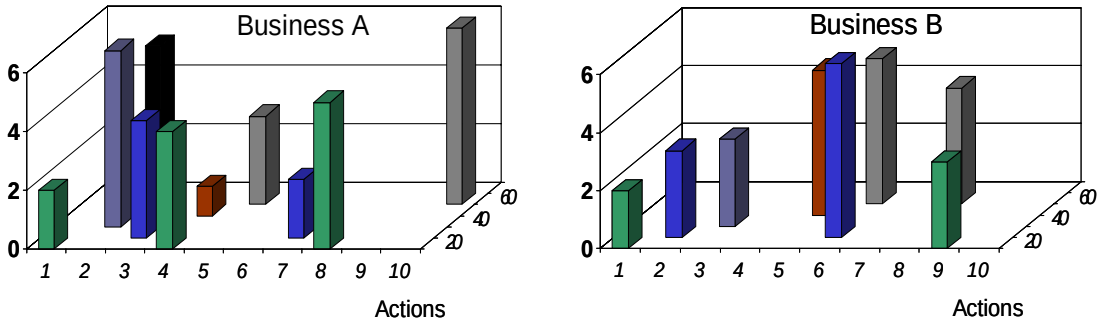
Let's look at the profit gains that can come from our design initiative. Suppose that such a program would allow you to increase average price by 2 percent, grow sales volume by 10 percent (since design sells), reduce COGS by 4 percent (easier assembly), and cut other variable costs by 5 percent (lower field-support expenses). However, it will create another one-time hit to fixed costs (for the upfront engineering and retooling) of 3 percent.

Factor	Profit Power	x	Range (%)	= Profit Gain (%)
Average Price	5.0		2	10.00
Sales Volume	2.0		10	20.00
Cost of Goods Sold	3.5		4	14.00
Other Variable Costs	0.6		5	3.00
Fixed Costs	.85		-3	-2.55
Total Profit Gain: *Design*				44.45

The profit gain here is much higher. So is the effort involved.

The Profit Gains of Management Actions Vary From Business to Business

The "big booster rockets" of one business might not lift another, as shown by the pair of charts below. For each business, the profit gains of 60 potential actions are shown as vertical bars. Notice how different actions drive profits in the two businesses.



Automating the Calculations

We're illustrating how The Fortune Finder works by showing the calculations it makes, but the entire process is automated. Executives need to estimate upsides and impacts and make decisions. The tool itself handles all of the revenue and profit gain calculations, and it tracks whether any resource constraints, like an expense budget, are exceeded.

Remaining Steps

Once you have the Profit Power values for your business, the remaining steps in *The Fortune Finder* are:

1. Find the revenue gain you'll get from taking an action.

2. Find the associated profit gain, using the Profit Power figures for your business.

   In both steps 1 and 2, coming to appreciate the full potential of an action you're considering is best done with the help of someone we call a *results guide.* The guide is an experienced operating executive armed with a book of exploratory questions that can bring you to fruitful new insights. This is actually the most beneficial part of the process; the hard head-scratching leads to aha's that become major breakthroughs.

3. Put both gains into a Potentials Table (a live spreadsheet—see the Potentials Table exhibit) that shows the upsides of the action and what it will take to accomplish (its cost, effort, etc.).

4. Repeat steps 1-3 for the other relevant actions.

5. Enter the Relative Value of Growth you arrived at in answering Question 1 into the bottom of the Potentials Table (or, for a privately held company, enter the equivalent results emphasis).

6. Pick your best shots. In some cases, your best shots can be found just by eyeballing the Potentials Table, or by checking and unchecking the "Do" column entries. Less obvious cases might require a results guide's help. You will also need to assess the Economic Margin (see page 12) of the management actions on your short list that

A Potentials Table

Action	**Do**	Upsides: Revenue Gain (%)	Upsides: Profit Gain (%)	Realities: Expense ($MM)	Realities: Capital ($MM)	Realities: Mgmt. time	Realities: First Scarce Resource
More compelling ads	X	5	8.30	.05	-	L	-
Customer experience		4	4.32	11	45	M	H
Harness *design*	X	11	44.45	80	50	H	L
...							
Selected actions total		16	52.75	80.05	50	H+	L
Results targets and realities		6	10	100	80	L	M
Over/under (-) **target** by...		10	42.75				
Under/exceeded (-) **resource** by...				19.95	30	**NG**	OK
Relative Value of Growth (RVG)	**3**	48	52.75	RVG-weighted Gains			
Combined RVG-Weighted Gain		**100.75**					

Actions

Gains & impacts of the chosen (**Do** column) actions

Targets & limits (budgets, etc.)

How much are we over/under targets?

Exceeded resources show in red box

Not enough management "bandwidth" to do this.

Notes

1. If a new RVG figure (say 2, not 3) is used, the RVG-Weighted gains will change. This does *not,* per se, have any effect on the value of the business. It just means that the market is no longer expecting revenue growth to be as strong relative to profitability.
2. The best shots for a business are the actions that together maximize the Combined RVG-weighted Gain without exceeding any of the resource limits.
3. Sets of actions with the same Combined RVG Gain and resource demands are equivalent.
4. The actions in the table above are for illustration only and they are *not* the best shots of the marketing and distribution company discussed earlier.
5. The overall revenue gains of the chosen actions (the sum of the average-price changes times the sum of the volume changes) will be slightly more than the sum of the individual revenue gains. Using the individual revenue gains is simpler and sufficiently accurate.

require significant investment, as well as to account for any overlapping benefits in your chosen best shots. In this way, you won't mistakenly count the same gain more than once and mislead yourself about how well you'll do.

There will be situations in which your best shots will constitute a real home run, but they will cause one or more of one of the "Realities" columns in your Potentials Table to be exceeded. This is a sign that it might make sense to ask for more resources because of the upside uncovered—or at least have a dialogue about it. It makes the Potentials Table a management tool in the truest sense.

Finally, it's well worth pointing out that when a general manager and his or her direct reports experience The Fortune Finder as a group, it can create a highly coherent, energized team who will drive execution of the best shots they find. Simply, it creates juice.

3. What's the most effective way to increase the economic value of our company?

Before we turn to increasing your company's value, there appears to be the need to restate the obvious—it's easier to increase that value if you can keep from losing the value you already have.

The recent debacle in the financial markets, with global collateral damage, makes clear the need to manage and mitigate risk. Those risks can take many forms besides financial risk: product liability (Merck), corporate-integrity outages (Enron), intellectual property disputes (RIM), new product failures (Coke and others), etc.

There's another, more subtle and possibly more serious risk—navigating with the wrong instruments. Put simply, you need to manage with the same wealth-creation-measurement tools your investors use. So you avoid situations where your performance measures say you did well and investors' metrics say otherwise—and your stock tanks.

What's the right instrument to guide you in maximizing your company's economic value: optimizing your company's portfolio of businesses, weighing the economics of major investments, not overpaying for acquisitions or getting lowballed in a divestiture?

The question is the proper concern of every operating executive, from general manager to CEO. It matters because each of them might be able to do something even more lucrative with the capital they're stewarding, such as:

- Ensuring that the wealth-creation ability of their businesses is better than that of others they can create, or migrate into. This is classic portfolio management—looking the wealth-creation ability of each current business square in the eye, then deciding what to do about it. Also, as Harvard's Michael Porter has pointed out, the profitability of various industries varies dramatically. Could you inexpensively and at low risk enter a higher-profit industry by, say, making a pivotal hire? The same thinking can be applied to industry growth rates.

A CEO might ask, "Why isn't the wealth-creation ability of our portfolio businesses the first thing to address, rather than trying to improve them (as prescribed in earlier sections)?" Unless a business can't be further improved (often unknowable at the outset), it's better to get it performing its best before making such an assessment.

If, at the outset, a business is clearly not worth fixing, so be it. Otherwise, first try to fix it, then sell or shutter it if unsuccessful. Reasonable people will differ about whether to try fixing first.

- Accurately assessing the wisdom of acquisition and divestiture opportunities.
- Weighing the investment required by a major new initiative like a best shot.

Outcomes can include selling business(es), or assuming the risk/uncertainty of making major changes and the need to overcome organizational inertia. But addressing the question comes with the territory of maximizing results.

Now about that "instrument"...

A Wealth Creation Measure We Can Use for Managing

Some context... Value lies in the beholder's eye. And in the depth of its pockets, and the value of its currency. As in, "When Google Bought YouTube." By most common measures, YouTube's value was some distance below the price Google paid for it. But to Google, the purchase price *was* YouTube's value (at least with the currency being Google's stock).

Back on Earth, we have managing to do—managing for value. Since we can't count on "the YouTube miracle" happening to our companies, we'll just have to pick a good measuring stick.

Of late, many companies have moved to economic rather than accounting approaches to measuring profit. These approaches recognize the cost of the capital the business ties up, which rises, as it should, with the level of risk the investors take on. So it's no longer simply: Does the business make money? Rather, it's: Does the business make money after we've paid the risk-related interest on the debt and we've given investors the risk-adjusted return they anticipated (an *economic profit*)?

It's critical, too, that executives manage with *accurate* measures of wealth creation, instead of trying to steer while blindfolded by distortion-prone or misleading metrics.

What We Need in a Wealth Creation Metric

Executives need a wealth-creation metric they can *manage with*, not just a measure that an investor might use. The executives' measure must:

- Speak the truth—*accurately* gauge wealth creation.
- Be easy for the "numbers people" in an organization to understand and calculate.
- Make intuitive sense to executives.
- Be useful for *making comparisons*—we need *a ratio*, not a monetary amount.
- Be applicable at *all levels* of a company.
- Be suitable for both public and private companies. (To avoid, "Whoops, Herman. We were just acquired by a private-equity firm, so all of our management measures are out the window.")

After a wide-ranging investigation, the sole measure that met *all* of the above criteria was *Economic Margin*, the difference between Operating Cash Flow and an appropriate Capital Charge which is then divided by Invested Capital. It was developed by Daniel J. Obrycki and Rafael Resendes of The Applied Finance Group.

ECONOMIC MARGIN (EM)

$$\text{Economic Margin} = \frac{\text{Cash Flow from Operations - Cost of Capital}}{\text{Invested Capital}}$$

In words, *How good is this business (or investment/initiative) at making real money?*

The sidebar below shows how Economic Margin tracks with share price for Biogen and references a more broad-based analysis.

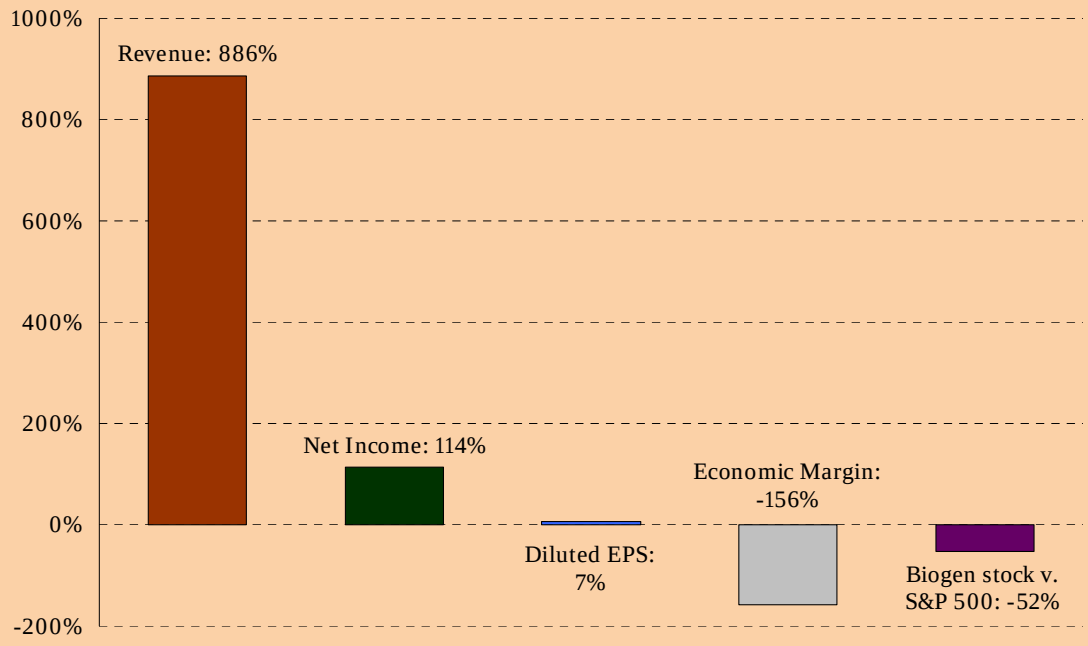
Why Profits Alone Won't Move a Stock

Once upon a time, the conventional wisdom among corporate executives was to grow earnings or earnings per share in the belief that the stock price would rise in response. That no longer works—investors now look at the underlying economic reality.

For example, in 2003, Biogen merged with Idec, creating Biogen Idec, a biotech giant. It was billed as a merger of equals with the ability to create strong earnings and sales growth. Biogen certainly achieved its goal of growing earnings and sales, but the cost of such accounting success was economic profitability (as measured by Economic Margin).

Since 2001, sales grew 886 percent through 2006; net income by 114 percent. Unfortunately, during that same period, Biogen's Economic Margin declined 156 percent and the stock under-performed the S&P 500 by approximately 52 percent.

***Changes* in Biogen's Performance 2001-2006 (%)**



Lest this appear to be an isolated phenomenon, The Applied Finance Group has done much more extensive analysis of how the value of Economic Margin correlates with stocks' cumulative returns. That typically includes an aggregate analysis and separate analyses of individual sectors (capital goods, finance, technology, etc.); small, medium and large companies; growth and value stocks, etc. To request a copy, please see the third Economic Margin reference in *Digging Deeper on Wealth Creation*, last page.

The author thanks Rafael Resendes of The Applied Finance Group for contributing this example.

The tables *Popular Wealth Creation Measures* and *Other Measures We Considered*, below, summarize the metrics we reviewed. We list reference sources under *Digging Deeper on Wealth Creation*, last page.

Popular Wealth Creation Measures

		Characteristics
Economic (risk and cost-of-capital based) metrics used to assess public companies as a whole.	**Total Shareholder Return or TSR** TSR is the change in share price over a period, plus dividends per share, as a percentage of the start-of-period share price. Used by *Fortune* and *The Wall Street Journal* in their public-company performance rankings. TSR paints a clear picture *for investors*. As a wealth-creation metric *for managers*, TSR reflects (through its use of the stock price) what the market thinks the company's present and future performance will be. Sometimes, that's correct. Not always.	Rooted in market's perception of future performance (share price)
	Market Value Added or MVA MVA is a company's market cap less invested capital. A positive figure shows that management has created value. More telling is a positive value appropriate to the risk of capital. MVA is a dollar amount, not a ratio that can be used to compare companies that differ in size.	Same
Accounting metrics used to assess public companies as a whole.	**Return on Capital or RoC** EBIT over invested capital. *Business Week* uses it (with distortions removed, averaged over three years) in its BW 50 performance rankings.	Based on accounting profit. EBIT is prone to distortion.
	Earnings Per Share or EPS Reported earnings over shares outstanding. The Diluted EPS variant includes stock-option-related, but unissued shares. Can drive share buybacks.	Meaningless for managing — both top & bottom halves.
	Price/Earnings Ratio or P/E Stock price over EPS for the past four quarters. What investors will pay for a company's earnings.	No relationship to wealth creation.
An *economic* metric *all* companies and their businesses can use.	**Economic Margin or EM** (Operating Cash Flow less an appropriate Capital Charge) over Invested Capital. Economic Margin has been shown to correlate well with changes in stock price. It can also be used to assess major initiatives, acquisitions and divestitures.	An accurate, widely applicable wealth-creation measure.
A *hybrid* metric usable by *all* companies & their businesses.	**Economic Value Added or EVA** After-tax profits (NOPAT) less Cost of Capital. EVA is a monetary amount, not a ratio. We can divide it by Invested Capital to get a ratio we can then use to compare businesses and companies. Note that EVA's a mixture of accounting (NOPAT) and economic (capital-related) terms.	Depreciation of old assets in the NOPAT calculation makes EVA distortion-prone.

Other Measures We Considered

The following measures were considered but can't be recommended for managing, either because they are not ratios, or could provide misleading results, as detailed below.

Cash Flow ROI	CFROI does not measure wealth creation, as it takes no account of the cost of capital. Because it mixes operating and financing decisions, the CFROI value can change depending on whether debt or equity is used for financing, even though there is no change in the business's underlying operating performance. Finally it is computationally complex. Because of all this, CFROI is not an ideal tool to manage with.
Cash Value Added or CVA	Operating Cash Flow less the Cost of Capital. Since CVA is a monetary amount, to use it to make wealth-creation comparisons, we can divide it by Invested Capital. But when we do that, the formula becomes identical to Economic Margin.
Shareholder Value Added (SVA)	This monetary amount seems to have acquired a number of different definitions. We'll go with Alfred Rappaport's—see Digging Deeper on Wealth Creation, last page. SVA is the present value of the capitalized *changes* in NOPAT over a series of time periods, less the present value of the incremental investments. Here too, we'll need to divide by Invested Capital to use this measure. Economic Margin seems simpler.
Market to Book Value (or Equity-Spread) Approaches	Market-to-Book-Value approaches, such as Residual Income, are based on the Gordon Model of valuation—see McTaggart, et al. in Digging Deeper on Wealth Creation, last page. That model has issues like over-sensitivity when the cost of equity nears the growth rate and it seems inappropriate for non-dividend-paying stocks.

How the Next Generation of Management Tools Work Together to Increase Results

The table below summarizes the tools for answering each of the questions we posed at the outset, along with what each tool reveals, and its implications for companies and executives.

Question	Tool	Insight provided	So that…
1. What are we being scored on?	The Relative Value of Growth –RVG	Tells CEOs the importance of profit versus revenue growth to owners.	CEO & Division Heads can use RVG to set goals for their businesses.
2. How can we maximize our score?	The Fortune Finder	Shows General Managers their best shots–the handful of management actions that will boost their results the most and that they can really take.	The company's businesses deliver the best possible RVG-weighted results.
Used together, these two tools can maximize the RVG-weighted profit and revenue growth of a company's portfolio of businesses—without changing the portfolio itself. But that might help, too… So we ask Question 3.			
3. What's the most effective way to boost the economic value of our company?	Economic Margin	Shows CEOs, Division Heads and General Managers how good the company's businesses are at creating economic wealth.	Adjustments to the portfolio (start, acquire, shutter or sell) can be made, along with value-enhancing investments and divestitures.

Using the Tools Together

The Maximum Results Roadmap below shows how these tools can be used together in mid-size and large companies.

A Maximum Results Roadmap

What Executives Can Do to Maximize Results

Step	Who	When	Action
Public Companies			
1.	CEOs (with help from the CFO)	Now	Find the Relative Value of Growth (RVG) figure that applies to your company, adjust and apportion as appropriate, and get those figures to your division heads.
		Ongoing	Monitor whether the RVG goals you set need changing in view of your businesses' performance and the stock market's perspectives.
2.	Division Heads	Now	Adjust and apportion the RVG figures for your division's businesses. Convey those figures to your general managers.
		Ongoing	Monitor whether the RVG goals you set need changing in view of your businesses' performance.
Private Companies			
3.	CEOs and Owners	Now	Choose the mix of profits and revenue growth that you'll use to gauge managers' performance.
All Companies			
4.	CEOs (with help from the CFO)	Now	Begin the implementation of Economic Margin to assess the businesses in your portfolio.
5.	General Managers	Now	Begin the hunt for your best shots. (Once steps 1 & 2, or 3 here are done—and usually before this step 5 is finished—you'll have the RVG figures or the primary results measure needed to pick those best shots.)
			Before choosing, you should also assess the Economic Margin of the management actions on your short list that require significant investment.
6.	CEOs and Division Heads	After step 5	Review the best shots of each general manager. Have the crucial conversations about the actions they chose not to take because of resource limitations.
7.	CEOs and Division Heads (with CFO's help)	Annually	Monitor the Economic Margins of the company's businesses. Start, acquire, shutter, sell or keep fixing businesses, as results indicate.
8.	All executives	Always	Keep an eye out for businesses with higher Economic Margins that the company could be in.

Conclusion

Management tools have now evolved to where executives do in fact have everything they need to deliver maximum results. The exciting part, using these tools and creating the results that would once have gone missing, lies ahead. Plus, leading's easier when your people and your owners believe you're on the right track, based on the insights you've gained.

References

The table below lists sources for the various wealth-creation metrics we investigated (page 13).

Digging Deeper on Wealth Creation

Cash Flow ROI-CFROI	Bartley J. Madden, CFROI Cash Flow Return on Investment Valuation: A Total System Approach to Valuing the Firm.
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