John Hagel III, John Seely Brown and Lang Davison

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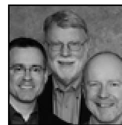

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The Best Way to Measure Company Performance

2:09 PM Thursday March 4, 2010 | Comments (7)

Most Wall Street analysts and investors tend to focus on return on equity as their primary measure of company performance. Many executives focus heavily on this metric as well, recognizing that it is the one that seems to get the most attention from the investor community. But is it the best metric?

Even though more sophisticated valuation techniques like IRR, CFROI, and DCF modeling have come along, ROE has proven enduring. At one level, this makes sense. ROE focuses on return to the shareholders of the company. If you are a shareholder, this gives you a quick and easy to understand metric.

But ROE can obscure a lot of potential problems. If investors are not careful, it can divert attention from business fundamentals and lead to nasty surprises. Companies can resort to financial strategies to artificially maintain a healthy ROE — for a while — and hide deteriorating performance in business fundamentals. Growing debt leverage and stock buybacks funded through accumulated cash can help to maintain a company's ROE even though operational profitability is eroding. Mounting competitive pressure combined with artificially low interest rates, characteristic of the last couple of decades, creates a potent incentive to engage in these strategies to keep investors happy.

Excessive debt leverage becomes a significant albatross for a company when market demand for its products heads south, as many companies discovered during the current economic downturn. It actually creates more risk for a company in hard times.

These efforts can become addictive. If underlying profitability continues to deteriorate, more stock buybacks or debt leverage will be necessary to maintain return on equity, further increasing company exposure to unanticipated

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downturns in consumer demand or financial market crises. But letting ROE decline is often too painful to contemplate since the impact on stock performance can be immediate. The risks on the other side are less immediate and less quantifiable, so there is an understandable temptation to avoid immediate pain.

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These issues with ROE led us to pick a different bottom-line metric for corporate financial performance when we constructed our Shift Index last year. We focused on a metric that receives far less attention from executives and investors alike — return on assets (ROA) — to analyze long-term profitability trends across all public companies in the US. Return on assets avoids the potential distortions created by financial strategies like those mentioned above.

At the same time, ROA is a better metric of financial performance than income statement profitability measures like return on sales. ROA explicitly takes into account the assets used to support business activities. It determines whether the company is able to generate an adequate return on these assets rather than simply showing robust return on sales. Asset-heavy companies need a higher level of net income to support the business relative to asset light companies where even thin margins can generate a very healthy return on assets.

Many companies outsource asset intensive manufacturing and logistics operations to more specialized providers in an effort to create "asset light" businesses. Those assets have not gone away — they have simply shifted from one company to another. Someone has to earn a reasonable return on those asset investments. Even intrinsically "asset light" businesses have some limited current assets and fixed assets required to support the business.

Using ROA as a key performance metric quickly focuses management attention on the assets required to run the business. Executives have more degrees of freedom today to outsource management of these assets and related business operations to more specialized companies. The key question is: who is in the best position to earn the highest return on those assets? This question helps executive teams to focus their own operations more tightly on the activities and assets they are best qualified to manage and to spin out other activities and assets to more specialized companies.

There's a powerful alternative form of leverage — capability leverage. As noted earlier, excessive financial leverage becomes a large and inescapable burden in an economic downturn. Capability leverage, in contrast, supports a business through all phases of the economic cycle. Specialized outsourcing providers, because of the scale and diversity of their operations, can provide key assets and capabilities quickly and more profitably to help companies ramp up rapidly during an economic upturn. Variable cost outsourcing arrangements support scaling back during downturns. Readily available financial leverage helped to drive returns to shareholders higher, leading many companies to neglect the potential of capability leverage.

Long-term ROA trends highlight the importance of capability leverage options. Our Shift Index revealed that since 1965 all US public companies experienced sustained and significant erosion in ROA — dropping by 75%. Mounting economic pressures are largely obscured by the metrics and time frames we use. This doesn't just reflect the current economic downturn. These longer-term trends suggest our traditional approaches to business are fundamentally broken. This decline is occurring in spite of a movement to more asset-light business activities and the absence of a crucial asset from the balance sheet — the talent of the workforce.

No single metric is perfect and different metrics are appropriate depending upon the circumstances. But our over-reliance on ROE is problematic on many levels. ROA may foster a better view of fundamentals of the business, including asset utilization. As economic pressures mount, executives would be well advised to ask: which assets are we uniquely capable of managing? And how can we let somebody else own and manage the rest of them, while we focus on my own unique strengths?

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What do you think? What are the most useful metrics for measuring bottom-line financial performance? What are the implications of long-term ROA trends? Are companies sufficiently aggressive in pursuing capability leverage? If not, what holds them back?

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7 **Add a Comment**

March 4, 2010 at 2:36 PM

Americans recuse to adjust equity to inflation. That overstates roi and leverage ratios for banks. In Brazil we adjust past inflation and them come out as less profitable. But no criais every 15 teses

— STEPHEN KANITZ

March 4, 2010 at 3:26 PM

What about economical value added (EVA)?

— AHMED

March 5, 2010 at 7:08 AM

For some time it has been traditional means of valuing companies are flawed. The new source of value seems to be the ability to leverage and develop capability to turn long term sources of cash, leaving traditional assets as liabilities.

— TOM PICKERING

March 5, 2010 at 8:58 AM

I was puzzled by these numbers and wrote about them when you released them last year.
http://www.i-capitaladvisors.com/2009/11/17/what-does-it-mean-that-roa-has-declined-since-1965/

The "assets" in the denominator of ROA are those that are booked on the balance sheet. Most of these are tangible. But tangible book value today is a fraction of total corporate value today (30% in 2007, more during the recession).

The kind of assets that fuel the capabilities the Shift Index is trying to measure are processes, networks and human knowledge capability. These, too, are assets that are built through investments. But these investments are not eligible for the balance sheet (except in the case of an acquisition). How, then, should these intangibles be treated in your ROA calculation?

I am also curious why your data differs so drastically from the data on rising labor productivity.

— MARY ADAMS

March 5, 2010 at 9:22 AM

Your findings make sense.....US manufacturing has steadily declined since the 70' & 80' and is almost non-existent today. Our economy is very skewed to service based companies...hence the decline in ROA. I think you bring up a great point in the absence of our most crucial asset these days - the

workforce. I would like to see a deeper dive into this topic.

— ADAM

March 5, 2010 at 2:20 PM

As the US continues it's shift to a knowledge economy, how do you adequately value assets? Use Google as a model. For the year ended Dec. 31, 2009, they had $6.5 billion in net income. Run the ROA on their total assets of $40.5 billion = 16%. (hmm, if you're "assets" are in US Treasuries or at the bank, you don't get near that.) Run the ROA on Google's net assets of $16.0 billion (minus $24.5 billion in cash) = 40%. Nice.

At Google, the most valued resource is not cash or the assets - it's access to their engineering talent. But that doesn't show up on their balance sheet.

I'm just saying.

— DEBRA BRADLEY

March 5, 2010 at 2:21 PM

Hello John, John & Lang,

I agree that ROA is a better metric especially within the context of the important question you have raised –

“Which assets are we uniquely capable of managing? And how can we let somebody else own and manage the rest of them, while we focus on our own unique strengths?”

This is an important question for senior leaders of the firm today, as most companies do not have the right set of tools and techniques to measure/identify their core strengths so that they can transition the non-core processes/assets to the partners (i.e. capability leverage) to achieve the best business outcome. In my opinion, the next wave in corporate performance management is to develop automated tools and techniques to help executives to leverage their capabilities better so that they can make effective business decisions on the areas of tapered integration models with outsourcing partners as you have pointed out correctly. Those companies that do this well using a “virtual networked enterprise concept” are going to be the winners in the next decade.

However, deciding which processes within the value chain are asset intensive is not easy and it is both an art and science. This is where well designed corporate performance management systems are extremely helpful. In my mind, CPM systems need to focus on three “focus areas”.

1. Financial performance indicators
2. Valuation indicators
3. Capability leverage indicators

1. Financial Performance Indicators: The key questions within this focus are -

- How much capital asset the company is using?
- What is the Return of Capital Asset (ROA/ROIC)
- How much does the capital cost?

The VBM framework methods such as EVA & CVA are very helpful to answer these questions. The first acid test I would do is whether companies are earning greater than the total cost of capital. The dollar difference between ROA and the cost of capital (which by and large is EVA) needs to be around zero or higher. With most competitors keep pushing the cost of capital returns to higher level, the dollar difference around zero is acceptable as well. If a company continuously cannot meet the cost of capital, it eventually will go under.

2. Valuation Indicators: The key question within this focus area is – How are companies valued?

I am sure there are lots of valuation methods available- enterprise value method (equity+debt), P/E method, market cap, DCF etc. Another simple method I like is - Profits that is capitalized at the capital cost of 8-10%. If the capitalized number is within the ball park of 75% of the market cap, then one can say that the company is rightly valued (&healthy) as the delta in the market cap value (i.e. the remaining 25%) is usually based on company’s future performance.

3. Capability Indicators: The key question within this focus area is – Given the fact that "assets" that are captured on the balance sheet are mostly tangible assets, how do we effectively measure intangible assets? In other words, with most of the intangible capabilities such as value-add processes, intellectual capital, and innovation capabilities (that are developed through investment) are not eligible for the balance sheet, how, in the world, we measure these intangibles? (Kind of the question raised by Mary Adams)

This is where a balanced score card with a clear linkage of drivers with causal relationship is helpful. The CPM that is designed with Dashboards driven balanced scorecard, with a broad set of measures

based on the four perspectives of Kaplan and Norton is needed: the learning and growth related elements, internal and external processes, customer satisfaction followed by financial results. We can also augment the BSC with lean principles for us to be more efficient. Lean can be defined as the effective utilization of various tools and techniques in a systematic, customer-focused manner that increases the flexibility of the manufacturing and supply chain processes with the goal of producing the highest-quality product within an environment of continuous improvement and thereby increasing shareholder's value.

For example, within this lean based BSC, we can link the KPI's of internal processes in terms of resources allocated and results achieved to strategic investments and then to EVA/CVA to simulate business reality. As an additional step, we can also automate this BSC with Business Activity Monitoring concepts and create a technology enabled real time balanced score card that can simulate the business reality in real time and help executives to make business decisions instantaneously.

Regards,
Charles

— CHARLES PRABAKAR

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