Make Managers into Owners with EVA-Based Bonuses

By Bennett Stewart, CEO, EVA Dimensions LLC, Author of Best-Practice EVA

What is the right way to pay for performance? Is it to hitch incentive pay to total shareholder return, the metric du jour? What about earnings per share, the most popular CEO pay metric in the U.S.? Or how about a mix of several goals? None of these is anything close to being optimal.

I submit that every incentive plan should reward managers, at least in part, for increasing economic profit, which is the profit earned over and above the full cost of the firm’s invested capital. I call this EVA, standing for economic value added.

EVA is so perfect for incentive pay because it combines all the positive and negative impacts of business decisions into an overall score that ties directly to shareholder value and shareholder returns. Incredible as it may sound, EVA consolidates operational excellence, asset management, capital discipline, profitable growth, restructuring and transformation, innovation and brand equity into a single measure of success or failure.

As you will see, sharing the increase in economic profit aligns managers with owners and hitches pay to the total returns that the company’s shareholders earn over time. Equally important, EVA equips managers with practical tools and insights that enable them to make better decisions—something TSR, EPS and other conventional metrics, including cash flow, simply cannot do.

What’s Wrong with TSR?

TSR is easy to define: It is the sum of dividend yield and price appreciation. It’s a way to keep score, and it definitely hitches pay to performance. But how does that lead to better performance? As good a scorecard as it is, TSR doesn’t tell anyone how to win the game. TSR is silent about the actions or decisions that will cause it to rise or fall. It doesn’t reveal anything about how managers can increase value, even while it pays them for doing so. Should managers aim for sales or concentrate on earnings, or pay attention to margins or to cash flow? What are the priorities? TSR hasn’t a clue.

What’s Wrong with EPS?

EPS isn’t a solution, either. When boards tie incentives to it, they end up encouraging managers to squander capital and debase the quality of earnings. It’s a recipe for a lower stock price, not a higher one. Granted, there is a superficial case for EPS. Companies that are churning out rapid EPS growth do tend to trade for higher earnings multiples than others. But does that correlation imply causation? Absolutely not. Height and weight are correlated, too, but eating more will not make a person grow taller. By the same token, speedier EPS growth is not a reliable sign that a corporation has performed well and is worth more.

The reason is that EPS ignores the cost of equity capital. There’s no charge for using retained earnings, which are assumed to be free money. But shareholders of course expect returns on their entire investment. That’s what the hub-bub over TSR is about in the first place. When companies reinvest retained earnings back into a business, EPS will increase as long as any positive accounting
return is earned. But unless that return exceeds the full cost of capital, which includes the “cost” of providing shareholders with a minimum shareholder return, it won’t impress investors or fool the market.

How prevalent is this? According to our research, about half of the public companies are generating EPS growth without providing anything more than a commodity return on new investments, or worse. They’re stoking EPS growth by burning capital on insufficiently lucrative investments or buying in shares. It’s a common problem, and it’s a prime reason why activists have so much game to hunt.1

To make matters worse, EPS is pock marked with accounting distortions that are at odds with business logic. One example is the mandated expensing of R&D and another is the immediate write-off of brand-building outlays. Both perversely motivate managers to cut spending or refrain from increasing it to make earnings commitments. The accounting tempts managers to take the low road to make a high bonus.2

EPS can also be manipulated by borrowing to buy back stock. If the change in leverage is temporary, as in most cases it is, and there’s no fundamental change in the company’s overall cost of capital, the shares will just end up trading for a lower multiple of earnings and not a higher price.3 If the CEOs pay is tied to EPS, the CEO can win even when shareholders don’t.

A classic example comes from Caterpillar. In 2014, Cat spent $4.2 billion repurchasing shares so that, even as net income slipped 2.5%, EPS increased from $5.75 to $5.88 a share, triggering an increase in incentive pay for the CEO. ISS noted that the CEO’s compensation “increased during a period of lagging returns.” CtW, a governance watchdog that serves union pension plans, joined ISS and Glass Lewis in recommending a say-on-pay no vote, observing:

“It is well known that by shrinking the denominator, share repurchases are among the tools of financial engineering available to executives to meet EPS targets...We are troubled, not only by the return to an EPS focus – and the jettisoning of ROA – but also by the decision to base a majority of the award on EPS. The change gives outsized influence to EPS which investors increasingly view as a problematic compensation performance measure given its susceptibility to large-scale buybacks and earnings management.”

Around a third of the shareholder votes cast at the annual meeting rejected Cat’s executive compensation policies. The Wall Street Journal called it “an unusually stinging rebuke for such a poll.”

There is also a practical problem with EPS. There is no way to calculate it (or TSR for that matter) for lines of business or individual business decisions. This puts a wedge between a CEO who is paid for EPS and the division presidents and field teams who are paid on something else. What companies really need is a common focus.

**What's Wrong with Strategic Goals or Multiple Measures?**

Paying managers to hit strategic goals puts the cart before the horse. Where is the guarantee that a chosen strategy will deliver more value? Besides, strategy milestones can be squishy and hard to pin down, and in today’s world that opens the door to criticism that the goals are being manipulated to deliver more pay. Paying for strategic outcomes also can handcuff managers into pursuing plans that

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1 EBITDA, incidentally, is even more absent-minded. There’s no charge for capital at all, not even to cover the depreciation of assets that must be replaced to stay in business.

2 For more insights into EPS flaws, see It’s Time to Abandon Earnings-Per-Share, by Bennett Stewart, at www.evaDimensions.com/Publications

3 For more insights into how stock prices react to stock buybacks, see Financial Strategies That Create Value, by Bennett Stewart, at www.evaDimensions.com/Publications
have become obsolete. They’ll continue to run the ball into the line even if they’re behind late in a game. It reduces agility, which is so vital in today’s dynamic economy. It’s far better to pay managers for delivering value, and then to let them figure out the best ways to do that and adjust as circumstances dictate.

Most companies punt, and pay for several selections from a grab bag of metrics that includes all the common performance measures. Growth, margins, returns, cash flow, working capital days, and the like, can all weigh in. That’s like paying a basketball team for a combination of blocked shots, rebounds, shooting percentage, assists, steals, 3 pointers, and so on. It’s complex, impractical, difficult to administer, hard to target and off the mark. It also spreads pay weights so thin that the attempt to make many things important ends up ensuring that nothing really is. It’s also never as simple or effective as just paying the team to win the game, which is something EVA does so well.

**EVA is the Right way to Keep Score**

EVA measures a firm’s true economic profit. It is profit computed according to economic principles and for the purpose of managing a business and maximizing value, and not by following accounting rules. While there are other adjustments to it, at root EVA is just a simple three-line calculation that anyone can understand. It is sales, less operating costs, less a full cost-of-capital interest charge on the net assets used in the business.

Unlike EPS (which only deducts a charge for the interest incurred on borrowed funds), or more so, EBITDA (which fails to set aside any charge for capital at all, not even to cover the depreciation of assets that must be replaced), EVA shows a profit only after all investors, shareholders included, have received a minimum acceptable rate of return on their investments in the business. EVA is a more conservative and far more demanding measure of profit performance, one that protects the owners—and a board of directors—like no other measure.

Simple as it is, EVA—or more specifically, a goal to increase EVA—gives managers all the right incentives and no bad ones. It tells managers to intelligently cut costs, to turn assets faster and develop leaner business models in order to reduce the capital charge, and to invest capital carefully, and only with the conviction that new investments will cost the cost of the capital. Like ROI, EVA is a disciplinarian. It pressures managers to keep the screws tight on costs and capital.

But unlike ROI, EVA is pro-profitable growth. It loudly applauds managers who keep investing, scaling, growing, and innovating, so long as the returns on the capital remain over the cost of the capital. Managers that concentrate on ROI behave differently. They perform like basketball players judged by shooting percentage. They make a sure layup and refuse to shoot any more. They systematically underscale, under-invest, under-grow, and under-innovate and leave valuable growth on the table. As Harvard Professor Clay Christensen has observed, some of the biggest mistakes in business history have come from companies and managers that were preoccupied with maintaining high returns and high profit margins. They stagnate, and open the door for less fastidious upstarts.

With EVA, the incentive is very different. Managers want to keep taking shots and pumping capital into the business so long as the next shot they take is better than passing the capital back to investors. EVA motivates innovation and growth and looking ahead to creating future value, not getting hung up on maintaining legacies.

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4 For a more detailed discussion of EVA as a measure and its tie to value, see Introducing EVA and EVA Dimensions, by Bennett Stewart, www.evaDimensions.com/Publications

5 For more on ROI errors, read What’s Wrong with RONA, and What’s Better, by Bennett Stewart, at www.evaDimensions.com/Publications
In sum, if you pay managers to increase EVA, you motivate them to pursue all the ways that performance can be improved and wealth can be created in any business. All the ingredients are there, correctly weighted, and nothing is missing from the EVA recipe. No other measure or combination of measures can do that so simply, completely, or accurately.

EVA also sidesteps many of the accounting distortions mentioned above. R&D and ad spending are typically written off over a 3-to-5 year interval, with cost-of-capital interest applied to the unamortized balance. Managers no longer manipulate the spending to make near-terms goals. They manage it strategically. They are far more inclined to seize opportunities and develop brands and technology when they are given time to make the investments pay off.

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 board that takes the time to measure EVA with more accurate rules is doing its management team a big favor. They are providing clarity around how decisions will be judged and motivating managers to think more strategically and rationally about business opportunities. They also are saving time as EVA assumes the role of the performance monitor. 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 board wishes to follow. We certify the computations for the company and its peer set as an important assurance to the board.

**EVA Measures Value**

Besides making good business sense, what really cinches EVA as the very best compensation metric is its direct link to value. As a purely mathematical matter, the present value of a forecast for EVA is exactly the same as the net present value (NPV) of the forecast cash flows. 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. The reason is simple: EVA sets aside the profit that must be earned in each period to recover the value of the capital that has been or will be invested, which means EVA always discounts to the value added to, or subtracted from, the capital put into the business. This connection is profoundly important and easy to follow.

For instance, if the EVA of a capital project or a whole firm is forecast to be zero, NPV will be zero, too. Investors will be unwilling to pay a premium over book capital for investments or companies that cannot return more than the cost of capital, or what the investors could otherwise expect to earn on their own. The opposite is also true. The only way an investment or business plan produces a positive NPV and adds to owner wealth and increases a firm’s TSR 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. What this means is that if a company or business unit or business plan is showing an increase in EVA year over year or on a trend line 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.

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6 Firms producing zero EVA can sell for NPV premiums if they are viewed as takeover targets or candidates for activist intervention
The connection between EVA and NPV is easiest to see with a sister measure called MVA, or market value added. MVA is the spread between a firm’s overall market value, given its share price, and its invested capital. It’s the difference between the total cash put into a business and the value from it. MVA measures a company’s franchise value, its owners’ wealth, and the firm’s aggregate NPV. It is literally a summing up in the market’s mind of the net present value of all existing and forecast capital projects. 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.

Honeywell’s MVA—its market to book wealth spread—is plotted as the gray bar in the chart at right for the 15 year period ending in 2014. As the 1990s drew to a close, and amidst the dot-com bubble, Honeywell’s owner wealth swelled to some $35 billion, from which point it took death defying tumble, reaching a low of under $5 billion at the end of 2002. That’s when David Cotes rode in on a white horse from GE to take charge. Since then, he and his team did a masterful job of creating owner wealth (putting aside a blip due to the 08-09 market meltdown). As of the end of 2014, owner wealth stood at near $50 billion. No surprise, then, that Cotes was named chief executive of the year by Chief Executive, in 2013, given this track record.

The key question is, 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 consolidated company will earn. And 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 EVA is portrayed in the chart as the blue line on the right-hand scale. Over time, and as expected, the movements in Honeywell’s MVA—the creation or destruction of owner wealth—closely tracked the firm’s EVA profits.

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7 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).

8 EVA Dimensions furnishes the blue ribbon panel that selects the CEO of the year for Chief Executive with vital EVA and MVA statistics on the companies managed by the candidate CEOs.

9 Fortune, cover article, September 22, 1993

10 Charts plotting EVA and MVA for all public companies in our data base can be viewed at no charge at www.evadimensions.com/EVA vs MVA
Honeywell is not an aberration. By studying the Russell 3000 universe of U.S. public companies from 1986-2014, 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 any other performance measure. The correlation was nearly 60%. The second closest—change in return on capital—was only about 44% correlated, and net income growth (a proxy for EPS growth), 32%. Free cash flow generation was even lower still, only 20%.11

The import of this can hardly be overstated. It implies that every company’s most important goal should be to increase its EVA profit as much as possible and let the other financial measures fall where they may. It also means that managers can use EVA to select the best decisions with a great deal of confidence. They can forecast various alternatives and pick the one that they think will produce the greatest stream of EVA profits over time. The decision that produces more EVA, even if it brings slower growth, lower margins, or less cash flow, always is the correct one. And if a decision produces more sales, market share, earnings per share, or cash flow, but less EVA, then it’s the wrong one.

EVA brings another important advantage. It can be measured directly from conventional financial reports. Managers are able to see how decisions flow through the financial records and into EVA. There is a trace trail to follow, which helps them discover ways to improve EVA. EVA also can be measured by line of business (and even for individual business decisions). Division managers can be paid not only for corporate EVA, but for adding EVA in the operations they manage. The line of sight from performance to pay is much more direct than with corporate measures like EPS and TSR. One measure, one incentive plan, applies from top to bottom and all around the firm to instill a common language and a behavior-like-an-owner culture.

A Model EVA Bonus Plan

No firm to my knowledge has used EVA more effectively and over a longer period than Ball Corporation (NYSE:BLL), a $9 billion in revenues maker of metal containers that also has an aerospace arm. Ball’s bonus plan is based solely on EVA, extends to almost all employees, and is essentially unchanged since I first designed it—in 1991. That the plan has endured so long has to be a record on its own, considering that most companies become disenchanted with their pay programs and typically revise them every couple of years.

The Ball bonus is computed as a base bonus (to bring total pay up to a competitive market standard) plus a percent of the spread between each year’s EVA and a target for EVA. In Ball’s case the target is

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11 A warning -- the correlations in the table do not add. The combination of the change in return on capital and EBITDA growth won’t produce a 79% correlation, for example, because those two are also correlated. Put another way, the overall correlation can never be more than 100%, because the R-squared in a regression can never exceed 100%; yet the sum of the correlations in the table is way more than that. The truth is, the correlation the other measures have with the change in MVA is only because of their correlation to the change in EVA.
simply the weighted average of the EVA profits earned in prior years.\textsuperscript{12} The plan plainly motivates managers to pay attention to EVA and to use it to make decisions because it rewards them for increasing EVA. It’s incredibly simple, and it’s been incredibly effective.

Ball’s EVA (the blue line on the chart below) was near breakeven in 2000 but rose impressively to reach $227 million for the four quarters ending in Q1 of 2015. On the one hand, that’s not surprising. You do tend to get what you pay for, and Ball paid the team to increase EVA.

In reality, it’s stunning. Making metal cans is a fairly mature, capital intensive and highly competitive business. There’s no reason why Ball should produce economic profits of that magnitude.

Former CEO, David Hoover, who worked with me to install EVA in 1991, recounts the time he attended Harvard’s Advanced Management Program in the late 1980s. Renowned strategy guru Michael Porter made a cameo appearance in which he used the metal can business as a classic example of an industry that had no chance of overcoming structural flaws and creating value. David said he almost decided not to return to Ball. But he did, and the rest is history.

So how did Ball manage to win? As you win a sail boat race. At every tack and turn, a little more EVA was added. A million insights, large and small, from the shop floor on up, ignited the value. Ball also invested capital carefully and after structuring plant expansion proposals to maximize the potential for earning EVA. Management also executed a series of astute acquisitions with price discipline, and used EVA as a common language to integrate the acquired companies and indoctrinate employees in the Ball way. They also took EVA on the road, using it to propel—and support—global growth.

Ball’s current CEO, John Hayes, recalls being put in charge of Europe soon after it was acquired and insisting those operations be put on the EVA program, even covering unionized employees in France. When I challenged him about that, he said, “no, everyone quickly came on board; that is the fun thing.

\textsuperscript{12} Other formulas are used to reset EVA targets depending on the business and preferences of the board. Some incorporate an expected EVA improvement factor that management must exceed to qualify for a target bonus award—but this must be used with caution. Others include an adjustment for the economy or sector conditions or the performance of peers in order to factor out cycles that management cannot control. Setting the formula requires careful consideration and simulation of the consequences.
about EVA, that once people get it—and that takes a little training — and they get paid for it, they become hunters for EVA. It becomes a very worthwhile game for everyone to play.”

And so it has been, because as Ball’s EVA went up, the Ball team earned premium bonuses—not in every year, but on average and over time the plan paid richly. In a recent interview, David Hoover recalled with pride a thank-you note from a newly-retired rank and file employee who had accumulated a small fortune—over $1 million—in incentive awards over his tenure with Ball.

Ball’s shareowners were also very well compensated. As EVA went up, Ball’s MVA ascended from essentially a breakeven valuation in early 2000 to $7.5 billion in owner wealth as of mid-2015. In more familiar terms, the appreciation in Ball’s MVA handed shareholders a top tier return—as it must. I have shown in a separate article that if TSR is defined as dividend yield and price appreciation, then TSR is just a leveraged version of the return that comes from earning EVA and increasing EVA to increase the corporate aggregate NPV\textsuperscript{13}. It’s a mathematical derivation, and true by definition.

In an economic sense, bonuses paid under an EVA incentive plan are not expenses. They are not charges to be controlled and contained. EVA bonuses are a share of added value, always self-funding, and a proxy for added owner wealth. The bigger the EVA bonus, the better, all around. The goal is to pay \textit{as large an EVA bonus as is possible}. I tell my clients, my mission is to make the managers and employees rich—so long as they make the shareholders filthy rich! Put more soberly, a board that pays managers to increase EVA over time, even if it pays them a lot, can never be criticized.

\textbf{The Magic in the Formula}

Let’s consider how the Ball plan works in more detail. Recall that the EVA target to earn a base bonus award is set by a weighted average formula of trailing EVA. I call it a magic formula because, although simple, its impact is profound and the benefits far-reaching.

Suppose a company’s trailing average EVA coming into a year is $10 and it winds up earning $15. That’s good news. Premium bonuses are awarded because EVA handily exceeds the target. The bad news? The EVA bar is automatically set higher in the next year as the $15 EVA blends into the weighted average formula. Managers quickly realize that the only way they can continue to earn premium bonuses is to continue to increase EVA.

Now suppose EVA drops to $5 when the trailing average is $10. Bonuses are greatly reduced if not erased. There is a penalty, as there should be, for the EVA shortfall. But what happens the next year? The $5 EVA blends into the average, pulling the EVA target down. The team can look forward to earning a bigger bonus the next year even if they only able to hold EVA at $5, and they can do even better if they are able bring EVA closer to its former luster. Knowing that the plan works like this, managers are willing to take the hit when EVA tumbles and work hard to get it back on track.

Suppose EVA profits are \textit{permanently} impaired, stuck at $5 due to a new competitor or a substitute offering coming into the business. Within a few years the averaging formula resets the EVA target all the way down to $5, and eventually bonuses are fully restored to a competitive level. Until then, though, they are under water and less than expected. That’s tough, but consider three things.

One, alignment is important. Pay does need to tie to performance. The team needs to suffer the pain of the owners. And with this plan they do.

\textsuperscript{13} For the derivation of the link between EVA and TSR, and study results confirming it for the S&P500, 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
Two, realizing that no amount of pleading or negotiation can make a difference, that their variable pay is strictly formula based, managers have every incentive to anticipate and mitigate risk rather than just ignore it. \(^{14}\) Directors who want managers to take risk management seriously should seriously ask whether their incentive plans are doing the job. Most aren’t, but the EVA plan does. It plainly motivates managers to think about risk, manage risk, and react to risk, because they are exposed to risk.

Three, as noted, the EVA target eventually does reset to $5, to what the business is apparently able to earn, and employees go back to collecting target bonuses. It’s like a boat with a deep keel that keeps righting no matter the direction the wind blows. It’s a major reason why Ball has been able to keep the same incentive plan in place for nearly 25 years and counting. And it’s the mechanism that assures directors they will not lose good people in bad times.

There’s another big advantage to using a formula to reset the performance targets. Managers can simulate incentive pay for years ahead. They can plot out a long-range plan to produce a quantum leap in EVA and compute in advance how much they’ll be paid if they succeed. With that assurance, they become far more willing to think strategically and invest in the future and execute long-term plans that create value. \(^{15}\)

Ball’s management has done exactly that. In 2010 the management team charted out a 10-year set of strategic initiatives intended to double the firm’s EVA by 2020. It’s called Drive for 10, and it is laid out in detail in the annual reports along with the commitment to increase EVA. I believe they will do it. But one thing is for sure. Nearly everyone in the company is trying as hard as they can to make managers to think and act like owners, by paying them like owners. Moreover, as is described, the plan will resist tinkering with the formula and making judgmental awards. That undermines the plan credibility and is antithetical to the plan goal – to make managers to think and act like owners, by paying them like owners. Moreover, as is described, the plan will eventually adjust and restore competitive pay without any need for intervention.

The implications should be obvious. With the EVA bonus plan I’ve described, managers don’t sandbag business plans or waste time negotiating goals. They work as a team to anticipate the future and shape it rather than respond to it or make excuses about it. In short, they’re motivated to think and act like owners because they are paid like owners—with a set share of the added value, and for better or worse. They also cut to the chase and communicate more effectively.

Here’s how Ball CEO John Hayes describes it: “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.”

EVA is the only measure that makes “behave-like-an-owner” incentive plans possible, because it is the only continuous improvement metric. It’s the only one where more of it always is better than less, because more EVA translates into more NPV and into a higher MVA, share price and TSR. It’s also the only measure that plainly stimulates managers to pursue all the right decisions and none that are bad. As John Hayes, puts it, “The best governance tool you can have is performance, and the best performance tool you can have is EVA.” \(^{16}\)

Here ends the white paper. But two more sections follow. The first exposes the flaws and unintended consequences from using budget or business plans to set compensation goals. The conclusion is:

\(^{14}\) There are rare occasions when the formula should be overridden, such as when the patent on a major product is expiring. In general, though, boards should mightily resist tinkering with the formula and making judgmental awards. That undermines the plan credibility and is antithetical to the plan goal – to make managers to think and act like owners, by paying them like owners. Moreover, as is described, the plan will eventually adjust and restore competitive pay without any need for intervention.

\(^{15}\) An annual EVA bonus plan actually functions as a long and short term incentive in one plan, in fact, it’s a longer term incentive in any so-called long-term incentive plan. It’s an evergreen incentive, an on-going share in the stream of EVA profits that are EVA produced over time, for as long as an employee stays with the company in fact. That’s a significant competitive advantage.

\(^{16}\) For more insights into how Ball uses EVA and benefits from it, watch an interview with CEO John Hayes at https://www.youtube.com/watch?v=OlGie0FKoMw&feature=youtu.be
“Hitching bonuses to budget targets is a time consuming, error prone, enervating exercise in value destruction.” The second is a catalogue of mini case studies documenting a number of the benefits that I’ve seen EVA bring to our clients over the years—how EVA led to changes in decisions and in strategies that created shareholder value that otherwise would not exist. I invite you to read them both, and to contact us if you have any questions or an interest in learning more about how to use EVA and make it come alive at your company.

The Conventional Wisdom is Dead Wrong

I’ve noted how EVA targets are set by an automatic-adjusting formula (of which there are a few variations), and I have illustrated the magic in this method. Most companies take a different route—they pay managers to achieve budget targets or business plan goals. It is typical for bonuses to begin at 80% of the budget figure, for example, and to reach a cap at 120% of budget. At first blush this seems eminently sensible if not the epitome of paying for performance. Why not pay managers to produce the plans that everyone has signed off on? Because it has a number of horrific consequences:

✓ It pits line teams who want easier goals against corporate executives (and board members) who push for more demanding ones. It inevitably leads to adversarial negotiations that corrupt the planning process. Line managers sandbag. They pad capital requests and play down the real potential for improvements in their businesses. A considerable number of promising opportunities are never surfaced, and never achieved. Facts go out, and political posturing and lobbying come in.

✓ It leads to fruitless debates over what is or is not “controllable,” with managers arguing pay should be adjusted after the fact to exclude the impact of “unforeseeable” risks and cyclical downturns (but never upturns or favorable developments, it’s always a one-sided argument). As the pleas often fall on sympathetic ears, managers are conditioned to learn that all is forgiven; their motivation to engage in pro-active and pre-emptive risk management diminishes significantly. If they aren’t really exposed to risk, they can’t be expected to manage it.

✓ Managers are unable to forecast their incentive pay beyond the budget year because they cannot predict how budget or plan goals will be revised after that. A short term incentive plan remains just that—an incentive to manage for the short term. There are unmotivated to plant seeds and see them grow to fruition. There’s no actual accountability or incentive opportunity for making significant progress in adding value over a multi-year horizon. It’s easy for pay to become strategically decoupled from performance even as it is seemingly linked to it in any one period.

✓ Ironically, and perversely, paying for budget goals institutionalizes failure. So long as bloated costs and exorbitant capital spending programs are built into the managers’ budgets, there’s not a big incentive to rock the boat and cut them aggressively. That would only raise questions about their integrity when they negotiated their budget goals in the first place.

Hitching bonuses to budget targets is a time consuming, error prone, enervating exercise in value destruction. It is universally reviled, the bane of corporate existence, and the door opener for the activist investor. It must go, and there’s only one way to do it. Pay managers to increase EVA relative to an automatic adjusting target. It won’t always deliver pay that seems fair and earned in any one year. But over time, it’s the fairest system, and the best way to spawn a true ownership culture.
Examples of EVA Wins

The prospect of being paid like an owner can be daunting at first. There’s a degree of responsibility, autonomy, transparency and accountability that is uncommon and more than a little uncomfortable. It does require, too, leadership courage to stick with it through lean years and make it stick. Over the long haul, though, there is no more exhilarating or rewarding compensation strategy. Being an owner—not just monetarily, but emotionally, and viscerally, with a deep personal attachment to the success and failure of the enterprise—is an amazing sensation that brings out the very best effort in each individual and the very best performance in an organization as a whole. Creating that behave-like-an-owner culture is what the EVA bonus plan is designed to do, and does so well. The companies that have fully embraced it, like Ball, can’t imagine running a business any other way.

It also works. I’ve seen it up close with many of my clients. I’ve heard the war stories from CEOs and CFOS and divisions presidents, even everyday employees. I’ve taken many a mental note. Here then, is a short and woefully incomplete list that will at least give you a feel for the many ways that EVA leads to better and more valuable decisions:

**Superior Operational Tradeoffs**

- Plant workers were motivated to eliminate excessive spare part inventories in order to reduce the company’s capital charge
- More time and money was spent on maintaining equipment, an operating expense, in order to increase uptime and reduce capital tied up in idle equipment, netting an EVA win
- Disposable cardboard boxes were substituted for long-lasting steel containers; the firm’s profit and margin fell, its unit production costs rose, but its EVA increased as the steel containers were liquidated and its capital charge was reduced

**Business Model Optimization**

- Computers were outsourced to the cloud and the company’s IT investments were reduced; EVA increased even though operating costs increased and operating margin decreased
- Lean manufacturing and continuous improvement were supported by EVA; one example—the firm incurred somewhat greater raw material and transportation costs in exchange for more frequent and timely deliveries of smaller batches, which trimmed inventories, sped cycle times, increased responsiveness, and added to customer satisfaction, while also reducing risk

**Contracting and Pricing**

- Raw material purchase terms were negotiated to defer payments and defray capital
- Pricing models were revised so that the sales staff could easily alter quotes on the spot to maintain EVA neutrality across a variety of negotiable features and terms

**Optimizing Scale and Growth versus ROI**

- Product lines that contributed to EBITDA and that in some cases boosted the firm’s profit margin were discontinued because they diluted EVA once capital costs were factored in
- In a return-challenged business, managers had been so focused on tightening the cost and capital screws that they’d overlooked opportunities; with the goal to increase EVA, they also successfully pursued opportunities to address profitable niche markets
- New products and service line bearing profit margins considerably lower than customary were added because they were materially EVA positive
- For a retailer, warehouses and stores were upsized and the pace of store openings was accelerated in order to maximize the present value of EVA instead of IRR and ROI
Improving the Yield from R&D and Marketing Investments

- R&D spending was hiked 40% to accelerate development of five promising new products; analysts projected the firm’s EPS would drop from $1.60 to $1.40 in the year ahead, but the firm’s stock price nevertheless increased 5% as the decision was announced.
- A product launch campaign was re-conceived and the investment in it reduced, a result of changing the cost from a budgeted expense into a capital charge to EVA, amortized over time with interest; the new product was EVA positive in its third month, a first for the company.

Buying, Selling, Restructuring

- An EPS-accretive acquisition was rejected because it would not generate an attractive EVA, and an EPS-dilutive one was consummated because it would\textsuperscript{17}
- EVA was employed as a common language to integrate the management teams and employees of acquired companies into the firm’s well-established “behave-like-an-owner-culture”
- Lagging assets and sub-par business units were sold at book losses but EVA gains, and profitable ones were sold for book gains and EVA gains—in all cases because the divested assets were worth more to other companies, and regardless of the accounting treatment
- A restructuring campaign that buoyed EVA amid a sea of accounting red ink was accelerated, and incremental out-of-pocket spending on it was curtailed

Improving Capital Allocation

- Managers throughout the company found ways to trim cap ex spending requests because they no longer were just factored into budget goals—they were charged for it
- The firm’s capital approval process became considerably more streamlined and fact based as managers began to limit requests to projects they were convinced would add to EVA
- As soon as top management had fully committed to EVA, the firm’s planning process became much more abbreviated, value-focused, strategic, and attuned to managing risks

Reducing the Cost of Capital

- With our counsel, a CFO decided to raise the firm’s debt target from 5% to 35% of capital (which added to EVA by reducing the firm’s overall cost of capital by several percentage points)
  The strategy was supported by a decision we also recommended to slow down dividend growth and apply the cash saved to service additional debt
  To implement the strategy, 20% of the firm’s stock was purchased in a Dutch Auction self-tender; in effect, dividends that would have been paid over time were transformed into an up-front stock buyback.
  Additional shares were purchased over the next six years in order to maintain the 30% target debt ratio
  When the changes were announced and carefully explained to investors, the firm’s share price increased 25% even though its bonds were downgraded a notch by credit rating agencies\textsuperscript{18}

\textsuperscript{17} For a more thorough discussion, read Pricing Acquisitions, by Bennett Stewart, at www.evaDimensions.com/Publications
\textsuperscript{18} For a more thorough discussion, read Financial Strategies that Create Value, by Bennett Stewart, at www.evaDimensions.com/Publications