

# HOW'S YOUR COMPANY *REALLY* DOING?

*A proponent of Economic Value Added says a new formula enables directors to measure their company's true performance—an essential first step if they also want to find out whether their CEO is earning his keep.*

Way back in 2008, before bonuses became politically synonymous with pelf and plunder, the logic behind big rewards for big profit gains seemed unassailable. Yet while the concept of pay for performance used to be widely accepted, putting it into practice has never been easy.

The linchpin of any incentive plan is its most basic element: the performance measure used to meter rewards. The measure has to tell directors exactly how the company is doing, both in absolute terms and relative to competitors and peers. And it has to tie directly to the stock price, since the whole point of incentive pay is to foster behavior that increases the corporation's value. Most comp committees believe they've answered the metric question correctly, but nearly all of them get it wrong. The conventional performance measures they rely on simply don't work. Those measures produce misleading and conflicting readings that can lead to crazy, unwarranted rewards and often promote behavior that actually destroys shareholder wealth.

A new measure called EVA Momentum captures all the income-statement and balance-sheet variables that affect value and can be used to rank corporations on the basis of profitability performance. The three companies that performed best by this measure over the last five years—far better than any others—are Gilead Sciences, Google, and Apple (see page 47 for a list of winners and losers).

EVA Momentum is calculated by dividing the change in a company's economic profit, or economic value added (EVA), by its sales in the trailing period. It is the creation of Bennett Stewart, chairman of EVA Dimensions LLC in Locust Valley, New York, and the principal inventor of the EVA framework back in the 1980s, when he was a partner at Stern Stewart & Co., a financial consulting firm. Before turning to the new measure, let's take a brief look at why conventional performance metrics fail.

Most incentive plans base rewards on goals that the board sets for earnings per share, return on

equity, and return on capital, either singly or in combination. A central problem with all those measures is that they are ratios, and every conventional ratio is fatally flawed. As Michael C. Jensen, an emeritus professor at Harvard Business School, puts it, "If it's a ratio and if it is used as a performance measure, it's wrong and you're paying people to do bad things."

Conventional ratios fail because they all give readings that are sometimes the opposite of what's really going on, indicating improvement when performance is actually deteriorating and vice versa. Consider return on capital, or ROC. A company that is losing money or barely breaking even can boost its ROC by making *any* investment with a positive return—even when the return is below the company's cost of capital and leaves shareholders worse off than they were without it. At the other end of the spectrum, focusing on ROC will cause managers in high-return outfits to reject genuinely attractive projects and grow the businesses more slowly than they should in order to prevent ROC from falling.

Earnings per share and return on equity can be equally misleading. Both measures "improve" whenever a profitable company repurchases shares. If a company buys back enough stock, EPS and ROE can rise, even as earnings decline. More subtle but equally important, the way management chooses to finance investments can powerfully affect ratios. Consider a company that finances a new investment entirely with debt. Its earnings per share and return on equity both rise so long as the project earns more than the after-tax cost of the new debt, even if returns fall short of the average cost of capital. Contrarily, if management finances an investment entirely with equity, the impact on ROE depends not on true profitability but solely on the investment's rate of return relative to the rate of return on existing equity—the same dynamic that bedevils ROC calculations.

Avoiding ratios and using earnings alone isn't a solution. That is because generally accepted

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by Al Ehrbar

APPLE CEO STEVE JOBS DELIVERS A BIG BANG FOR HIS BUCK.

accounting principles (GAAP) are riddled with errors that run counter to the economic reality driving business value. The most obvious example—but there are plenty more—is the expensing of research-and-development outlays. R&D is an investment designed to produce future profits, but GAAP treats

economic profit and performance improved; any negative reading means they declined.

The second leap forward that EVA Momentum takes is converting the change in EVA into a ratio by dividing it by sales in the prior period. Yes, a ratio. EVA Momentum is the only performance ratio for

which a higher level is always better than a lower one. It avoids the flaw that brings down other ratios, and passes what might be called the Jensen test, by making trailing sales the denominator. Because the denominator is “frozen” and does not change, a higher (or lower) reading

comes about only when EVA rises (or falls) by a greater amount. Other ratios fail the Jensen test precisely because their denominators (capital, equity, the number of shares) are not frozen and change when new capital is invested, when equity increases or declines with share issuance or repurchases, or when the number of shares changes.

Scaling changes in EVA as a percentage of trailing sales is what makes it possible to compare profit performance among companies of varying size. As anyone who has tried knows, the percentage change in profit itself cannot work as a basis for comparison. Among other problems, there is no sensible way to deal with companies that are losing money. But scaling absolute dollar changes as a percentage of trailing sales does allow valid comparisons between winners and losers and between companies of vastly different size. Meanwhile, the automatic risk adjustment in the capital charge is what enables comparisons across industries as well, and comparisons among disparate operating units within a company.

EVA Momentum isn't just accurate; it is also incredibly revealing. It completely and correctly consolidates all the contributions of operating efficiency, balance-sheet management, strategy execution, and profitable growth or retrenchment into one overall score. And while it combines all the variables that matter into a single measure, it can be dissected to identify specific areas that need improvement. Additionally, because it converts all pluses and minuses to a percentage of sales, it facilitates judgments about trade-offs between the income statement and the balance sheet and enables managers to prioritize projects by quantifying their impact on business value.

One can get a better perspective on the sources of profit performance by breaking down EVA Momentum into two basic components. The first is the change in a company's EVA profit margin, which

**AS PETER DRUCKER AND MANY OTHERS HAVE NOTED, PROFITS DO NOT REALLY BEGIN UNTIL MANAGEMENT PROVIDES A MINIMUM ACCEPTABLE RETURN ON EQUITY CAPITAL.**

all R&D as a wasteful expense that immediately reduces earnings and assets on the balance sheet. The most serious error in GAAP, however, is that it totally ignores the cost of equity capital. It deducts the interest cost for debt but assumes that equity is free. As management expert Peter Drucker and many others have noted, profits do not really begin until management provides a minimum acceptable return on equity capital. Until it compensates shareholders for this “opportunity cost” of putting their funds at risk, an enterprise is losing money.

Economic profit, or EVA, corrects the significant distortions in GAAP, and it deducts an explicit charge for the opportunity cost of all capital, including equity. The remainder, EVA, is the dollar amount by which properly calculated after-tax profits exceed or fall short of the minimum acceptable return to all providers of capital. The capital charge, which varies with the riskiness of the business and the degree of leverage, provides an automatic risk adjustment to the EVA calculation.

EVA Momentum takes the original EVA two giant steps forward. First, it is based on the change in EVA rather than the level. That puts the focus on what matters most to investors. Stock prices are driven by the profits that investors expect companies to earn in the future, and changes in current profitability are a key driver of those expectations. Equally important, by using the change in economic profit instead of the level, EVA Momentum allows comparisons between profitable and unprofitable companies. Making a negative EVA \$10 million less negative gets the same credit as making a positive EVA \$10 million more positive.

This focus on the change in EVA gives EVA Momentum another important characteristic shared by no other performance measure. It provides a clear, incontrovertible divide between good and bad performance. The dividing line is zero EVA Momentum. Any positive reading means that

is EVA divided by sales. Changes in the EVA margin capture all the productivity gains or decrements that span the income statement and balance sheet, including operating efficiency, capital efficiency, building brands or designing products that give a company pricing power, making investments that return more than the cost of capital, and disposing of assets that earn less than the cost of capital. The second measure is “profitable growth.” This is calculated by multiplying the sales growth rate by the company’s concluding EVA margin.

EVA Dimensions, which sells corporate performance-management software, financial-benchmark data, and investment management and research incorporating its proprietary EVA measure of economic profit, created the first profitability performance ranking by calculating the average EVA Momentum over the last five years for the 763 companies in the Russell 3000 Index that had sales of more than \$1 billion at the beginning of the period. Five-year EVA Momentum is calculated as the change in EVA from 2004 to 2009, divided by the 2004 sales. That figure is then divided by five to arrive at a simple average annual EVA Momentum. EVA Dimensions looked at five-year EVA Momentum to identify firms that improved performance over a sustained period and held up well during the recession.

The winners are a diverse group. The top 50 companies span 25 industries out of a total of 55 industry groups, which gives the lie to the notion that industry is destiny. Some of the companies grew a lot, especially Gilead Sciences, Google, and Apple, while some had flat revenues. Eight had declining revenues, yet four of those provided double-digit rates of total return to shareholders over the five years. Growth, in other words, can be great, but it isn’t essential to providing great returns to shareholders. Most of the top 50 are currently earning EVA profits, but not all. Ten have EVA deficits, but all of them are much smaller than the deficits the companies were running five years earlier. All of the top 50 managed to generate prodigious increases in their EVA profits relative to their initial sales bases.

The bottom of the ranking is much less diverse. Nearly half (23) of the bottom 50 are commercial banks and financial-services firms, a result of the carnage caused by the financial meltdown in 2008. Nine are in the oil and gas business, victims of the sharp drop in oil prices that followed. All of the bottom 10 are either financial-services or oil and gas companies, and all swung from respectable EVA profits in 2004 to substantial EVA losses in 2009.

Gilead Sciences, Google, and Apple stand out even among the winners. All three achieved enormous

## THE 10 COMPANIES THAT DID BEST FOR THEIR SHAREHOLDERS, MEASURED BY THEIR EVA MOMENTUM ...

<b>Company</b> (Business)	<b>EVA Momentum</b>	<b>CEO as of 12/31/09</b> (His total 2009 comp)
<b>Gilead Sciences</b> (Biotechnology)	<b>26.0%</b>	<b>John C. Martin, 58*</b> (\$14,675,231)
<b>Google</b> (Internet software and services)	<b>22.3%</b>	<b>Eric Schmidt, 55*</b> (\$245,322)
<b>Apple</b> (Computers, peripherals)	<b>16.1%</b>	<b>Steve Jobs, 55</b> (\$1)
<b>Biogen Idec Inc.</b> (Biotechnology)	<b>8.9%</b>	<b>James C. Mullen, 51</b> (\$10,440,166)
<b>MasterCard</b> (Credit and debit cards)	<b>7.9%</b>	<b>Robert W. Selander, 59</b> (\$10,331,575)
<b>BMC Software</b> (Software)	<b>6.1%</b>	<b>Robert E. Beauchamp, 50*</b> (\$12,092,843)
<b>Corning Inc.</b> (Electronic equipment)	<b>6.1%</b>	<b>Wendell P. Weeks, 50*</b> (\$12,050,391)
<b>Broadcom Corp.</b> (Semiconductors)	<b>5.7%</b>	<b>Scott A. McGregor, 53</b> (\$10,171,525)
<b>CBS</b> (Media)	<b>5.5%</b>	<b>Leslie Moonves, 60</b> (\$43,238,875)
<b>DirectTV</b> (Media)	<b>4.6%</b>	<b>Larry D. Hunter, 59</b> (\$6,070,610)

## ... AND THE FIVE THAT DID WORST

<b>Bank of New York Mellon Corp.</b> (Capital markets)	<b>-13.4%</b>	<b>Robert P. Kelly, 55*</b> (\$14,046,435)
<b>Newfield Exploration Co.</b> (Oil, gas, and consumables)	<b>-13.6%</b>	<b>Lee K. Boothby, 48*</b> (\$3,917,424)
<b>PMI Group</b> (Thriffs and mortgage finance)	<b>-16.2%</b>	<b>L. Stephen Smith, 60*</b> (\$3,032,733)
<b>MGIC Investment</b> (Thriffs and mortgage finance)	<b>-16.6%</b>	<b>Curt S. Culver, 57*</b> (\$2,279,259)
<b>Chesapeake Energy</b> (Oil, gas, and consumables)	<b>-50.7%</b>	<b>Aubrey K. McClendon, 50*</b> (\$18,551,296)

\*Also the company’s chairman

sales growth while also building or maintaining some of the highest EVA margins in corporate America.

Gilead, a maker of drugs for AIDS, hepatitis, and flu (Tamiflu), had an average EVA Momentum of 26% per annum over the past five years, with Google close behind at 22.3% and Apple at 16.1%. That is the average rate at which their EVA profits expanded per year compared with initial sales. To put this in perspective, the No. 4 company, Biogen Idec, had an average EVA Momentum over the same five years of 8.9%, and Flowserve was No. 25 at 2.5%. The average for the full group of companies was *minus*

expected going into the period and, second, that investors now expect it to produce more profit improvement in the future than they expect from Gilead.

Five years ago Apple's Implied EVA Momentum was just 2.6%, far below the 16.1% it achieved. Steve Jobs had not yet convinced investors of the staying power of the iPod, iTunes, and the iPhone. Second, investors have revised their expectations of future profits slightly upward, giving the stock a second boost. Apple's recent stock price indicates that investors expect it to add to its already high economic profit at a rate of about 3% of its now much higher sales.

In contrast, Gilead's Implied EVA Momentum five years ago was 11.2%, substantially higher than the EVA Momentum it was producing at the time. The company's actual EVA

Momentum greatly exceeded expectations, of course, so its shares have done far better than the market as a whole. But expectations about Gilead's future performance have dropped dramatically. Its Implied EVA Momentum was recently down to 1.9%, indicating that investors clearly expect either diminished growth or pricing pressures, or both, to constrain its future profits.

Thirty of the top 50 companies produced more EVA Momentum than investors expected at the beginning of the five-year period, and their shareholders enjoyed average annual total returns of 19.7%. The other 20 achieved less EVA Momentum than expected, and their total returns averaged just 8.8%. Unsurprisingly, the bottom 50 companies all did worse than expected on EVA Momentum. They had total shareholder returns averaging minus 6.2% a year.

In sum, shareholder returns are substantially influenced by whether a company beats or falls short of investor expectations, and how that performance—and other factors in the economy—cause investors to readjust their expectations up or down. It's a messy equation, but the key fact is that earning and increasing economic profits is the key to creating wealth, generating outsize shareholder returns, and determining how well your CEO and other top management are performing. 🌐

## APPLE'S RECENT STOCK PRICE INDICATES THAT INVESTORS EXPECT IT TO ADD TO ITS ALREADY HIGH ECONOMIC PROFIT AT A RATE OF ABOUT 3% OF ITS NOW MUCH HIGHER SALES.

0.5% per year; the median was minus 0.1%. As those numbers suggest, "normal" levels for EVA Momentum are small percentages. That's what one would expect, since EVA Momentum is the change in economic profit, not the level, divided by trailing sales.

Apple's average EVA Momentum over the five-year span was less than two-thirds of what Gilead generated, because Apple's sales growth was slower and its concluding EVA margin was 10 percentage points lower than Gilead's. Yet Apple's shareholders were more richly rewarded, with a 51% annual total return over the five years, versus 19% for Gilead (and 24% for Google). How can that be? EVA Momentum provides the answer—but like all things in the stock market, it isn't as simple as one would prefer. Stock-market performance depends both on how well a company performs relative to what investors expected at the beginning of a period and on how investor expectations about performance going forward change during the period.

EVA Momentum provides a way to quantify investor expectations. Given a company's current EVA, it is possible to calculate the amount of EVA Momentum a company would have to achieve on average over the next 10 years to produce a present value equal to the current share price. That is, what amount of EVA improvement per year, measured as a percentage of this year's sales, would be necessary over the next 10 years to discount to the present market value? This figure is a company's Implied EVA Momentum. Apple's superior stock-market returns reflect, first, that the company performed better than Gilead relative to what investors