Incentive plans for privately held businesses

JUNO PARTNERS

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Attracting, motivating and retaining key staff is a challenge for every business. Incentive plans can play a big part in achieving that aim, but many privately held companies shy away from using incentives, wary of experimenting with something as sensitive as pay.

But with care, a powerful and highly attractive incentive scheme can be designed for managers of privately held companies; one that focuses attention on sustained gains in the value of the business, while offering meaningful, competitive rewards for successful mangers.

With care, an incentive scheme can be designed for privately held companies that focuses attention on sustained gains in the value of the business.

Let's review some of the most common mistakes that privately held companies make in approaching the question of incentives, before looking at a sketch of what I have seen work well.

Modern remuneration practice

Traditional remuneration practice in Australia and New Zealand has seen the majority of rewards for managers paid in fixed remuneration, such as a salary. Then, if the business or manager has a particularly good year, he or she may qualify for a 'bonus'.

Modern remuneration practice is different. At its heart is the concept of 'at-risk pay'. Employees have a meaningful part of their pay at-risk, subject to loss if performance is disappointing, but capable of significant upside if performance exceeds expectations.

This is nothing new to anyone who has ever worked in sales. Most sales positions have an element of 'at-risk' pay, usually tied to sales performance (eg sales commission). If sales targets are met, the commission earned when added to base salary, combines for an attractive total remuneration package. But if sales are low, it makes for a tight year all round.

Owners like this kind of pay structure, because costs are more variable and good sales people like it, because they can usually earn significant amounts if they beat their sales targets.

Modern remuneration practice applies the same approach to managers. If targets are met, the at-risk component when added to base salary combines for a market competitive total remuneration package. But if performance is poor, the executive will be paid well below market. And of course, if performance is above expectations, rewards can be substantial.

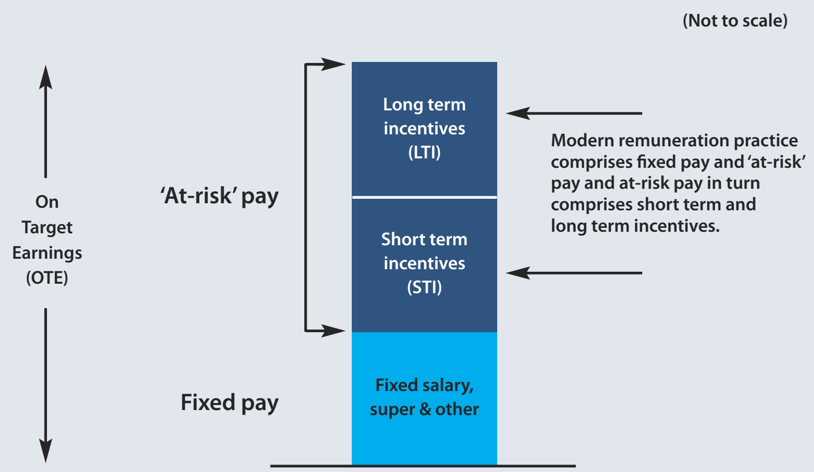
Within that framework, remuneration for senior executives today comprises three parts: fixed remuneration, short term incentives and long term incentives.

Fixed remuneration is the employee's salary and any additional perks, such as superannuation or a car allowance that do not vary with performance.

Rewards that are linked to performance measured over one year (or less) are called 'Short-Term Incentives' or STI, the most common example being an annual bonus paid to employees.

'Long-Term Incentives', or LTI, reward multi-year performance. LTI plans are most common in public companies and usually comprise equity based rewards such as shares or share options.

The three parts of modern remuneration



The most common incentive plan mistakes made by privately held companies

#1: No incentive plan

My experience is that most privately-held businesses in Australia would say that they do not use any sort of structured incentive plan; they just pay their people a fixed salary which is subject to some kind of annual review. But this approach can have a number of unintended consequences.

No incentive opportunity means higher fixed costs…

Offering no incentive plan usually leads to higher levels of fixed pay, to allow for the lack of bonus opportunity. A competitor's offer of $180,000 salary with a bonus opportunity of $50,000 may need to be countered with a $215,000 salary with no bonus opportunity, for example.

Offering fixed remuneration with no bonus attracts risk adverse managers more interested in peace of mind than performance.

And it doesn't stop there. In the absence of an incentive plan, if the employee has a good year, he or she will often expect some recognition of that in the form of a raise. But this again locks in higher fixed costs that will survive long after the employee's performance has returned to normal levels.

Higher fixed pay means higher fixed costs that put more pressure on the bottom line when business inevitably turns down.

…a risk-adverse culture…

A lack of incentive opportunity also influences the type of people attracted to a position: a well structured bonus plan will attract someone that is prepared to back their skills and abilities, someone that is more comfortable with a little risk. But a position that offers a higher level of fixed remuneration, with no bonus will attract risk adverse managers more interested in peace of mind than performance.

…and a resistance to change

With no upside, managers with no incentive opportunity often advocate against change. As one manager put it to me when the owner wanted to expand internationally, 'How do I explain all the extra hours away from home to my wife and kids? There is absolutely no upside in it for me.'

But even those companies that do use incentives often make costly mistakes. Here are some of the worst to watch out for.

#2: Bonuses based purely on the owner's judgement

Work out a sum to share with managers and divvy it up based on how you think they've performed during the year. Its simplicity is appealing, but there are a few problems with this approach.

First, people talk, leading to sibling-like rivalry: 'Why did he get more than me?' The amounts no longer matter, if what gets paid differs due to a subjective assessment, someone is going to feel hardly done by. The business ends up paying people just to tick them off and make them more vulnerable to poaching.

Second, discretionary bonuses like this discourage open and frank discussions about personal performance. When the employee knows that his boss' impression of his performance makes the difference between a holiday for his family to Dubbo or Disneyland, the incentive plan encourages him to hide problems, rather than discuss them.

Third, the value of discretionary bonuses is discounted by employees because they know that there is no guarantee of delivery, no matter how good the results they achieve. In the market for talent, a $50,000 bonus opportunity decided on discretion is not worth as much as one objectively determined, except of course, to those skilled at creating the *impression* of good work.

Finally, the day-to-day behaviour encouraged by discretionary bonuses can be damaging to the performance of the company. Imagine two sales people, one on a discretionary bonus and one on a flat 10% commission. It pays the former to spend time in the office ensuring the boss knows just what a good job he is doing, it pays the latter to get out of the office and make the next sale.

#3: Bonuses based on performance against budget

Given the short-comings of discretionary bonuses, an obvious solution for many companies is to base bonuses on performance against budget. Hit the budget, get the bonus. Simple. But there is a major unintended consequence of this approach– it pays people to lie.

Basing bonuses on performance against budget means you are paying your people to lie.

The case of a client, I'll call George, is illustrative. George owns a privately-held plastic injection molding business and he was sharing with me recently his frustrations with the sales forecasts put together by his sales team each year. While George feels the business is fairly stable and sales should be fairly predictable, each year demand has been under-forecast by the sales team, leading to under-resourcing in the production department, lost sales and damage to the firm's reputation for reliability.

The sales team incentive plan runs on performance against budget and the budget is set with the involvement of the sales team each year. The sales team responds to this arrangement by maximizing sales and minimizing the budget.

While George is aware of the in-built conservatism of the sales forecasts, the sales team is closer to the customer base than he is and he feels unable to rigorously challenge their projections.

Not only does linking incentives to the budget reduce the reliability of George's sales forecasts, it means sales managers are being paid higher incentives than what George feels they truly deserve.

In order to build 'buy-in' to the numbers, many owners will, like George, involve the managers responsible for performance in the preparation of the firm's budget. And the final set of numbers usually involves some degree of negotiation between the 'aspirational' goals of owners and the 'realistic' goals of managers.

But while the benchmarks set in the final budget make no difference to the wealth of owners (what matters to them is the actual results), that is not the case with managers whose bonus is tied to performance against budget. For them, where the budget lands can make tens of thousands of dollars difference to their pay that year. And the higher the budget, the lower the probability they will be paid a bonus. So incentive schemes that use performance against budget to determine incentive payments encourage managers to negotiate for the lowest, most 'realistic', budget they can get away with. The problem is so widespread we even have a name for it: 'sandbagging'. But what it really is, is lying.

Tying incentives to budget encourages a swag of dysfunctional behaviour, including:

- Low-balled budgets, leading to under-resourcing and in turn missed sales and missed profits.
- Hoarding of information by managers (sharing it with owners will weaken their negotiating position), which reduces the quality of decision making at the top.
- Time wasting: with meaningful amounts in bonuses at stake, it's not surprising that the preparation of the annual budget is often drawn out over months as each layer of management negotiates with the next. Owners, of course, pick up the tab for this massive time wasting exercise.
- Money wasting: if a manager has negotiated and won some expenditure in his budget but fails to spend it, he weakens his negotiating position for that and other expenditure in the following year. Better to spend it on useless activity than loose the money for future years. Far from encouraging managers to trim their costs, tying bonuses to budget encourages them to pad their costs, building a buffer for the year when performance is sailing close to budget and they need to 'pull out all stops' to get their incentive.

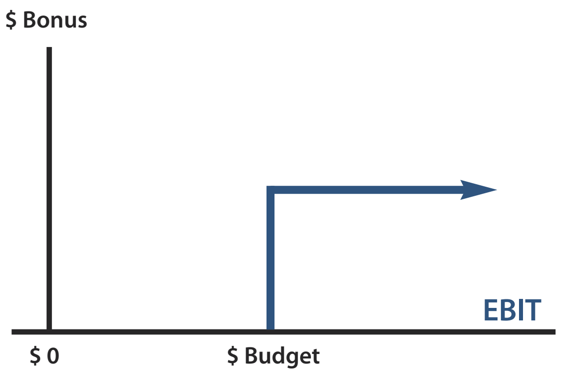
And of course, by negotiating budgets annually, much of the risk of non-payment is taken out. Annual negotiation allows targets to be reassessed for their 'reasonableness' so that projections that were made for that new market or acquisition, can be reassessed 12 months in and ratcheted down to 'realistic' levels, 'given what we now know'. And bonuses can still be paid, despite the woeful returns to investors.

Perhaps worst of all, tying incentives to budget and then negotiating the budget puts the vast bulk of honest, hardworking managers in an unenviable position. It forces them to either lie about what they think the business is capable of and benefit their families, or be truthful and watch as the rewards flow to others. It generates a high degree of cynicism or a low degree of morale. It does not encourage managers to sustainably grow wealth for shareholders and it makes bonus payments made in this way very poor value for money for owners.

#4: All or nothing

The problems with tying bonuses to budget are exacerbated when the bonus is made on an 'all or nothing' basis, such as, 'You hit budget you get a bonus, you miss budget, you get nothing.'

All or nothing incentive plan structure



This structure puts further pressure on budget preparation as negotiating the budget down by just one dollar could make tens of thousands of dollars difference to the take home pay of the manager.

When performance is close to budget in an all or nothing plan, managers are encouraged to do any of the thousand short term things that are at their discretion to improve performance. You may have seen some of these before, especially near year end:

- cutting back on training;
- cutting back on or research and development;
- cutting back on advertising;
- asking too much of their people;
- deferring the hiring of new people until the new financial year;
- discounting or providing generous payment terms to bring forward sales into the current financial year;
- deferring maintenance expenditure;
- arguing the interpretation of accounting treatments.

And so on.

The list is only as long as the creativity of managers. But this is the key point: instead of spending time on sustainably growing the business, all or nothing incentive plans provide so much pay off for that last few dollars, it's very tempting for managers to spend their time making decisions that boost short term financial performance and deliver them a bonus, and ignore what really matters to the business, its long term growth.

And of course, if performance is safely over the budget, there is no incentive to make the most of a good year in an 'all or nothing' bonus plan. The incentive scheme is effectively dead once budget is reached.

In fact the incentive is to hold back any more upside as out-performing the budget by too much will weaken the manager's negotiating position going into the next round of budget discussions. In this circumstance it pays to defer revenue till next year. It pays to bring forward expenses. This is not the behaviour any owner would want, but the behaviour that is encouraged by an all or nothing incentive plan, especially one tied to budget.

Ultimately, an all or nothing plan does damage at a deeper level of the business. The bulk of managers who 'short term' the business gain no pride or sense of achievement from their behaviour and the employees who watch on and suffer the consequences become cynical and detached. It can be a very costly error to make in incentive plan design.

#5: Payments made in full in one year

Because the financial calendar is 12 months long, it seems to make sense to tie bonus payments to annual performance. But most business owners will agree that one year is too short to get any real sense of the strength of a result. You need the perspective of three or more years to judge how sustainable and how repeatable the result was[1].

Most business owners know that you need the perspective of three or more years to judge how sustainable and how repeatable a result is.

Yet, most bonus programs pay out in full each year and often with the benefit of hindsight, therefore, over pay.

Ironically, the consequence of this approach can be lower bonuses for managers, as owners are often reluctant to tie large amounts to single year performance, knowing what an unreliable indicator it is.

#6: The wrong measures

Finally, the wrong measures of performance are too often used to determine bonus payments. The most popular financial measures used in bonus plans are pre-tax, pre-financing ones like Earnings Before Interest and Tax (EBIT) or Earnings Before Interest, Tax, Depreciation and Amortisation (EBITDA). But these measures ignore a major component of doing business, the capital put up by investors.

Most businesses require capital – money from banks and owners – from day one and every day thereafter as they grow and prosper. But measures like EBIT and EBITDA completely ignore the use of capital and hence give managers no incentive to manage it more efficiently.

For example, for an EBIT of \$2m, would you rather put up \$10m in capital or \$20m? A bonus scheme based on EBIT doesn't differentiate between these two alternatives and so it's not surprising that EBIT and EBITDA based schemes often go hand-in-hand with bloated working capital, gold-plated asset purchases, and a preparedness to pay suppliers early to keep them happy. Under these schemes capital has no cost, so it's not surprising that it's used so wastefully.

But you can't blame managers for responding to the rules of the game that are written for them. The blame sits squarely with the owners and Boards that write the rules of the bonus game without careful thought or research.

[1] Buyers of businesses know this, they look for 'repeatable earnings' in order to value a business.

An incentive plan that pays for sustained gains in the value of the company

Different owners have different objectives for their business and for the incentive plans that they offer to their managers. But in my 15 years advising in this area, some common themes have arisen:

- Owners want an incentive plan that will encourage managers to do the things that grow the long term value of the business. This means sometimes making decisions that will lower near term financial performance for the sake of the business' long term value. It also means putting safety and regulatory compliance above short term financial factors.
- They want to share a fair portion of the success of the business with managers but they also want managers to have some real 'skin in the game' on the downside.
- They want to encourage a collaborative culture, as much between owners and managers as within the ranks of management.
- They want to encourage managers to reach for the stars and share the owner's ambitions for the business.

In short they want an incentive plan to make their managers think and act like good owners without the complexity of actually selling them a piece of the business.

An incentive plan to achieve that aim might look like this.

1. Just like an owner, the majority of the financial rewards would come from building the business – achieving sustained, multi-year improvements in profitability.
2. Just like an owner, every dollar of profit would be worth the same to managers, as if they owned a flat 10% of the business.
3. Just like an owner, actual results would be paramount, with the budget playing no part in determining the size of rewards.
4. Just like an owner, some portion of rewards would be enjoyed annually but the majority would be deferred and subject to loss if performance was not sustained.
5. Just like an owner, rewards on offer would be meaningful.

Achieving sustained, multi-year improvements in profitability.

Ultimately an 'ownership-like' incentive plan must have financials at its heart, as it is sustained gains in financial performance that power the value of a business. Single period spikes in performance are unlikely to grow the value of the business a great deal however – buyers look for high levels of 'repeatable earnings'. The more reliable the profit flow, the higher the premium buyers are likely to pay for a business.

But as we have seen, the most common profit measures, such as EBIT and EBITDA (or Net Profit, Earnings Per Share, Return on Equity and so forth) can actually encourage decisions that reduce, rather than grow, the value of the business.

One measure of profit that can be relied on to drive decisions that will grow the value of the business is 'Economic Profit'. Economic Profit is the only metric that can be measured as easily as EBIT or Net Profit and yet ties reliably to wealth creation for owners.[2] It's measured like this:

	Revenue
less	Expenses
equals	**Earnings Before Interest & Tax (EBIT)**
less	Interest
less	Taxes
equals	**Accounting Profit**
less	Charge for use of shareholder funds
equals	**Economic Profit**

Most owners know that 'Profit' is what is left over from sales revenue once all the costs of running the business have been taken out. But accounting profit forgets one very important cost – the cost of using shareholder funds. And by failing to put a price on the equity used to fund the business, accounting profit effectively says it's free. Pay managers to grow accounting profit and they will be encouraged to use as much of the shareholders' money as they can put their hands on, after all its free and if they invest it at just 1%, accounting profits – and their bonuses – will grow.

By charging for capital, managers are encouraged to treat it like the scarce and valuable thing every business owner knows that it is.

But by charging for the owner's capital used in the business at a rate that reflects what could be earned elsewhere at similar risk, managers are encouraged to treat capital like the scarce and valuable thing every business owner knows that it is.

Economic Profit puts into practice what anybody starting a new business has to think about from day one: if I put my savings into this business, will it generate more profit than I could have got elsewhere at similar risk? For managers on an incentive plan linked to Economic Profit it forces them to think the same way: not just will this decision be profitable, but will it make enough profit to justify the owner's investment?

Every dollar of profit would be worth the same to managers

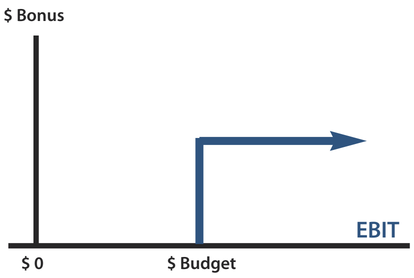
For an owner, an extra dollar of profit is worth just that, one dollar. But many incentive plans reward managers in a dramatically different way. They require a certain level of profitability (such as meeting budget) before they pay the first dollar in incentives. Then, at the point of

[2] See Appendix: Economic Profit and Wealth Creation

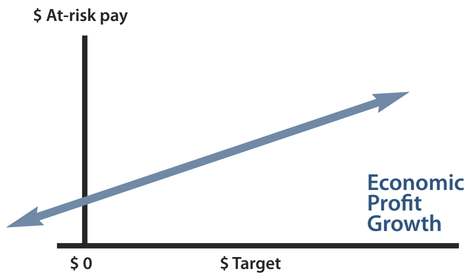
reaching the budget, one extra dollar of profit can be worth thousands to the manager, even if it's worth just one dollar to the owner.

Many incentive plans also have caps, so that an extra dollar of profit to the owner is worth nothing to the manager.

Typical incentive plan structure



Ownership-like incentive plan structure



An incentive plan that paid managers like owners would have at its core a formula with a constant sharing percentage, just like if the manager had a 10% ownership stake in the business.

The budget would play no part in determining the size of rewards

As we've seen, using the budget as the benchmark to determine incentive rewards unintentionally encourages managers to low-ball their budget. The answer is to decouple incentive targets from budget altogether and set incentive targets that reflect reasonable three to five year expectations for the business.

The answer to sandbagging is to decouple incentives from budget altogether and set targets that reflect three to five year expectations for the business.

Setting 'reasonable' three to five year targets could be just as prone to gaming as the annual budget if not done carefully. The key is to have an independent third party involved such as a trusted accountant or experienced advisor. They should conduct and present to the owners and managers a recommended growth target based on analysis including a detailed review of the historical performance of the business and that of a group of peer companies, examination of forward projections for the business and of the valuation of the business. Comprehensive scenario testing can then be conducted with the owners and managers to build confidence in the appropriateness of the target.

Just as important is the sensitivity of the plan. At what level of performance would no bonus be paid? At what level of performance would a double bonus be paid? These questions are best addressed again with the help of an independent third party who, through detailed analysis and collaboration with the owners and managers, can recommend the sensitivity of the plan.

The majority of rewards would be deferred and subject to loss if performance was not sustained

The value of any company reflects what buyers (and sellers) believe it can earn well into the future. The future being uncertain, buyers usually put great store in the sustained, historic earnings of a business.

To pay managers more like owners, put rewards into a reserve and pay out only a portion each year, provided gains are sustained.

Any incentive plan that aims to pay managers like owners, therefore, needs to recognise the importance of sustained gains in performance. One way to do this would be to measure performance over five years, for example and only make incentive payments at the end of that period.

But managers asked to wait five years for an incentive payment would rightly demand a higher level of payment, to justify the risk that they might leave during that time without any payment and to cover the time value of money.

A more practical alternative is to assess performance on an annual basis, calculate a reward and then place that reward into a reserve, paying out just a portion in the current year. The balance would be paid out over time if the performance can be sustained. A simple illustration of an incentive reserve or 'bonus bank' scheme is included below.

Incentive reserve mechanism

Year $'000	**1**	**2**	**3**	**4**
Opening balance	$0	$50	$125	-$75
Incentive declaration	$100	$200	-$200	$300
Available balance	$100	$250	-$75	$225
PAY OUT 50%	**$50**	**$125**	**$0**	**$113**
Closing balance	$50	$125	-$75	$113

In this illustration, the profit growth of the business in year 1 is good and a $100,000 incentive is declared for the manager. This amount is put into his incentive reserve and 50% of the balance is paid out, or $50,000. The balance is carried forward as the opening balance of his reserve for the purposes of calculating the following year's payment.

In the second year, profit growth is very strong and a $200,000 incentive is declared. The manager now has $250,000 available, of which 50% is paid out and 50% carried forward.

In year three, all of the profit gains of the prior year are lost and the incentive declared is negative $200,000. This is offset against the $125,000 carried forward leaving a negative balance of $75,000. This amount must be earned out through improved performance before any payment is made in following years.

Coming off a low base, year four sees a big leap in performance and a $300,000 incentive declared, which brings the incentive reserve balance back into positive territory allowing a payment to be made.

The incentive reserve mechanism allows annual payments to be made that reflect multi-year performance. While the deferral of incentive payments is gaining popularity, many companies fail to hold deferred payments at risk, that is, subject to loss if performance is not sustained. This is a crucial component if managers' and shareholders' interests are to be aligned.

In addition to providing Boards and owners with the comfort that incentive payments reflect sustained gains in performance, the incentive reserve also acts to smooth payments through the economic cycle and can act as 'golden handcuffs' – a mechanism to retain key staff, as the balance of the reserve is forfeited on the termination of the executive's employment.

Rewards on offer would be meaningful

While good managers, like good owners, are motivated by more than just money, the rewards on offer to employees need to be competitive to attract, motivate and retain key staff.

A well designed incentive scheme allows owners to safely offer meaningful sums to managers.

A well designed incentive scheme allows owners to safely offer meaningful sums to managers, amounts that can have a significant impact on the wealth of the manager over three to five years, but that represent a fraction of the increase in the owners' wealth.

Indeed, managers are more likely to look for greater amounts of their remuneration tied to performance if 1) they are prepared to back their abilities and 2) the plan is well designed and they are confident, therefore, that the owners will stick to it.

Finally, managers tend to value the sums on offer under well-designed plans more highly than those offered under poorly designed plans. This allows privately held businesses to compete with publicly held companies: even though they may be putting less money on the table, their offer can be competitive with the more lucrative, but poorly designed plans on offer in most public companies.

Case study

The Bicycle Warehouse[3] is privately owned sporting goods retailer with operations throughout regional New South Wales, the ACT and Victoria. Recently, the owner-managers of The Bicycle Warehouse were looking for a way to attract and retain store managers in an employment market where the Group competed against highly paid public servants and boom-time mining businesses.

One plank of their strategy was to put in place a carefully designed incentive plan for store managers and head office staff. A Working Group was formed with the owner-managers and an advisor from Juno Partners to develop a plan that would pay store managers for sustained increases in performance.

[3] The name of the business has been changed to protect its privacy.

Over three months, the Working Group developed and implemented the new plan, starting with how to measure performance. After some deliberation, Economic Profit (EP) was chosen, with the aim of getting managers to think about profits and capital invested. But the Working Group recognised that EP would be a new measure to their store managers, one that would require some time for their managers to get used to.

To help speed that understanding and show managers the link between the Key Performance Indicators they were used to, like conversion rates and items per basket, and the new measure of performance, Economic Profit, a detailed EP driver tree was developed. Built in a spreadsheet, it allowed managers to simulate the impact on EP of changes in different KPIs, building understanding and confidence in the new measure.

Store Level Economic Profit Driver Tree

Av item price	33.91		Average Sale	67.87		Sales	2,181,237	
Items per sale	2.00	x						
Door count	96,816		No. of transactions	32,140	x	COGS	1,313,879	-
Conversion rate	33.2%	x	Gross profit margin	39.8%		Gross profit	867,358	=
			Depreciation/WDV of fixed assets	14.7%		Depreciation	13,145	-
Marketing/Sales	5.4%		Marketing	117,990	+	Other costs	638,709	-
Occupancy/Sales	9.1%		Occupancy costs	198,264	+			
MV costs/Sales	0.0%		Motor vehicle costs	0	+			
HR costs/Sales	12.7%		HR costs	276,129	+	NOPBT	215,504	=
Admin/Sales	2.1%		Admin costs (exd depcn)	46,325	+	Taxes	64,651	-
Target Variable Pay			Bonus expense	0	+	NOPAT	150,853	=
Stock DOH	119		Inventories	429,539	+	Capital charge	72,696	-
Fixed Asset turnover	24		Assets/fitouts (net)	89,719	+	EP contribution	78,157	=
			WACC	14%	x	Previous EP	78,157	-
						Change in EP	**0**	=

Next, the Working Group developed an incentive plan design with the aim of rewarding sustained gains in EP. To that end, the plan included:

- store level, three year targets for growing EP;
- a simple incentive formula that shared a constant amount of the sustained gains in EP with each store manager; and
- an incentive reserve that allowed payments to be made annually, but also kept some in reserve in case gains turned out not to be sustainable.

Then the Working Group moved on to look at how much could be offered to managers under the plan. With a number of safeguards in place that ensured only exceptional, sustained gains in performance would lead to large payments, the Working Group decided to set target variable pay, the amount declared for hitting targets, at 25% of base pay.

To help pay for this increase in remuneration, the Working Group decided to offer the plan to all managers in exchange for a three year freeze on fixed pay rises. This freeze would represent real skin in the game for managers used to 5% pay rises annually.

Finally, education material was put together ahead of a launch day, that involved all store managers coming together to go through the workings of the new incentive plan.

The plan was received well by managers, as shown by their willingness to accept the fixed pay freeze over three years, used to fund the introduction of the plan. Key to that acceptance was the transparency and objectivity of the plan.

In the period following the implementation of the new plan, the Group has successfully attracted new talent, while minimizing unplanned departures. Managers report being more interested and more involved in the financial performance of their store and the business and the owners have reported that managers are taking a more thoughtful approach to managing their stores, including expansion opportunities. In short, The Bicycle Warehouse has developed more of an ownership mindset amongst their managers, without the complexity of issuing shares.

Summary

Many privately held businesses struggle to compete with the rewards on offer at larger, publicly held companies. But the truth is, while public company rewards can be generous, they are often poorly designed and undervalued by employees. This presents an opportunity to shrewd owners to design and put in place well designed incentive arrangements that attract and retain managers prepared to back their abilities and that only reward sustained gains in the value of the business.

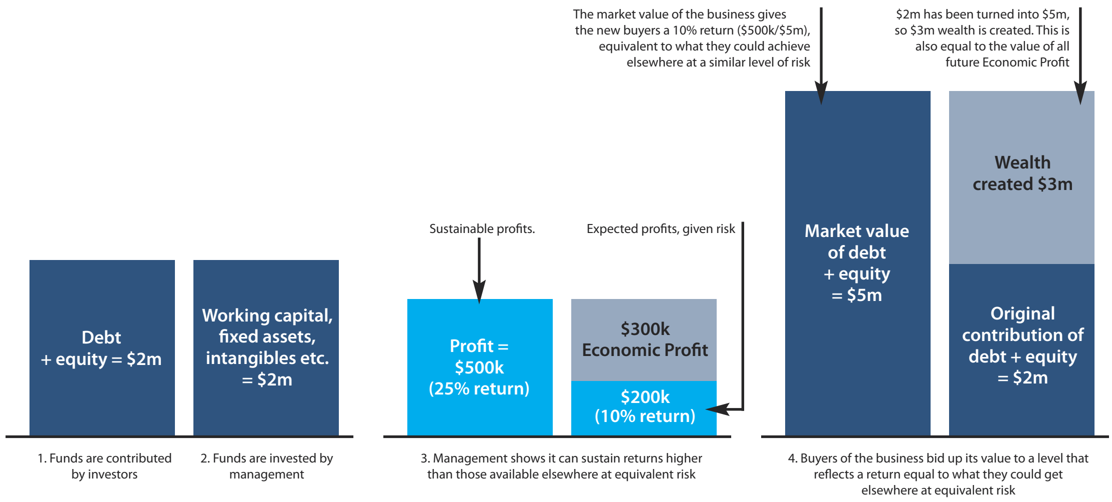
Appendix: Economic Profit and the creation of wealth

At it's simplest, wealth is created when investors put money into a business and some time later the business is worth more, so that if a company can turn $10m of investors' money into an asset worth $50m, it has created $40m of wealth.

While there is ready agreement that the creation of sustained gains in shareholder wealth should be the over-arching objective of all companies, there is some disagreement about how this is achieved. For the sake of clarity, I have outlined the findings of my research below, that forms the basis of my recommendations for how Boards measure the performance of executives.

As John Stuart Mill noted, the creation of wealth has its necessary conditions. My research shows that wealth is created when a company invests the funds entrusted to it at high rates of return. If the high rates of return are sustainable, the business will be worth significantly more than the amounts contributed by investors and hence wealth is created, (see Figure A1).

Figure A1: The creation of wealth



For example, let's say you own a business that generates a 25% return on the $2m you have invested in it (or $500,000 in profits) and can do so well into the foreseeable future, despite the fact that investments of similar risk could only generate 10%. By generating 25% returns where other investments of equivalent risk offer only 10%, your business generates value at 15% for its owner for every dollar of capital invested. Value in this sense is no different from the way we all think about making buying decisions: am I getting more for my money that I could get elsewhere?

In dollar terms, your business generates $300,000 of value for its owner – that is, $300,000 more than what you could expect to earn elsewhere at equivalent risk ($500,000 profit less $200,000 that could be earned elsewhere at equivalent risk). Economists have long referred to this $300,000 amount as Economic Profit (EP), or economic rent.

Now you are looking to sell the business. Not surprisingly, there are several buyers interested in your high quality business. If they pay you $2m for it, they too will be able to enjoy 25% returns, 15% more than they could receive elsewhere at similar risk. But in a competitive auction for the business, bids would rise quickly above $2m. Why? Because even at $4m, the business will generate a 12.5% return ($500,000/$4m) for the buyer, still 2.5% better than what could be achieved elsewhere. Logic suggests that bids would go to $5m – the level required to give the buyer a 10% return, or what she could earn elsewhere at a similar level of risk.

For you the owner, $3m of wealth has been created: you took $2m and turned it into $5m.

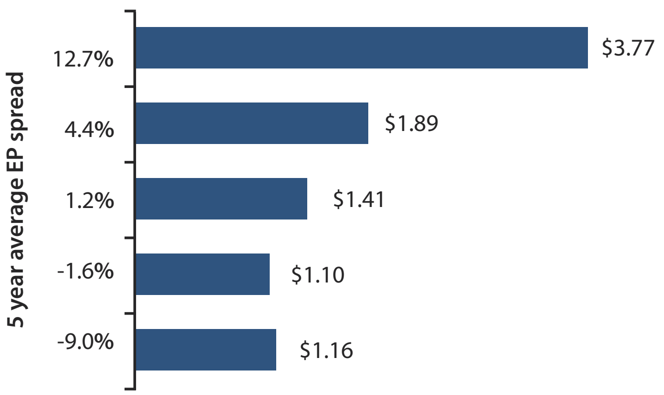
So businesses that create high levels of sustainable EP attract high valuations as their value is bid up to a level that equals what buyers could get elsewhere at similar levels of risk.

Now what if the business was expected to suffer consistently low rates of return? What would that do to your wealth? Well let's say the business was expected to only earn 7% or $140,000 well into the foreseeable future. Investors can get 10% on their money elsewhere at similar risk, so at auction, logic would suggest that the price would rise no higher than $1.4m. Any higher than that and investors would be accepting a rate lower than they could achieve elsewhere. In this instance, the business suffers negative Economic Profit and $600,000 of wealth has been destroyed. You started with $2m and ended with $1.4m.

So the Economic Profit that your company is expected to create is a key determinant of the price that it will sell for and the wealth that will be created for investors.

We can see how that plays out in practice by looking at Figure A2, which summaries the results of our 2019 Wealth Creators Report[4], a study of the EP performance of 300 of Australia's largest companies.

Figure A2: Average market value per dollar of shareholder funds invested vs. EP spread



[4] Further details on the 2019 Juno Partners Wealth Creators Report is available on our website,

The figure summarises the five year average EP spread for the 237 companies for whom we have 5 years or more of data, into quintiles. EP spread is the difference between the return on capital enjoyed by the business and the rate that investors could expect to earn elsewhere at similar levels of risk.

The top 20% of businesses enjoyed a 5 year average EP spread of 13% – that is, they generated returns on investor funds 13% higher than what was available elsewhere at equivalent risk. They also enjoyed the highest levels of wealth creation, turning, on average, each dollar of shareholder funds invested into $3.77 of market value.

The trend continues, with businesses with lower average EP spreads enjoying lower levels of wealth creation per dollar of capital invested.

These findings have been repeated across time periods, across industries and across geographies and provide managers and directors alike with comfort that sustained EP growth is the right measure to place at the heart of a high powered incentive plan, for the vast majority of companies.

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