

CHAPTER 4: ECONOMIC VALUE ADDED (EVA)

4.1 Theory of EVA

What is the solution? One that has gained currency in the corridors of company management, market commentators, consultants, analysts and investors is the now ubiquitous concept of ***Economic Value Added (EVA)***.

EVA is actually Stern Stewart & Co's trade name for a specific method of calculating economic profit, which is the company's net operating profit (after taxes) less the cost of capital. The capital includes all the money tied up in assets such as computers, equipment, and real estate, with the addition of working capital consisting primarily of cash, inventories, and receivables. The cost of this capital is minimum rate of return demanded by lenders and shareholders, and can vary depending on the riskiness of the investment and the company. When a firm can make more money than the cost of doing business plus the cost of capital, it is also creating wealth for its shareholders. Thus, one can see the power of this simple measure – as a tool for measuring the wealth-creating power of the corporate whole, a division, or any activity within a division as it impacts the bottom line.

EVA, however, is not only a powerful measurements tool – for many companies it has become a way of life. EVA is actually a centerpiece for a very comprehensive

financial management system which can be guide policies, procedures, measures, strategies, and compensation programs for the companies that use it.

EVA measures the difference between the return on a company's capital and the cost of the capital. It is similar to conventional accounting measures of profit but with two important differences: EVA considers the cost of all capital, and it is not constrained by general accepted accounting principles (GAAP). The net income figures reported in company income statements consider only the most visible type of capital cost, interest, while ignoring the cost of equity finance. Although estimating the cost of equity is a highly subjective exercise, measure of performance that ignore such costs do not reveal how successfully a company has been in creating value for its owners.

Take a company that has invested RM100,000 in its business. To satisfy investors, such a company may be required to generate a return of 12% - its overall cost of capital. Let us say that the company actually generates an operating profit after tax of RM20,000. The business is ahead of the game and, under the Stern Stewart criteria, has created value. The company's EVA is calculated as RM8,000, (RM20,000 minus 12% x RM100,000).

The concept is simple and effective: a business that invests capital has to make a return on that capital, if the return is good enough, value is created. From this simple idea flows a plethora of applications:

- Business planning and budgeting

- Capital expenditure appraisal
- Executives reward systems

At the corporate level, the application of EVA-type management is intended to focus decision-making on how and where value is created, rather than simply on increasing accounting earnings – this is a good thing. Asia's recent turmoil can be argued to have been compounded by companies allocating capital on the basis of enhancing accounting earnings rather than generating value. The major failure of accounting earnings is that no cost is implied for either equity capital or foreign exchange risk in debt capital.

4.2 EVA: A True Measure of Corporate Success

The answer, for the most part, is actually quite straightforward: Management should focus on maximizing EVA, which is operating profits less the cost of all the capital employed to produce those earnings. EVA will increase if operating profits can be made to grow without tying up any more capital, if new capital can be invested in projects that will earn more than the full cost of the capital and if capital can be diverted or liquidated from business activities that do not provide adequate returns. It will be reduced if management fritters away funds on projects that earn less than the cost of capital or passes over projects likely to earn more than cost of capital. It just so happens that EVA is the only performance measure that is entirely consistent with the standard capital budgeting rule: Accept all positive and reject all negative net present value investments. (Earnings per

share, on the other hand, will increase so long as new capital investments earn anything more than the after- tax cost of borrowing, which is hardly an acceptable return.)

The most important reason to adopt EVA as the main corporate financial goal, however, is that it is the only measure to tie directly to intrinsic market value. Discounting the EVA to be generated by an individual capital project, for instance, automatically results in its net present value. (The cost of the new capital employed to finance the project is explicitly subtracted in the very calculation of EVA.) The capital budgeting prescription to accept positive NPV projects can be restated as follows: Accept all investment opportunities which will produce a positive discounted EVA. It is one and the same thing.

Carrying this concept to a higher level, projecting and discounting EVA for an entire company automatically sums the net present value of all of the firm's past and projected capital investment projects. The sum accounts for the company's market value premium to capital employed (which is simply the total of all investments the company has made to date). A company for which projected EVA discounts, to say, RM100 million, and which currently employs RM500 million of capital, has an intrinsic market value of RM600 million. This relation tells us that if its EVA is expected to be positive, a company has added value to the out-of-pocket cost of the resources drawn into the firm; if EVA is projected to be negative, value has been destroyed. EVA, in short, is the fuel that fires up

premium in the stock market value of any company or accounts for its discount. That is EVA's greatest significance, and it is a property that sets EVA above every other financial performance measure, including cash flow.

EVA is both a measure of value and a measure of performance. As a matter of fact, it is the only measuring that can link forward-looking valuation and capital budgeting procedures with the manner in which performance subsequently can be evaluated. The conclusion is inescapable but perhaps shocking: Abandon the practice of discounting cash flow, and discount EVA instead. The valuations will be the same, that's true, but comprehension and communications will be dramatically strengthened.

For those reasons and more, EVA is the right measure to use for setting goals, evaluating performance, determining bonuses, communicating with investors, and for capital budgeting and valuation of all sorts.