

Corporate Moneyball

Clyde Rettig

• • • • •

The popular movie, *Moneyball*, based on Michael Lewis's 2003 book of the same name, tells the true story of how the 2002 Oakland Athletics major league baseball team nearly made it to the World Series after applying nontraditional criteria to select new players. Oakland General Manager Billy Bean was trying to rebuild a team that had been decimated by departures of its best players to richer, big-market teams. The criteria the Athletics used were based on statistical analyses of target players' historical on-base and run-scoring results instead of subjective, non-quantitative measures long used by scouts and coaches.

What is crucial in both business and baseball is using metrics that maximize the chances for competitive success. In baseball, metrics that identify players who can get on base and then score runs are the most critical. For the corporation, the right metrics that can highlight businesses that generate real returns in excess of the cost of capital while providing value-adding growth opportunities can make the biggest difference in an enterprise's value.

Unfortunately, the metrics most commonly used to evaluate the performance and direct the strategy and operations of many large companies are as misguided as the ridiculous, but time-honored biases of baseball scouts and coaches. Like baseball's traditional practices, most accounting-based metrics are at best irrelevant and often totally misleading and damaging, both for the operating managements of companies as well as their boards of directors and shareholders. Consider:

- *Return-on-net-assets (RONA)*. Employing RONA to make capital allocation decisions can drive companies to under-invest in their most promising new business opportunities. It favors mature businesses by valuing their highly depreciated capital assets rather than the high future revenue growth of currently less profitable fledgling enterprises that require the latest (often expensive) equipment to compete.
- *Earnings before interest, taxes, depreciation, and amortization (EBITDA) multiple*. Creating an EBITDA multiple requires both an EBITDA calculation -- which by itself is not a bad measure of earnings --

and the creation of a multiplier. The technique for doing so is to find several "peer" companies, calculate an average of their implied multiples (from their stock prices) and use that number to value the company. Unfortunately, the whole peer group multiple exercise delivers what one would expect: the standard deviation around the calculated average is often very high, and thus the accuracy of the calculated average multiplier is highly suspect.

- Finally, the very popular and heavily touted metric, *EVA*, again fails to deliver insight into real value. It does not take revenue growth into account, it operates with GAAP rather than cash profits, and it makes no inflation adjustments. And, EVA provides little direct linkage to stock price and its statistical accuracy in estimating share prices is very low.

One metric that may be superior to all the more common metrics relies on just four variables: cash profits, real fixed assets, growth, and an accurate, not a discredited CAPM, cost-of-capital. This metric, *CMP-Q*, equals the market value of a company's debt plus its equity divided by the amount of its real net assets. It is accurate whether explaining past, current, or future valuations.

CMP-Q provides the means to assess strategic options, to accurately price acquisitions and ventures, and to value new business opportunities and operational improvement initiatives by comparing incremental corporate value-added with the incremental investments involved. It also makes it possible to objectively allocate capital resources among business units and other investment options based on their relative contributions to corporate value. *CMP-Q* can also be approximated in a simplified form so that line managers can use it to both manage their businesses in a manner consistent with corporate value objectives and to assess subordinates' performance contributions against personal, business unit, and corporate goals.

Just as in baseball, in corporate business, the right metrics do matter.

Clyde Rettig

Clyde is a Director at CharterMast Partners, an Outward Insights partner firm. He can be reached at clyde.rettig@chartermast.com.

© Copyright 2011 CharterMast Partners