EVA, for economic value added, is a better way to measure the true profit performance of a business. It also is a fundamentally better way to manage a business, make decisions, meter pay, and maximize value. Investors, too, use it for insights into buy-sell decisions and to improve portfolio returns.

For all its remarkable qualities, EVA is a simple measure to grasp. It’s a three-line profit calculation anyone can understand. It is sales, less all operating costs, less a full cost-of-capital interest charge applied to the net assets invested in the business.

To take an example, suppose a company’s sales are $1,000 and operating costs are $850, leaving operating profit of $150. Further assume that the company is carrying $1,000 in net assets on its balance sheet for things like working capital, plant and equipment, and goodwill. If its overall weighted average cost of capital is 10%, the capital charge is $100 (10% x $1,000), and its EVA is $50. In other words, EVA is the profit that remains after deducting all costs, which includes the cost of providing lenders and shareholders with a minimum competitive return on their investments.

EVA has the important property of demystifying the balance sheet by turning it into an operating cost like any other, like cost-of-goods-sold. Once they are tuned into EVA, line managers naturally look for ways to reduce capital. If they are able to withdraw $100 from working capital, for example, their EVA profit increases by $10 (10% x $100), just as much as it would by reducing raw material costs by $10. With EVA, separate P&L and balance sheet statements do not exist; they fuse into a calculation of economic profit and loss, and are managed holistically.

All the Right Incentives

EVA gives managers all the right incentives and no bad ones. It increases when they streamline processes and cut costs or when they add customer value and raise prices, in other words, when they raise profits without raising capital. That’s not unique to EVA of course, but it’s not overlooked either. EVA earns its stripes when capital goes into, or out of, a business. That’s when P&L and balance sheet collide.

EVA increases, for example, when managers free capital by turning assets faster and developing leaner business models. It recognizes and rewards quality asset management. EVA benefits, too, when managers show capital discipline—when they invest only with the conviction that they will be able to cover the full cost of the capital, and when they retool investment proposals to produce even more EVA.

EVA also is solidly pro-profitable growth. It loudly applauds any new investments that cover the cost of capital, even if that means existing margins or returns come down. It motivates managers to scale, innovate and invest in opportunities where they have a true economic advantage rather than to be content with resting on their laurels or milking a business and opening the door for upstarts to jump in.¹

EVA even rewards restructuring activity. It tells managers to exit product lines or drop customers if the profits they produce cannot cover the cost of the capital they require. Managers may even find it pays to abandon lucrative lines with high margins depending on how the math works out. It gets the

¹ For more on the deficiencies with ROI, read What’s Wrong with RONA, and What’s Better?, by Bennett Stewart, at www.evaDimensions.com/Publications
managers back to focusing on businesses, markets and customers where the firm has a true competitive advantage instead of chasing business all over the place. It also motivates them to part with assets that are worth more to others, even when they are sacred cows or crown jewels. It tells managers to sell businesses where the divestiture proceeds, invested at the cost of capital, more than compensate for the foregone operating profits. EVA encourages intelligent portfolio pruning and a focus on the core, which in today’s world of activist investors are essential incentives for companies to have in place.

Simply put, EVA measures all the ways to create value, in any business. It’s all there, correctly weighted, in one measure, and nothing is missing. And here’s why.

EVA is Directly Tied to Shareholder Value and Shareholder Returns

EVA’s most important property, and what really cinches it as the very best measure of corporate performance, is its direct link to value. The rule is this: the present value of a forecast for EVA is exactly the same as the net present value (NPV) of the forecast cash flows. This is not an assertion; it is a mathematical identity. So long as one uses the same assumptions about costs and revenues and the same cost-of-capital discount rate, the NPV of cash flows and the present value of future EVA always come out the same.

NPV analysis deducts capital investments at once, when the money is spent. With EVA, investments are deducted only as they are used up, as inventories turn into cost of goods sold and as plant and equipment assets are depreciated against earnings. Until investments are used up, they carry a cost-of-capital interest charge on the unamortized balance. The year-by-year deduction of capital consumption plus the charge on the remaining capital is the reason that the present value of EVA always is exactly the same as what you get by deducting capital as it is spent. They are mathematically equivalent.

EVA, though, is far superior to cash flow as a management tool. It not only calculates net present value; it provides insights into why the value is what it is, and how to improve it. Suppose a business is forecast to generate zero EVA profits, for example. It’s clear, then, even without formally computing NPV or running the cash flows, that its NPV will be zero, too. Investors will be unwilling to pay a premium for a business that cannot give them a higher return than they can earn on their own. It won’t be worth more than the book capital put into it, no matter how much other measures may improve or what’s happening to cash flow. That’s a signal that action of some kind must be taken to improve the business model, that business as usual will not pay.

The opposite is also true. The only way an investment or business plan produces a positive NPV and adds to owner wealth is by earning EVA and ideally increasing it over time. In fact, the more EVA there is, the faster it grows and the longer it endures, the greater the spread will be between the money put into the business and the value coming out of it.

Cash flow doesn’t reveal any of those insights. The pattern of cash flow from period to period is no help at all in understanding if a business or project is becoming more or less valuable. Cash flow could go down because managers are stepping up the pace of valuable investments, and it could go up

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2 If selling a business generates $1,000 in proceeds, and its cost of capital is 10%, the firm’s owners will be better off selling the business rather than keeping it if it is contributing less than $100 in operating profits.

3 A similar analysis tells managers to outsource business functions to firms that have a competitive advantage. A decision to move company-owned IT operations to cloud computing, for example, may reduce the firm’s profits and margins, but by releasing capital tied up in IT equipment and data centers, pick up an EVA win.

4 Zero EVA firms can sell for NPV premiums—if they are viewed as turnarounds, takeover targets or candidates for activist intervention.
because they are forsaking good investments in order to boost or maintain ROI. It’s impossible to tell whether more cash flow or less is a good or bad thing. Cash flow, and changes in it, are highly uncorrelated with changes in NPV.

EVA, on the other hand, aligns cost and benefit because it converts up-front capital spending into an annual cost equivalent, as if all assets had been rented. It is a far better measure of the value that is being added or lost period by period. If a business unit or business plan is showing an increase in EVA year over year or over a span of years, for instance, it is very likely to be increasing NPV (and measures derived from it, like share price and TSR) in those years or over that interval.

This becomes clear with a sister measure called MVA, or market value added. MVA is the spread between a firm’s overall market value and its invested capital. It’s the difference between the cash put into a business and the value from it, as of a point in time.

MVA effectively measures a company’s franchise value, its owners’ wealth, and the firm’s aggregate NPV. It is a summing up in the market’s mind of the net present value of all existing and forecast capital projects. Increasing MVA increases the owners’ wealth, and it increases the firm’s TSR as a natural byproduct. Maximizing MVA is ultimately every company’s most important goal. It is certainly a metric that every public company and board of directors should monitor.

And what determines MVA? What explains why a business will trade above or below the book capital put into the business? It’s EVA, of course. MVA equals the present value of the EVA profits that the market projects the business will earn. As EVA rises and falls, and investors revise their EVA forecasts, MVA will tend to follow suit. It’s this connection that prompted the editors of Fortune to label EVA “the real key to creating wealth, and so it is.

Honeywell provides a textbook illustration. Its MVA is plotted as the gray bars on the left-hand scale and its EVA is the blue line on the right-hand scale for the 15-year period from 1999 to 2014. Over time, and as expected, the movements in MVA—the creation or destruction of owner wealth—closely tracked the EVA profits.

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5 In fact, many highly-valued companies operate with persistently negative net cash flows because they are aggressively investing in valuable growth. See How to Measure Earnings for Long Run Value, by Bennett Stewart, for a case study featuring Amazon, at www.evaDimensions.com/Publications.

6 Market value reflects the total of debt (including the present value of operating leases), plus value of the firm’s equity, given its share price, net of excess cash. Capital is the net book value of debt and equity, also net of excess cash. From the operating perspective, it can also be defined as the sum of money invested in working capital, net property, plant and equipment, investments, intangibles, goodwill and other operating assets (as modified for accounting adjustments; it includes, for example, the as yet unamortized balance of R&D and ad spending that are capitalized under EVA, and the cumulative unusual items and non-recurring charges, less gains, after taxes, that also are added back).

7 For a derivation that proves TSR is a function of earning EVA and increasing it to increase MVA, see What Determines TSR, by Bennett Stewart, published in the Journal of Applied Corporate Finance, Volume 26 Number 1, Winter 2014, at www.evaDimensions.com/Publications.

8 Fortune, cover article, September 22, 1993

9 Charts plotting EVA and MVA for all public companies in our database can be viewed at no charge at www.evadimensions.com/EVAvsMVA
Honeywell is not an aberration. By studying the Russell 3000 universe of U.S. public companies from 1996 through 2014, a period of great turbulence, we found that the changes in MVA over moving 5-year windows were far more correlated to changes in EVA than to any other performance measure. The correlation was nearly 60% for EVA. For the second closest candidate—change in return on capital—it was only about 44%, and for net income growth (a proxy for EPS growth), 32%. Free cash flow generation was even lower still, only about 20%.

The import of all this can hardly be overstated. It means that EVA offers a fundamentally better way to manage a business and maximize value by following these five tenets:

1. **Mission**: Aim to increase EVA as much as possible. Make that the firm’s most important financial goal, applicable to all lines of business, and let all other measures fall where they may.

2. **Manage**: Use EVA to make decisions. Forecast various alternatives for plans, projects, and acquisitions, and pick the one that in each case will produce the greatest stream of EVA profits over time. If a decision will increase EVA, but slows growth, lowers margins, or dings cash flow, it’s still the right decision. And if a decision that increases sales, market share, earnings per share, returns or cash flow also happens to reduce EVA, it’s the wrong decision.

Stop using cash flow analysis, and discard statistics like IRR—they’re redundant distractions. Just analyze EVA instead. It’s simpler, consistent with the mission, and analytically superior because EVA shows the added value in each forecast period and not just a single NPV answer.

3. **Measure**: Focus quarterly performance reviews on EVA. Ask how much EVA profit we earned, for the company and by line of business, and how is EVA faring compared to plan and to peers, and versus the prior period? What notable factors are causing variances in it?

By giving EVA prominence at the outset, reviews are elevated to strategic insights instead of getting mired in details. Top management also compels the line teams to feel accountable for delivering the EVA they said they would deliver. It closes the loop.

4. **Motivate**: Pay managers to increase EVA. Motivate them to think and act like owners, by paying them like owners, with a share of the added value. Don’t pay them for hitting a contrived bunch of financial metrics. That’s complex, ambiguous, and off the mark. Don’t pay them for beating budget or plan goals, either—that only corrupts planning and turns managers into negotiators.

Give them a piece of the EVA action, and you’ll get more EVA action. (This is so incredibly important I have written a companion article about it entitled, *Motivate Managers to Think and Act like Owners*, which you can download at [www.evaDimensions.com/Publications](http://www.evaDimensions.com/Publications)).

5. **Mindset**: Train your team to use EVA. It’s the best way to embed EVA in your culture. Says John Hayes, CEO of Ball Corporation, “EVA makes for shorter meetings, because when you have a common sense of purpose, and a common language about that, and people understand what that language is, you don’t have to have debates.”

Cement your commitment to EVA. Tell investors your company is focused on it. They’ll appreciate knowing that you don’t get paid until they get paid a priority return on their capital. That’s the best form of corporate governance going.

By adopting all five “M’s” of EVA as I call them, a company ends up with a simple, connected, and highly-effective management model, one that is resolutely focused on increasing net present value.

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10 For the study results correlating MVA to the financial variables, see What Determines TSR, by Bennett Stewart, published in the Journal of Applied Corporate Finance, Volume 26 Number 1, Winter 2014, at [www.evaDimensions.com/Publications](http://www.evaDimensions.com/Publications)
Almost all companies say they are interested in maximizing NPV, but most find that very hard to do. But that is exactly what EVA does so well. No longer are managers perplexed by a vast and varying mix of metrics and methods. No longer are bonuses tied to beating negotiated targets, which saps trust, energy and initiative. They work as a team to increase NPV by laser focusing on EVA. It’s an exhilarating and liberating change compared to how most companies are managed. And the bigger and more diverse a company is, the more advantageous this is.

Focus on Economic Value not Bookkeeping Rules

Accounting profits follow accounting rules that frequently distort the real economic value of decisions. Those can be fixed with a few rules that transform EVA into an even more reliable measure of the value added period-to-period. For example, with GAAP accounting, research outlays and brand spending are immediately written off, charged to earnings as a period expense. The accounting tells managers to cut the spending when they need help to meet an earnings commitment and to refrain from proposing bold hikes even when favorable opportunities to invest come up. They manage as they are measured. They sub-optimize and reduce long run value. Even smart managers can be misled.

EVA doesn’t let that happen. It does not let the accounting tail wag the business dog. Research and brand-building outlays aren’t expensed, because they aren’t expenses. They are capital investments, and they are written off against earnings over a 3-to-5 year horizon (with cost-of-capital interest applied to the unamortized balance). That way, a manager who considers a spending cut finds it won’t help EVA much. Managers on the EVA program keep spending the money if it is money well spent.

Managers also are far more inclined to seize opportunities and step up the development of brands and innovation in-house because they are given the time needed to make the investments pay off. In exchange, they’re accountable for covering the cost as it is spread over time, with interest. In most companies, success is defined as winning budget authority to spend money. With EVA, it’s for producing an attractive ROI on as much money as can be profitably invested. That’s a major philosophical shift that can reap huge benefits in the quality of the decisions.

Restructuring charges, too, are treated as investments. They are added back to earnings and back to capital where they are subject to the capital charge. Managers suddenly want to fail fast—to stop propping up bad businesses and exit as soon as they see that’s sensible because no accounting charge stands in the way. They also want to fail well. They are no longer willing to spend wantonly in a sea of red ink; they look to invest money only as far as it really pays. Restructuring decisions are no longer heads-down admissions of failure; they are transformed into heads-up opportunities to invest capital and mobilize resources and redirect attention to more promising initiatives.

A company team that takes the time to define a set of rules to measure EVA can radically improve the quality of decisions, because managers want to win and they manage as they are measured. Establishing the rules and explaining them is an area in which we have considerable experience and valuable insights. We also provide custom software to compute EVA per the specific rules that a company wishes to follow. We certify the computations, and attest to the quality of the EVA program as an important assurance to the board.

The New Best-Practice Version of EVA

In recent years we pioneered a set of enhancements that have made EVA considerably easier to understand and much more effective as a management tool (and as a technique that is helping investors to screen and value stocks). We figured out a way to express EVA in ratios. It’s no longer just a money measure. EVA is now managed through a set of headline ratio statistics and a ratio analysis framework to go along with them, which is proving to be a big advantage.
The most important ratio is called EVA Momentum. It is the change in EVA as a percent of base period sales. It’s effectively an EVA growth rate scaled to the sales size of the company. It has many important properties and applications:

- Incredible as it sounds, EVA Momentum is the only performance ratio where bigger is always better, and more of it is better than less, because it gets bigger when EVA does. Maximizing it should be every company’s most important financial goal, applicable across all lines of business.

- Momentum ignores history and is always forward looking. It isolates the performance progress over a specific period and the value of decisions at the margin. ROI, in contrast, overlays new decisions on the legacy of returns from all prior investments. It’s a blunt statistic, where EVA Momentum is razor-edged.

- It’s a sooner, suer indicator of turning points and business model fatigue than other measures. It’s the proverbial canary in the coal mine, sensing the arc of the EVA curve in response to all variables, and typically raising a red flag well before other metrics signal a need for concern.

- It’s a totally accurate gauge of the quality of a business plan. There is a 100% correlation between the EVA Momentum of a plan and the value of the plan. With more Momentum, the more EVA growth a plan generates and the greater its discounted cash flow value will be.

- EVA Momentum is the best technique to anchor planning to value creation. Our clients challenge division presidents to generate as much Momentum as possible over their planning horizons, and are allocating resources to the units that prove best able to produce Momentum.

- EVA Momentum can be traced to all the underlying gears that are moving the EVA needle—familiar things like gross margins, working capital turns, plant utilization and the like. It spearheads a superior analytical framework that helps managers make better decisions.

The ratio analysis framework is called the EVA Momentum Pyramid (illustrated at right). It is a structured way to trace the growth in EVA to all the levers that managers can pull to increase business model productivity and fuel profitable growth. It’s a truly balanced and value-anchored scorecard that is topped with an actual score.

Nearly all companies claim to have scorecards, but most have dashboards. They track a bewildering array of performance indicators on a flat and formless landscape with no sense of relative importance or how they sum to an overall valuation score. It’s like making managers into spectators at a basketball game, giving them a record of blocked shots, rebounds, shooting percentages, assists, turnovers and such, and never letting them see which team is winning. In an attempt to illuminate decision-making, companies make it more complex, more ambiguous, and far less accountable. The EVA Momentum Pyramid is the remedy.
Some clients, like Ball Corporation, are using it as a format to explain business strategies to investors and their global teams. Others, like Dow Chemical and Pepsico, are using it as a technique to help their managers to improve the value of their business plans during the planning process. They are handing line teams custom versions of the Pyramid schedules that directly connect EVA Momentum to the underlying operating metrics and strategic milestones that will determine it. Managers use the integrated EVA scorecards to probe tradeoffs and test alternative strategies and respond with cleverly revised plans that will create even more value by generating even more EVA Momentum. For example, one Dow Chemical team had been concentrating on improving returns, but realized that it could also add Momentum and add value by pursuing profitable market niches that were previously ignored.

We maintain a comprehensive data file that endows Momentum with statistical rigor. Each day we derive a full array of EVA metrics and the full spectrum of the underlying performance drivers for more than 20,000 global tickers. We filter reported GAAP financials through a meticulous set of 20 or so adjustment rules that we have found best suited to yield consistently reliable estimates of economic profit. We believe our data represents the standard that defines “EVA” on a global scale.

Our corporate clients access the statistics to benchmark performance with peers, spotlight notable trends and gaps, and rank opportunities. It’s remarkable how often the statistics change perceptions. In a recent example a client felt its performance had improved significantly. But the firm’s percentile grades appearing on the Momentum Pyramid told a different story. The company was making progress, but its peers even more. The scorecard showed how far below median the firm’s Momentum had fallen, and the precise performance areas in which the greatest deficits existed. The company promptly convened a meeting of its leadership team to tackle the problems and formulated new strategies.

An overall corporate scoring system is another good example of how our EVA data is being aggregated to provide “big data” insights. Our Corporate Performance Index, or CPI, distills four key ratio statistics into a single percentile score of financial health from a shareholder perspective.

In 2014 MasterCard was the highest-ranked company. It maintained a phenomenally valuable and extremely profitable business franchise (its MVA was 9 times sales and EVA was 33% of sales, way above the 90th percentile company in the S&P500). MasterCard also generated one of the fastest EVA growth rates (its 3-year EVA Momentum clocked in at a 5.5% a year pace compared to 4% for the 90th percentile S&P500 firm). Investors, moreover, believed MasterCard was well positioned to continue generating profitable growth and was no flash in the pan (the EVA Momentum forecast discounted into its stock price was near 4% a year, versus 3% for the 90th percentile firm). MasterCard, in short, was masterful, garnering an A+ rating in each category, and when those were combined, took top honors with a perfect score.

The appeal of CPI is that it’s a comprehensive corporate report card summed into one letter grade, and it’s not just based on stock price performance over some arbitrary interval as TSR is. It brings the firm’s EVA profit growth, its economic profit margin, and implied EVA growth expectations into the picture as well. The index was first published in Chief Executive in 2014 for S&P 500 companies. It’s

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11 The adjustments cover things like removing surplus cash to focus on the EVA in the business, treating leased assets as if owned, amortizing R&D and ad spending over time, treating restructuring charges as investments, backing out and capitalizing unusual and non-recurring charges, likes losses on asset sales, converting retirement accounting from reported cost to the service cost in the period, crediting EVA with the cost of capital saved by deferring taxes, smoothing the effective tax rate, among other things. We also define capital for financial intermediaries to exclude debt financing and purchased funds, i.e., capital is just an adjusted equity figure, and to be consistent, the associated interest expense is treated as an operating cost. The adjustments produce a smoother and more consistent reading of true profit performance, which enhances comparability of the EVA data across time and among companies, even in distant markets. Each increases the correlation of EVA to share value.
been gaining traction as a credible supplement to TSR in rating performance, judging pay, assessing vulnerability to activist overtures, and red flagging worrisome trends for boards.

**How We Add Value**

All our services revolve around EVA. We are passionate about it, we specialize in it, and we are committed to rendering world class solutions for the companies, consultants and investors who want to use it. We express our value in three words— technique, technology and training.

We bring an unrivaled knowledge about and experience with the latest and most effective EVA techniques. We invented most of the advances in the EVA field, and that continues to this day. My latest book, *Best-Practice EVA* (John Wiley and Sons, March, 2013), is an up-to-date look at the enhanced EVA methodologies we’ve devised.

Second, we pioneer technology that makes it incredibly easy to install and sustain EVA best practices. Now in the ninth year of development, our *EVA Enterprise Software Solution* automates all the calculations necessary to transform raw financials into custom EVA analytics. In a matter of only one or two days, a company’s management reporting, planning, and decision-making can be completely switched over to EVA. The software fully supports peer benchmarking with our global EVA data file, charting the EVA Momentum Pyramid, tracking metrics needed to determine EVA-based bonuses, and measuring the true value of acquisition candidates and capital projects through an EVA lens. Consultants and bankers use similar tools to help them dissect and benchmark a company’s business model, simulate the value of strategic alternatives, and prepare marketing presentations that elevate C-suite conversations into discussions about adding value. They become better advisors when they are armed with the insights that EVA offers.

Major institutional investing houses in the U.S. and UK also are also finding value in our services. We are the source of a proprietary model that uses 24 key EVA metrics to rate every stock in our global file every day with a buy-sell score. Our clients use the scores to screen for mispriced equities and rate their portfolios, and as an early alert system. With a custom tool called *Investor Express*, they go deeper, examining the EVA Momentum expectations implied by share prices, discounting EVA projections to determine a company’s intrinsic value, and probing sensitivities as key assumptions are altered, all at the push of a button, and with the assistance of the knowledgeable team in EVA Dimension’s equity research division. Many of our investor clients have become quite EVA savvy, even EVA-prone—interested to meet with executives of firms that are embracing EVA.

Last but not least is training and support. We’re experts at transferring our technology and helping clients customize our tools and target the applications that are most important to them in the formats they prefer. Over the years, we have coached countless numbers of companies, consultants, and investors on how to bring EVA in house and use it in the best ways possible. No other organization comes close to matching the experience we’ve accumulated. As you might imagine, we’re also quite good at using our software tools and interpreting EVA and serving as advisors to companies that want help with valuing acquisitions, turbo-charging their planning process, or resolving strategic issues. Perhaps our greatest value, though, lies in this: We know how to explain EVA in a way that a CEO, CFO, management committee, even directors, can understand it, buy into, and start to use it. Give us three hours for an on-site presentation to your team, and we can put EVA in the palm of your hand.

We’re EVA Dimensions. We’re the experts in economic profit, and how to use this incredibly powerful technique to improve the quality of decisions and add economic value. I invite you to learn more with the resources on our website, or to contact us directly for more information.