

Real measures for market realities*

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For over a decade, a single metric—share value—has dominated market evaluations and corporate goals. Today, the consensus is that a range of more meaningful factors should be used to guide long-term company performance. Real growth will need to be generated internally from product and service quality, customer satisfaction, innovation and operating efficiency. Performance management can help companies bridge the gap between short-term market expectations and long-term durability.

Introduction

During the bad old days of irrational exuberance, share value reigned supreme. Companies such as Enron were applauded for their entrepreneurial acumen in using “financial engineering” to increase share value. Many mergers, acquisitions and takeovers were executed solely to beef up share value. Good company performance, by definition, meant increasing short-term share value. A high-profile investor like Warren Buffett, CEO of Berkshire Hathaway, was written off by analysts as quaint and out of tune with the times because of his fixation on long-term company value—and values. “Warren Buffett should say, ‘I’m sorry.’ How did he miss the silicon, wireless, DSL, cable, and biotech revolutions?” wrote Harry Newton, publisher of *Technology Investor* magazine, in 2000.

The times and tides have changed, equity markets have tanked, and other investors are sorry now—but not Warren Buffett. Today, the consensus is that share price is a deeply flawed indicator of management performance, and that the market is too obsessively focused on short-term earnings. To encourage managers to focus on long-term growth, Coca-Cola announced it would no longer provide guidance to analysts about the course of its quarterly earnings. Market observers speculate other companies may follow suit, but it is too soon to tell if a fundamental shift of focus from short- to long-term thinking will prevail.

So, what indicators should properly be used to evaluate true company performance, and to what extent have investors actually bought into using them? How can companies manage their performance while markets adjust to new economic realities?

Unyielding markets

The most serious problem caused by the relentless scrutiny of shareholder value is that the long-term potential of a business is sacrificed to short-term, quarterly expedients. Management decision-makers become slaves to budgets that must show the expected earnings increases every quarter, or else face punishment by markets. The budget becomes a rigid document to be achieved at all costs, which discourages alternative action opportunities, no matter how promising.

The premise that the growth of share value should be the central criteria for measuring performance rests on the assumption that management should be capable of producing consistent growth. But this premise is faulty. Even during the boom years of the past decade, consistently strong growth was, in fact, the exception, not the rule: from 1990 to 2000, only 10% of publicly traded companies enjoyed eight or more years of double-digit growth, according to the *Harvard Business Review*.

Moreover, the economy overall is slowing: noted market bull Jeremy Siegel, finance professor at the University of Pennsylvania's Wharton School, says the next five to 10 years will likely bring lower market returns. He predicts the Standard & Poor's 500-stock index will yield 7.5% to 10%—which is really 5% to 7% after inflation, according to *BusinessWeek*. Nevertheless, many investors conditioned by unsustainable returns in the nineties continue to maintain the unrealistic belief that

stock markets should rise about 10% to 12% a year, in real terms. “The investing public—even highly educated people—are terribly financially illiterate,” says Professor Paul Marsh of the London Business School.

Unfortunately, demographic factors conspire to reinforce the short-term focus on share value. The aging of the post-Second World War baby-boom generation, lower birth rates across the industrialized world and increasing longevity spell a looming demographic crisis for pension systems. The leading edge of baby boomers born in 1945 will reach the regular retirement age of 65 in 2010. Millions of people who are in the pre-retirement window of about 10 years, and who relied on market investments to fund their retirement, have suffered major losses in the recent downturn.

This large and influential cohort will likely chase high returns even harder to make up lost ground. “In a low-inflation world of subnormal equity yields and derisory bond returns, anyone who thinks they have built up a nice pot for those round-the-world cruises in their golden years is in for a rude awakening,” writes Andrew Hilton in *The Banker*. “It may take \$3 put aside now to earn the return we expected on \$1 a decade ago.” Market dynamics will likely be complicated by demographic factors and inflated expectations of company performance in the near term.

The measurement of a company's performance is, at best, complex. For more than a decade, a single metric—share value—has been used as a proxy for good management. Enron appeared to grow its business by pumping debt instead of pumping petroleum on this assumption. Today, management experts agree that input measures—how a company manages strategic direction, customer service, product development, innovation, and so on—are better indicators of a company's future performance than an output measure like share value.

But this requires more work evaluating subjective factors, and there is no consensus view yet on which indicators are the right ones to use. Moreover, this approach requires more meaningful information on these indicators. In the absence of long-term information about management, the markets they choose to operate in and their strategies for growing the value of investors' hard-earned money, short-term earnings will continue to be used as a proxy for good management by many investors.

Evidence suggests leading companies are using performance management to enhance both their short-term and long-term prospects. According to PricewaterhouseCoopers' *2002 Management Barometer* survey, top executives at multinational companies consider non-financial performance measures more important than current financial results in creating long-term shareholder value. However, financial results remain a key factor in making ongoing management decisions. About 69% of these companies have attempted to link a broad range of measures of key business performance factors with future financial results or share price.

Overall, those attempting to link business performance factors to future financial outcomes had greater growth than those that don't—they generated 2.5 times greater revenue growth over the past five years than companies that don't link measurement and performance. Better measurement of key factors helps these companies bridge the gap between short- and long-term management.

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Does company strategy measure up?



At a fundamental level, an organization's viability as a going concern rests on its ability to generate true net cash from operations—not just borrowing. This is a function of factors like product and service quality, customer satisfaction and loyalty, innovation and operating efficiency. Results of a recent survey by the Institute of Management Accountants show that financial professionals believe such factors have considerable strategic value: the majority of respondents said non-financial performance metrics should be used more extensively within their company. When asked why, many said non-financial metrics are more closely aligned to strategic initiatives and have more calls to action.

And an overall theme expressed by the respondents was that non-financial metrics represent the drivers of financial performance.

A sophisticated investor applying the acid test in evaluating a company's financial performance and ability to generate net cash might ask questions such as: is it in the right market? Does it have the right business model? Are there robust business processes in place to generate net cash? Evaluation of a company's long-term prospects involves a more complex question: how does the company achieve a permanent advantage for its business that can't be immediately matched or exceeded by its competition?

This quality—also known as sustainable competitive advantage—is what Warren Buffett has identified as the single most important factor when he evaluates a company’s investment potential: “The key to investing is not assessing how much an industry is going to affect society, or how much it will grow, but rather determining the competitive advantage of any given company and above all, the durability of that advantage.”

Product innovation was singled out by the management team. But careful analysis of information about the way the company really created value revealed that product innovation was not nearly as important as customer service and process management. Worse still, focusing on product innovation was diverting management from real opportunities to create value. As in any other sphere, the maxim “know thyself” is a critical first step to determine a business’s real source of competitive advantage.

The next logical step is to work on this core area to the exclusion of lesser areas. If possible, external benchmarks should be used where there is a legitimate and meaningful basis for comparison to decide which areas of the business perform well and support the sources of competitive advantage. Many leading-edge companies are simplifying their business models as a way of concentrating energy on their core business. Once the core piece is identified, the next logical question is: can we give the non-core piece to someone else who can do it better?

This strategy is manifested in the recent surge in outsourcing, which represents a strategic focus on the core business, reinforced by the need to simultaneously improve performance and cut costs. But the way the outsourcing is managed can wind up nullifying perceived benefits. For example, while IT outsourcing has been welcomed as a way to keep costs in check, at companies with very low levels of standardization, outsourcing a process like application development actually increases process costs by 300%, according to Hackett Benchmarking.

Defining corporate goals and strategies with clarity so progress can be measured is also key. High-level company strategies and mission statements often lack a measurable link between strategies and goals. This linkage is needed to develop concrete business plans. For example, a company may talk about becoming the leading provider in its market, but there’s no real definition of what “leading provider” means. Does it mean highest quality? Fastest growing? Biggest market share? Without this definition, it is very difficult to develop an execution plan and monitor its progress. Result: no one is accountable, no information is gathered that might help the company improve, and the vague high-level goal is not achieved. Although this is a well-known starting point, many companies still do not get this level of clarity about their core aims and objectives.

The merits of metrics

Once the high-level strategic goals are precisely defined, organizations need to drill down and identify key processes that drive business value and the associated metrics to track them. Metrics for customer management, for example, might include customer satisfaction, price relative to the competition, and market share. Drilling further down from customer satisfaction, metrics might include on-time delivery rates, product returns and customer service response time.

Not unlike the atom, metrics on key performance indicators (KPIs) are the basic building blocks of performance management. KPIs need to be carefully selected so they can be compared consistently over time to track improvement. If customer management is measured one way at the starting point, it must be measured in the same way in the future to give valid results.

And the number of KPIs used to track performance should be kept to a minimum. “You don’t need 1,000 KPIs,” says Tom Harwick, research director at Giga Information Group. “You can’t manage that. Managers need a short list of KPIs. Most managers will be content with two or three.” Many organizations use a balanced scorecard, a performance management tool that tracks and presents KPIs in a way that is meaningful to management and employees.

All top-level scorecard critical success factors for which an area is responsible link metrically to lower-level cards, and then to the next level, and so on. Goals become fewer and less complex as you drill down through the organization. In this fashion, high-level strategies are communicated throughout the organization to every employee. Implementing the card responded to a fundamental question all employees ask: how does what I do every day fit into the bigger picture of the company?

According to *Optimize* magazine, 90% of CFOs in a recent survey cite the annual business plan process as the area in most urgent need of reform. The typical company spends four or five months completing its annual plan, the effort absorbs 20% to 30% of IT managers’ time—and rigid adherence in meeting the plan’s financial targets can lead to highly dysfunctional behavior throughout an organization.

At the enterprise-wide level, one of the greatest challenges companies face when measuring performance is reconciling the silo view of KPIs at the departmental level with broader, cross-functional goals. For example, an important cross-functional metric is time-to-market—a process that spans the organization from design to production to billing. It has a direct impact on the customer experience, which influences customer satisfaction, which in turn affects the organization’s ability to generate revenue. Reducing time-to-market is a critical success factor for many companies, but integrated information may not be available.

Lack of information stymies many companies' efforts to manage and improve key areas, largely because many haven't designed or put in a system that facilitates data capture, processing or integration of information for internal performance measurement. Existing ERP (enterprise resource planning) systems are unlikely to be adequate and will need to be reconfigured to generate meaningful information. In addition, data warehousing/mining tools will need to be implemented to dig through and aggregate existing information. Getting the right baseline information, and tracking it over time, is a core component of performance management.

What gets measured has only the potential to get done. The dynamic that moves companies forward today is their ability to make better decisions faster than their competitors. Performance management opens up internal processes so that business leaders can see what is going on in the organization, understand it, make informed decisions—and take swift, corrective action.

It also gives management a clearer picture of the company's underlying issues and true performance, and it provides a basis for more informed dialogue with analysts, investors and the general public. Companies need to use a wider and more meaningful set of measures to support this dialogue and to communicate their strategies to sustain a solid business. Market expectations of what constitutes "good" company performance are in flux. Better performance management can help companies manage both the market's expectations and their businesses in the present and in the future.



Footnote: [The Value Reporting Revolution: Moving Beyond the Earnings Game](#) by Robert G. Eccles, Robert H. Herz, E. Mary Keegan, David M. H. Phillips, John Wiley, 2001, ISBN: 0471398799

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