The Imagination Premium: an anticipative performance metric

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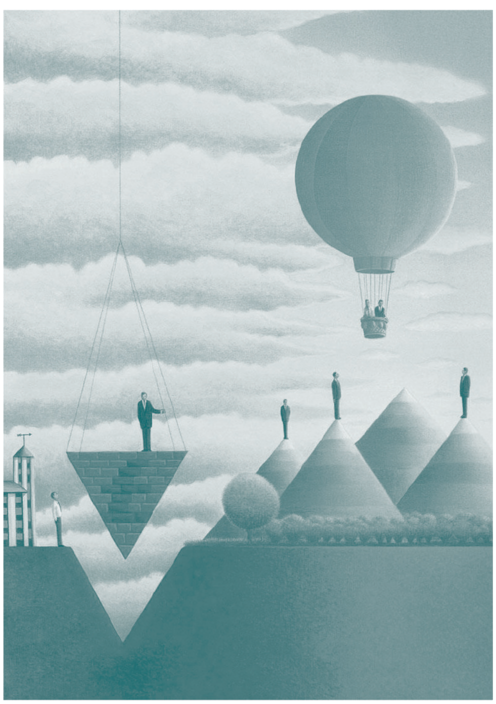
Most backward looking corporate performance metrics leave a lot to be desired as measures to drive long-term, forward looking decision-making by corporate strategists and CEOs. Jeff Bezos, former CEO of Amazon, has often said that when being congratulated on Amazon having a great quarter, he's really thinking, "that quarter, the one we just had, has already been baked two or even three years ago."[1]

Adding to the problem is that companies incentivize corporate leaders on the basis of backward looking measures, for instance, on stock price during a given period. As behavioral economist, Dan Ariely points out, "Human beings adjust behavior based on the metrics they're held against. Anything you measure will impel a person to optimize his score on that metric."[2] As a consequence, CEOs who would like to fatten their current bonus are therefore not motivated to make risky investments in unproven innovations that might fail and cause lower quarterly earnings and a drop in company stock price.



And yet, there are exceptions – companies that manage to invest for the long-term even as they experience short-term performance pressures. Amazon, of course, Best Buy, Honeywell, Klöckner, ørsted, Bosch, Wal-Mart, Adobe and many others have transformed themselves digitally, made investments in innovation and growth, left behind legacy businesses and explored new business models. If that is the kind of leadership behavior that should be incentivized and evaluated, it stands to reason that business needs a metric for assessing the potential for growth that CEOs and leadership teams can actively manage. As a more forward-looking measure for evaluating companies' prospects and executive success we propose The Imagination Premium.^{TM}

The Imagination Premium (TIP) – assessing the value of potential growth

The Imagination Premium is a fitting name for the metric because it reflects the intention of leaders to move their companies forward into new business models, markets, technologies and ways of working, either through incremental growth or acquisition. The value of such insightful imagination is substantial, and measuring it could offer boards and company strategists a leading indicator of expert observers' judgment of a company's growth prospects.[3]

The value of a company's equity can be thought of as comprising two parts that determine The Imagination Premium. The first represents the

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value a reasonable investor might estimate based on the ongoing streams of profits it generates from operations. This is the Value of its Current Operations [Vo]. Investors, however, are future oriented. If they believe that a company will enjoy healthy future growth, there is a premium they are willing to pay for the equity of a company that will permit them to participate in that growth. This is the Value of Growth [Vg], or the additional value an investor will attribute to the equity beyond what is reflected in simple cash flow generation from the current business. The Imagination Premium reflects the ratio between the two – dividing the value of operations by the value of growth. The Imagination Premium reflects the value of a company's equity, beyond what can be readily explained by its ability to throw off cash.

To calculate The Imagination Premium, start by considering what investors think about the value of the equity of a company. Using the Capital Asset Pricing Model, determine what returns investors would expect, based on the riskiness of the underlying stock. Look up the "beta" of a company's stock, calculated monthly over a five-year period. This is a measure which assesses how volatile the price of a stock is relative to the overall market. Investors use this number to estimate how much return they should expect, as the more volatile a stock, the riskier it is.

In general, stocks that have higher beta values need to provide better returns to investors than those with low values because they represent riskier bets. This provides a way of figuring out, based on a firm's cash flows, what an investor would consider a fair value for their investment. Using the Capital Asset Pricing Model, calculate what proportion of a firms' equity can be explained by that cash flow. This is the implied required investment return, or the Value of Operations (VO). If, however, a firm's equity is valued more highly by investors than can be explained simply by market expectations given current performance, that portion of equity is attributable to potential growth. This is the Value of Growth [Vg].

The two components of TIP, the Value of Operations [Vo] and the Value of Growth, [Vg] can be thought of as the steak and the sizzle of a company's offering. It isn't just that companies have to have a good growth story, but their leaders also need to be able to tell it, and then deliver on their promises.

You have our attention!

Consider a biotech firm with a TIP of 2.0. That means its investors attribute the Value of Growth (the sizzle) that is twice what they would insist on given the value of the company's Operations (the steak). In this case, its current operations support a valuation that is $12 billion less than the company currently trades at on its stock exchange. Even though its stock price has fluctuated considerably over the past three years, its market cap has increased steadily, fueled by an increase in its Imagination Premium.

The acceleration of the firm's Imagination Premium parallels the decisions made by a new leadership team that is determined to make significant investments in growth. It has moved into new markets, developed new but related product categories and essentially implemented a growth mindset throughout the organization. Importantly, the firm broke with past practice of insisting on present value calculations as the basis for its investments, looking instead to increasing the future value of those investments, making substantial, but de-risked bets in growth markets.

This is indeed a great story – a future-oriented CEO and leadership team are rewarded by the markets with an increase in the value of their company as they make the right long-term decisions for growth. But there is a darker side to this – having a great growth story isn't enough. With a TIP of 2.0, investor expectations that the team will be able to deliver on those growth expectations are sky-high. Slipups in execution, a few big bets that don't pan out and wavering on the commitment to the strategy can be swiftly punished if investors lose faith.

When the senior leaders of this biotech learned that their TIP was 2.0, their response was "you have our attention." They are now focused on delivering on the promise of such a high TIP.

Attracting activists

When TIP is 1.0 it signals parity between the Vo and Vg. A TIP below 1.0 means that the firm is potentially extracting value rather than investing for its future, a surefire indicator of short-term thinking. Much below 1.0, and a company is valued for current operations, but not for growth. A negative TIP signals that investors will not even pay for the capitalized value of current cash flow and this usually leads to activist investors, hostile acquisition threats and C-suite turnover.

For example, consider Buffalo Wild Wings. Founded in 1982, expanding by franchise agreements beginning in 1992 and going through an Initial Public Offering in 2003, the firm was an outstanding performer from the perspective of its investors. Indeed, $10,000 invested in the stock at the IPO was worth more than $175,000 on March 31, 2017. Its CEO, Sally Smith, had overseen a long period of steady growth, expanding the chain since taking the role in 1996 from fewer than 100 locations to over 1,220.[4] Nonetheless, in 2017 the firm attracted the attention of an activist investor, Marcato Capital Management. Its founder, Mick McGuire, called for Smith's ouster, board seats and refranchising many of the store operations.

A "bitter" proxy contest followed, and two-thirds of the company's investors reportedly voted in favor of the slate put forward by the activist hedge fund.[5] In a fascinating twist, Smith, got the last laugh. Behind the scenes she was negotiating with Roark Capital, owner of Arby's Restaurant Group.[6] It acquired Buffalo Wild Wings for $157 per share in cash, a deal valued at about $2.9 billion, including net debt.[7]

The Imagination Premium allows us to look at a hostile acquisition story like this one and anticipate how the TIP metric could have warned of impending investor disappointment with Smith's performance. Sales growth slowed at the company, and its TIP in 2017 was a sorry -.60. It indicated that investors not only had no faith in the company's growth prospects, they actually expected it to shrink!

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TIP anticipated the opportunity seen by the activist. With a low TIP, a company can be acquired for a relatively low price, then have its apparent value juiced up by what are essentially short-term measures. In Buffalo Wild Wing’s case, Marcato’s solution would have been to bring a lot more cash into the company by increasing the outlets owned by franchisees, reducing the investments the company might need to make in growth to remain relevant to a changing customer population. A low TIP signals to potential activists that assets may be available for a quick acquisition.

TIP analyses for companies that had undergone a forced or turbulent CEO transition identified interesting correlations. Campbell’s long-time leader, Denise Morrison, abruptly retired in 2018, a year when the company’s TIP was -.45. Mondelez’ long-time CEO Irene Rosenfeld retired in 2017, when the company’s TIP was .73. Xerox both attracted activist investors and changed CEOs in 2017, when its TIP was -.23. GlaxoSmithKline’s CEO retired in 2017, when the company’s TIP was 0. Danone S.A., a multinational food-products corporation based in Paris, had sales in 2018 of €24.65 billion; its TIP was +.20. This was far below its peer group, indicating a muted expectation for growth. Its TIP fell to -.60. Emannuel Faber, its CEO, stepped down in March of 2021. As the *Wall Street Journal* reports, Danone shares were up 11 percent since Mr. Faber took over in October 2014, but rival Nestlé’s stock had risen 43 percent and Unilever PLC’s by 55 percent[8]. And so it goes.

The case of Coke

Any company that exhibits more insightful imagination than its competitors can increase its TIP, and by extension, its market cap. Consider the recent history of Coca-Cola. Former CEO Muhtar Kent recalls trying to figure out a growth strategy for the company for the long term after taking the helm at the firm during the Great Recession of 2008. His solution: “I started saying from 2010 onwards that we need to run this business not just for the next quarter but also for the next quarter of a century.[9]”

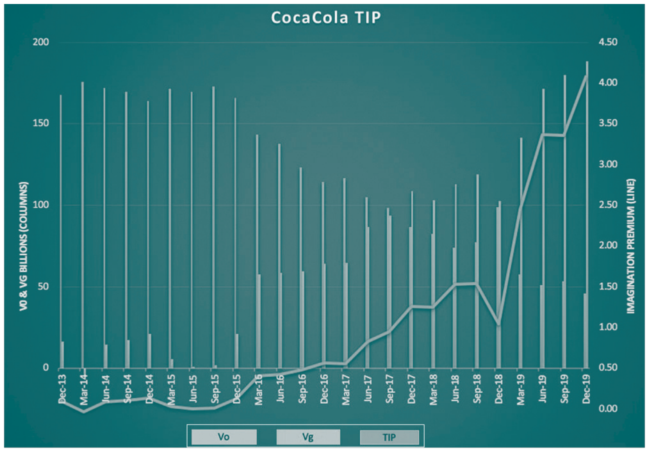
At the time Kent took office, Coca Cola faced a decline in the sugary drinks business, and a market trend toward healthier drink alternatives. The headwinds were considerable. Kent felt the company needed to offer consumers alternatives to sparkling beverages and products and operations that were more eco-friendly. A controversial move was to acquire Coca-Cola Enterprises, its unwieldy distribution partners, who were owned and operated independently of Coke. It proved to be a capital-intensive task that dragged on earnings until Coke re-initiated a re-franchising program toward the end of that decade.

Exhibit 1 offers an analysis of Coke’s Imagination Premium, Vg and Vo over the period from the end of 2013, when Kent had been in the role for about five years, through the end of 2019, when he had handed the reins to James Quincey, the current CEO.

Initially, TIP is negative in the early Kent years, when the company was basically cleaning house of its distributors and trying to figure out what consumers really wanted. It was efficiency and operations oriented.

Coke’s TIP was negative from late 2013 to 2016, signaling that investors didn’t believe Kent had an effective strategy for growth. The company’s market cap was based mostly on the cash flow it could generate. But in 2017, the seeds of change began to sprout at Coke.

Exhibit 1 Coca Cola TIP during the Kent years and beyond



Its TIP has responded very strongly to James Quincey's assumption of the CEO role in 2017 and to the "sizzle" of potential growth he is communicating to shareholders and others. In his first letter to shareholders as CEO, he announced the company would move to a growth mindset and to selling more natural items with healthy benefits.

Coke's TIP continued to rise in anticipation of a new strategy during 2017 and it increased sharply in 2018 with Coke's purchase of Costa Coffee. This very imaginative acquisition moved Coke into hot drinks and physical retail shops around the world. In an interesting anomaly, Coke's revenues from 2016-2018 actually fell, from $41,863 billion in 2016 to $34,300 billion in 2018, and yet shareholders were pleased enough with the company's prospects for growth that they invested anyway (see Exhibit 2," Coca Cola Market Capitalization, 2016 – 2020"). During this increase in TIP, the Value of Operations that reflects the capitalized value of its operating cash flow steadily declined. Were it not for the expectation of future growth, Coke's market cap would have collapsed; instead it grew from $170 billion at the end of 2015 to $234 billion at the end of 2019.

Exhibit 2 Coca Cola Market Capitalization, 2016 - 2020

Coke's TIP at the end of 2019 was 4.0, which is an impressive number for a company in a slow-growth sector. Arch-rival Pepsi's TIP is 2.71. In the aftermath of a pandemic wracked economy, investors are judging the future of innovations intended to position them for the post-Covid world.[10]

Implications for leaders

The Imagination Premium provides a leading indicator of changing investor sentiment, with potential implications for how executives manage their growth portfolios. Indeed, investors appear willing to give corporate leaders the benefit of the doubt in terms of operating metrics if they believe a compelling story about growth. They are also swift to punish leaders who appear to either prioritize factors other than growth or who don't seem able to deliver on their growth promise.

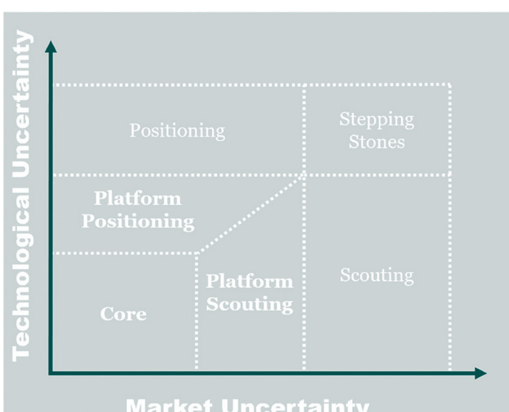
Whether the goal is to increase an organization's TIP or to maintain a healthy one, how its leaders allocate resources across a range of uncertainty is the critical process. A useful way of picturing this is by imagining a portfolio of potential investments across the dimensions of technological and capability uncertainty or external and internal market uncertainty (see Exhibit 3).[11][12]

Where uncertainty is low, in the core, investments strengthen and improve the core business. While these are essential, they don't signal much in the way of potential value to a growth-seeking investor, as these investments represent known transactions in known markets. Indeed, an analysis of return on investment versus levels of uncertainty found that projects in this category represent the lowest future returns.[13]

Investments in new platforms are those which represent important extensions to the core – it is compelling commitments to these areas that get investors excited, as these are the projects and programs that will fuel the next wave of growth for the firm, [14]. We can see how Coke's Quincey publically championed ventures into the new healthier drink markets from his remarks at the Sept. 10, 2020 Barclays Global Consumer Staples Conference:[15]

> "The company's Beverages for Life strategic transformation was well underway before the pandemic, but the global crisis is speeding the changes. The company is paring down its portfolio to focus on category-leading brands with the greatest potential to scale and grow."

Exhibit 3 Allocating resources across a range of uncertainty



> "This is a golden opportunity for us to accelerate the curation of the portfolio. . .," Quincey said during a virtual interview with a Barclays Capital Analyst. "We believe it will set us up with more momentum behind stronger brands as we come out of this crisis."

Taking action to boost TIP

One of the first things strategists can do to manage their company's TIP is a portfolio analysis that looks at how uncertain each current investment is, and whether the whole portfolio is one growth investors will reward with an increased TIP.

A sure strategy for failure is to systemically under-invest in important extensions to the core that can show growth in a 24-36 month time-frame.[16] Many CEOs justify this behavior on the basis that their shareholders are impatient for short term performance, and dislike unpredictable results. This just isn't true, as TIP analysis suggests.

The most uncertain of all investments in the portfolio, but those that have the highest ROI, are investments in "options." These investments buy an organization the opportunity to make future choices, and signal to investors that the management is keeping an eye on the future. These are the corporate equivalent of startups, and the goal is spectacular returns on the few that work out, while containing the downside of the majority that won't.

Too many firms systemically under-invest in the somewhat uncertain "near-field platform" opportunities and in options while over-investing in the operational programs that represent the core.

If you drive your company to deliver predictable operational results, investors will take note and your TIP will deflate. If you invest in true growth programs, represented by those opportunities that are the next generation core, investors will note this as well and your TIP will increase.

TIP can provide C-suite executives, boards and their investors with a useful perspective on developing their strategies for the future. For a CEO, TIP provides support for an argument that investments in future growth are well warranted. For board members, it offers a way of getting a forward-looking, outside evaluation of how well a firm's management is prioritizing its future. And for investors, it offers a fresh perspective on the kinds of firms worth adding to their portfolio.

TIP also offers strategists a metric that counters, to some extent, the arguments that are always made about breaking up companies that offer different business models *en route* to a transformation. If a new model boosts a company's TIP, even if it operates with different multiples and ratios than the core business, it can be defended. Incorporating TIP into a strategic analysis, and monitoring any sudden changes, also provides an early warning in case investors begin to believe a growth strategy is competitively problematic. This in turn suggests that companies' implementation plans for investing in innovation and growth be coherent, analysis-based and inspiring to investors.

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TIP versus other inputs to financial models

Is the Imagination Premium (TIP) just another way of looking at signals in the shifting value of a firm's market capitalization? The underlying question is whether TIP is highly correlated with other variables commonly used in financial modeling. In fact, the answer is no – TIP indicates something different about expected future company performance.

We compared company data from the end of 2019, using Nordstrom and Macy's to represent the struggling retail sector, across industries to Apple and Tesla that represent mega cap companies to see how TIP would correlate with other conventional metrics.

The findings:

- TIP vs. Price/Earnings ratio: a very low correlation 0.164. TIP is not a rehash of P/E which is supposed to capture investor sentiment about a company's future prospects.
- TIP vs. market cap: correlation of 0.31, a moderate correlation, which is surprisingly low as market cap is one of our inputs to computing TIP.
- TIP vs. operating cash flow: correlation of 0.08, again a very low correlation.
- TIP vs. sustainability index: negative correlation of 0.39.
- TIP vs. earnings yield [1/PE ratio]: −0.57, a strong negative correlation.

Our conclusion is that TIP provides a different insight than other commonly used financial measures. It indicates what investors are thinking and when they start thinking it. We believe that for anyone interested in whether management is making the right moves and investments to ensure future growth of a firm, TIP is a useful leading indicator.

Notes

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