



The Basics

Selecting the optimal performance measure(s) for executive compensation or other business purposes starts with an understanding of the most common measures and their respective strengths and limitations.

The Most Common Types of Performance Measures

There are two broad categories of performance measures most often used in executive incentive plans: financial measures and market measures. Financial measures are those that are based on the underlying financial statements of a company, while market measures are based on stock price and/or dividend results of the company. (Operational measures, a third category, are not as common in incentives except in short-term incentive plans for certain industries.)

I. Financial Measures

Financial measures can generally be broken down into three categories, profit, return on investment and growth, as shown below.

Profit	Return on Investment	Growth
<ul style="list-style-type: none"> ▪ Net income ▪ Earnings per share (EPS) ▪ Operating income ▪ Earnings before interest, taxes, depreciation and amortization (EBITDA) 	<ul style="list-style-type: none"> ▪ Return on invested capital (ROIC) ▪ Return on assets (ROA) ▪ Return on equity (ROE) 	<ul style="list-style-type: none"> ▪ Revenue growth ▪ Asset growth

II. Market Measures

Market measures are stock price-related metrics. Stock options and restricted stock derive their value directly from stock price and the change in stock price. The most common market metric for performance plans is relative total shareholder return (TSR).

$$\text{TSR} = \frac{\text{Change in stock price plus dividends}}{\text{beginning stock price}}$$

Since TSR is a stock-price based metric, it is volatile. Moreover, since it is impacted by many external as well as company-specific factors, rarely are TSR goals set in terms of absolute TSR. Rather, TSR is nearly always measured *relative* to a relevant comparator group. Applied in this fashion it can screen out or neutralize external factors impacting stock price, i.e., those factors that may tend to impact companies to one degree or another in comparable ways.

The Details

Profit Measures Defined

- Net income = bottom line profitability after all sources of income and expenses are included.
- EPS = bottom line profitability per common share outstanding.
- Operating income = Revenues less normal operating expenses (excludes interest, taxes and non-operating revenues and expenses).
- EBITDA = Cash-based operating income. Excludes interest, taxes and non-operating revenues and expenses and also non-cash expenses such as depreciation and amortization.

Strengths of Profit Measures	Limitations of Profit Measures
<ul style="list-style-type: none"> ■ Intuitive concept ■ Commonly referenced metrics of performance ■ Often effective for evaluating short-term results ■ Flexibility to define in manner that best fits facts and circumstances ■ Some measures (e.g., operating income, EBITDA) are able to better describe ongoing operating results 	<ul style="list-style-type: none"> ■ Ignore the level of investment required to achieve a given level of profit, i.e., whether profit was sufficient to warrant the investment and related risk ■ Some profit metrics are distorted by non-operating items and changes in capital structure (e.g., EPS, net income) ■ Less cash flow-oriented metrics (EPS and net income) while familiar, are often not as correlated with stock price changes ■ Cannot be compared across companies (not neutralized for differences in size)

Return on Investment Measures Defined

All return measures attempt to characterize profitability as a percent of a certain measure of investment, i.e., “*what did we get for what we put in?*”

- $ROIC = \text{Net operating profit before interest expense} / (\text{Total debt} + \text{total equity})$
- $\text{Return on assets} = \text{Net operating profit before interest expense} / \text{Total assets}$
- $\text{Return on equity} = \text{Net income} / \text{Total stockholders' equity}$

Return on net assets (RONA), return on capital employed (ROCE), and return on gross investment (or gross assets) are all close variants of ROIC and ROA.

Strengths of ROI Measures	Limitations of ROI Measures
<ul style="list-style-type: none"> ■ Captures not just profitability but whether <i>magnitude</i> of profitability is appropriate for investments made ■ Can be compared across companies and industries (neutralizes for size) ■ Generally provides a closer link to key drivers of value creation 	<ul style="list-style-type: none"> ■ Without reference to “cost of capital” cannot determine whether a particular return is “good” or “bad” ■ Value creation is about return and growth; an undue focus on returns alone can result in foregoing value-added growth ■ ROE is subject to distortions related to capital structure which can obscure risk and limit comparability

Growth Measures Defined

Value creation is about balancing profitability *and* growth. Strictly speaking, growth measures are those that help quantify the expansion of the scope, reach and depth of an organization. Growth metrics are focused principally on changes in size, not changes in profitability. Although profit metrics sometimes are characterized as growth measures, they are really variations of profit measures. Therefore, the two most common growth metrics are:

- Revenue growth = Year-over-year or multiyear change in sales of the company.
- Asset growth = Year-over-year or multiyear change in total assets of the company (common for financial firms or in more specialized natural resource applications).

Strengths of Growth Measures	Limitations of Growth Measures
<ul style="list-style-type: none">■ Key driver of long term value—when coupled and properly balanced with profitability■ Easy to understand	<ul style="list-style-type: none">■ If not properly balanced with the appropriate profitability metric, can lead to value-destroying growth or excessive risk taking■ Can be complicated to interpret when acquisitions and divestitures occur

Market Measures Defined

As noted, market measures are stock price-related metrics, often including dividends as well.

Strengths of Market Measures	Limitations of Market Measures
<ul style="list-style-type: none">■ Final measure of shareholder value/success; strongest alignment with shareholders■ Fully captures both financial success and investor expectations for future success■ Objective, transparent external metric■ Permits comparison across companies of varying size and industry	<ul style="list-style-type: none">■ Incentive qualities can be more limited; participants do not often see how they impact stock price and relative stock price results■ Notably influenced by whether relevant comparator group can be identified