SEGALL BRYANT & HAMILL

# Why ROIC is Our Focus

*Return on Invested Capital: A true measure of how efficiently a company allocates their capital.*

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The SBH Small Cap team's philosophy focuses on investing in improving ROIC (Return on Invested Capital) companies. The ROIC formula takes Net Operating Profit After Tax (NOPAT), which is then divided by total invested capital. ROIC in its simplest form is the return a company earns on each dollar it invests. When a company earns an ROIC above its Weighted Average Cost of Capital (WACC), it is generating value for shareholders. We use a rigorous and proprietary due diligence process within our Small Cap strategies to identify those companies which have the largest opportunities to drive significant improvement of ROIC and which is not being reflected in the current enterprise value of the company.

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Opinions differ on the efficiency of the stock market to allocate capital at various points in the business cycle. This is important because making sure that capital flows to the "best"investments is one of the stock market's prime reasons for being. From our viewpoint, the lack of focus in identifying those companies that are undertaking projects which will drive an improvement in ROIC is a major source of this inefficiency. This could be due to the behavioral aspects of a herd mentality chasing into those companies thought to be "winners". Our viewpoint is that this mentality runs the risk of leading investors to those securities which are actually becoming expensive and, in turn, providing a poorer risk-adjusted expected return.

In distinction, our process identifies those companies that could be thought of as riskier or "out of favor" (which have the virtue of offering very attractive relative valuations). As a result, investors don't take the time to identify the ROIC catalysts of change that might be developing. A new management team that is return-focused, for example, will drive improvements from lean manufacturing principles and divestiture/improvements of underperforming business units. Such actions, successfully implemented, allow firms to invest every incremental dollar at higher return levels. Innovative management incentives will focus on not just improving returns in the near-term but to sustain them at levels well above their WACC It is not always easy to see how this philosophy and process of identifying those ROIC catalysts early generates significant returns over time. One reason our views may not be as widely accepted is that both investors and the media are primarily focused on just revenue and earnings growth which, in many cases, can hide a deteriorating ROIC profile. Here is why we have strong conviction that ROIC is a better place to focus. The chart below shows the cumulative performance of the highest ROIC companies in the Russell 2000 Index vs. the Russell 2000 Index as a whole. Simply put, $100 invested at the beginning of 2004 in this basket of stocks would be worth 125% more while an investment in the Russell 2000 ETF (a passively managed index fund) would be worth 50% more.

The chart below paints an even more compelling picture of this data. As is evident from this data, the higher ROIC companies historically have performed very well versus the index as a whole over time. Now let's take it another step further. The critical element of our due diligence process is to identify ROIC catalysts (which leads to significant improvement in ROIC). This deliberate focus on such catalysts is one way we believe we gain our competitive advantage. We are less interested in the ROIC today than we are in understanding what will drive positive changes in ROIC over time.

The chart below shows the performance of those names that possess the Best "Change in ROIC" vs. the Russell 2000 Index. To repeat this example from above, $100 invested in the Best "Change in ROIC" names since 2004 would be worth $300, a 200% gain, while the Russell 2000 ETF investment would be worth $150, a 50% gain.

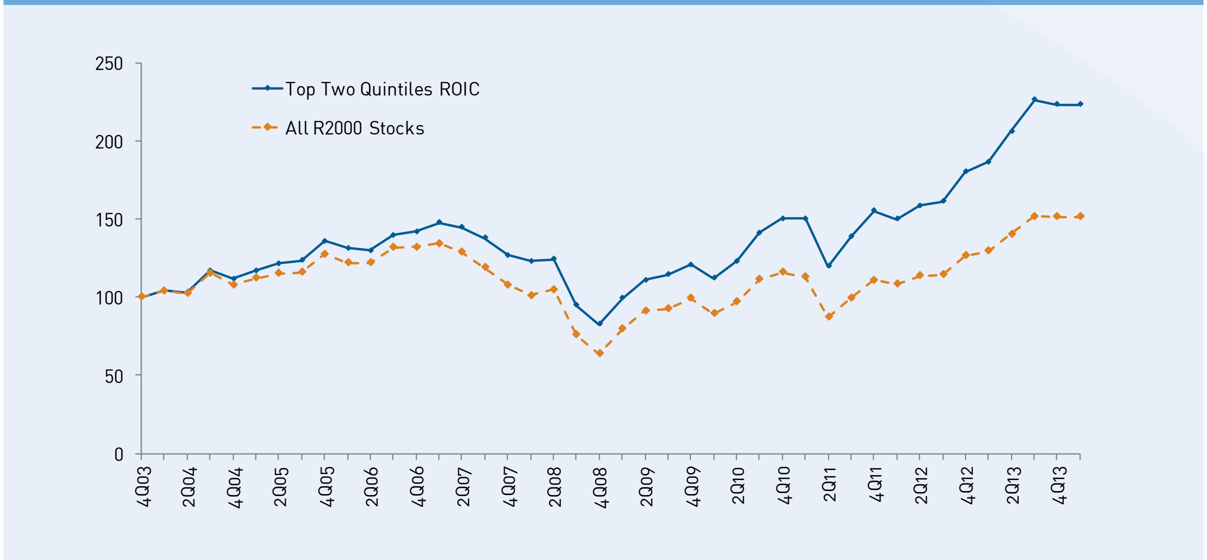
The early identification of those companies which could make the Best "Change in ROIC" list is clearly critical to value creation. Much analysis has been done around overall value creation. We have found that the majority of value creation is concentrated in 50% of a company's invested capital. It is quite common for ROICs to differ widely between divisions or segments within a firm. As a result of this, our "ROIC Dashboard" directs our due diligence efforts and leads us to assessing a company's ROIC and capital allocation decisions at the segment level where appropriate. This repeatable process allows us to discover both the areas of strength and also, more importantly, those areas of value destruction before they appear in reported earnings.

The "ROIC Dashboard", to which we referred earlier, is at the heart of our due diligence process. Within this 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 respective levels of ROIC the company is generating. Once we identify those areas of return improvement, we then continue our due diligence process by analyzing management strength, incentives, competitive position and other industry factors, which we do through face-to-face meetings, site visits, and supplemental phone contact. The key, of course, is that our inquiry is driven by the touchstone of ROIC.

## AN EXAMPLE OF OUR PROCESS

Let's walk through an example of our process. Consider an industrial company which manufactures a diverse range of products for industrial, agricultural, automotive, and commercial and consumer markets. It operates through four segments: Material Handling, Lawn & Garden, Engineered Products and Distribution.

**TOP TWO ROIC QUINTILES INDEXED PERFORMANCE VS ALL R2000 STOCKS**



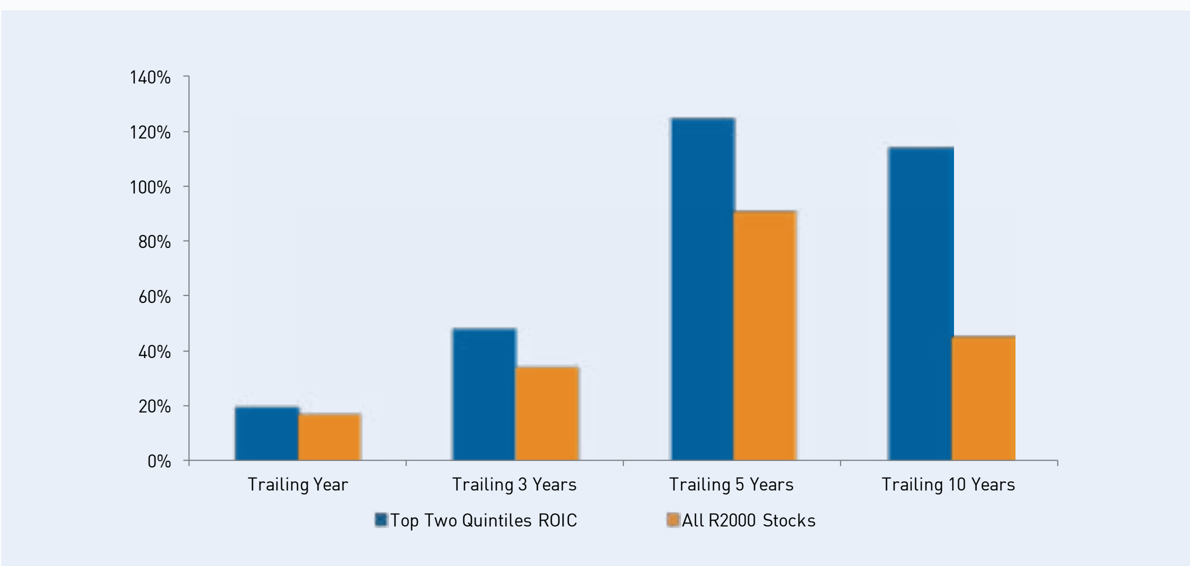

Source: Furey Research

*Phase I*

The beginning of our investment process is our proprietary screening process. This industrial company was identified in the top quartile of relative value within its respective industry.

*Phase II*

Next, we analyzed the ROIC of the business through the "ROIC Dashboard". It was clear that overall returns were being significantly impacted by the returns within the Lawn & Garden segment. Although the second largest segment by assets in the company, the L&G operation was earning a near zero ROIC. We calculated the company's WACC to be close to 10%, suggesting a clear case of "value destruction".




Source: Furey Research

*Phase III*

**R2000 BEST "CHANGE IN ROIC" QUINTILE – INDEXED PERFORMANCE**


Source: Furey Research

We had to determine if there were ROIC catalysts of change. From our meetings with management, a plant tour, and follow-up calls, we learned that a new CFO (from a highly respected and ROIC-focused larger industrial company) joined this company approximately one year prior. The new CFO was starting to implement a new culture focused around ROIC incentive metrics. Furthermore, the CFO was seeing the same issue we identified: The Lawn & Garden segment returns were lagging and destroying value of the entire enterprise. What was just as exciting for us was no other analysts appeared to have identified these internal cultural changes.

*Phase IV*

The final phase was to understand their plan of action to drive an increase in ROIC and to set benchmarks to measure management against our expectations. We learned that the intention of the management team was to drive the ROIC of the Lawn & Garden segment back to at least cost of capital within the next year. We concluded such an action could lead to higher profits, to a re-assessment by the Street of the company's prospects, and thus to a higher valuation. That led us to initiate a position in the company. Management plans to determine if this business should be divested or will remain a core business. For our part, our tools will allow us to determine what value will be created by these actions.

Though this is just one example, we repeat this proprietary process to find new opportunities and pockets of value that have significant upside. We believe this has been one of the key drivers of our success over varying business cycles.

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