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Farient Update

The Return of EVA?

What ISS' Interest in EVA Means for Compensation Governance

By Marc Hodak

In the 1990s, economic value added (EVA) was a hot financial measure adopted by dozens of major companies, as well as equity analysts, in their evaluations of firms. EVA promised managers and investors the holy grail of performance measurement: the ability to track value creation from one period to the next, in a single measure, derived from the company's financial statements. GAAP earnings have long had that purpose and intent but suffer from significant limitations, including an inability to provide apples-to-apples comparisons between companies with very different business models and capital structures. A company's stock price, of course, tracks value, but it is based on perceptions that only indirectly relate to management activities and achievements. The degree to which EVA strikes a better balance in tracking value based on reportable company results remains a source of discussion—and some controversy.

Although currently used by fewer than 10% of companies, EVA has again emerged as a hot topic among issuers and institutional investors. This began with the acquisition of EVA Dimensions by Institutional Shareholder Services (ISS) in February 2018 and was ratcheted up by its November announcement to "feature" EVA in their Financial Performance Assessment methodology. This has been seen as a likely prelude to incorporating EVA as a supplemental or replacement measure in that assessment.

What is EVA?

The basic EVA math is straightforward:

EVA = Net Operating Profit after Tax (NOPAT) – [Total Capital (TC) x Weighted Average Cost of Capital (WACC)]

This measure overcomes the basic problem of GAAP earnings, i.e., that earnings do not account for the cost of equity, and therefore the full cost of capital. Whether or not NOPAT growth is value-creating depends on how quickly capital is growing and the cost of that capital.

So Why Should Companies or Investors Care About EVA?

A key benefit of EVA is how it tracks changes in value over time. To create value, earnings must grow more than the return required by investors on any new capital invested.

Like earnings, corporate EVA can be divided into business unit (BU) EVA (or EVA contribution) to provide a common language for management across the organization. But EVA at the BU level enables apples-to-apples comparisons among divisions with very different business models; a manufacturing division can be compared to a service or finance division in terms of its relative contribution to overall corporate value.

EVA can also transform how capital is internally allocated. In most companies, capital budgeting is a tug of war among business units, each wanting to grow its revenues or profits. With capital looking "free," as it does when you're measuring people just on earnings, top management ends up with investment wish lists to sort

Sample EVA Calculation

		2017
NOPAT		**$2,000**
Total Capital (TC)	$10,000	
WACC		8%
Capital charge		**$800**
EVA=NOPA - Capital Charge		**$1,200**

out each budget season, with some divisions bound to be disappointed. In contrast, when AT&T was the poster child for EVA in the mid-1990s, it talked about how the sum of internal capital requests in its budgeting process more or less matched the company's level of depreciation—a key benchmark for how much it should be spending. This balance happened without the CEO and CFO having to cajole the business unit heads about the importance of only surfacing the best projects; it was the organic result of each unit's accountability for capital based on the charge it would get for whatever it invested.

Investors appreciated EVA, too. A number of analysts in the 1990s began to build their models around company returns relative to the cost of capital, looking beyond earnings to see if the company was really creating value for shareholders.

EVA also was used by a number of companies in their incentive plans by essentially awarding management a defined share of EVA growth over time. This EVA plan worked particularly well for large, multi-divisional, capital-intensive firms, promising an enduring, definitive linkage between management rewards and value creation. Once calibrated, this mechanism could operate without budget-based goal setting or any significant plan changes over many years. For example, Genesco has had its EVA plan in place for nearly two decades. Ball Corporation is going on its third decade. This longevity is itself a benefit, with EVA companies knowing that it will reap the rewards of profits exceeding the capital used to generate them, even if it takes years for their projects to mature. This extends management's time horizon beyond the end of the fiscal year, enabling it to effectively balance short-term and long-term imperatives.

So, What Happened to EVA?

After being adopted by a variety firms in a wide range of industries, the limitations of EVA began to become apparent. Unlike the well-understood standard of GAAP earnings, EVA is very much a non-standard measure, subject to numerous adjustments. These adjustments enable EVA to be tailored for each firm, but also make the measure more complicated for management, and more suspect to outside investors, especially as the basis for management incentive pay.

Next, EVA's much vaunted ability to track value creation is severely degraded when returns lag investments by a year or more. This lag generally describes technology firms, or any sector undergoing disruption. The dot-com boom in the late 1990s, characterized by companies using a lot of investment without generating any NOPAT, made EVA look particularly irrelevant.

Finally, any incentive plan is only popular as long as it is paying out. In the wake of the dot-com bust in 2001, many bonus plans, including EVA plans, were dropped. By the time business began to recover in the early 2000s, new standards for accounting and compensation programs had grown up that would run counter to the EVA philosophy and mechanics, including a lower tolerance for non-GAAP metrics driving incentives.

Why Does ISS Care About EVA Now?

Although EVA lost much of its popularity as a corporate measure, a significant corner of the investment community continues to see it as the best proxy for value creation, at least for capital intensive firms that don't suffer from a significant investment lag. Other analysts continue to see as-

pects of EVA as fundamentally useful analytic tools; returns above the cost of capital are the literal, textbook definition of value creation.

The governance community has kept its own little corner of sustained interest in EVA. EVA is an economically sound measure, which is attractive to mutual fund managers focused on value creation. EVA bonuses require management to overcome a capital hurdle before getting paid, which is attractive to fund managers looking to hold management to a higher standard. And ISS is in the business of creating governance standards, including for compensation governance, in order to advise its investor clients how to vote their proxies. Until now, ISS has taken the path of least resistance by assuming that what investors care about most are total shareholder returns (TSR). Although true, the focus on pay versus TSR has had the unintended consequence of dramatically increasing the use of TSR as a compensation metric, particularly in long-term plans.

This use of TSR has created problems. For one, TSR is not something that managers can directly "manage" quarter-to-quarter, or even year-to-year, at least not in a way that is good for shareholders. Strong TSR is the expected result of running one's business well over a business cycle. Using TSR over three years—the typical duration of a "long-term incentive" plan—sounds better, but near the end of the performance period, management is still left with trying to "manage" TSR.

So focusing on another measure of value creation based on operating results, like EVA, makes sense to some governance experts. But if ISS decides to push EVA as an alternative basis for assessing all the companies it covers, it will have to consider the evidence that it is not a good standard for all — or even most — companies, and be flexible in how it is applied. It will also have to consider that the definition of EVA will need to differ across industries, undermining it as a "standard."

What's Next?

With ISS paying attention to EVA, companies and their boards will have to invest in learning or refreshing their knowledge of this metric. Companies can prepare for the advent EVA, and potential renewed interest in it by investors, by taking the following steps:

1. Calculate both a "basic EVA" (as ISS is likely to calculate it across all companies) as well as an "adjusted EVA" (based on NOPAT, Capital, and Cost of Capital suitable to your sector) for your company and its peers to see where your company would stack up
2. Determine the degree to which your EVA level or growth trend provides an accurate reflection of your company's value creation over the last three to five years
3. Prepare to explain your company's position on the applicability of EVA as a measure in your shareholder engagement activities, including in disclosures and other communications, as appropriate

Some companies with the right set of characteristics noted earlier may even find that EVA is a better metric than the one(s) they are currently using. And with the imprimatur of ISS, they will have an easier time justifying tracking and reporting it, and even building it into their reward system.

For more information on EVA and potential implications, call us at **(646) 626-6930** or visit **Farient.com**.

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