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Starting at the Top

Assessing management quality is more subjective than other aspects of investment analysis, but it's no less important. Here's how one researcher suggests bringing more rigor to the analytical process.

While they won't always admit it, most investors hold a special place in their hearts for successful and honest corporate managers. That's primarily driven by the significant role strong management plays in their investments' increasing in value – the surest way into an investor's heart – but it also reflects respect for the difficult job top managers have. As Fairholme Fund's Bruce Berkowitz says of the best CEOs: "These are people who are great operators and managers, with excellent people skills – not qualities value investors are generally known for."

Investors similarly hold a special enmity for corrupt or inept management, who waste shareholders money and, in an almost personal way, breach a trust. "Investors face a variety of risks, which we can more or less address in how we conduct our analysis and make our investment choices," says Thomas Russo of Gardner Russo & Gardner. "But the risk that can really set you back – and is more difficult to control – is if you have a management that takes these great cash flows and expropriates them more for their own benefit than for the benefit of the company. That, I think, is the biggest risk public equity owners face."

One challenge in addressing this risk is that the task doesn't as easily lend itself to the same type of systematic analysis one can employ in assessing a balance sheet or income statement. We're talking about people, not numbers, so the judgments are necessarily more subjective. Some value investors, as a result, deemphasize an assessment of management, both to avoid being "sold" and also because they assume if current management isn't getting the job done, someone else eventually will.

ON MERCENARY CEOS:
Studies show significantly better performance for shareholders when a CEO comes from within the same industry.

Renny Ponvert, CEO of start-up research firm Management CV, is looking to bring the same type of structured methodology to the analysis of management quality that exists for determining, say, earnings quality or competitive strength. Most recently CEO of financial-data provider CoreData Group, Ponvert says the genesis of the idea for Management CV came from his many years of acquisition due diligence. "Our financial and legal diligence had structured methods, but when it came to evaluating the management teams it was about going to dinner and watching their Power Point presentations," he says. "I've always thought there had to be a better way."

Not surprisingly, given that past performance can very often be an indicator of future performance, Management CV's analysis starts with the numbers. CEO's with public-company track records are ranked on the basis of nine core operating metrics – the obvious ones, such as revenue growth, operating margins and returns on capital – but strictly relative to the equally weighted metrics of industry peers. "Managers always claim great genius and success, when in fact they were primarily in the right place at the right time," says Ponvert. "We've corrected for that."

For the more qualitative analysis, Ponvert first pored through research into the factors that have been found to correlate with leadership success, finding insight from researchers such as Boris Groysberg and Lucien Bebchuk of Harvard, Geoffrey Tate of Wharton and the University of California's Alison Mackey. While his team goes through a 21-point checklist for each CEO, the qualitative review focuses on three primary areas: core skill fit, incentive alignment and clarity of the capital-allocation process.

The Right Fit

Research has consistently shown that when the operating skill set and experience

Tale of Two CEOs

Research firm Management CV assesses CEO quality by working through a detailed quantitative and qualitative checklist of what it considers the most reliable indicators of success. Below are brief summaries of two recently evaluated CEOs, for which the researcher came to different conclusions.

Thumbs Up

Name: Jim Whitehurst
Company: Red Hat
CEO Since: January 2008

Management CV Key Findings:

- Whitehurst developed a very good reputation as an operating executive at Delta Airlines (most recently COO) and his initiatives to improve customer service were hailed across the industry.
- Whitehurst's core skills revolve around operations, with a proven ability to shape and implement a large, complicated customer service and support operation – a very good fit for Red Hat in coming years.
- Enterprise software is an increasingly global business, so Whitehurst's international experience in his schooling and at Boston Consulting Group will help him as CEO.
- The management team Whitehurst inherited is very strong and has worked together for some time at Red Hat, a major plus.
- Cautionary points: Company CEO compensation has risen sharply and at a rate inversely proportional to the returns generated for shareholders. Whitehurst's prior experience is in a significantly different industry (airlines) and he is one of the youngest CEOs we cover (40).

Thumbs Down

Name: Mark Greene
Company: Fair Isaac
CEO Since: February 2007

Management CV Key Findings:

- Company has underperformed peers and now faces difficult industry conditions in core franchise of providing consumer credit analytics and ratings to lending institutions.
- Greene's experience at IBM and his core skill set (strategy and business development) may not best match current sales-development and cost-cutting demands. We don't yet see a sense of urgency in addressing poor operating results.
- Greene and his team are paid reasonably and perhaps modestly given the operating issues they face.
- Greene's incentive criteria are not clearly defined and have been subject to regular modification. Shifting incentive programs can alter management's behavior from year to year and confuse tactical execution.
- Management equity ownership is virtually nil, so they may act more like vested managers than owners.
- An agreement with activist shareholder Sandell Management places a potential deadline on Greene's efforts to improve operating results. Perhaps not an unwelcome thought.

of the CEO best matches the tactical challenges of the company he or she leads, the result will be more successful. While this may seem obvious, examples abound of the finance person taking over a high-growth company or the sales and marketing expert being named CEO of the maturing one. Ponvert wonders, for example, about newly named CEO David DeWalt of security-software power McAfee [MFE]: "He's a sales and marketing guy who's spending aggressively to expand the firm while the industry is maturing and moving toward margin competition. His skill set may not be a great fit longer-term."

Beware also the superstar outsider coming in to "fix" things (remember Robert Nardelli at Home Depot?), says Ponvert: "Studies show significantly better performance for shareholders over time, on average, when a CEO comes from within the same industry and even from inside the company."

Aligned Interests

How CEOs are paid can shed considerable light on what their focus will be and how they will likely perform. Management CV puts particular emphasis on basics such as the evolution of CEO pay relative to shareholder returns, the balance between cash and incentive compensation, the relevance of metrics used to determine incentive pay, and how well the CEO is paid relative to the rest of the top-management team. Performance-based pay should be at least three times salary, says Ponvert, while bonuses or option grants should be based on specific operating metrics like cash flow rather than non-controllable or irrelevant factors like the stock price or length of service. Among red flags for future shareholder performance: when the top five executives' cash compensation exceeds 3% of earnings before interest and taxes, or when the CEO's salary is more than three times each of the other top executives. "Again, we're leery of 'celebrities'," says Ponvert.

Also of concern are shifting priorities. Ponvert chides management of software firm Parametric Technology [PMTC], for example, for regularly changing its benchmarks and tactical milestones in a way that

makes it impossible to track how they're doing relative to stated goals. "It's like reshuffling the deck every time you don't like the way the cards come up," he says.

Capital Stewards

Finally, Management CV places particular importance on how well the CEO has defined and articulated the company's capital-allocation strategy. The absence of such a strategy – or lack of adherence to it – increases the likelihood that shareholder capital is invested in sub-optimal or unexpected ways, says Ponvert, sharply increasing event risk.

A rigorous analytical approach – which in Management CV's case results in detailed individual reports and numerical ranks that Ponvert hopes will "bring to the analysis of management quality what Value Line brought early on to financial analysis" – obviously can't insure against betting on the wrong jockey. But the effort is likely worth the trouble. Eagle Capital's Boykin Curry described well the importance of management to investors in last month's *Value Investor Insight* (March 31, 2008): "If you expect to own a company's shares for 10 years, management is going to make thousands of decisions you can't predict and may never even know about, which collectively make earnings compound at a rate more or less than they would have otherwise. I'm not talking just about huge restructurings or inventing a new product, but do you pick this ad agency or that one? Do you promote this person to run finance or that person? Those things can add up over time to the difference between a Staples and an Office Depot." VII

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