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In Tech, One Measure Rises Above the Rest

Residual Cash Earnings is the only measure you'll need if you want to know how well both publicly and privately owned technology companies are doing.

Gregory V. Milano, Arshia Chatterjee and David Fedigan, Contributors

This is the third article in a four-part series on what drives success for shareholders in technology industries..

In the previous article, we showed how growth and return measures are superior to margin measures when it comes to evaluating tech company success for shareholders. In this article, we'll take that idea a step further and describe a single metric that adeptly captures this vital growth-versus-return tradeoff. It is really the only measure you'll need if you want to know how well both publicly and privately owned technology companies are doing for shareholders.

Residual Cash Earnings, or RCE, is a comprehensive financial performance measure that captures growth, margin, and asset utilization, which are the three major drivers of shareholder value. The measure is calculated as the cash generated by the business less a charge that reflects the expected return of the shareholders and lenders for the use of the company's capital.

Cash generated is defined as Gross Cash Earnings, which is essentially after-tax EBITDA. The capital of the company is defined as Gross Operating Assets, which include gross undepreciated property, plant, and equipment, plus operating net working capital and other net assets. RCE is similar to Economic Profit, but typically better explains market valuation stemming from the use of cash flow and undepreciated assets.

RCE is typically customized for a company to keep it simple and understandable while reflecting company-specific characteristics. For technology companies and other research-and-development- intensive companies, RCE is customized by treating R&D as an investment. That can improve the motivation to invest in growth while imposing accountability for earning adequate returns on the investment. Once customized, the measure typically is renamed using the company name. For example, Bristow Value Added, or BVA, was implemented by The Bristow Group — the first company to fully adopt RCE.

The tendency is often to regard positive RCE as good and negative RCE as bad. Although this is true over the full life of a company, during a shorter window of time — such as a year or three-year period — value is created by increasing RCE even if it's negative. Just as much value is created in a given year by increasing RCE from -80 to -30 as would be created by increasing from 20 to 70. In both cases RCE increases by 50, and the change in market capitalization should be similar as a result.

In our capital market study, we examined the relationship between RCE improvements and total shareholder return, (TSR), which reflects the capital gains plus dividends as a percent of the beginning share price. To normalize for size, we measured the change in RCE over three years as a percentage of the starting gross operating assets.

As it turns out, the change in RCE correlates to TSR better than any other measure we studied. The high-RCE-improving companies had median RCE improvement over the three-year period of 15.1% of beginning gross operating assets and had a median TSR of 19.1%. The Low RCE-improving companies suffered a median decline in RCE of -2.0% of beginning gross operating assets and had median TSR of 4.7%. The difference in median TSR of 14.4% was the highest of any measure we studied.

This research finding provides substantial evidence for the notion that increases in RCE will lead to higher TSR, making it a more revealing metric than any we tested.

Tradeoffs are easier to make when using RCE. For companies measuring growth and return, it can be hard to know what to do when, for example, a company makes an investment that reduces the rate of return by 1% but increases growth by 2%. Is that a good investment? It's hard to say. But with RCE, if the incremental gross cash earnings are adequate to more than cover the expected return on the incremental capital, then RCE increases and the investment is good as long as the RCE is adequately sustainable.

What's in it for technology company managers? Some companies tie the change in RCE to manager compensation — essentially arguing that it's okay for managers to become wealthy, just as long as they have made shareholders wealthier and that wealth is sustainable. Successful managers gravitate to RCE because they receive a share of the excess value they create, in essence giving them a simulated ownership position in the company or business unit of the company.

While in many companies the best performers seem to be assigned tougher goals— making it difficult to get paid well for great performance— RCE typically focuses on improvement versus the prior year. In that way strong performers get paid for their success, just as owners do. With RCE, the budget or target negotiation game comes to an end.

What's in it for technology investors? Since RCE explicitly recognizes the required return on capital, investors benefit from knowing managers are motivated to treat the investors' money as if it were their own.

If management makes an investment that fails to meet or exceed the required return on capital, RCE will decline and so will the bonuses of management. If management invests in the future, and current RCE is constrained, managers have the confidence of knowing they will be rewarded when the investment benefits materialize and RCE increases. In addition, if management takes a short-term action to boost RCE that has negative longer-term consequences, any short-term boost in bonuses will be mitigated when the bonuses in later years are reduced by the inevitable RCE declines.

These simple relationships have profound management-behavior benefits for shareholders. Nobody can perfectly predict the future, so investment decisions are made in an environment of uncertainty. Managers rewarded based on improving RCE cannot just negotiate softer targets, so they must exercise judgment about whether the likelihood and amount of success are adequate to compensate for the potential of an unsuccessful outcome. The accountability provided by RCE is designed to improve the quality of these judgments. If RCE increases, they earn more money, and vice versa.

The high value of growth in technology is clear when you realize that technology companies have a higher median RCE margin, so each dollar of sales growth is typically worth more in technology companies than in the rest of the market. Once we treat R&D as an investment— just like capital expenditures and acquisitions— we find that the median RCE margin for technology companies in 2015 was 15.5%, which is 2.5 times the 6.3% median for the rest of the 1000 largest non-financial companies listed in the United States.

Yes, that’s right. When measured properly using RCE, technology companies are actually much more profitable than the rest of the market.

This analysis provides salient proof of the bias of traditional accounting against technology companies that emphasize R&D. The worthlessness of accounting when evaluating technology companies leads many managers and investors to downplay the importance of financial measures. But by treating R&D as an investment in the RCE measurement framework you get a substantially better measure that can be given greater importance without motivating all the wrong behaviors encouraged by traditional accounting measures.

To encourage the use of RCE, companies can integrate RCE into their planning, budgeting, investment decision making, pricing, and performance-measurement processes. Much as the use of metrics in the book and movie “Moneyball”, the process of implementing RCE leads to a fact-based discipline of making decisions based on data and evidence rather than on conjecture, gut feel, or historical norms. This is good for management and shareholders.

Gregory V. Milano, a regular CFO columnist, is the co-founder and chief executive officer of Fortuna Advisors LLC, a value-based strategic advisory firm. Arshia Chatterjee and David Fedigan are associates at the firm and led the research discussed in this article.