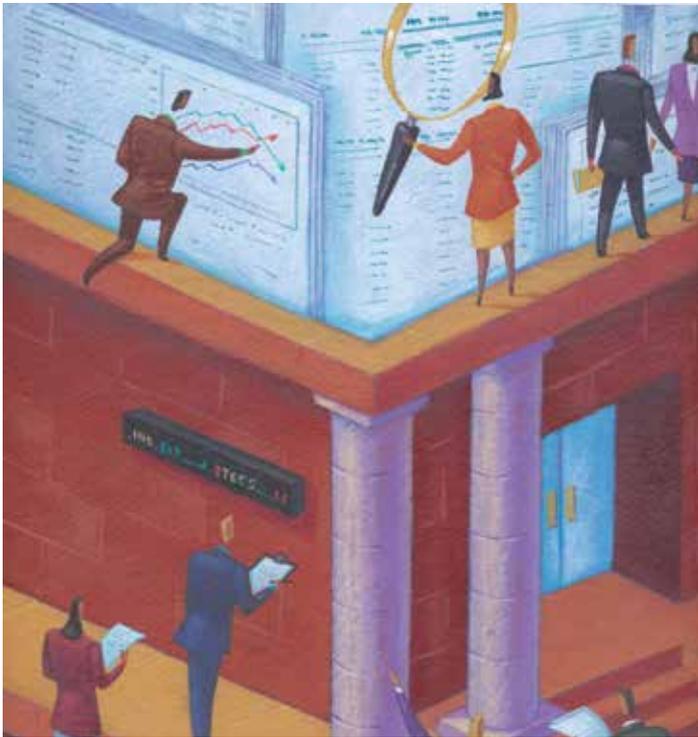


In Practice

Economic Value Added Makes a Comeback

By Seymour Burchman



It's like déjà vu all over again. That's what many directors might have thought after Institutional Shareholder Services (ISS) recently announced its new embrace of economic value added (EVA). Several decades ago, this measure of financial performance—akin to economic profit—climaxed in popularity, championed by Stern Stewart & Co. It then swooned for various reasons, even as many financial analysts lauded its advantages.

But now EVA is back. Last year, ISS acquired EVA Dimensions, a business intelligence firm that specialized in measuring economic value run by Stern Stewart cofounder Bennett Stewart. This spring, ISS began to report the EVA scores for each company in its voting recommendation reports. With ISS as the new EVA champion, directors may want to take a fresh look at the measure's virtues and shortcomings, and prepare to respond to investors who will be comparing one company's EVA to another's.

Introduced in 1982, EVA's core benefit has always been that it combines three crucial metrics—earnings, invested capital, and capital costs—under one umbrella. Executives don't need to reconcile the conflicting signals from three measures to decide if the company is creating value, eliminating the game of see-saw in trading

off earnings and returns. It also gives companies a handy metric for value creation, which can be an effective supplement to relative total shareholder return (TSR) as a prime performance measure.

EVA swooned in part because, as a new measure, it had trouble storming the gates of tradition and elbowing its way onto the list of well-established metrics for financial reporting. Still, EVA aids capital efficiency by providing a guide for people at all levels on when to avoid bad investments. For starters, it indicates how to make good investments as productive as possible. It also shows when and how to redeploy capital from the bad investments to the good. In such ways, it raises capital efficiency without sacrificing growth.

A few studies show that EVA correlates well with TSR, making it appealing to executives and directors focused on satisfying investors. Although other studies yield mixed results on that score, advocates suggest that when you maximize EVA, you also maximize TSR.

In its original iteration, however, EVA was criticized as being a “black box” metric. Financial professionals found it challenging to calculate and use, and consequently, employees had difficulty following the numbers to understand what factors were driving the financial success of the organization. Although the calculations have since been tweaked to make them somewhat more accessible, using EVA still requires people to gain a new kind of financial literacy.

That in mind, with well-thought-out education to advance literacy, people right down to the front lines can be taught the basics of EVA. In their own lives, individuals don't expect to borrow for free to earn a good return on an investment. Nor do they expect to make money if they don't get returns that outpace borrowing costs. The same principles go within their company: The less capital they use to produce each dollar of earnings, the more EVA they help the company make. Conversely, if they invest more, so long as their returns exceed the company's combined debt and equity capital costs, they also create value.

The trick for making EVA easier to use across the workforce is for the financial function to break down top-line EVA measures into a broad menu of performance drivers. In preparing a list of the subordinate measures that drive EVA, all employees can then understand the measure. Here are the steps the finance people along with senior management need to take:

- Unbundle EVA into primary, secondary, and tertiary drivers—the key economic, strategic, and operational items that deliver value.
- Isolate the leverage points—the specific measures where changes yield the most value.

- Map these drivers to departments, locations, and individuals who have accountability for improving performance.

- Set improvement targets calibrated to deliver the desired value improvements, within resource constraints.

- Educate people on the basics so the old familiar numbers are seen as sitting naturally in the calculation of EVA.

One company in the business of renting equipment embraced EVA a number of years ago. It broke down EVA into the following top-tier drivers: revenue, operating costs, and capital charges. The company then divided each of these drivers into subordinate parts, as follows:

1. Revenue drivers included average rental price per day for each piece of equipment, average number of days each piece was rented, number of each type of equipment, and additional servicing fees. Subsidiary factors included the quality and responsiveness of customer service and the quality and condition of the equipment. Tertiary factors included innovations to increase the ease of doing business with the company versus competitors.

2. Operating cost drivers included customer acquisition, equipment depreciation, servicing, fuel, and maintenance. Subsidiary factors included productivity improvements and negotiating prowess in cutting deals on marketing and fuel costs.

3. Capital charge drivers included the value of working capital, equipment, buildings and parts inventories, and the costs of equity and debt. Subsidiary factors included working capital management, inventory management, and capacity utilization.

To calculate its EVA score, the company subtracted the operating cost and capital charge drivers from the revenue drivers. The result was a true picture of economic profit—and a good proxy for creating shareholder value and raising the stock price.

While this basic breakdown of drivers would have most meaning to manager-level employees within the organization, the company's finance people could break these items down further so that individuals at every level know how they can improve an EVA driver. Identifying measures in such a granular way provides a clear line of sight for different functions in the organization to maximize top-line goals by first maximizing familiar measures of performance.

For the board, EVA provides an internal, management-controllable measure to complement TSR, which is external and not directly controllable. That may make EVA a useful measure for determining executive compensation.

Is your company ready for that final step in assuring accountability for value creation? It is if you have the financial systems to capture EVA and are able to model the effect of decisions on EVA; the planning and operational systems to embed EVA; the systems to report EVA in easily understood ways; and a financially literate workforce

that grasps how the effective use of capital underpins business results. Many companies already have some of these prerequisites in place.

As in conventional pay plan design, the most appropriate annual incentive designs would include key financial, strategic, and operational drivers of EVA. Longer-term EVA-related results, or high-level EVA drivers such as earnings and returns, could be covered in long-term plans. To ensure optimal line-of-sight, the designs should include lower-level drivers in team or individual incentives. Today, approximately 50 companies use EVA or economic profit in some form for compensation.

Of course, even when prepared, companies need to counter the shortcomings and unintended consequences of using EVA. One is that financial people make so many adjustments to financial figures that many managers and nonfinancial people don't understand or trust the final number. These adjustments are often warranted because they eliminate the economic distortions inherent in GAAP accounting—for example, expensing investments and research and development in a single year doesn't reflect true economics as expensing them over their useful lives. A second is that employees, even with training, don't grasp what actions within their purview or control boost EVA. A third, critical shortcoming is that EVA can understate the value of long-payback investments because business units making long-term investments incur a capital charge in the short and intermediate term, shrinking the near-term EVA number in a way that gives the appearance of excessive investment. That can discourage smart long-term initiatives, which make the biggest difference in game-changing competitiveness.

To keep EVA from understating long-term returns, executives can take several precautions: set targets based on intermediate expected results during the longer performance period; use performance periods that are long enough to encompass initial paybacks; set goals up front for multiple performance periods; or use enduring goals that reflect continuous improvement in EVA from period to period. In the case of acquisitions, goodwill could be recognized over a period of years, although this would move the company further away from reported financials.

Although ISS's embrace of EVA may not please everyone, the move does not require adopting EVA or its family of ratios company-wide. You can still use its calculations to double check that your company is delivering competitive performance. If ISS ever rolls EVA results into its assessment for say-on-pay voting, directors will be ready to field investor questions about how the company's EVA performance stacks up from year to year and among competitors. By 2020, if your EVA performance lags your peers', investors may start to wonder if your oversight of financial decision-making passes muster. Is your company deploying investors' capital wisely? 