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Selecting Effective Performance Metrics: Why Shareholders Are Wild About Return on Invested Capital

John Borneman,
Semler Brossy
Consulting Group

Return on invested capital (ROIC) is a complicated and often controversial performance metric for executive incentive plans. Difficult to understand and control and potentially anti-growth, ROIC and its cousins, such as return on assets, return on equity and economic profit, can be difficult to use as incentive plan metrics. If used carelessly, return-on-capital metrics can have serious unintended consequences that can be very damaging to a company's long-term success.

Yet shareholders love ROIC as a measure of financial performance. This theme comes up over and over again in shareholder engagement conversations, at leading HR conferences and in media reports on shareholder activism. ROIC is seen as the best gauge for how effectively corporate leadership is using shareholder capital and managing investments to generate an adequate return. Many shareholders believe that ROIC is the metric of success and should be more strongly reflected in executive incentives, especially in long-term incentive plans where such metrics make the most sense.

Such measures are also very common. Semler Brossy Consulting Group recently completed an analysis of

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long-term incentive practices for the S&P 500, and found that, of those that use performance-based awards for their senior executives (nearly 90%), return-on-capital metrics are used by nearly one-third of the companies (31%). This prevalence is even higher in capital-intensive businesses, such as industrials or financials, where the prevalence is close to 50%. (See Table 1)

TABLE 1 Prevalence of Performance-Based LTI Metrics — S&P 500

	Stock Price/TSR	Profit/ EPS	Return on Capital	Revenue
Total S&P 500 by Sector	**56%**	**41%**	**31%**	**18%**
Consumer Discretionary	38%	57%	32%	19%
Consumer Staples	47%	50%	28%	28%
Energy	78%	11%	24%	3%
Financials	42%	42%	50%	6%
Health Care	58%	44%	21%	32%
Industrials	40%	40%	49%	21%
Information Technology	58%	42%	10%	31%
Materials	63%	22%	48%	4%
Real Estate	86%	11%	14%	7%
Telecommunications	80%	20%	20%	20%
Utilities	96%	61%	18%	0%

Source: Semler Brossy Consulting Group

This article examines the different perspectives on ROIC. It looks at the pros, cons and risks of ROIC as an incentive plan metric and examines why many companies have evaluated ROIC and rejected it for incentives. The article also looks at the fact-based evidence to understand if ROIC as a measure really is well correlated with shareholder value creation and why or why not this is the case. Finally, the author addresses how and when ROIC might be the right measure of performance and discusses approaches to implement ROIC in a way that will maximize the benefits while limiting the downside risks.

In order to understand the role of ROIC as a potential incentive plan metric, it is first important to understand why investors are so interested in ROIC. This is because generating sufficient returns on investments is critical to creating value for shareholders. At its very core, this is what senior executives are responsible

DEFINITION OF ROIC

Return on invested capital? Return on assets? Return on equity? What does all this actually mean?

All of these measures are variants on a common theme. In all cases, the measurement in question is looking to capture the level of profits of a company expressed as a percentage of invested assets or capital. At its simplest level, these measures are:

$$\frac{\text{PROFIT}}{\text{ASSETS}} = \text{RETURN ON CAPITAL}$$

The variants are based on different definitions of profitability and assets. For example, profit can be operating income, tax-adjusted operating profit or net income. Assets can include or exclude cash, can include or be net of short-term liabilities, or otherwise adjusted for controllable versus noncontrollable investments. Sometimes debt is included and sometimes the measure is just against shareholders equity. In nearly all cases, the assets are measured as the average throughout the year to account for changes in investments made during the year and the fact that income was earned during the entire year rather than just at the end of the year.

So there is not really any one definition of ROIC. One version is:

$$\frac{\text{NET INCOME}}{\text{AVG. TOTAL DEBT} + \text{AVG. EQUITY}} = \text{RETURN ON INVESTMENT CAPITAL}$$

This article uses ROIC and return on capital interchangeably. These are all versions of the same concept — how much money the company is earning for the "stuff" into which it has invested its money.

for doing. They identify customer needs and opportunities in the market, make investments to create the products needed to realize those opportunities (building new plants, opening new offices, etc.), and end up with more money "in the bank" than what they started with. At its simplest level, that is creating value for shareholders.

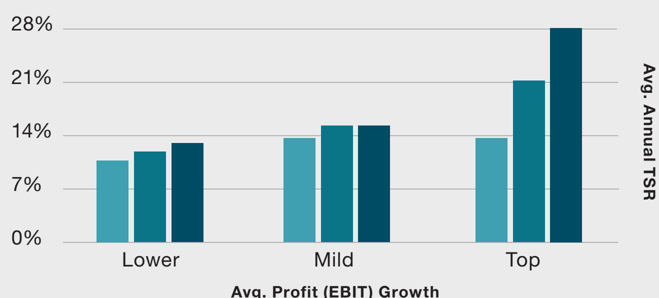
The details are somewhat more complicated, of course, as the level of return generated needs to be above a minimum standard, which is called the cost of capital. To use a simple example, say you wanted to open a restaurant and needed to buy $500,000 worth of furniture and equipment. Then assume you decided to borrow all $500,000 from a bank and it requires that you pay 10% in interest every year. If you run the restaurant and after all expenses (food, employees, advertising, etc.) you end up with $100,000 in profit for the year, then you have money left over. You earn $100,000, pay the bank $50,000 in interest and end up with $50,000 in the bank. Value created. If after all expenses you end up with only $45,000 in profit, you just destroyed $5,000 in value because you still owe the bank $50,000. The extra money has to come from somewhere.

Of course, businesses do not borrow all the money that they need from a bank, but the point is that all money that is invested in the business requires a return. If it is not owed to the bank, then it belongs to shareholders, and they also expect a company to generate a return on its investments. If the company cannot generate a sufficient return by investing available cash, management should give the money back to shareholders (through dividends or stock buybacks) so that they can invest it elsewhere. This is another reason many shareholders like ROIC as an

explicit metric — it enforces capital discipline and encourages managers to get rid of excess capital that they cannot invest effectively.

This is more than just hypothetical: ROIC works in practice. Analyses of the stock market over time have consistently demonstrated that companies with higher ROIC generally outperform companies with lower ROIC. The Semler Brossy analysis of the S&P 500 during the past 10 years shows that the companies in the top one-third of ROIC performance delivered more than 5% more in total shareholder return (TSR) than the companies in the bottom third. But this is largely true only if those companies are also growing profitably at the same time. In other words, ROIC alone is not enough. As shown in Figure 1, a company needs both growth and returns to create shareholder value.

FIGURE 1 S&P 500 Total Shareholder Returns 2006-2015
Average TSR by top-, middle- and bottom-third ROIC and EBIT growth performance



Source: Semler-Brossy Consulting Group

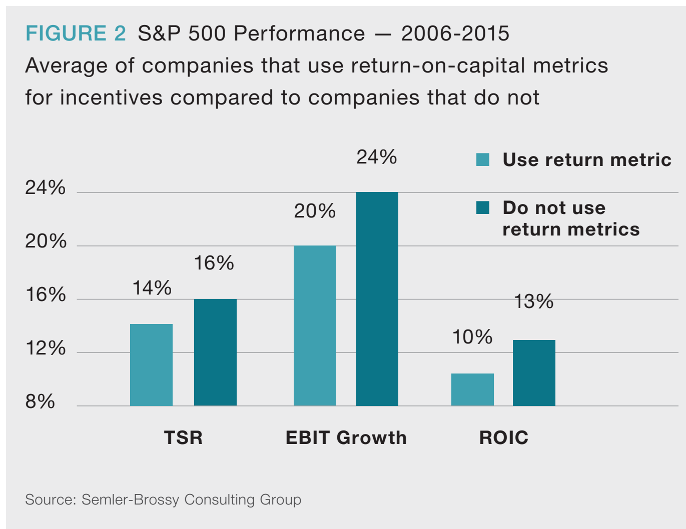
UNINTENDED CONSEQUENCES — THE CASE AGAINST ROIC AS AN INCENTIVE PLAN METRIC

Clearly ROIC is strongly aligned with shareholder interests. It seems like it would be a natural incentive plan metric, especially for long-term incentive plans because capital is usually invested over a period of more than one year. So what can be wrong with using ROIC as a performance metric?

Incentive plan metrics are often about continuous improvement — looking at prior-year performance or recent historical trends and seeking opportunities to do better. But more ROIC is not always better ROIC. If a company has a 10% return, getting to 12% or 15% may or may not be an improvement. As shown in Figure 1, it depends on how a company gets that improvement. By growing revenue and improving profits while remaining controlled and disciplined on investment? Great! That will create more value for shareholders. But cutting back on investment or forgoing good but not great investment opportunities to improve ROIC? That can be a disaster. A company can achieve high returns by deferring necessary investment or slowing down growth without creating any value for shareholders. As a general rule, businesses cannot shrink to greatness. The job of management is to invest capital and create more returns, not just to squeeze higher returns out of capital already in place.

An ill-designed incentive plan that puts too much emphasis on increasing returns on capital — or focuses on hitting excessively high rates of return over the expected rate of return required by shareholders — can end up driving the wrong behaviors, limiting good growth opportunities and even undermining long-term performance by trading off short-term gains in ROIC for long-term problems. For example, a distribution company that underinvests in renewing its fleet to reduce capital investment, resulting in big problems years later as maintenance costs skyrocket and the next generation of leaders has to make big catch-up investments, or a manufacturer of premium products that limits investments in automation for many years in order to achieve above market rates of ROIC, and then struggles to enter the lower-end segment of its market due to its higher cost structure compared to competitors.

FIGURE 2 S&P 500 Performance — 2006-2015
Average of companies that use return-on-capital metrics for incentives compared to companies that do not



Source: Semler-Brossy Consulting Group

It is also not clear that return-on-capital metrics work in practice to drive superior performance. If anything, the inverse often appears to be the case. As shown in Figure 2, on average, companies that use return-on-capital metrics in their long-term incentive plans appear to underperform peers across dimensions. Surprisingly, even ROIC is often lower for those companies that explicitly measure return on capital compared to those that do not.

Of course, this reflects only averages and does not represent every company or even industry. But the general underperformance on average for those using return metrics appears to be persistent during many different time frames. This does not imply cause and effect. It is possible that companies that are already underperforming are more likely to adopt return on capital as a performance metric for incentive plans than those that are performing well.

GETTING IT RIGHT — HOW TO USE RETURN ON CAPITAL METRICS EFFECTIVELY

So how and when should return on capital be used for executive incentive plan designs? Using return on capital effectively requires answering three key questions:

1 | Are there opportunities to control capital spending?

2 | How high do we want returns to be?

3 | Do we have the right balance in our incentive plans?

First, ROIC makes sense only in capital-intensive businesses. Industrials, raw materials and financial services all have substantial balance sheets that they use to generate profit and create returns. Professional services, information technology companies, media and even many consumer products businesses invest more in people and ideas rather than physical assets, so ROIC generally does not make as much sense for these companies. Even in capital-intensive businesses, there may be limited opportunities to move the needle on ROIC. For example, if a company has completed a major merger in recent years, a significant part of the balance sheet could be goodwill. This is a fixed number that cannot be improved by any future decisions that managers may make and there may be little managers can do to improve performance other than driving profit growth. In this case, the company should directly measure profitability for a more focused and simple incentive plan design.

Second, if a company is going to use ROIC, it is important to be clear on just how much ROIC is desirable. As discussed earlier, once a company has achieved the expected rate of return on investments, getting more or higher returns is not necessarily a good thing, especially if it requires forgoing good and profitable investment opportunities or trading off investments in the short term that need to be made up in the long term. If anything, it could be argued that ROIC is only a good incentive plan metric if a company is underperforming the minimum required rate of return — in other words, used to fix a problem rather than drive continuous improvement. And indeed, that may be exactly why ROIC appears to be more commonly used by companies that are underperforming their peers.

Finally, for those companies that use ROIC as an incentive plan metric, it is critical that it is used in balance with other goals and objectives. Most importantly, ROIC should almost always be used in conjunction with growth metrics (whether revenue growth or profits) to ensure that executives are being encouraged to make new, profitable investments to achieve the ROIC goals, and not discouraged from investing all capital. Sometimes, ROIC is better as a modifier or even a threshold condition to earn incentives, rather than being used as the primary metric, to avoid undue emphasis on capital returns.

SUMMARY

ROIC is an extremely important metric, especially for capital-intensive businesses. With greater shareholder emphasis on ROIC, the author anticipates that the prevalence of return metrics for incentive plans may increase over time. But using return-on-capital metrics effectively requires:

- Understanding the balance sheet and making sure there are opportunities to improve capital investments.
- Using return metrics to achieve the required minimum rate of return on investments, but not necessarily to overachieve on ROIC performance.

- Creating a balance between generating returns and taking advantage of opportunities for growth.

Used in a limited, balanced or indirect way, ROIC can be extremely effective for aligning executive incentives with shareholder value creation. But used as the major or only metric for incentive plans, ROIC can be disastrous. Use with caution.

AUTHOR

John Borneman (jborneman@semlerbrossy.com) is a managing director at Semler Brossy Consulting Group in Los Angeles. He is an executive compensation adviser with nearly 20 years of experience advising senior management teams and boards of directors on compensation, performance measurement and governance issues. He received an MBA in finance and strategy from the University of Chicago and a bachelor's degree from the University of Michigan.