SEGALL BRYANT
& HAMILL

Why ROIC is Our Focus

The Advantages of Investing with a Return on Invested Capital (ROIC) Approach

JUNE 2019

SEGALL BRYANT & HAMILL SMALL CAP TEAM PUBLICATION

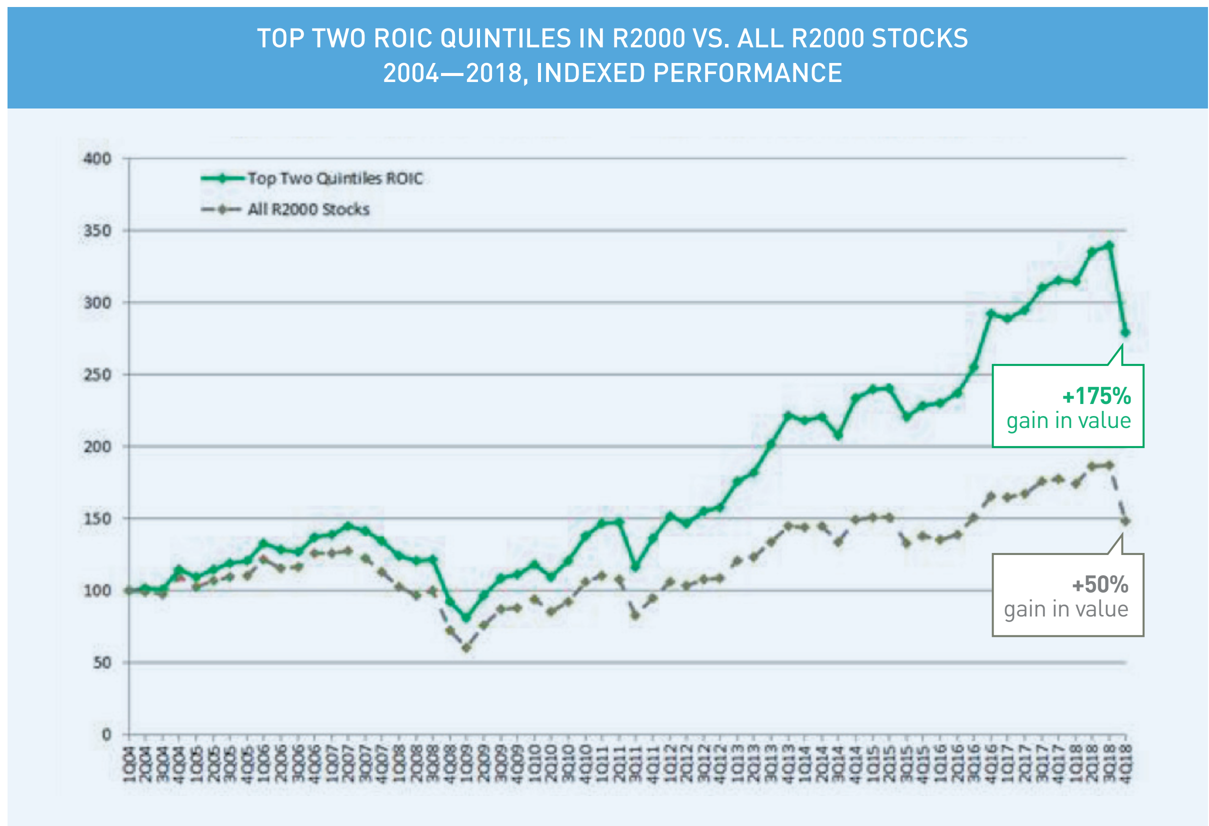
The investment approach of Segall Bryant & Hamill's (SBH) Small Cap team is defined by its focus on being early to invest in companies with improving returns on invested capital (ROIC). ROIC, in its simplest form, is the return a company earns on each dollar it invests. The ROIC formula takes net operating profit after tax and divides it by total invested capital. When a company earns an ROIC above its weighted average cost of capital (WACC), it is generating value for shareholders. Across the Small Cap team's strategies, we use a rigorous and proprietary research process to identify companies we believe have the largest opportunities for significant improvement in ROIC that is not being reflected in the current enterprise value of the company. This process is designed to uncover investments that have the potential to offer consistent returns over time and downside protection through market cycles.

A primary role of the stock market is to help ensure that capital flows to the "best" investments. Opinions differ, however, on how efficiently the market allocates capital at various points of the business cycle. We believe the market is inefficient due primarily to investors' lack of focus on investing in those companies with the potential to drive improvements in ROICs (e.g., undertaking new projects, management/culture change, a new strategic direction). This lack of focus could be due to the behavioral aspects of the herd mentality, whereby investors chase the stocks of those companies thought to be "winners" today instead of focusing on stocks that may become "winners" tomorrow. This often leads investors to stocks that are becoming expensive which may ultimately result in poorer risk-adjusted returns over time.

In contrast, our investment process seeks to identify companies that could be thought of as out of favor and overlooked by investors, with low embedded expectations. We are focused on identifying catalysts for change—which "Wall Street" may not have identified and may be overlooked by our competitors—that can lead to significant improvements in ROIC. For example, a new management team that is return-focused can drive improvements through implementing lean manufacturing processes and divesting and/or improving underperforming business units. Such actions, successfully implemented, can allow companies to invest every incremental dollar at higher return levels. Further, innovative management incentives can help ensure that management is focused not just on improving returns in the near term but also on sustaining returns over time at levels well above the WACC.

So why do we invest based on a company's ROIC instead of its reported earnings? We believe reported earnings are often too constrained by accounting rules to accurately reflect changes, whether good or bad, that occur in a company's economic earnings (i.e., true earnings to shareholders). Changes in factors that influence economic earnings such as a deterioration in a company's ROIC ultimately lead to changes in reported earnings, a measure on which many investors focus that can lead to revaluations of appropriate multiples. We believe our focus on ROIC leads us to companies with growing economic earnings and low valuations before other investors become aware of them. This provides us with the potential to generate significant returns over time.

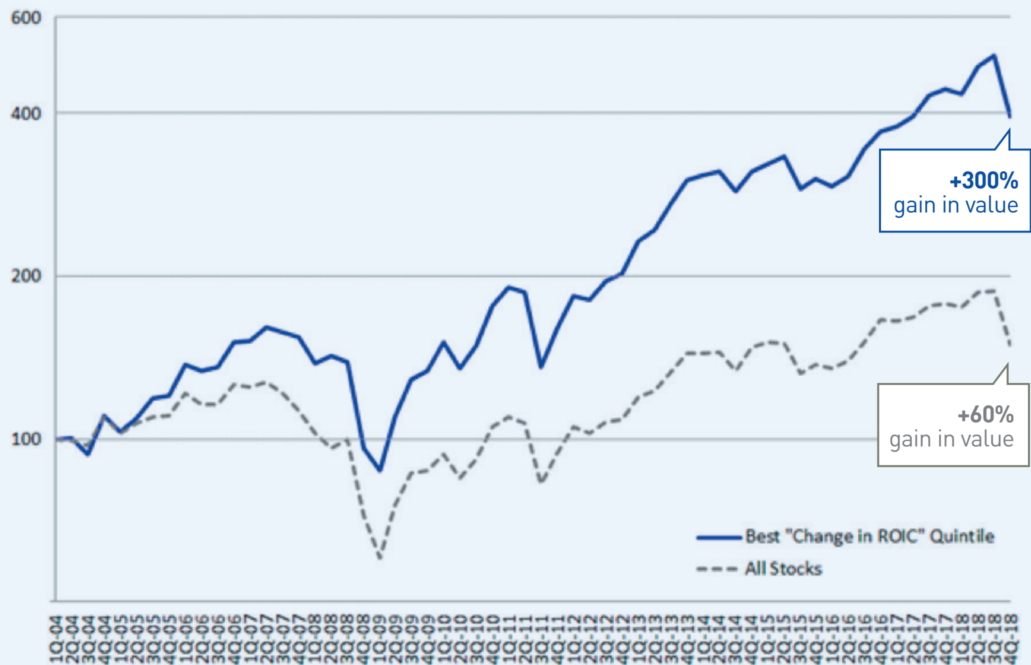
The following chart supports our belief that ROIC is a better place to focus. It shows the cumulative performance of the highest ROIC companies in the Russell 2000® Index vs. the Russell 2000® Index as a whole. Over the past 15 years, Russell 2000® companies with the highest ROICs have outperformed their peers on a quarterly basis. From an investment standpoint, $100 invested at the beginning of 2004 in the highest ROIC companies would be worth 175% more while an investment in the Russell 2000® ETF (a passively managed index fund) would be worth only 50% more.



Source: Furey Research. Past performance is not indicative of future results. Figures on y-axis are in dollars.

The chart on the next page paints an even more compelling picture. As context, we are less interested in a company's ROIC today than we are in understanding what will drive positive rates of change in ROIC over time. The chart shows the performance of those companies that have the best "change in ROIC" vs. the Russell 2000® Index during the past 15 years. An investment of $100 in the best "change in ROIC" companies since 2004 would be worth $400, a 300% gain, while the Russell 2000® ETF investment would be worth $160, a 60% gain. Clearly, being early in identifying the best "change in ROIC" companies is critical to value creation. Further, we have found that the majority of value creation is concentrated in just 50% of a company's invested capital. It is quite common for ROICs to differ widely between divisions or segments within a firm. Given this, our proprietary "ROIC Dashboard," which directs our research efforts, includes an assessment of a company's ROIC and capital allocation decisions at the segment level, when appropriate. This allows us to discover not only the areas of strength but also, and more importantly, those areas of value destruction, before the impact of this destruction is reflected in a company's reported earnings.

BEST "CHANGE IN ROIC" QUINTILE IN R2000 VS. ALL R2000 STOCKS
2004—2018, INDEXED PERFORMANCE



Source: Furey Research. Past performance is not indicative of future results. Figures on y-axis are in dollars.

Our ROIC Dashboard is at the center of our research process. We believe that if a company is generating returns in excess of its cost of capital, it is creating value with every incremental investment. Conversely, we believe that a company that earns returns below its cost of capital is destroying shareholder value with every incremental investment. Within our Dashboard, we can quickly identify the areas in which a management team is allocating capital and determine if those decisions are appropriate based on the levels of ROIC the company is generating. Once we identify those areas of return improvement, we analyze management strength, incentives, competitive position and other industry factors. This research includes face-to-face meetings, site visits, and supplemental phone contact. The key, of course, is that our research is centered on ROIC.

AN EXAMPLE OF OUR PROCESS

Consider an industrial company that provides dredging services in addition to environmental and infrastructure project work. The company has a dominant market share within its core dredging business; however, the company had underperformed for years due to poor allocation of capital and deterioration in its environment and industrial segment. The business became challenging to manage and the company missed its earnings expectations over several years. As a result of this underperformance, a new CEO and several new board members were appointed. This positive change was overlooked by the market. However, we viewed this change favorably and it was the first part of building our thesis.

Phase I

The beginning of our investment process starts with our proprietary screening process, which ranks stocks by decile based on relative performance within sectors. We focus on the top three deciles, which include stocks with the greatest underperformance relative to peers. This industrial company was at the top of this list. As with other stocks that rank in the top three deciles, this company had low embedded expectations and a history of poor capital allocation.

Phase II

Next, we analyze the ROIC of the business through our proprietary ROIC Dashboard. During this early phase of our process, it is key to identify which areas of a company's business are impacting ROIC levels. For this industrial company, it became clear that overall returns were being impacted

by significant levels of capital expenditures across both its dredging, and environmental and industrial businesses. While the dredging business had a relatively solid margin profile, the trends in invested capital had prevented ROIC improvement. In the environmental and industrial segment, the situation was more dire as both margins and invested capital were impediments to allowing the business to drive ROICs higher.

Phase III

In this phase of our process, we focus on determining if catalysts exist that can create a positive rate of change in ROIC. Once catalysts are identified, our research is focused on analyzing the stability of ROIC and a company's plan for achieving a positive rate of ROIC change at or above the firm's WACC. For this industrial company, we spent time with company management—including the CEO, CFO and relevant board members—to gain conviction that management was implementing a new and realistic strategy centered around improving capital allocation, based on its thorough understanding of the problems in its business. We also analyzed changes management was making to incentive compensation that better aligned incentives with the priorities we believed would ultimately drive ROIC improvement.

Phase IV

The final phase of our investment process is to: (1) solidify our analysis of a company's action plan, to gain conviction that the plan will drive a substantial positive rate of change in ROIC levels, and (2) to set benchmarks to measure how well management is performing relative to our expectations. For this industrial company, we determined that management should divest its lowest return business, the environmental and industrial segment, in order to materially improve ROICs. Through our discussions with the management team, we learned that it was planning to put in place a more disciplined capital expenditure approach for its dredging business which could significantly lift overall ROICs for that important business. We concluded that such actions would lead to significantly higher ROICs not just in the near-term but, more importantly, over the longer-term from improved margins and lower capital intensity. While these changes would not be reflected quickly in the frequently watched metric of reported EPS growth, we believed that, once implemented, they would significantly increase earnings over time. We then derived our reward-to-risk view and modeled out the improvements in return to determine the ultimate earnings power of the business and future valuation. The work led us to initiate a position in the company. Following this, the company significantly lowered capital expenditures, started to generate free cash flow for the first time in several years, and made the decision to sell the environmental and industrial segment. Our research process is equally as rigorous after we buy a stock in terms of monitoring a company and determining when/if to sell a stock. We continually monitor reward to risk and embedded expectations, and scrutinize and try to "poke holes" in our investment thesis over our ownership horizon. This keeps us acutely aware of where the position is within its life-cycle within the portfolio.

Though this is just one example, we utilize this proprietary process to find out-of-favor companies with improving business models and the potential to improve ROIC. These companies have management teams that are investing capital wisely and can add value regardless of where we are in the market cycle. We believe an ROIC focused investment approach offers investors the potential for consistent returns over the long term and downside protection through market cycles.

SEGALL BRYANT & HAMILL
540 West Madison Street
Suite 1900
Chicago, IL 60661

Phone (312) 474-1222
Toll Free (800) 836-4265
Fax (312) 474-0521

www.sbhic.com

This information has been prepared solely for informational purposes and is not intended to provide or should not be relied upon for accounting, legal, tax, or investment advice. The factual statements herein have been taken from sources we believe to be reliable, but such statements are made without any representation as to accuracy or completeness. Opinions expressed are current opinions as of June 2019. These materials are subject to change, completion, or amendment from time to time without notice, and Segall Bryant & Hamill is not under any obligation to keep you advised of such changes. This document and its contents are proprietary to Segall Bryant & Hamill L.L.C., and no part of this document or its subject matter should be reproduced, disseminated, or disclosed without the written consent of Segall Bryant & Hamill L.L.C. Any unauthorized use is prohibited.