Measure for measure: new ways of looking at the long-term performance of firms

by George S. Yip, Timothy M. Devinney and Gerry Johnson

The need for sustainable long-term performance is an expectation driving the actions of those at the top of organisations. Yet there are few illusions about just how difficult that is to achieve – nor is it easy to determine precisely what should be measured and how.

The difficulties managers face in sustaining long-term performance arise not just from a competitive environment that naturally flattens out a firm's performance. There are also inherent problems in accounting for the multidimensional character of performance as it is commonly understood and measured. We need to understand what it means to perform, and to find robust and consistent ways of measuring that.

Senior managers typically face three particular challenges in measuring performance:

- how to balance short-term and long-term performance
- how to deal with different measures of performance which may throw up conflicting results
- how to find the right peer comparators

Such issues were very much in our minds when deciding on a new approach for our recent study, which examined the financial performance of 215 of the UK's largest public companies, across 38 industries, from 1984 to 2003. What was striking was that only 13% of those firms achieved consistently superior performance when compared with their British and international industry peers.

Some of our qualifiers – such as BP, Cadbury Schweppes or Tesco – would have been named by the most casual observer. Others are far less well-known niche players, such as the Scottish soft drinks manufacturer AG Barr (producers of Irn-Bru) and Bespak, producer of medical devices for drug delivery.

The method we chose was frontier analysis, an input-output efficiency measurement technique more commonly used in economics and operations research. It has, however, proved valuable in evaluating the performance of organisations with no direct profit imperative, such as hospitals, and those with multiple inputs and outputs.

Frontier analysis undoubtedly offers real potential for companies looking to improve their strategic management. And it could prove equally useful for investment analysts, board directors, policy makers and others interested in how companies are performing.

It involves quite complex statistical processes, but essentially it is a sophisticated form of benchmarking. It focuses not on absolute measures of performance but on actual extremes of performance for the industry on any given measure. This enables you to define a frontier for each type of industry/peer group, against which you can then plot the relative performance of firms.

Plotting annual deviation to show how far a company is from the frontier each year provides a graphic picture of performance over an entire period, and makes it easier to pinpoint periods of superior or inferior performance. Even more importantly, it can reveal clearly how performance tracks over time

relative to a defined maximum set by selected peers.

The logic is that a firm is being benchmarked not just against other firms' performance in a given year but against any firm's performance in any given year.

The beauty of the frontier approach is that it can accommodate any number and mixture of measures and still allow companies to be ranked against each other, even where they excel on different criteria. In this sense, frontier analysis can compare apples with oranges!

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The mix of measures used should not only reflect the various interests of different corporate stakeholders but also be relevant to the strategic ▸

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decisions being made by managers, and to what top managers can influence. The criteria will almost certainly differ for different firms, depending on their age and operating environment. What is vital is that the measures should be sufficiently broad and diverse – choosing ones that are too similar will yield less useful information about any ranking order.

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For our UK study, for example, we selected five performance measures: profit margin, return on shareholders funds, return on total assets, return on capital employed, and cash flow to operating revenues. All represent precisely the type of information used by investors, managers and key stakeholders to assess how well a firm is performing.

Selecting the right comparators to include both domestic and international peers requires careful thought, but the technique offers valuable flexibility for companies operating in multiple sectors. While frontier analysis does not eliminate the problem of company diversity it reduces its effect by allowing different companies to, in effect, select their own dimensions of performance. So, for example, both Cadbury-Schweppes and Unilever qualified in the food category, despite having quite different product mixes.

Where a company has sufficiently diverse businesses to require analysis in more than one industry, the exercise can be repeated placing the company in different sectors.

If a different answer emerges – for example, if the same company shows up as a long-term superior performer when compared to peers in one industry but not in another – that is a valuable finding, which the company might use to consider rebalancing its portfolio of businesses towards those sectors in which it qualifies as a long-term superior performer and away from those in which it does not.

You could also use this technique alongside business portfolio analysis to evaluate whether a company is in the right mix of industries.

Getting the right view of performance can make a huge difference in getting the right performance. ■

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