Rewarding Value Creation via EVA

Featured In Compensation News
Spring 1996

There is increased recognition of the need to develop accurate measures of performance that can be used in determining incentive compensation, for the executive as well as for individuals or teams. The concept of pay for performance, while often used to reward value-adding results, can sometimes be misdirected, if the measures of success are short-sighted.

For example:

A manager of a computer software company is awarded a bonus on the basis of achieving a net income target. The shareholders are happy with their dividend and share price. Three years later, this company finds its net income have dropped significantly, as their new product developments have not kept pace with their competition and they are now lagging behind. The shareholders are not happy with their diminished dividends and reduced share price.

This is an example of ***What gets rewarded gets done!*** The CEO achieved his profit goals through cutting costs, in particular, the R & D department, thus reducing the ability of the organization to produce innovative products ahead of the competition. The results are not unexpected; short-term gain causing longer-term pain.

A NEW ERA

According to Frederic Cook, we have entered an era where the investment community has a strong focus on ***return on capital, or shareholder value***. Shareholders expect that an venture in which they invest their capital, will provide them a return at least as good or better that the return they would receive from investing in another venture.

WHAT IS CAPITAL?

It is the all of the money tied up in assets such as equipment, real estate computers, etc., as well as, working capital which includes cash, inventories and receivables. This capital enables an organization to operate and produce revenue, etc., resulting in the increased value of that capital.

LINK BETWEEN VALUE CREATION AND CAPITAL CREATION

There is an obvious link between creating value in an organization and the resulting capital creation. Value-addition provide temporary increases in income, while Value-creation builds permanent increases in the income stream of the business. There are three basic approaches to creating capital :

- Increasing revenues while maintaining profitability through new products, service innovations, start-up or spin-off operations etc.
- Permanent reductions in expenses through strategies such as improved productivity, waste reduction, distribution cost reduction or outsourcing.
- Permanent reduction in employee costs without reduction in the income stream.

Many current earnings-based incentive plans reward value addition, which is certainly appropriate for short-term goals. However, some organizations have found that this romance with earnings may not be the best measure of value creation in the longer-term. The change in market value of share prices (& dividends) is the clearest indicator to shareholders of the return that they can expect on their investment. Therefore an easy way to align organizational goals and shareholder's expectation for capital creation is use a financial measure that is linked to the changes in the market value of shares.

A financial measure that is gaining favor as an indicator of Value Creation is Economic Added Value or EVA. Several of the top 10 ranked US companies, such as Coca Cola, Wal-Mart & A T & T, have employed EVA measures not only to assess the performance of their business units, but as a component of their compensation strategies. A number of Canadian organizations, particularly in the manufacturing and hi-tech sectors, are also introducing EVA performance measures.

EVA = Net Operating Profit after Tax (NOPAT) - Cost of Capital

For example:

Company X with a capital base of $200 million, NOPAT of $25 million and a cost of Capital of 10%:

> EVA = $25 million - (.10 x $200 million)
> = $ 5 million

EVA represents the value that the organization creates that is above what shareholders could expect to receive from investing their money elsewhere in ventures of similar risk. This is called opportunity cost. What makes EVA measures different from other financial indicators based more strictly on upon Net Operating Profit, is that it takes into consideration this opportunity cost of the capital invested in the organization.

WHY USE IT?

Numerous studies have shown that comparisons of year over year EVA calculations closely correlate to the change in share price. According to James Mehan of AT&T's long distance business: "We calculated our EVA back to 1984 and found an almost perfect correlation with stock prices." This measurement allows the management of a company to be aligned with their shareholders expectation of increased shareholder value and focus on the goals of Value Creation that will lead ultimately to Capital Creation. That EVA can be a good indicator of value creation in the longer term encourages its use as:

- An excellent performance measure as a basis for incentive compensation, for both short-term and longer-term plans.
- As a criterion for making business decision in which projects to invest capital.
- A tool in re-engineering or process improvement strategies that have value creation as their goal.

Organization which employ EVA measures to assess the performance of business units or departments are able to identify factors that do not use capital effectively and have developed solutions which often include:

- Reduction in inventories
- Outsourcing of non-core services
- Process streamlining

EVA INCENTIVE PLANS

According to Bennett Stewart, who initiated the current EVA popularity, "If you change the way a company measures performance, you will change executive behavior and ultimately organizational behavior."

EVA measures can be used as a basis for incentive plans in several ways. The simplest approach is as a fixed percentage of EVA.

For example:

The CEO of Company X is eligible for 2% of EVA for the corporation:

> Annual bonus = 2% of $5million
> = $100,000

If EVA increases to $8 million, his annual bonus would be:

> Annual bonus = $160,000

If EVA decreases to $2 million, his annual bonus would be:

> Annual bonus = $ 40,000

This indicates that the elements of variability and risk that are observed in share prices also applies to EVA measures, so there is no guaranteed bonus payout. In fact in most plans there is a negative payout that is banked against future earnings.

EVA measures can also be used for developing longer-term incentives where EVA earnings are pooled over a 3 to 5 year period. There are other approaches that can be used that include the use of:

- EVA improvement targets
- Assume the annual development of improvement over previous years, with no payout added to the pool, if a target threshold is not achieved, and a potential for a negative payout if there is a decline in EVA. A bonus bank
- Assumes that a portion of the earned payout is banked to cushion against negative earnings in future year. The annual payout would then be based on a weighted average.

SOME OF THE ADVANTAGES OF EVA INCLUDE:

- To align organizational goals with shareholder expectations of value creation.
- Provides motivation for management and employees to step out and take calculated risks in order to maximize shareholder value, with the potential for greater rewards.
- Particularly useful in organization which are privately held, thus employees, including executive have limited access to purchasing stock.
- More effective in capital intensive than labour intensive organization.
- Can easily be applied to separate business units, etc.

ISSUES TO CONSIDER IN USING EVA MEASURES

Implementing EVA-based measures cannot be done overnight, as there are implication for the organization. Besides the obvious need to have the executive understand and support these performance measures, the impact on financial management and accounting practices must be considered, as they are used to determine the EVA calculations. Two issues are:

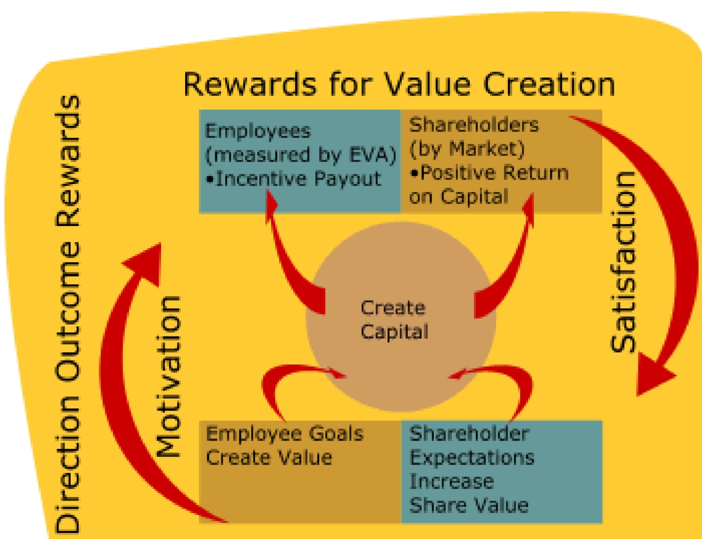
- The implication for cost accounting method used as the treatment of certain costs can vary, depending whether a Full Cost Accounting, or Successful Efforts Accounting methods are applied:
  - For example, In the Oil & Gas industry, the costs of seismic services, or in the manufacturing sector, there are R & D costs, that may be expensed or capitalized, depending upon the accounting method used.
  - Both types of expenditures add value within the first year because of increased information and knowledge gained through the process, which can be applied to other decisions. However the more tangible results may not be apparent until years later, which could then be viewed as value creation.
- The basis on which the Return on Capital is calculated:
  - Should the return on capital be determined by the consolidated group or should it be adjusted for each individual business unit based upon the level of risk associated with each unit?
  - The type of capital structure that is used, may also be different for different subsidiaries and again affect the calculations.

APPLICATION TO NOT-FOR-PROFIT OR PUBLIC SECTOR ORGANIZATIONS

There are also applications in the public sector. Although there are no shareholders, in the same sense as in the market-driven sector, the concept of opportunity cost as the basis of determining cost of capital still applies. The fact that EVA measures tend to track the increases in capital creation of market-based shares can also be applied to non-market based organizations. The need to choose the application of available funds that will produce the most effective return is critical with the current limitations on public funding. EVA can help to do this as well as being a strong indicator of the value created through asset management, and productivity improvements Particularly with the strong business focus required in all organizations today, EVA is a method of measuring successful performance that can easily be employed by the not-for-profit sector.

FOCUS ON VALUE CREATION

One of the biggest advantages of EVA measures that cannot be overstated, is the ability to align the goals of not only, shareholders and executives, but all members of the organization by focusing on Value Creation in all aspects of the enterprise, as demonstrated in the model above. Through the integration of EVA-based measures in performance and reward systems, an organization can clarify the path of success and share the rewards of the value-creation with employees. This should result in continuing commitment to building the future together. While Canadian companies have only recently stepped on the EVA bandwagon, we can expect to see many examples of success in the future through the focus on Value Creation.



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