Economic Value Added

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Why EVA

- A better Performance Measure?
- Easy to understand and implement.
- Links internal profit performance to the expectations of capital market.
- Links compensation with ultimate corporate objective.
- Less emphasis on subjective factors!! Value based measure replaces subjectively determined goals and performance measures.

Illustrating EVA: The Pizzeria Story...

You have Rs500,000 in savings that is currently invested in an investment fund that invests exclusively in fast food joints and generates a 20% post tax return every year.
You decide to fulfill a life long ambition, and invested the entire amount in opening a small Pizzeria. At the end of the year, your pizzeria shows the following results:

	Sales	Rs950,000
–	Operating Expenses	825,000
=	Profit	125,000
	Taxes @ 35%	43,750
=	Actual Profit	Rs81,250

Are you pleased with the performance of the new business? Did you really make a profit?

The actual profit from the Pizzeria was less than your minimum profit expectation

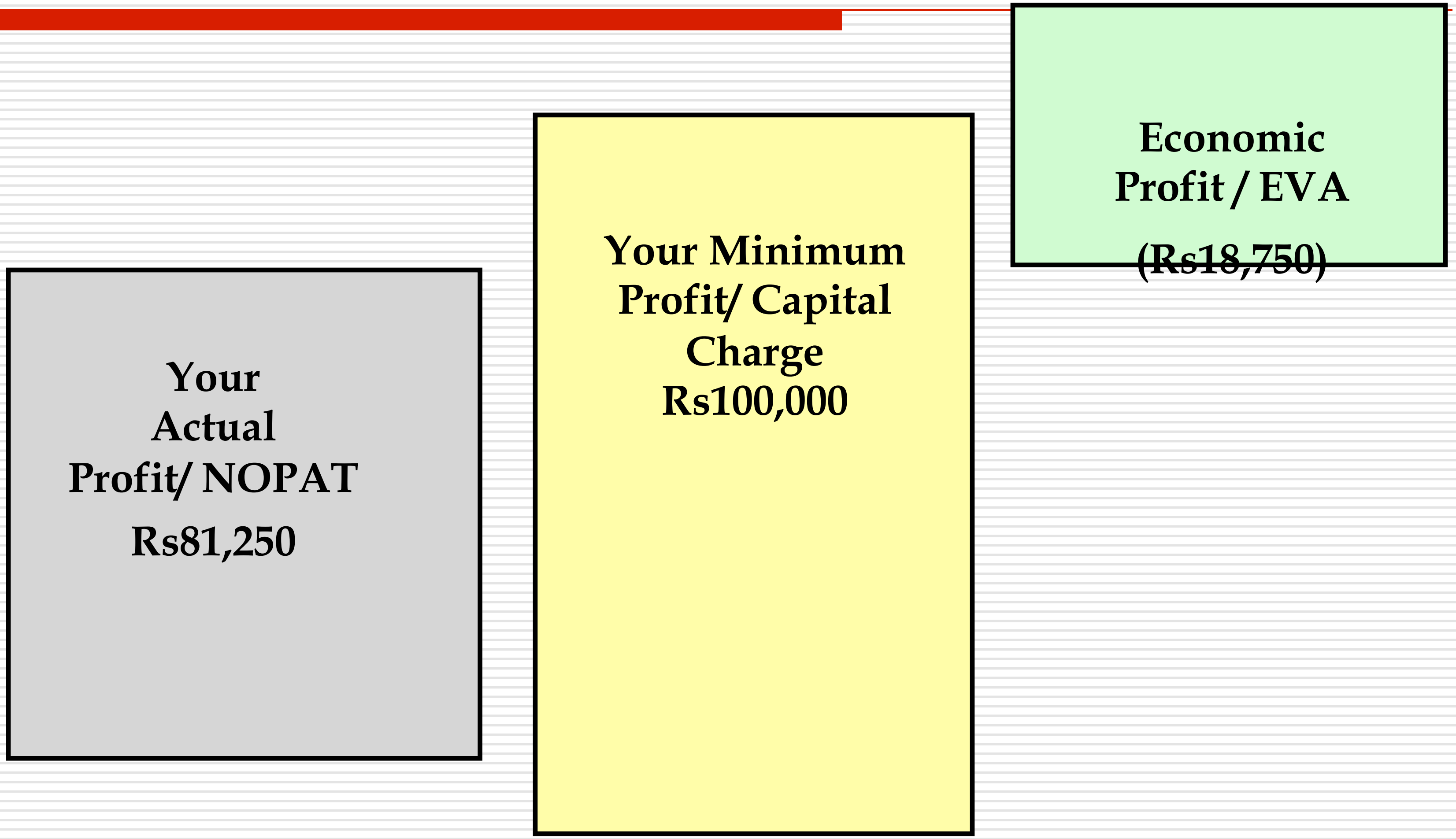
Your ***actual profit*** in the pizzeria (after paying taxes) is Rs81,250.

Had you kept your money in the investment fund, you would have expected to make Rs100,000 in profits.

Since you expected to earn Rs100,000 if you kept your money in the investment fund, you should require ***at least*** Rs100,000 of profit from the pizzeria...and hopefully a lot more than Rs100,000!!!

This expectation is called your ***minimum profit***.

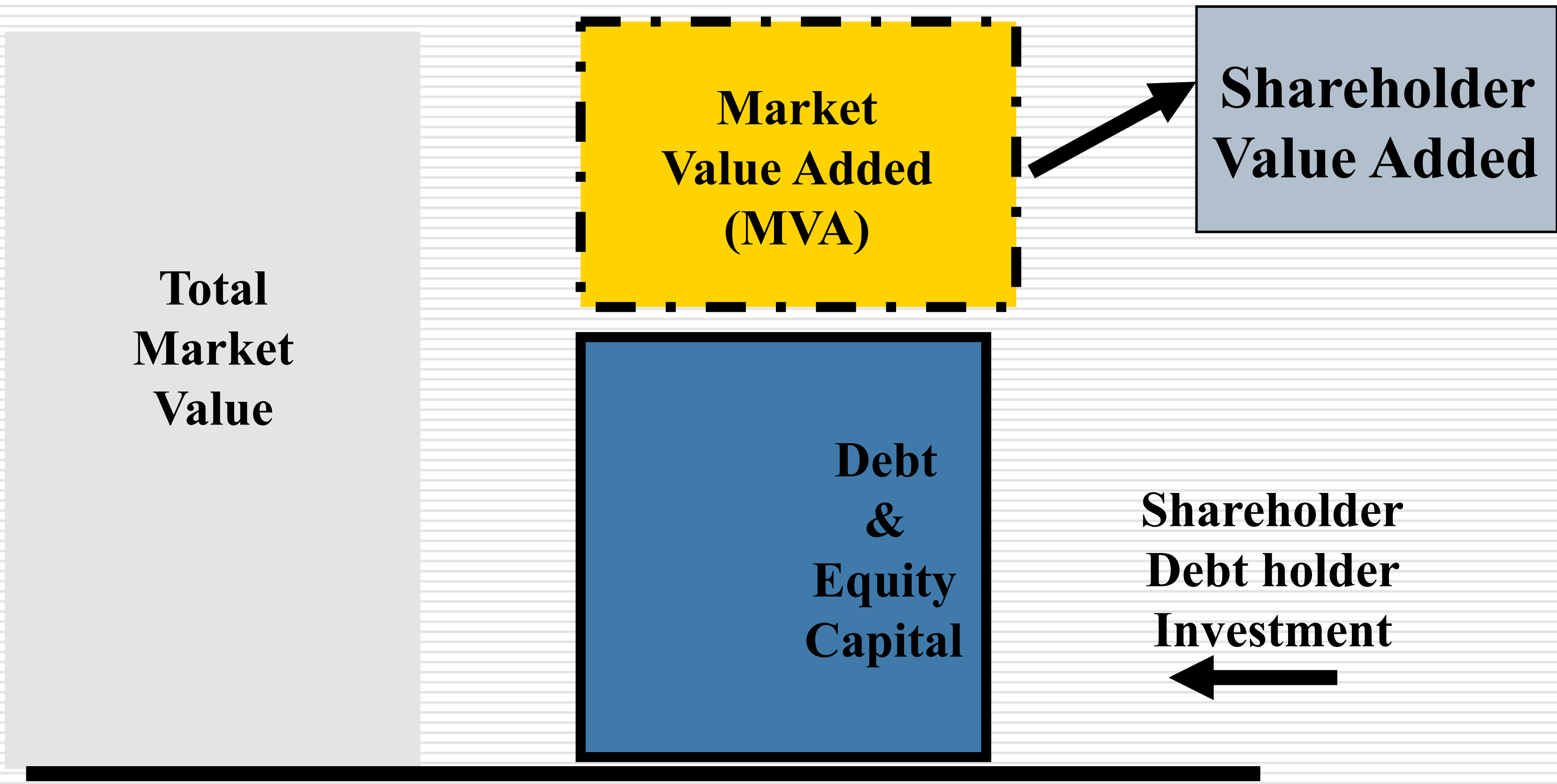
***Economic Value Added*, or EVA, is what is left over after recovering your minimum required profit ...**



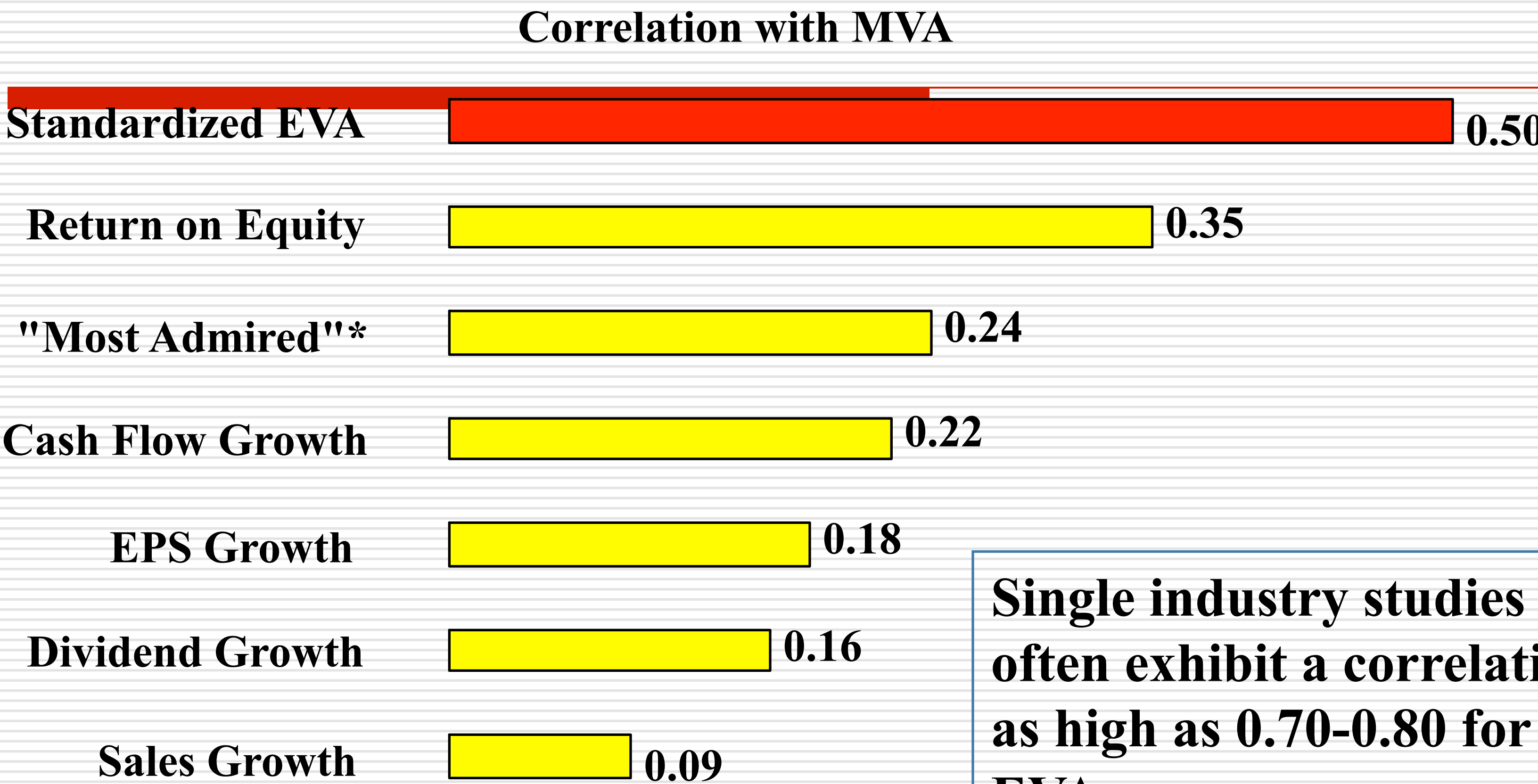
The Components of EVA

1. **NOPAT (Net Operating Profit After Tax)**
   - Actual profit
2. **Capital**
   - Amount of money invested in the business
3. **Required Return (C*)**
   - The return the investors require for the risk of investing their money in your business
4. **Capital Charge**
   - Minimum profit required
   - Calculated as Capital multiplied by the required return.

The goal of any Corporate Management is to Maximize Market Value Added (MVA)



EVA vs. Other Measures

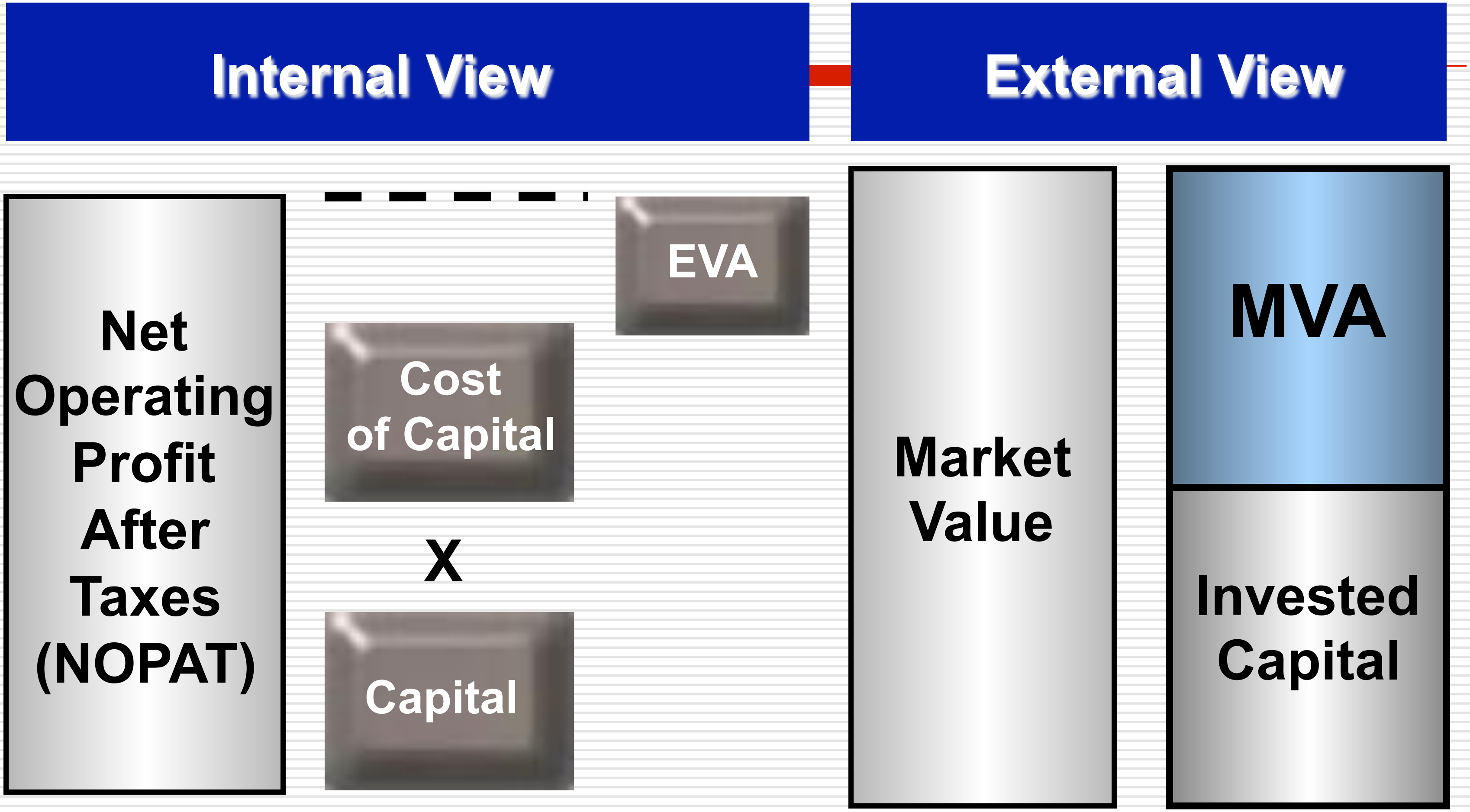


Single industry studies often exhibit a correlation as high as 0.70-0.80 for EVA

Source: Stern Stewart & Co.

*300-company sample versus 1000-company sample for other measures

The close relation is because EVA mirrors MVA within the firm



A Common Focus, Language & Mission

Four Fundamental Strategies to improve EVA

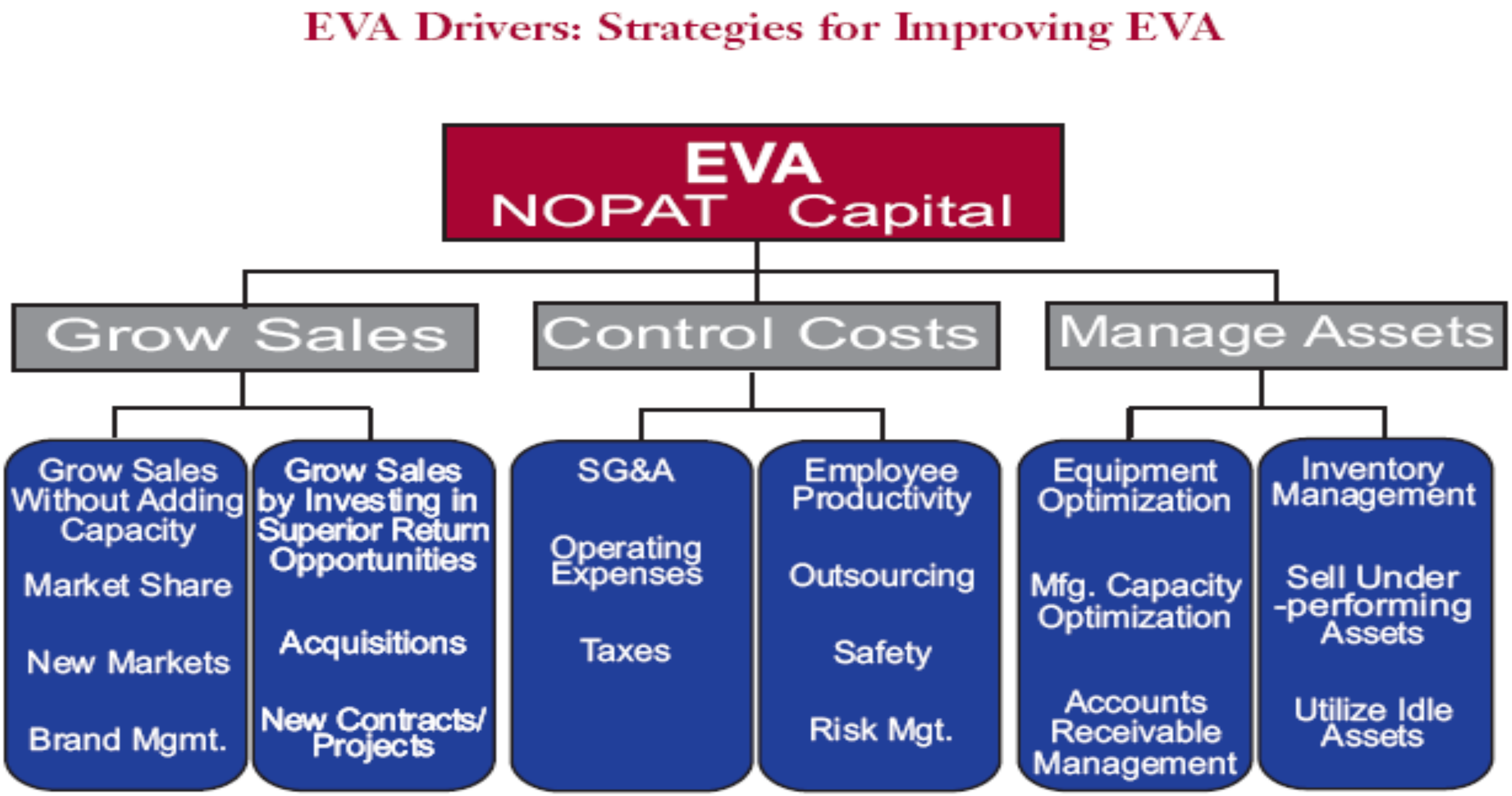
4. ***Optimize*** **- Reduce cost of capital by optimizing capital structure**

$$\text{EVA} = \left[\frac{\text{NOPAT}}{\text{Capital}} - \text{Cost of Capital} \right] \text{X} \quad \text{Capital}$$

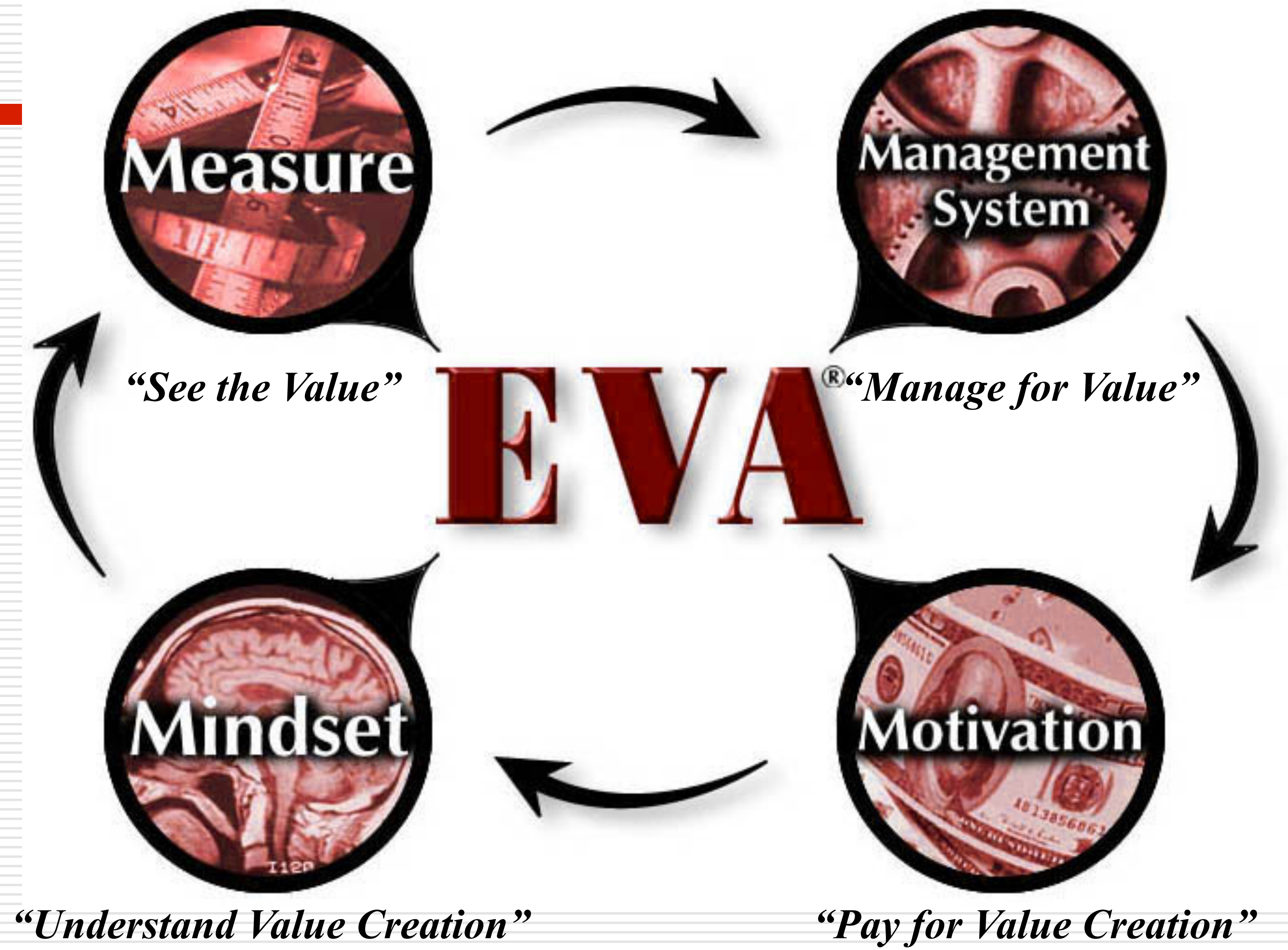
1. ***Operate*** **- Improve the return earned on existing Capital**

2. ***Build*** **- Invest as long as returns exceed the cost of capital**

3. ***Harvest*** **- Divest capital when returns fail to achieve the cost of capital**


EVA Drivers: Strategies for Improving EVA
EVA
NOPAT Capital
Grow Sales
Control Costs
Manage Assets
Grow Sales Without Adding Capacity
Market Share
New Markets
Brand Mgmt.
Grow Sales by Investing in Superior Return Opportunities
Acquisitions
New Contracts/ Projects
SG&A
Operating Expenses
Taxes
Employee Productivity
Outsourcing
Safety
Risk Mgt.
Equipment Optimization
Mfg. Capacity Optimization
Accounts Receivable Management
Inventory Management
Sell Under -performing Assets
Utilize Idle Assets

The Building Blocks of the EVA Framework



Management System

- Step two of an EVA implementation is using EVA to make better decisions.
- For a well diversified organization, the need for standardized and consistent decision tools is critical.

What do you think?

- **Would it be good if ROCE went from 40% to 35%?**

The problem with measures such as RONA and ROI, is that they ignore the cost of Capital

	Existing Business	+	New Investment	=	Results After Investment
Income	400		300		700
Capital	1,000		1,000		2,000
ROCE	**40%**		**30%**		**35%** ↓
Cost of Capital	20%		20%		20%
Capital Charge	200		200		400
EVA	**200**		**100**		**300** ↑

An investment can decrease RONA but increase EVA

Motivation

- Craft an incentive plan that creates better alignment between an organization's goals and the goals of its employees.
- For a widely diversified company spanning several industries, business models, and geographic regions, creating alignment at the company level can be very difficult.
- At the same time, achieving this feeling of ownership is crucial to the success of the company, as division management, by necessity, knows more about its particular industry than the central management team.
- As a result, the delegation of decision rights to subsidiary management is an important part of the EVA management process.

Motivation

- This delegation is only successful, however, when managers can be reasonably expected to think and act like owners.
- This ownership mindset is enhanced further by basing incentives to the degree practicable on business unit performance, thereby creating appropriate line-of-sight for divisional managers.
- In an effort to extend the decision-making horizon of all managers, it is desirable to have long-term incentive goals.
- Managers can worry less about the short-term impact that a particular project might have on incentive payments and look to the life of the project.

Managerial Implications of EVA

- To motivate proper management behaviour and instill accountability, a firm will also require an *incentive system* that pays managers for sustaining the improvements in EVA over a period of years.
- EVA focused firms will experience *capital discipline.*

EVA-linked compensation: Basic Elements

- ***Accrued Bonus*** Each participant's accrued bonus will be determined as a function of the participant's basic pay, the participant's target incentive bonus, company performance factor, and the individual performance factor for the plan year.
- ***Target EVA*** : (Prior-year target EVA+ Prior-year actual EVA)/2+ Expected improvement in EVA.
- ***Individual Participation Levels:*** Each participant's accrued bonus will be calculated (Participants basic pay* target incentive award* company performance factor* individual performance factor)/2
- ***EVA Leverage Factor:*** Expected deviation in EVA from the average EVA, generally reflected as percentage of capital employed. The leverage factor actually measures the volatility of the industry returns.

EVA-linked compensation: Basic Elements

- **Target Incentive Awards:** The target incentive awards will be determined according to the following schedule:

Executive Position	Target Incentive award (% of basic pay)
Chairman and CEO	80
Managing Director/COO	60
Executive Vice-President	50
Secretary	50
Corporate Line executives	35
Divisional General Manager	35
Corporate Staff Executive	35
Others	20

EVA-linked compensation: Basic Elements

- ***Company Performance Factor :*** For any plan year the company performance factor will be calculated as below :
  - Company Performance Factor = 1.00+ (Actual EVA- Target EVA)/EVA leverage factor.

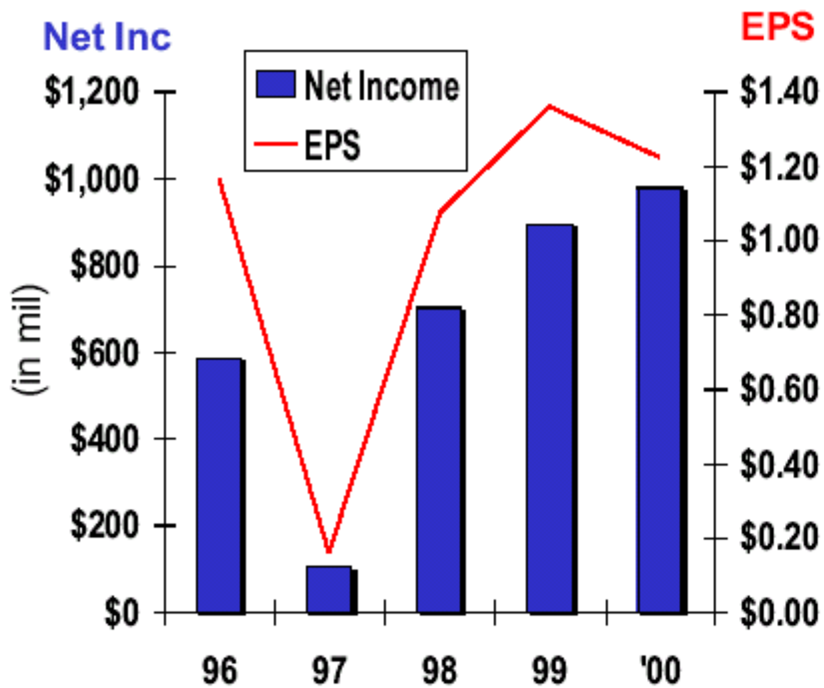
- ***Individual Performance Factor :*** Determination of the individual performance factor will be the responsibility of the individual to whom the participant reports.
  - ***Quantifiable Supporting Performance Factors***
  - ***Non-Quantifiable Supporting Performance Factors***

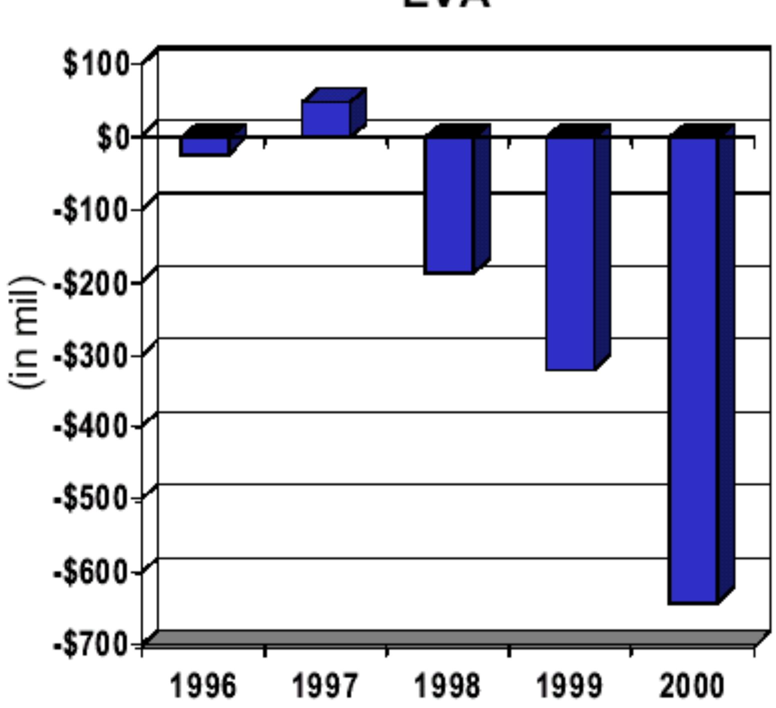
EVA-focused Firm: requirements

- To employ EVA effectively, an oil and gas firm would first need to divide its activities into a series of inter-linked EVA "centers".EVA "centers" are not the broad divisions of "upstream' and "downstream".
- Downstream operations should be divided into transportation, chemicals (if any), refining, and marketing units.
- Upstream operations may be taken as an integral whole.
- The management of oil price risk could also be delineated as a separate EVA center, leaving field operators solely responsible for operations. The corporate risk management center would write internal contracts to buy future production from field units at forward prices consistent with the market price curve.

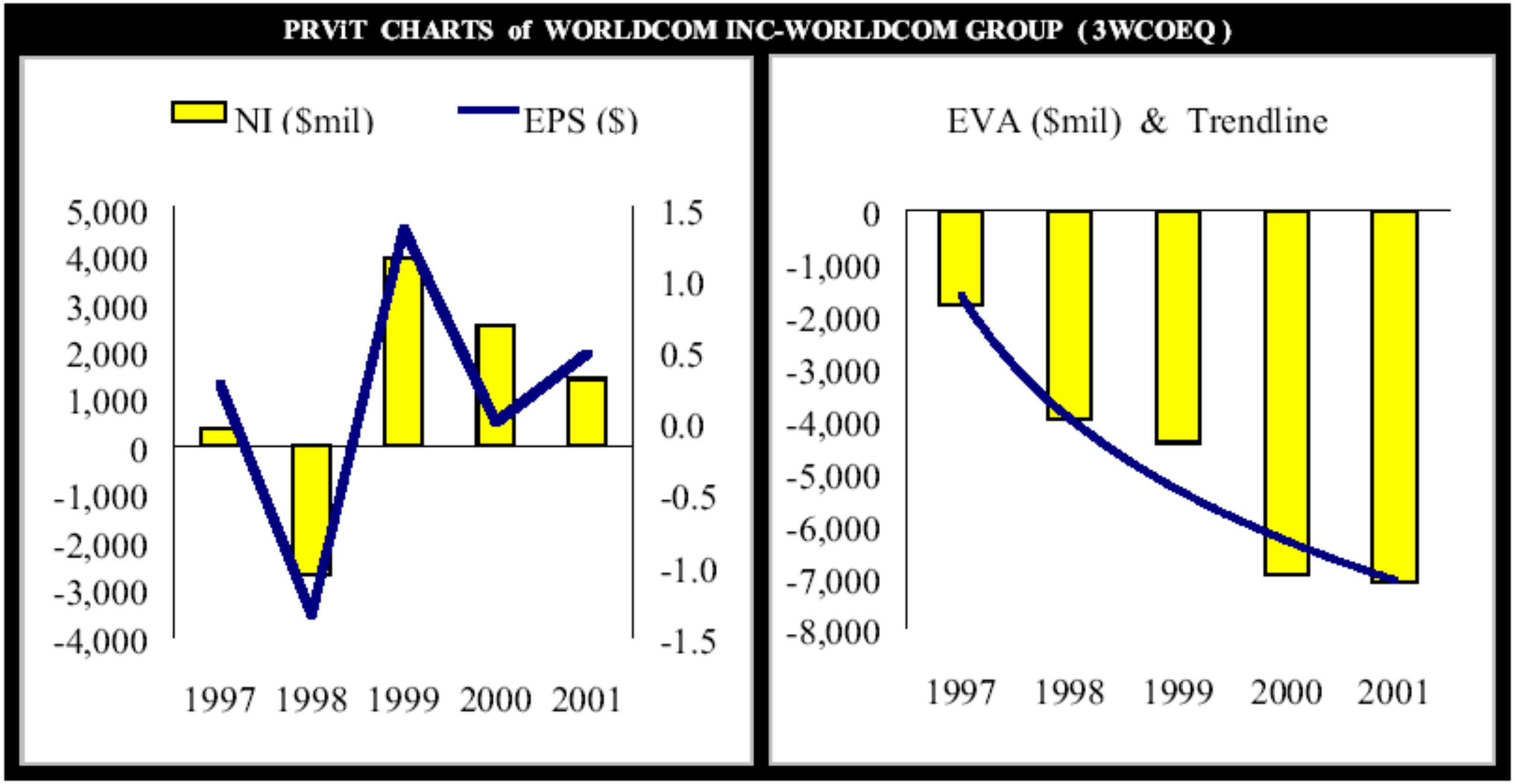
Enron's Real Failure -- A "Laser-Focus" on Earnings and EPS when its EVA profit was Crashing

From Enron's 2000 Annual Report (Letter to Shareholders):
"Enron's performance in 2000 was a success by any measure…The company's net income reached a record in 2000. Enron is laser-focused on earnings per share, and we expect to continue strong earnings performance."





Worldcom Did Not Make Economic Profit, either.



Thank you!