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## FINANCIAL PERFORMANCE MANAGEMENT

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Performance management is about identifying the right short-term key performance indicators (KPIs) to be monitored and measured over time, to evaluate performance and trends, to ensure the organisation is driven towards relevant long-term goals in order to accomplish its mission and maximise value creation.

It is an ongoing process that should be constantly reassessed and improved to ensure the right fit between strategic and business decisions and meeting value creation expectations. Finding the right mix of short-, mid-, and long-term metrics alignment, to boost performance efficiency towards clear financial and business goals, is key.

### **Economic value**

From a financial perspective, the economic goal of an organisation is to maximise its economic value over time. Economic value is based on the future long-term capability of a firm to generate free cash flows from operations, being supported by the appropriate capital structure that minimises the cost

of capital with a moderate level of risk, so that the return on invested capital overcomes the cost of capital.

**Free Cash Flow from Operations** over time is a key metric as it drives the business's intrinsic value. Interestingly enough, free cash flows from operations are determined by the revenue growth rate and the return on invested capital under the following relationship:

$$\text{Growth rate} = \text{ROIC} \times \text{Reinvestment rate} \Rightarrow$$

$$\text{Free Cash Flow from Operations} = \text{EBIT} \times (1 - \text{tax rate}) \times [1 - (\text{growth rate} / \text{ROIC})]$$

Hence, the following parameters will have to be targeted and monitored over time to ensure expected free cash flows from operations will be generated and value created as planned.

- Revenue growth rate
- Gross and Earnings before interest and tax (EBIT) margin
- Return on invested capital (ROIC)
- Operating working capital requirements to grow
- Net capital expenditure requirements to grow
- Effective corporate tax rate

### Cost of capital as a risk metric

Projected free cash flows from operations are discounted at the cost of capital to determine the firm's intrinsic value. The cost of capital is made up of the weighted average cost of debt and equity after tax, as shown below:

$$\text{Cost of capital} = \text{Cost of debt} \times (1 - \text{tax rate}) \times \frac{\text{Debt}}{\text{Debt} + \text{Equity}} + \text{Cost of equity} \times \frac{\text{Equity}}{\text{Debt} + \text{Equity}} \quad 44.1$$

On top of the interest rate policy and the market situation, the cost of debt is affected by the business operating risk. Operating risk is dependent

on the recurrence of revenue, the cost structure, and the gross and operating margin volatility. The cost of equity is affected by the debt-to-equity ratio.

Hence, the cost of capital is also one of the relevant metrics to be determined and monitored over time. Increases in the organisation's operating and/or financial risk will raise the cost of capital. Increases in the cost of capital will cause a negative impact on value.

### Competitor performance

Competitor performance and strategy become another pertinent set of inputs and data for a board, as relative value drives a firm's market value as much as its own intrinsic value. Hence, benchmarking relevant financial indicators against those of peers is a useful source of high-quality data, when available.

Regarding performance management, the first step is to identify the right short-term KPIs that support the long-term strategic goals and to build a financial dashboard. A **financial dashboard** should provide enough high-level data to the board, for members to draw a general picture as to how the organisation is performing towards value creation in the short, mid, and long term. It should also include enough detailed data in different appendices for the members to drill down into any of the high-level indicators, to reach root-based conclusions.

- Does the dashboard provide a high-level view of how the main short-term financial goals are being achieved in a one-pager? *Short-term goals should ensure long-term goals will be met.*
- Does the dashboard provide data to monitor the different value drivers' performance and trends, at consolidated, regional, and product/service/brand portfolio level?
- Does the dashboard include current versus target for all the indicators on the different periods of time that are being tracked?
- Does the dashboard include an annual one-page peer analysis on the main value drivers' performance to identify areas of improvement and inner strengths?

1. **Revenue growth** is one of the key value drivers. In order to increase economic value over time, organisational growth must be accomplished.
  - What is the target size of the company in five years' time, in terms of consolidated revenues?
  - What is the annual growth rate that needs to be achieved on the way to accomplishing the long-term goal?
  - What are the main revenue streams at product/service/brand/regions level?
  - Have they been categorised accordingly to where they are in the life cycle, as high growth, mature growth, stable, and declining?
  - Have specific growth rates been established for each of the main revenue streams that ensure the annual consolidated revenue growth rate is achieved?
  - Is there enough available information to the board to determine if the overall situation is appropriate and fits with the mission and economic goals in the short, mid, and long term?

**Growth drivers:** What are the key growth drivers for the organisation to reach its target revenue growth rate?

- Is it expanding the annual customer ticket as the business competes in a mature market?
- Is it scaling the number of customers as the segment or region is currently expanding?
- Is it leveraging current facilities through online channels to improve return on invested capital?

**Customer engagement and satisfaction:** Most successful growth companies are those that are very close to their customers. Therefore, an organisation should be capable of identifying its growth value drivers within its strategy.

- Have the right metrics and channels been identified to keep a close eye on customers' feedback and needs?
- Have they proved to be efficient on the task of gathering reliable information?

2. **Margins** are at the heart of an organisation's profitability process. Margins are also value drivers. Gross margin speaks of the customers'

perception of value. High gross margin (60–80%) is a cushion that reduces operating risk. Low gross margin (10–25%) increases the break-even point and leaves the company at higher exposure to operating risk when facing declining revenues. Earnings before interest, tax, depreciation and amortisation (EBITDA) and EBIT margins are also of high relevance to the business performance. The relationship between growth and margin is also relevant.

- Where is the organisation strategically positioned in terms of gross margin at consolidated, regional, and product/service/brand portfolio level?
- What are the EBITDA and EBIT margins at consolidated, regional, and product/service/brand portfolio level? How are they performing against budget and in terms of growth? Are overhead costs being efficiently managed to hit margin goals?
- Does the current growth strategy go against margin? If so, for how long? How and when will the situation be reversed?

### 3. Return on invested capital

ROIC, also known as return on capital employed, is a simple ratio that has a direct relationship with the capacity of a firm to create value, as explained earlier.

$$\text{ROIC} = \text{EBIT margin} \times \text{Invested capital turnover} \times (1 - \text{tax rate})$$

Invested capital turnover multiplied by the operating margin after tax determines ROIC. When ROIC exceeds the cost of capital, value is created. Invested capital is made of total net capital expenditures and operating working capital. Hence, invested capital turnover is about the relationship between revenues and the amount of capital invested. When a growth strategy is being pursued, new capital will be required in addition to capital required for assets being replaced or updated (capex).

- What is the minimum consolidated ROIC to meet the cost of capital? When is it expected to be reached if not yet?
- Is there information available to the board to determine whether the company should focus on improving ROIC or pushing growth

further to maximise value creation at regional and product/service/brand portfolio level?

- Does the board have a clear target on growth rate and ROIC for the different revenue streams/business units and regions that maximises value?
- What is the actual ROIC at regional and product/service/brand portfolio level, and how has it been evolving over time against budget?
- What is the amount of new capital available on an annual basis? If restricted, what are the rules for capital allocation? What are the products/services and regions that have priority? Value creation should drive these decisions.
- Is there a clear plan for the annual capital expenditures, broken into replacement and new investments, that matches the firm's strategy in the short, mid, and long term?
- How is operating working capital turnover performing at consolidated, regional, and product/service portfolio level against budget and compared to previous periods?
- Are higher operating working capital requirements, at different regions, offset by higher margins?
- What are the plans to keep on optimising operating working capital, without increasing risk?

**ROIC, together with the revenue growth rate, are the free cash flow from operations drivers:**

- What's the current and expected cash flow from operations?
- If positive and stable, what portion of it will be deployed to capex to self-finance growth and replace obsolete assets? What portion of it will be used to distribute dividends or buy-back shares?
- If negative, when is it expected to turn positive? How is it going to be financed?

4. **Cost of capital as a risk metric:** Intrinsic business risk can be broken into operating and financing risk.

**Operating risk** is about EBIT's volatility when revenues change over time.

- What's the break-even point in terms of revenue?
- What is the composition of the cost structure in terms of variable versus fixed expenses?
- Does the company have sufficient recurrent revenue to break even?
- What is the worst-case scenario in terms of potential drops in revenue? Would that lead to a crisis situation?
- How could fixed expenses be converted into variable? How long would it take?

**Financing risk:** net debt-to-equity ratio, solvency assessment, and the relationship between net debt and EBITDA are prevalent indicators.

- Has the board determined the target debt-to-equity ratio and the net debt/EBITDA ratio that minimises the cost of capital with a moderate level of risk?
- How are these ratios related to those of peers? Falling far from peers' results will cause a negative effect on the cost of capital, and hence on value.

The capital structure together with the operating risk of a firm will determine the cost of capital. The cost of capital will be the rate at which expected free cash flows from operations will be discounted to estimate intrinsic value. Hence, it has a direct impact on value. Companies that do not use debt capital are not maximising shareholder value. On the other hand, when there's too much debt in the capital structure, it will cause a negative effect on value as risk increases.

Many private companies do not estimate the cost of equity, especially those owned by few shareholders. In order to drive a company towards value creation, it is vital to determine the required rate of return and discuss the meaning and implications of this with the shareholders (based on market data), so that the cost of capital can be identified. Otherwise, how do directors know what the hurdle rate is for the company's invested capital and for new opportunities?

- Does the board have a clear strategy on the appropriate capital structure that suits shareholders' appetite and culture for risk that can ensure the firm's viability in the long term?

- Are there specific guidelines to determine the cost of capital at project and regional level to ensure sound economic decisions that drive long-term value creation are in place?
  - Are plans to raise new capital to cover investment needs being rolled out as scheduled?
5. **Dividend policy** establishes a commitment with shareholders that should be met.
- Is there a dividend policy in place?
  - If so, will the company be capable of meeting it? If not, what are the reasons? How long will it take to reverse the situation?
  - If there has been a strategic decision not to distribute dividends, has it been explained to shareholders?
6. Regarding **share price performance**, when applicable.
- What is the total shareholder return (TSR) on an annual basis?
  - What is the accumulated TSR for the past five to ten years? Compared to peers and appropriate indexes?
  - Is it in line with the board plans? If not, what's the reason behind this?