CVP™ news
Corporate Finance Insights

What are Your Measurements?

During the 1990's the idea of corporate performance measurement received a good deal of attention. Probably the most well-known advocate was Bennett Stewart of Stern Stewart & Co. and their Economic Value Added® ("EVA®") model. Measures of corporate performance remain a topic of interest however the focus doesn't seem to be as much on the "best" measure, as it is on encouraging the use of some measure consistently and how best to interpret it.

In the last newsletter we looked at the components of Return on Assets ("ROA"). What we considered was the impact that asset levels have on the calculation. If you like ROA we're going to spend a little time refining it in this newsletter. In the next newsletter of this series we'll cover Residual Income (also known as Economic Profits) as a measure of corporate performance (the EVA® model is a specialized form of Residual Income).

OROA? Don't You Mean OREO?

In the last newsletter we showed that Return on Assets was a function of profitability and asset utilization, as follows:

ROA =

Profit/Sales	X	Sales/Assets
Profitability		*Asset Utilization*

Sometimes it is useful to make a few adjustments to the calculation and break it down into further detail. I call it Operating Return on Assets, and it looks like this:

Operating ROA =

Gross Profit / Sales	X	Operating Profit / Gross Profit	X	Sales / (Operating Assets - Operating Current Liabilities)
Operating Efficiency		*Administrative Efficiency*		*Operating Asset Utilization*

"You were a gingerbread man in a past life. That's why your boss is always biting your head off."

The two key adjustments are: 1) defining profitability as operating profit and 2) using operating assets net of operating current liabilities. The additional detail is defining profitability as having two components: Operating Efficiency and Administrative Efficiency. Otherwise it's just the same old formula we looked at last time.

CVP™
Corporate Value Partners, Inc.

Corporate Value Partners is a corporate finance consulting firm. Services include:

- Assisting with the acquisition or sale of a business, business unit or product line;
- Assisting with the placement of debt and equity financing;
- Preparing business valuations;
- Assisting creditors in corporate bankruptcies;
- Assisting attorneys with the financial aspects of their case.

Corporate Value Partners
Ronald D. DiMattia
President
1340 Depot Street,
Suite 102
Rocky River, OH 44116
(440) 333-1910 Office
(440) 333-4449 Facsimile
ron@corporatevaluepartners.com
www.DealDesk.com

Corporate Value Partners, Inc.
1340 Depot Street, Suite 102
Rocky River, OH 44116

First Class Stamp

Mailing Label

CVP news

Corporate Finance Insights

Focus on Operations

I am a big believer that valuation revolves around operations. So defining profitability as operating profits and the asset base as net operating assets is a natural for me. Operating profits should exclude the effects of financing decisions (interest-bearing debt) and tax-structuring decisions (income-based taxes). The asset base should exclude assets that aren't used in operations (such as investments in marketable securities) and should be reduced for spontaneous, non-interest-bearing liabilities that arise through operations (such as accounts payable and accruals).

By splitting profitability into two components, Operating Efficiency and Administrative Efficiency, we're just providing some trail markers to see why things changed and where they are going. Gross Margin is a reflection of pricing strength and efficiency of operations. Operating Profit per Dollar of Gross Profit is a reflection of our ability to be lean and mean in the back office. The shop floor and the back office have to work together to make a company valuable.

Focusing on operating assets provides a better picture of our ability to earn a return from operating activities. Many privately-held companies have assets on the balance sheet that aren't used in operations, be it excess cash, marketable securities or investment real estate. But be careful in netting non-interest-bearing liabilities against the asset base. Sometimes a company can get a boost in OROA simply by extending terms on accounts payable.

Set a Baseline

Corporate performance measures mean nothing in a vacuum. But they can have great meaning when viewed across time, or relative to another company's performance. A useful exercise is to measure your corporate performance over an extended period in the past; let's say 10 years. That will reflect a variety of market conditions and a variety of changes your company went through. Then analyze the performance measure(s) in light of what the company was going through. What sort of things were you doing that seemed to help?

It's also very useful if you can follow one or a group of companies' performance over time. Some trade groups can provide good information. A publicly-traded company that is similar to yours would also be useful to track. Then compare their results to yours and look for trends and unusual relationships in the data.

The magic in corporate performance measurement is in the interpretation and action that results. Use one or more measurements that help you identify trends and issues quickly. If ROA or OROA don't quite fit the bill, then maybe Residual Income will do the trick. Maybe a combination works best. The key is to get comfortable with the calculations, analyze them regularly and convert analyses into value-creating actions.

Please contact Ronald DiMattia at Corporate Value Partners at (440) 333-1910 or ron@corporatevaluepartners.com with any questions or to discover how CVP can help you get the most out of your assets.

Corporate Value Partners, Inc.