

## Research Comments

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#### Management Efficiency

How do you properly measure the level of management effectiveness in a company? There are plenty of ratios to quantify the company as a whole, but how do you quantify management?

#### **Analysts have long searched for precisely this Holy Grail.**

Traditional measures of earnings per share growth have been used extensively in an attempt to measure management efficiency. The problems with this approach are obvious to the careful observer. Earnings per share include the net effect of the capital structure of the firm in question. That is, the decision to capitalize your company with debt instead of equity has an enormous influence on earnings as reported. That's the reason leveraged buyouts continue to thrive. To the extent that interest expense continues to be a deductible expense, the government is essentially subsidizing leveraged capital structures. As a manager, you can either pay the money to the tax man in the form of income taxes, or you can shift the tax burden to bondholders by paying them interest.

Another approach that is commonly used in gauging management efficiency is to look at the dollar amount of sales per employee. This is great if you're a technology company, but not so good if you're in heavy industry. Again, distortions occur with this approach, particularly across industries. This ratio does, however, get to the heart of the productivity issue, as annual changes in sales per employee can be used as a proxy for measuring productivity.

Still further, many analysts use return on equity or return on assets as a measure of management effectiveness. Again, these ratios experience many of the same problems of earnings per share growth, as they rely largely on income as reported after capital structure influences, although some variations of these ratios attempt to capture capital structure effects to some degree. Additionally, all the turnover ratios are commonly used to gauge various types of company efficiency.

Sometimes you discover something so elegant, that it seems too simple to be true. In addition to the above ratios, and many others, the ratio we like to use to get to the crux of the management efficiency is the ratio of gross profit dollars (GP) to selling, general and administrative expenses (SGA). I don't think you will find this in any textbook on financial analysis and we are grateful to Mr. Carl E. Pellegrini, CFA of Analytics, Inc. in Dallas, TX for revealing this ratio to us many years ago. Think about what this ratio does, for it is very comprehensive. In essence, it measures the efficiency of management in generating gross profit. Gross profit, as you know, is what makes the world go around. It pays all the bills - salaries, phones, interest, dividends, the tax man, you name it. Think of it, if grocery stores sold only milk and Miracle Whip, they would be out of business.

This ratio can only improve over time by management becoming more efficient. You either raise your prices or lower your cost of goods sold to increase your gross margin, the numerator. Or, you do more with less SGA (the working mans true definition of

efficiency) to decrease the denominator. It's as simple as that. No capital structure effects, no earnings management effects, no anything. Pure and simple - how efficient are you in operating your business? No manipulation is allowed with this ratio short of fraud unless you call it a restructuring charge. Management either executes their strategy or they don't. Also, this ratio can be used among different industries (as can many others) as a gauge of the efficiency levels across industries. Keep in mind that under changing economic conditions a higher gross margin allows for many things. It allows management a higher margin of error in executing its strategy. It also allows for, all things being equal, a more leveraged capital structure. There's simply more money to pay interest versus a low gross margin business. This is particularly useful when sudden opportunities arise. Management can use a high gross margin to inflict severe pain on the competition. But they must operate efficiently to do so. Keep this ratio in mind when evaluating companies. Use it to thoughtfully quantify the efficiency and effectiveness of management in the context of what they are telling you. This will be a particularly useful approach when many of the other tools in your arsenal may seem to be smoke and mirrors in this day and age of earnings manipulation (see "Managing Earnings", Northwest Arkansas Business Journal, 9/20/99, p. 4).