

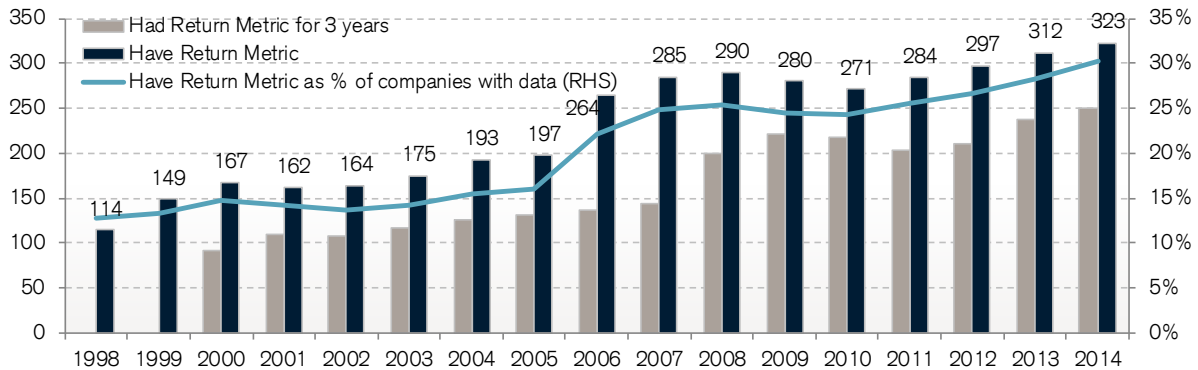
# HOLT GOVERNANCE

## Do Return on Capital Incentives Drive Improvement?

Market Commentary 4 November 2015

Return on capital can be a very powerful incentive for a Board to encourage improvement of corporate profitability by giving focus to both the income statement and the balance sheet. Using the HOLT Governance database, we find about 30% of firms currently use a Return on Capital (ROC) metric in their compensation plan. The use of ROC metrics has grown steadily over time and we find Material, Industrial and Financials sectors use the ROC metrics most frequently. The sectors least likely to use ROC incentives are Utilities, IT and Healthcare.

### Return on Capital as an Incentive Metric is growing in Usage

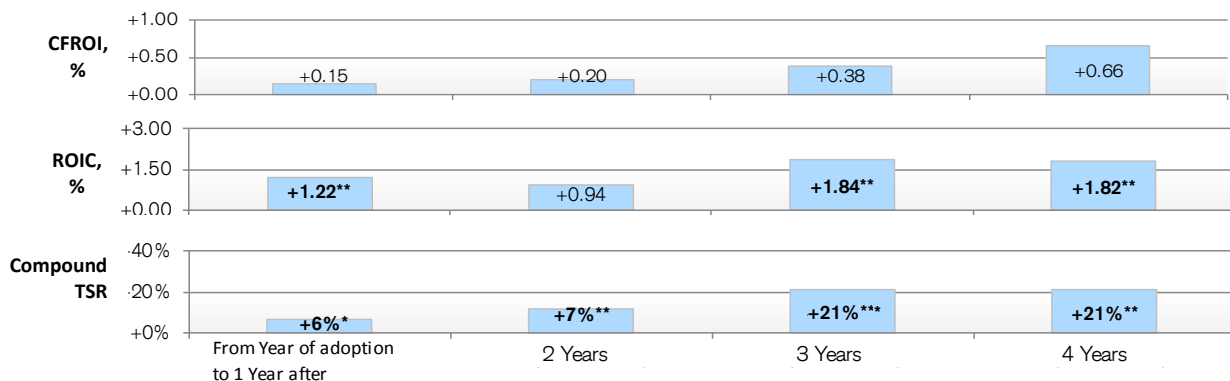


Source: HOLT Analysis, HOLT Governance Database, Universe: U.S. | Criteria Market Cap >\$.5bn. All firms with a Return Metric.

### Is the adoption of a Return on Capital incentive metric effective?

While the trend in ROC usage is growing, is it effective? The short answer is yes. Using HOLT's Governance database back to 1998, we identified all US firms that have adopted a ROC incentive and measured their subsequent performance. The results below show the adjusted CFROI®, ROIC and Total Shareholder Returns (TSR) is all improving post adoption of a ROC metric.

### Adopting ROC show subsequent average improvement in ROC and TSR



Source: HOLT Analysis, Universe: U.S. > .5B Mkt Cap in HOLT Governance database | Method: OLS Regression output. For ROC metrics – difference between return at Year x vs median of Years 0, -1 and -2. For TSR – compound TSR of Year 0 to Year x. Excludes companies that adopt/drop the ROC metric after one year. Adjusted Metrics = Controlled for effects from market, company and start return levels. \*, \*\*, \*\*\* - significant at 10, 5 and 1% respectively.

## Screening for firms that have adopted ROC metrics this past year

Using HOLT Lens™ we screen for firms that have added a Return metric in the past year. With a focus on the balance sheet, these 33 firms may benefit from improving ROC profiles.

Name	Symbol	Mkt Cap (\$ bil)	HOLT Management Incentive Score	Firm uses ROC Incentive (FY-1)	Firm uses ROC Incentive (FY)	CFROI (FY-1)	CFROI (FY)
MONDELEZ INTERNATIONAL INC	MDLZ	74.836	Good	No	Yes	16.38	16.66
DANAHER CORP	DHR	65.294	Good	No	Yes	20.95	22.67
GENERAL MOTORS CO	GM	56.912	Good	No	Yes	6.06	5.04
CARNIVAL CORP/PLC (USA)	CCL	41.662	Good	No	Yes	3.82	4.07
HUMANA INC	HUM	26.761	Good	No	Yes	12.26	10.42
MYLAN NV	MYL	22.511	Good	No	Yes	11.03	13.34
HESS CORP	HES	16.540	Average	No	Yes	4.44	4.79
M & T BANK CORP	MTB	16.008	Below Average	No	Yes	12.57	9.63
CENTURYLINK INC	CTL	15.995	Good	No	Yes	5.42	5.36
WEYERHAEUSER CO	WY	15.809	Below Average	No	Yes	4.65	3.77
TYCO INTERNATIONAL PLC	TYC	15.618	Good	No	Yes	11.11	10.27
TRANSDIGM GROUP INC	TDG	12.160	Good	No	Yes	42.08	40.92
HOLOGIC INC	HOLX	11.144	Good	No	Yes	20.71	26.96
BED BATH & BEYOND INC	BBBY	10.005	Average	No	Yes	12.75	11.93
EVEREST RE GROUP LTD	RE	7.881	Average	No	Yes	13.07	13.04
CIT GROUP INC	CIT	7.474	Good	No	Yes	5.83	7.71
PACKAGING CORP OF AMERICA	PKG	6.770	Good	No	Yes	8.56	9.79
WASTE CONNECTIONS INC	WCN	6.735	Good	No	Yes	8.63	10.63
NVR INC	NVR	6.713	Good	No	Yes	11.98	15.09
MID-AMERICA APT CMNTYS INC	MAA	6.559	Average	No	Yes	2.33	2.86
SVB FINANCIAL GROUP	SIVB	6.457	Average	No	Yes	12.54	11.46
HUDSON CITY BANCORP INC	HCBK	5.359	Average	No	Yes	1.84	-0.02
OLD REPUBLIC INTL CORP	ORI	4.711	Average	No	Yes	8.01	4.16
SYNOVUS FINANCIAL CORP	SNV	4.259	Good	No	Yes	2.48	4.44
QUANTA SERVICES INC	PWR	4.126	Good	No	Yes	11.55	11.81
ALERE INC	ALR	4.080	Average	No	Yes	11.54	8.75
COLUMBIA SPORTSWEAR CO	COLM	3.871	Good	No	Yes	5.75	9.00
MDU RESOURCES GROUP INC	MDU	3.729	Average	No	Yes	3.92	3.32
MGIC INVESTMENT CORP/WI	MTG	3.210	Average	No	Yes	-4.63	13.23
CLEAN HARBORS INC	CLH	2.705	Average	No	Yes	9.42	8.02
BIG LOTS INC	BIG	2.293	Average	No	Yes	6.37	6.32
KB HOME	KBH	1.226	Good	No	Yes	-0.13	2.89
WEIS MARKETS INC	WMK	1.131	Average	No	Yes	3.50	2.56

Source: HOLT Lens™ Screening Criteria: US firms with Mkt Cap. > 0.5 Bn with the addition of a Return Metric in FY. Note Mgmt Incentive Score measures how well a firm's incentives align with shareholder value creation principles. Using disclosed incentives, we score both positive and negative attributes. Scores range from a low of -8 to a high of 7. Firms with scores 4+ are deemed Good. Firms scores less than 1 are Below Average.

### Not all Return on Capital Metrics are created equal

While the adoption of ROC appears good, not all ROC metrics are equal. The metric should be robust and reverse accounting distortions and non-cash charges and capture off-balance sheet investments such as leases and investment in R&D. It should also be measured on a real basis to remove the effects of inflation, allowing a firm to be compared across time. ROE is not included as a ROC metric in HOLT Governance database for Industrial firms due to a lack of robustness and the metric being subject to financial engineering.

Even firms that appear to be using robust metrics such as ROIC should be reviewed for completeness. As an example, we have flagged Tesco PLC as a firm that engages in significant use of off-balance sheet leases, but did not include these leases in their ROCE incentives<sup>1</sup>. Whereas both Walmart and Walgreen Co. are similar retail firms that use ROIC<sup>1</sup>, but capitalize rent expense as part of their ROIC. Digging into the details can be important to understand if the firm may be miss-measuring their performance.

<sup>1</sup>Source: Company filings.

## What is HOLT?

HOLT is a value-based, return on capital framework proprietary to Credit Suisse. HOLT provides an objective view on over 20,000 companies in 65 countries using a methodology that examines accounting information, converts it to cash, and then values that cash, allowing investors to identify key drivers of value.

Credit Suisse HOLT's governance database systematically scores incentive plans along shareholder valuation principles. Combined with HOLT's proprietary return on capital metric, investors can accurately and independently assess management skill, wealth creation and governance risks.

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