Are You Wasting Time on Poor Performers?

Maximizing shareholder value often requires investing substantially more in strong businesses than in weak ones.

Gregory V. Milano, CFO.com | US

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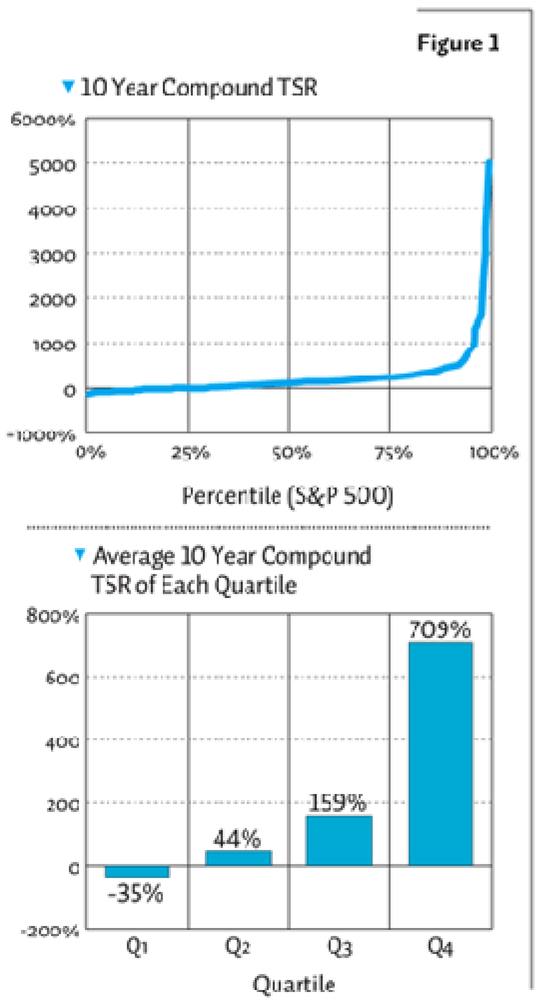
It is common for executives to devote more managerial attention, and in many cases more financial capital, to fixing poor performing businesses while they often assume, as a CFO recently said, that "the stronger business units will take care of themselves."

Often, this behavior is driven by investors challenging executives with tough questions about unsuccessful business units. In other cases, it's personal pride that motivates executives to labor relentlessly to eliminate failures on their watch. Either way, significant corporate resources are devoted to "fixing" problem businesses. And that potentially leads to less than the best outcomes.

Is shareholder value maximized when the corporate office devotes a higher proportion of management time and/or capital to turning around poor performing business units? Or would their shareholders be better served by exiting losers and focusing executive effort on nurturing, investing in and growing the value of the winners?



We examined long-term shareholder return trends in the capital markets to develop a pragmatic perspective on where corporate resources should be devoted. We evaluated the current members of the S&P 500 over the ten-year period from 2001 through 2010 on the basis of cumulative total shareholder return (TSR), which is the annualized growth in value due to share price growth and dividends. (Those not public for the full period were excluded.)

The top graph in Figure 1 shows the distribution of TSR for the 437 companies. It is clear that the stars on the right side of that graph delivered outstanding value creation. The top performers were Priceline.com, Apple, FLIR Systems, Urban Outfitters, and Cliffs Natural Resources, representing a wide range of industries. Within industries, the top performers typically deliver dramatically higher TSR than the bottom performers.

The bottom graph in Figure 1 is a more practical depiction of the TSR information, showing the average TSR within each quartile. The companies were rank-ordered based on TSR and organized into four equally sized groups, or quartiles. The top performers delivered 709% of average TSR and the bottom performers delivered negative 35%.

Achieving outstanding share-price performance requires sound strategy and outstanding execution. In most cases the top-quartile companies successfully reinvest a substantial percentage of their cash flow in capital expenditures, R&D, acquisitions, and other investments that lead to strong top-line revenue growth. They typically deliver strong return on capital as well.

To apply these findings in an organization, consider a hypothetical company with four business units, each valued at $100 million at the start of 2001. The business units then grow in value at the average TSR of one of the quartiles in our study. In other words, the value of the top business unit A grows by 709%, B grows by 159%, C grows by 44% and D declines in value by 35%.

Figure 2 demonstrates the change in value of our hypothetical company. The star business unit A grows over ten years to be worth over eight times its starting value and it represents 63% of the value of the company in 2010. This value creation in A is 20 times higher than the value destroyed by the bottom business D.

Figure 2

	Inital Value	10 Year TSR	Ending Value	Percent of Total
A	$100	709%	$809	63%
B	$100	159%	$259	20%
C	$100	44%	$144	11%
D	$100	-35%	$65	5%
Consolidated	$400	219%	$1,277	100%

What does this mean for the priorities of executives? If a lack of corporate attention and investment causes the top business to deliver only 90% of its potential, then $71 million of the $709 million in expected value vanishes. For sure, A would still be a great business, but this $71 million shortfall wipes out twice as much value as the entire $35 million in value destroyed by D.

In many client situations, my colleagues and I have observed that executives at multi-business companies often limit the potential of their star businesses by under-investing in their future. Capital allocation can become a bureaucratic process whereby negotiations and a concern for fairness lead to smearing capital across the company with inadequate regard to differences in opportunities. Some companies even assess their allocation of investments as a % of sales, which tends to divert resources away from smaller businesses which often have the best value growth potential.

Maximizing shareholder value often requires investing substantially more in strong businesses than in weak ones, and CFOs must be sure to bias their companies' investment programs toward the businesses with stronger opportunities.

Many performance measures and bonus plans reward improvements in return on capital, which inadvertently establishes a higher hurdle rate for successful businesses. For a business unit earning a return on capital of 30%, new investments must exceed that high threshold to increase the average return and be rewarded. At the same time, a sister business earning a 6% return on capital can improve returns with any investment that earns more than 6%.

Sometimes the only way to properly divert attention away from poor performers is to sell them or spin them off. There is often a hesitancy to sell, because these poor businesses don't fetch much in the market. Executives thus often prefer to "fix" performance first and then consider a divestiture.

Unfortunately, that often perpetuates the problem by delaying the realization of the true potential value of the stars. In our example above, it may be beneficial to sell business D at the outset even at a substantial discount to focus management attention and investment on business A to avoid depleting the $71 million in value potential that could result if only 90% of the upside in A were achieved.

Executives are often better off spending less time and capital on turning around their poor performers and instead devoting efforts toward cultivating, motivating, and investing in their strong businesses to ensure they achieve their full value-creation potential.

Gregory V. Milano is the co-founder and chief executive officer of Fortuna Advisors LLC, a value-based strategic advisory firm.