

The journey to improved financial performance

By Derek Pankratz and Michael E. Raynor



Most every company seeks to improve its financial results, whether in the form of higher profitability, stronger growth, or some other measure. This quest for better business performance is a kind of journey: The point of departure is your company's current outcomes; the destination is your desired future performance; and the challenges of navigation, piloting the ship, and coping with stormy seas are the effort required to get there. Unfortunately, this journey is far less like a modern cruise and far more like the voyages of discovery of the 16th to the 18th centuries. The crews of Barbosa, Columbus, and Drake set forth, not with charts based on satellite imagery, but with maps that were the products more of imagination than exploration. Tracking progress was not done with a GPS device that places a ship within feet of its true position, but with sextants and dead reckoning. And successfully making the voyage was not abetted by reliable weather forecasts, but turned as much on the caprices of fate as it did on the seaworthiness of the ship and the crew.

This is the first in a series of articles that will equip you with the maps, navigational instruments, and successful exemplars to guide your own journey to superior financial results. The research presented here is adapted from *Charting superior business performance: The 2015 Exceptional 100 and the drivers of breakthrough financial results*, published by Deloitte University Press and available [here](#). You can access the report's interactive companion website [here](#).



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Better maps

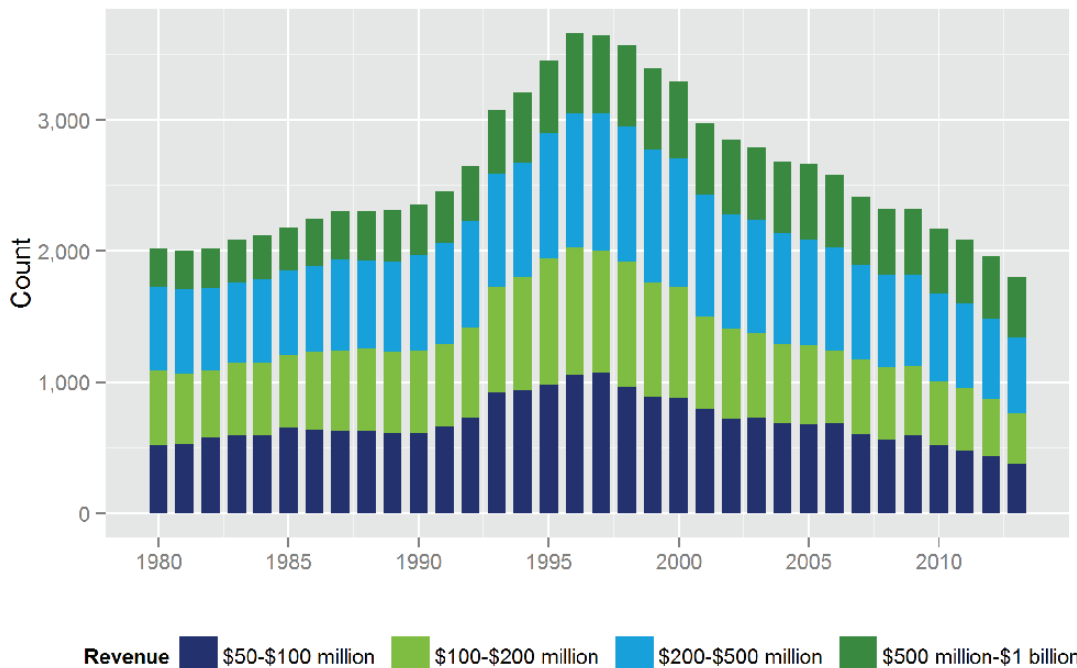
A SHIP'S course can be dramatically affected by the currents, tides, and trade winds it must navigate. Similarly, a company's long-term results can be dramatically affected by long-run, macro-level trends. Consequently, a voyage to improved business performance is greatly aided by a more accurate map of the oceans we hope to navigate.

For mid-market executives, map making is particularly challenging. Many of the companies that populate the middle market, or mid-market, are privately held, and so comprehensive performance data at the industry or sector level can be difficult to gather. Thankfully, a sample of US-domiciled, publicly traded companies that share key features—namely, size—with the broader middle market is a reasonable approximation of the market.

We define the middle market as companies with inflation-adjusted revenue between \$50 million and \$1 billion (figure 1). This large and diverse group is divided into six industries (figure 2). Comparing trends in performance between the collective mid-market and industries, as well as among industries, reveals where value is being created. Industries that are growing faster or are more profitable may offer compelling opportunities for growth, or be sources of insight into new strategies for success in your own industry.

Even within industries there can be considerable diversity, and so it is useful to divide industries into sectors (figure 3). Just as the analysis of industry within the context of the mid-market reveals potentially significant differences and similarities in long-term trends,

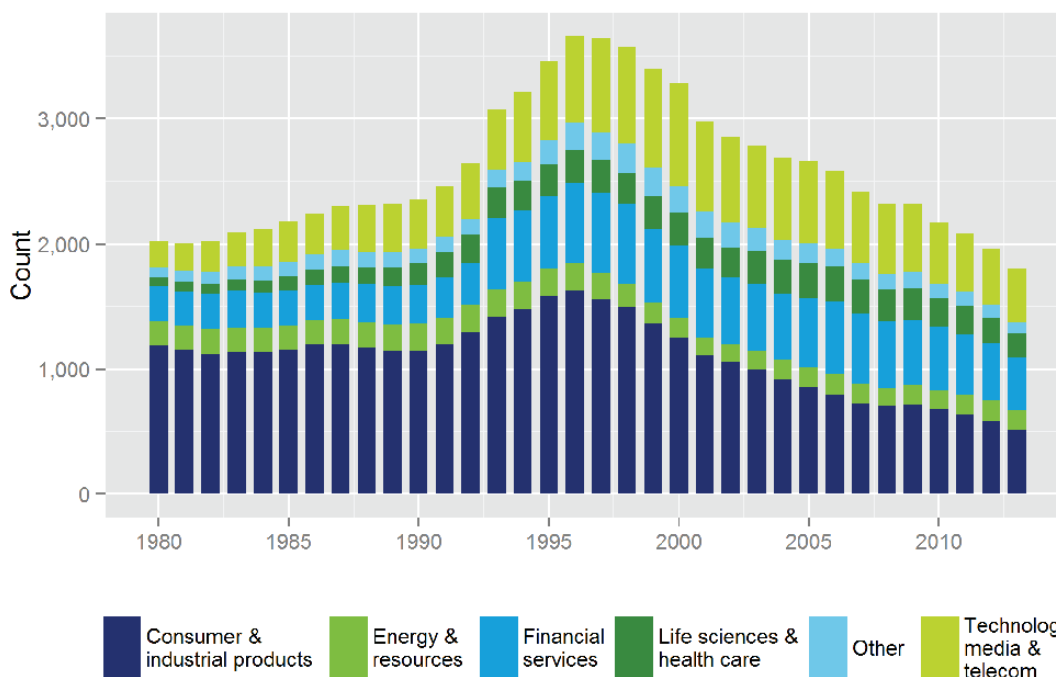
Figure 1. Total number of US-based, publicly traded companies with \$50 million–\$1 billion revenue



Source: Compustat, Deloitte analysis.

Graphic: Deloitte University Press | DUPress.com

Figure 2. Industry distribution, US-based publicly traded companies with \$50 million–\$1 billion revenue, 2013



Source: Compustat, Deloitte analysis.

Graphic: Deloitte University Press | DUPress.com

knowing which sectors are growing the fastest, are the most profitable, or are generating the most value can be sources of critically important insight. Some of these industry- and sector-level shifts play out over decades and go almost ignored despite their impact, while others can arrive abruptly and so be dismissed as one-time anomalies rather than the beginning of permanent change. Consequently, understanding what industry and sector you compete in and how its fortunes are waxing and waning over time is critically important to understanding the high-level forces that constrain and enable your performance.

Measuring performance

In the context of the middle market, we focus on two measures: profitability and growth.ⁱ

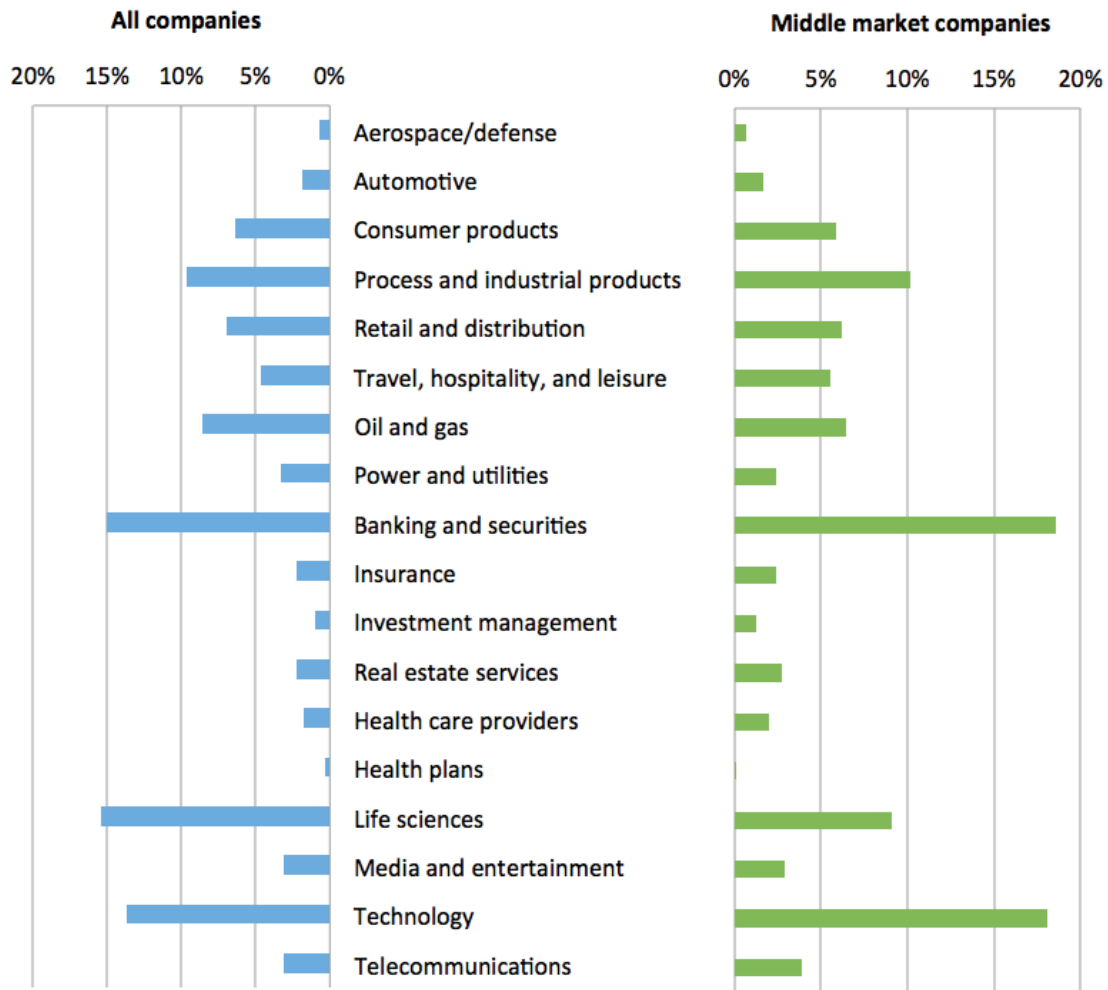
Profitability

A company's ability to generate profit determines its solvency. We do not measure merely the dollar value of profits, however, as this would lead us astray thanks to the different magnitude of profits generated by companies of different sizes. Instead, we measure profitability, a ratio of income to the value of some or all of the assets or capital required to generate that income.

We have chosen three measures of profitability from which to construct our map of business performance: return on assets (ROA), free cash return on assets (FCROA), and return on equity (ROE). Because we seek to generalize to the broader middle market, and since the latter metric is most relevant to public companies with stockholder equity, we focus here on ROA and FCROA.

ⁱWe add a third dimension when our analysis focuses on publicly traded companies: value. While mid-market companies are undoubtedly engaged in—and concerned with—value creation, the measures we have available are poor proxies for estimates of value that are not based in capital markets.

Figure 3. Sector distribution of US-based publicly traded companies, 2013



Source: Compustat, Deloitte analysis.

Graphic: Deloitte University Press | DUPress.com

Growth

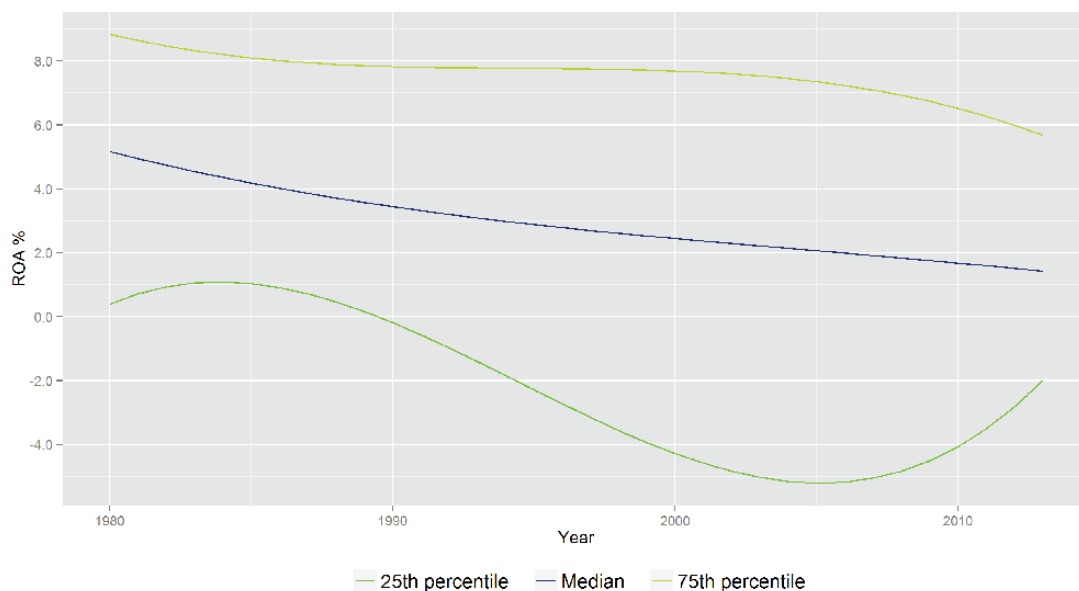
For each of our three measures of profitability, we are interested in a company’s level rather than the change: A company that maintains a high level of profitability has achieved something significant even if growth in profitability has slowed or stalled. Revenue is a different story. Companies that merely “stay big” are less interesting than those that continue to grow. Consequently, we measure growth in revenue. Since we are looking at revenue growth over decades, and because we want to avoid being fooled by inflation, we deflate annual revenue figures to express growth in real terms.

The contours of business performance

As with the explorers of old, although our maps are improving, they are far from perfect. Performance data can be very noisy, thanks to extreme outliers and sometimes large yearly fluctuations. This can make it challenging to identify meaningful trends, even when examining decades of data.

We have adopted a nonlinear, quantile regression method that estimates, rather than merely describes, the ROA for publicly traded mid-market companies from 1980 to 2013 for the median, 25th, and 75th percentile

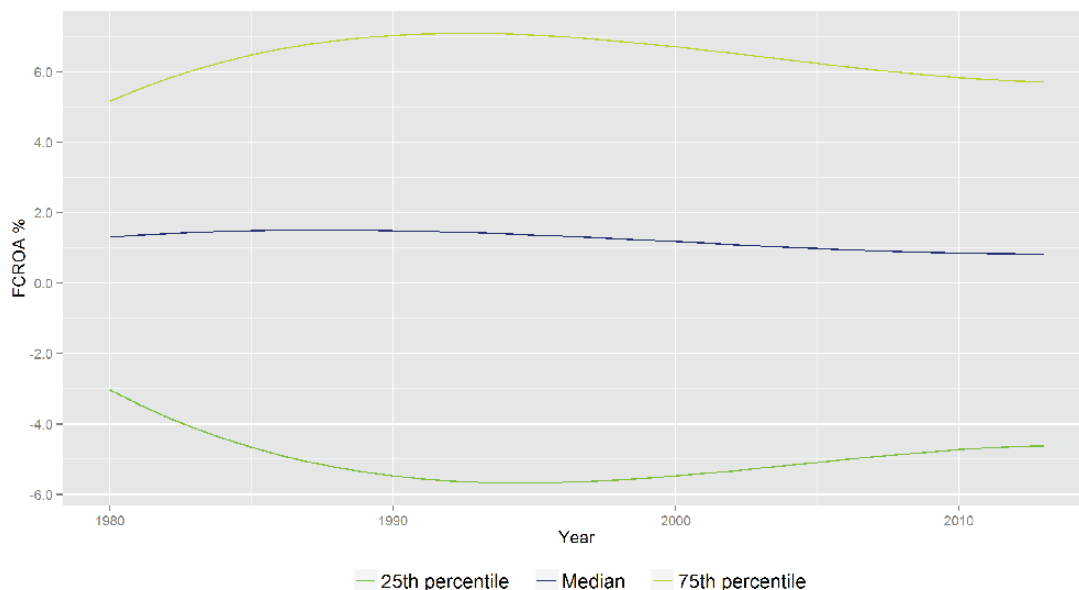
Figure 4. 25th, 50th, and 75th percentile return on assets performance for US-based, publicly traded middle market companies (1980–2013)



Source: Compustat, Deloitte analysis.

Graphic: Deloitte University Press | DUPress.com

Figure 5. 25th, 50th, and 75th percentile free cash return on assets performance for US-based, publicly traded middle market companies (1980–2013)



Source: Compustat, Deloitte analysis.

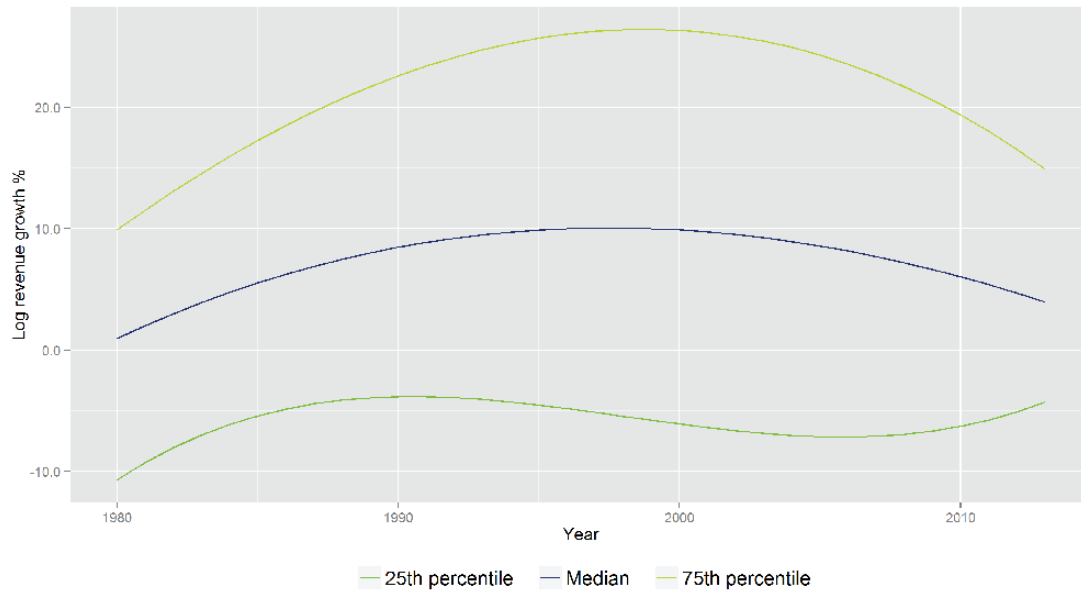
Graphic: Deloitte University Press | DUPress.com

performance levels (figure 4). What emerges is a picture of overall decline in ROA, but with material differences by level over time.

At the 75th percentile, the slowing decline experienced in the 1990s has been replaced by a sharper turn downward. This implies that achieving top-quartile performance is getting

slightly easier. At the 25th percentile, the steep decline beginning in the 1980s has been arrested and reversed in recent years, with lower-quartile ROA recovering from its trough at -5.2 percent in 2005 to -2.0 percent in 2013. Trends in our other profitability measures fill in additional valuable detail (figure 5), and

Figure 6. 25th, 50th, and 75th percentile revenue growth for US-based, publicly traded middle market companies (1980–2013)



Source: Compustat, Deloitte analysis.

Graphic: Deloitte University Press | DUPress.com

these metrics are consistent in describing a decline and recovery in performance at the 25th percentile.

In other words, for a time there seemed to be a high tolerance for negative results. More recently, however, mid-market public companies—either through performance improvements or selection pressures—are no longer swimming in quite so deep an ocean of red ink, and there is less room for extreme negative outcomes than there once was.

Growth rates have traced a generally concave curve that is especially pronounced at the 75th percentile: rising from 10 percent in 1980 to a peak of just over 26 percent in 1997, and since falling back to 15 percent (figure 6).

It would appear that, at the aggregate level, the more things in the middle market change, the more they stay the same. In general, levels of profitability and growth have not changed in almost 35 years, and where the levels are materially different, they are trending toward a convergence with historical values. The end of the Cold War, four recessions, three foreign wars, two stock market bubbles, and the rise

of the Internet . . . and the picture of corporate performance that emerges is one of underlying stability. This might be seen as boring, but we choose to see it as rather comforting. Companies are profitable, but not increasingly profitable, suggesting a competitive market. Companies are growing, but not without limit, suggesting dynamism. In short, a long view from a high perch suggests that the system is behaving as one might hope.

Good maps allow one to identify the shores one hopes to reach and understand the oceans one must cross to get there. But good maps are only the lesser half of the challenges associated with a voyage to improved—and perhaps exceptional—performance. The ability to navigate accurately is indispensable. That means being able to find yourself on that map and track your progress along the way.

It is the question of navigation we will take up next month, with a focus on the importance of understanding relative business performance; how difficult it is to estimate relative performance accurately; and how to do it well and use the information effectively.

See www.exceptional.dupress.com for more on this research, along with guidance on how to use these insights to improve your organization's business performance.

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