



EVA and Value-Based Management

A Practical Guide to Implementation

by S. David Young and Stephen F. O'Byrne
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Take-Aways

- The primary goal of any business should be increasing shareholder (owner) value.
- Economic Value Added (EVA) is the best available metric for measuring value.
- EVA is a measure of economic (not accounting) profit. An EVA calculation shows the difference between the cost of capital and the return on that capital.
- You can calculate EVA for the company and for individual business units or divisions.
- Implementation of EVA is company-specific; no single template fits all companies.
- Some companies' structures are ill-suited for EVA, but the principles of value-based management can still apply to them — using different metrics.
- To reap EVA's benefits, you must adopt it as a performance metric from the top down.
- Employees won't change their behavior to align with shareholders' interests unless they are motivated to do so, with both short- and long-term incentives.
- Unlike stock options, EVA performance targets can reward managers for improvement in the performance of their individual divisions or business units.
- EVA is a measurement system, not a strategy unto itself.

Rating (10 is best)

Overall	Applicability	Innovation	Style
8	9	8	7

Relevance

What You Will Learn

In this Abstract, you will learn: 1) The definition of EVA and why it is a superior measure of shareholder value; 2) Which types of companies can benefit most from EVA; and 3) How EVA can be the centerpiece of an effective management compensation policy.

Recommendation

Kudos to S. David Young and Stephen F. O’Byrne, management consultants who largely steer clear of their industry’s usual empty catchphrases and superficial hype. Instead, their lucid explanation of the importance of shareholder value takes center stage. The heftiness of *EVA and Value-Based Management* may be daunting, but most readers will be satisfied with Part I’s strategic overview. The concepts reappear in Part II accompanied by a wealth of technical details, calculations and case studies to help finance professionals with nitty-gritty implementation of EVA (Economic Value Added) programs. The book honestly assesses EVA’s power to motivate managers, noting that some companies just are not well-suited for this performance metric. *getAbstract.com* prescribes this book to corporate executives who have overdosed on consultant jargon but still want to drive value growth in their companies, and to finance specialists who seek a comprehensive roadmap to EVA implementation.

Abstract

The Significance of Shareholder Value

Although businesses exist to create value for their owners, corporate executives and managers do not always act to maximize shareholder value, because of perceived conflicts with other goals. Shareholder value does not necessarily conflict with good citizenship toward employees, customers, suppliers, the environment and the local community. Companies that respect those constituencies tend to outperform others, suggesting that value can be delivered to shareholders only if it is first delivered to other constituencies.

Value-based management strategies have been around as long as business has existed. Every useful performance metric attempts to measure changes in shareholder value. Economic value added (EVA) is the best metric available. The others each have significant drawbacks:

1. Traditional income measures, including net income and earnings per share, can be easily manipulated, and they do not account for the cost of equity.
2. Market-based measures, including market value added (MVA), excess return and future growth value (FGV), can only be calculated for publicly-traded entities.
3. Cashflow measures, including cashflow from operations (CFO) and cashflow return on investment (CFROI), include neither the cost of equity nor the cost of debt.

EVA is highly accurate because it includes the cost of debt financing and equity financing. Since you can calculate EVA for private entities or for divisions within companies, you can use it as a motivational tool deep within your organization. Traditional managers understand that their companies need to control operating costs and succeed in the commercial markets. Today, companies also must compete in the capital markets by keeping their cost of capital low.

“Great business leaders, past and present, have always known about EVA without calling it that.”

“EVA is much more than a measurement system. It’s also an instrument for changing managerial behavior. It is about changing mind-sets, getting managers to think differently about their work.”

“Think of EVA as a means of revealing to the rest of us the insights that Jack Welch and other great managers have always had at a deep intuitive level.”

“Managers must think like owners, not like employees, but such a change is not possible unless managers are paid to think this way.”

“Capital has attained a degree of mobility that is unprecedented in human history, and it will go anywhere it is most appreciated.”

Understanding EVA

EVA measures residual income; that is, it measures the difference between a firm’s cost of capital and return on capital. EVA is expressed as either a positive or negative currency amount. To calculate EVA, assign a cost to each component of your firm’s financing (equity and short- and long-term debt). The resulting weighted average cost of capital (WACC) is one of EVA’s most important components. It requires transparent, credible calculation, because there are differing ways of assigning costs to capital (in particular, to equity financing).

The simplest way to calculate EVA is to subtract capital charges (invested capital multiplied by the WACC) from net operating profit after taxes (NOPAT). Clearly, you can increase EVA several ways, including: 1) increasing NOPAT; 2) lowering the WACC; and 3) reducing invested capital (divesting functions that do not contribute to value growth).

Often, companies refine their EVA calculations by making accounting adjustments to overcome the inherent limitations in generally accepted accounting principles (GAAP). More than 150 possible accounting adjustments are available, but most EVA companies make five or fewer. The most important criterion when considering an accounting adjustment is whether it will have a direct effect on managers’ incentives to create value.

EVA and Corporate Culture

Paying managers for performance is a backward-looking practice, but the capital markets assign value on a forward-looking basis. Therefore, companies that pay for past performance may be unwittingly paying their managers to undermine value creation. If you are going to implement EVA-related performance measurement throughout your company, all affected employees need to understand the goal, as well as how their actions contribute to meeting it. In this respect, the EVA’s popularity parallels the 1980s “total quality management” trend. Like quality, value is every employee’s responsibility. To this end, management and employee training programs are a crucial component of any EVA plan.

Implementing EVA is a highly company-specific process. Companies are more likely to benefit from EVA if they have these characteristics:

- The corporate structure consists of relatively autonomous business units, rather than one large unit or a matrix organization with substantial shared resources.
- Strong managerial wealth incentives are tied to business unit performance, rather than corporate-wide goals (as with stock or stock options) or the discretion of the compensation committee.
- The CEO is an enthusiastic advocate, rather than going along with something he/she doesn’t fully understand or support. EVA implementation should begin at the top.
- Business unit heads have long tenure and thus are motivated by long-term incentives.

Creating an EVA-based Compensation Plan

The four primary factors in creating a compensation plan are:

1. Align management performance and shareholder value.
2. Create strong wealth leverage, so employees work hard and make difficult decisions.
3. Employee retention risk, particularly in bear markets or industrial slumps, when performance-based compensation may decrease through no fault of the employee.
4. Cost of the compensation plan to shareholders.

“Quite simply, senior corporate executives are too often paid to worry about things other than creating value.”

“Value creation is the responsibility of every employee, not just top managers and finance specialists.”

“There is no substitute for judgment, experience, and an intimate knowledge of capital markets and investor expectations.”

“EVA implementation is a largely pointless exercise unless the company intends, at least eventually, to tie EVA to management compensation in some way.”

The ratio of the percent of change in management wealth to the percent of change in shareholder wealth is called the wealth leverage ratio. The ratio is 1.0 for a sole proprietor, which is why a 100% correlation between shareholder wealth and management wealth is referred to as entrepreneurial wealth leverage. The ratio is far lower for managers who own only a tiny percentage of shares, and whose divisions only contribute a fraction to stock price. This is why stock options are an effective motivating tool only for top executives.

Management buy-outs (MBOs) create strong wealth leverage, but at a high risk — including the creation of high levels of debt and an increased risk of default. EVA is as powerful as an MBO in creating incentives and focusing managers on a single goal, without the leverage risk.

The EVA-based Managerial Bonus Plan

A traditional managerial bonus plan awards a target bonus for meeting expectations. These expectations can be linked to share price or any other metric. The amount of bonus that can be earned by exceeding expectations is capped. The cap controls costs, but it provides no incentive to improve performance above a certain level. Subpar performance is punished by reducing the bonus, with no further disincentive once the bonus bottoms out at zero. The EVA bonus plan also includes a target bonus, plus a fixed percentage of excess EVA improvement (since EVA is measured in currency and can be positive or negative). The fixed percentage component results in an uncapped bonus level, on the upside or the downside.

Removal of the upside cap creates an unlimited incentive for improvement. The removal of the downside cap could theoretically result in a negative bonus, but the bonus bank eliminates that possibility. With a bonus bank, a portion of any bonus exceeding the target bonus is banked for payout in future years. Thus, managers can still get a bonus in years when EVA declines more than expected, which lessens retention risk. For any given year, no bonus is paid only if the bonus bank balance is negative, due to long-term decreases in EVA. This bonus model has three major limitations:

1. The bonus plan can backfire if the corporate or national culture spurns strong wealth incentives. Older managers near retirement may see strong wealth leverage as too risky.
2. In highly cyclical industries, creating strong wealth leverage while avoiding large negative bonus bank balances in downtimes, can only be achieved by setting compensation above market levels, resulting in a high cost to shareholders.
3. In start-up companies or emerging markets, EVA is not the best performance metric.

Two possible alternatives to EVA bonus plans are 1) equity carve-outs (as distinguished from pure spin-offs), which create equity incentives at lower levels of the company while retaining the corporate structure, and 2) creation of a tracking stock, which allows performance to be reflected in a smaller division’s share price without the disclosure requirements of a carve-out.

Possible Objections to EVA

1. Because business-unit EVA calculations include the cost of capital, the prospect of a lower short-term EVA and the resultant bonus may discourage managers from investing in new projects. Potential solutions include:

“One of the most important tasks of a company’s chief financial officer is to select that capital structure that minimizes the firm’s cost of capital and thus maximizes the value of the firm.”

“Railing against managers for their behavior is pointless; shareholders would behave the same way if faced with the same risks and incentives.”

- Using a bonus bank to make sure long-term EVA is not sacrificed for short-term EVA.
- Deriving a portion of managers’ bonuses from nonfinancial value drivers, such as product innovation, customer satisfaction, market share or employee safety.
- Treating large investments as being made gradually to smooth short-term EVA.
- Using stock options to provide a long-term incentive.

2. Measurement can be difficult at divisional and subdivisional levels if divisions share resources or if vertical integration allows more control over the value chain. EVA calculations must not allow divisional managers to boost their own EVA at the expense of other divisions and the corporation. Potential solutions include:

- Choosing other value drivers that serve as a proxy for EVA at lower levels.
- Grouping divisions and using EVA to evaluate the group.
- Linking part of managers’ bonuses to EVA in other divisions.
- Allocating costs to divisions based on divisional profitability.
- Using activity-based costing (ABC) instead of allocating costs based on volume.
- Approaching transfer pricing in new ways, such as internal auctions or arbitration.

What Went Wrong?

In the early 1990s, several well-known companies, including Monsanto, Georgia-Pacific and AT&T, trumpeted adoption of EVA as a performance metric, only to abandon it within a few years. The companies that dropped EVA shared three main trends in the way they implemented it in the first place, differing from firms that continued to use EVA successfully.

1. Their compensation plans capped bonus levels, instead of allowing an unlimited upside.
2. They did not use bonus banks. Instead they paid full bonuses in the year in which they were earned. This increased retention risk.
3. Their compensation committees were allowed considerable discretion in determining bonus levels, diluting the power of EVA targets to focus managers on a single goal.

These companies did not get good results because they did not follow EVA best practices.

About The Authors

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Buzz-Words

Bonus bank / Economic Value Added (EVA) / Value-based management / Wealth leverage (ratio) / Weighted-average cost of capital (WACC)