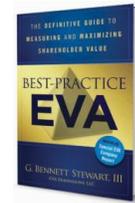


What's Really Wrong with Using RONA, and What's Better?

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



RONA, ROI, ROE, IRR, take your pick. Each is a way to measure the productivity of capital, to relate profit to invested capital, or cash flow to spending, and quantify the rate of return earned after getting the money back. Returns matter. Earning a return over the cost of capital is a prerequisite for adding value and enriching the owners. The higher the return, the more value is being created with the capital. A CFO may also logically assume that a business line earning a higher return may be a better candidate than another for further investment and growth – assuming past results can be replicated. A higher projected return also provides assurance that a given decision or plan is more secure. Key assumptions can slip, yet value can still be added or at least preserved when the expected return is higher going in. And as an analytical tool, RONA can be traced to operating margins and asset turns, in accord with the classic DuPont formula, and used to give line teams a rounded view of operating performance and balance-sheet asset management. For many reasons, return measures like RONA have earned a prominent role in financial management over the years. But I come not to praise RONA. I come to bury it.

RONA and its variants actually are highly misleading and incomplete performance indicators, for reasons I will explain. And the deficiencies are far from academic. As you will see, companies that have aimed to increase RONA or maintain a high one have committed major blunders in strategy and resource allocation. And when RONA is judged from the bird's eye view of how well it performs as an element in a firm's overall financial system, it fails, or at least, it is far inferior to another approach which is based on using economic profit, or EVA as I like to call it (for economic value added), as I shall also elaborate.

RONA fundamentally fails because it is inconsistent with what is – or should be – the main mission of every firm, which is to maximize the wealth of its owners by maximizing the net present value of all existing and projected investments. The goal, in short, is to maximize the difference between the capital that investors have put or left in the business and the present value of the cash flow that can be taken out of it, a difference I call MVA, standing for market value added.

Take an example. A company that trades for a total market value or “enterprise value” of \$1 billion, and where \$600 million of capital has been invested in its net business assets, has created an MVA of \$400 million, the difference. That measures how much wealth the firm has created for the owners by comparing what they have put in with what they can get out. Put another way, it is “franchise value,” the value of the business above just putting the assets in a pile. It is also, mathematically, the market's assessment of the net present value, or NPV, of all investments, those already in place plus those expected to materialize down the road. *Increasing MVA – or maximizing corporate NPV, if you will – is therefore every company's most important financial goal, as any corporate finance text will remind us, for it not only maximizes the owner's wealth but at a macro level it generally leads to an optimal allocation of scarce resources and the greatest possible growth in the standard of living.*

Here's the problem in a nutshell. RONA tells us about the *ratio* of market value-to-invested capital, but that is not the same thing as maximizing the *spread* between market value and invested capital, which is

the real goal. A company that aims to maximize RONA will always tend to hold back and underinvest, under-innovate, under-scale, and under grow. It will leave value and growth on the table, and become vulnerable to a hostile takeover or a toppling by upstart rivals, as I will demonstrate.

The glaring deficiency of RONA first became apparent to me in the early 1980s, when I had the privilege of advising The Coca-Cola Company. The company at the time was fabulously profitable, earning about a 25% return on its capital, but the company was reluctant to put the Coke name on growth products – Cherry Coke, Diet Coke, Caffeine-Free Coke – because those products were reckoned to earn only a 20% return, not 25%, and would dilute the rate of return on the Coke brand. Worse, the company had made a mistake 100 years before. The founders had granted perpetual franchise licenses to bottlers that by 1980 were in economically undersized territories, and in many cases run by lackadaisical third generation owners. Coke needed to buy them up, consolidate contiguous regions, install hungry operators, and revise its pricing formula. But again, the capital to be invested in that vital strategy could not approach the phenomenal return from one of the world's most valuable brands. So Coke was stuck, because management was stuck on maintaining its high RONA.

The solution for Coke, as it is for every other company, was to let go of RONA and instead to define success as growth in economic profit or EVA. EVA replaces RONA's percent ratio with a money measure of total value added. EVA is equal to the percent spread of RONA less the cost of capital, multiplied by the amount of capital invested in the business, which means that EVA is the *dollar* spread of the return versus the cost of capital. Put another way, EVA is the dollar economic profit after deducting all costs, including the cost of capital. The distinction may appear subtle and effete. After all, EVA uses the same data as RONA – to measure profit less the cost of capital instead of profit divided by the capital. I've even had CFO's tell me they are using EVA when they are actually using RONA or return on capital. But in fact, the two are not the same at all, and the difference is quite profound and incredibly far reaching.

Let's go back to Coke. At the time that management was confronted with the decision to expand or punt, Coke's weighted average cost of capital was about 10%, so it was earning a RONA return about 15% above that cost. Coke was thus earning an EVA profit of \$150 for every \$1,000 of invested capital. Suppose to roll out the new products and acquire bottlers, Coke would double its invested capital, while only earning a 20% return on the new money put into the business. Then its RONA would fall half way, from 25% to 22.5%, and its spread over the cost of capital would narrow from 15% to 12.5%. But the spread would be multiplied by twice the amount of capital, by \$2,000, for an EVA of \$250, an *increase* of \$100. This is a classic example of where RONA goes down and yet EVA and share price go up. Coke's managers wisely decided to go for more EVA and let their focus on RONA lapse, which is always the right decision, at least in principle. By setting aside the cost of capital, EVA automatically deducts the profit that must be earned to recover the amount of capital that has been or will be invested, and so, a projection for *EVA always discounts to the exact same net present value you get by discounting the projected cash flow.*

I say this with great conviction and emphasis because we have developed a software tool that automatically calculates NPV by discounting both cash flow and EVA, and it always gives the same valuation answer for a given forecast. Please understand that the equality is not a theory or something you might or might not "believe." It is a mathematical truth, just as $2 + 2 = 4$. And so, everything that validates cash flow or discounted cash flow as a management tool automatically validates EVA as well. Discard EVA, and you might as well discard discounted cash flow, for they come to the same thing. But putting the math aside, which need not trouble us here, consider the implications.

If a company or business line or business project is forecast to just break even on EVA, to just earn the cost of capital, then that business or investment is just worth the book value of its invested capital. There is no franchise value, there is no owner wealth, and there is no NPV if the profit only but covers the cost of capital. But once EVA turns positive, then the greater it is, the faster it grows, and the longer and more surely it endures, the greater is the NPV and MVA. For this reason, *Fortune* magazine dubbed EVA “the Real Key to Creating Wealth” in a cover story article that first introduced EVA to the business world, way back in September 1993.

Recognizing this, Coke decided in the early 1980s to expand its product portfolio and acquire its bottlers – which it might not have been done had RONA remained the measure that mattered. The decision led the company to such a phenomenal improvement in its EVA profit that by 1996 Coke was producing the most MVA wealth of any American firm, as *Fortune* chronicled in a story titled “America’s Best and Worst Wealth Creators” featuring Coke’s legendary CEO, Roberto Goizueta, on its cover.

Other companies were not so lucky, Anheuser-Busch among them. For years the beer behemoth had opportunities to invest, acquire and grow globally, but turned all of them down, leaving the firm ring-fenced and vulnerable to a hostile takeover. On November 18, 2008, the company reluctantly succumbed to the Brazilian-Belgian brewing company InBev. A-B became a target because its CEO, August Busch, refused to dilute the RONA the firm was garnering in its U.S. beer business by entering more competitive overseas markets. As one advisor close to the company explained it:

“When you have a business that was as profitable as his [August Busch III, CEO] was, where the returns were as strong as his were, I’m not sure anyone would be so smart to say, “We’ve got to take over the world,” said one A-B adviser. “We understand now why he should have, but it would have diluted his margins and his returns.”

Dethroning the King
By Julie Macintosh

As a sidebar, InBev, the buyer, grew out of Brahma Beer, the first Brazilian company to adopt EVA. I helped Brahma to adopt EVA in 1996 after I got a call from the CEO, Marcel Telles, who became aware of EVA after First Boston published an analyst report on Brahma using EVA. Marcel was so intrigued he asked the analyst, “Where can I learn more about EVA,” which led to me. We spent about 6 months developing a program to measure EVA throughout the company, and it became a key asset and capability of the firm that helped it to successfully gobble up many other brewers and eventually become the world’s largest and most successful.

Coke and Anheuser-Busch are not isolated examples. You probably know that Steve Jobs and Intel’s Andrew Grove’s favorite business book is *The Innovator’s Dilemma* by Harvard Professor Clayton Christensen. The book chronicles how established industry leaders almost always cede their top spot to upstarts that start small, in the low-margin end of the business, and then over time take over the whole business. It led Andrew Grove to coin the expression, “Only the paranoid survive,” which is perhaps one solution. But Christensen thought there must be another more fundamental reason why this happens over and over, and which would lead to a different remedy than paranoia to cure the Innovator’s Dilemma. It is, unsurprisingly, to give up on a “finance orthodoxy” that worships at the RONA church:

After puzzling over this mystery for a long time, he finally came up with the answer: it was owing to the way the managers had learned to measure success. Success was not measured in numbers of dollars but in ratios. Whether it was return on net assets, or gross margin percentage, or internal rate of return, all these measures had, in the past forty years, been enshrined in a near-religion (he liked to call it the Church of New Finance), by partners in hedge funds and venture-capital firms and finance professionals in business schools. People had come to think that the most important thing was not how much profit you made in absolute terms but what but what percentage profit you made on each dollar you put in.

And that belief drove managers to shed high-volume but low margin products from their balance sheets... this is why he called it a church-- it was an encompassing orthodoxy that made it impossible for believers to see that it might be wrong.

“When Giants Fail – What Business Has Learned From Clayton Christensen”

By Larissa MacFarquhar
The New Yorker, May 14, 2012

RONA is simply not conducive to corporate health. The bottom line is this: EVA is additive, but RONA is not. Add something good to something great and EVA is greater still. Add a low margin business to a strong one, and EVA increases so long as the cost of capital is covered. EVA is a measure to maximize, because more is always better than less, because more EVA is more NPV is more owner wealth. But that’s just not true of RONA. There is literally no way to tell whether a company or division is better off reporting a higher or lower RONA, taken by itself. Of course, you can always bring in other factors like growth and combine them with RONA, but all you are really doing is trying to recreate EVA by imperfect proxy. Why not make it simpler and more accurate and just go for the real thing? Why not focus on a single measure that accurately scores the actual total value added by a business, by a plan, or by a decision, which is exactly what EVA does?

RONA is not only a misleading and incomplete measure at the corporate or line of business level, as I have discussed so far. It also fails to provide reliable insights concerning the configuration of individual projects, particularly when questions of how big, how fast, how many, and how much come into play. Most investments, and most strategies for that matter, are characterized by increasing and then decreasing returns to scale. As more money is plowed in, the return initially grows larger and larger as unavoidable fixed costs are covered and market traction is gained. But at some point diseconomies set in and the returns begin to tail off as investment spending is stepped up even further. This dynamic causes companies that focus on RONA to almost always undersize their investments and leave profitable growth and added value on the table.

As an example of this general phenomenon, consider the decision of how high to build a building. Suppose analysis shows a 10-storey building won’t even cover the cost of capital. Its internal rate of return (IRR), or RONA (assuming for simplicity that the returns are even), is only 5% when the cost of capital is 10%. The building is so small that the rental income cannot even cover the full fixed cost of the land. It’s a negative NPV project, and not worth considering except as a stepping stone.

On the next step up the ladder, a 20-storey building costs \$20 million, let’s say, and it generates an 18% RONA, and an NPV of \$16 million. The return climbs because the additional rental income and higher rental rates that management can charge for the higher floors is gravy to cover fixed costs. This is an example of “increasing returns to scale.”

But now it gets complicated. A 30 storey building costs \$40 million, or twice as much to construct. It's more expensive per floor, and generates a RONA of only 15%. Extra elevator banks must be added, which cuts into rentable space on all floors. The building requires sturdier reinforcement and takes significantly longer to construct, which delays the start of revenues. All these elements conspire to reduce the overall RONA of the proposed 30-storey building to less than the rate of return projected on the 20-story building. This is an example of "diseconomies of scale" creeping in. Nevertheless, the 30-story building does show a higher NPV. The NPV is estimated to be \$20 million, or \$4 million more than for the 20-storey building.

The final candidate is a gleaming 40-storey tower, costing a whopping \$70 million to construct, and generating a RONA of just 10%, and NPV of \$0, as even more diseconomies of scale set in. It is however a magnificent structure and it generates gushers of cash flow and EBITDA— after the investment has been made – neither of which are important in the question of allocating scarce resources. So what's the correct decision – the 20-storey edifice that maximizes RONA, the 30-story one that maximizes NPV, or the 40-story tower that maximizes EBITDA? True, the 20 and 30 storey projects are both acceptable, being that both earn returns more than the cost of capital and generate positive NPV. But the 30-storey project is the *best* project, because it's the one that maximizes NPV. It maximizes the spread between capital put in and the value gotten out. It maximizes corporate MVA, owner wealth, franchise value, and societal well-being by using scarce resources up to the point where incremental value added still exceeds the incremental resource cost.

There are two ways to see this. Compared to the 20-storey project, the 30-storey project costs another \$20 million in investment, but generates an extra \$4 million in net present value on top of that. Simply put, the incremental project to build from 20 to 30 stories is attractive in its own right. Why turn that down just to maximize RONA? And the same reasoning applies to why management should NOT build a 40-storey tower, for that is the same as taking on the 30-storey building, for a positive NPV, and then adding another project to build to the 40th floor, which is a negative NPV use of the added capital. The 30-storey project is also distinguished by its larger EVA. The annual EVA profit of the 20-story building is $(18\% - 10\%) \times \$20$ million, or \$1.6 million. The EVA of the 30-storey building is considerably higher, actually 25% higher – it is $(15\% - 10\%) \times \$40$ million, or \$2 million. True, it's a lower rate of return, but it is earned on more capital. Size matters, too. The right answer is always to choose more EVA, since that always translates into more NPV, which is why it is so important to use EVA not just to judge the performance of whole lines of business but also to use it for judging – and actually helping to improve -- the value of individual projects. And the best way to make sure that happens is to stop using discounted cash flow to measure NPV, and instead to get business managers and finance professionals to start projecting, analyzing and discounting EVA to measure and improve the NPV of plans, projects and acquisitions! By using EVA to make the decisions and set the plans that will maximize NPV, and also to use it to monitor and analyze actual performance after the fact, the finance process is fundamentally simpler and more cohesive – the same measure matters in both directions. It also makes managers more accountable for delivering the value they promised by realizing the EVA they projected. Companies that use cash flow and RONA may think they are doing the right thing, and the simple thing, but that is just not true. EVA is easier, and better, once you get there.

But do not just take my word for it. The pitfalls of IRR and by extension RONA are well recognized in the finance literature. Scholars with no axe to grind join me in recommending that corporate managers stop using IRR and RONA. Consider this excerpt from world's best-selling corporate finance textbook, *Principles of Corporate Finance*, by Stewart C. Myers (MIT Sloan), Richard A. Brealey (London Business School) and Franklin Allen (Wharton):

Many firms use internal rate of return (IRR) in preference to net present value. We think that is a pity....Financial managers never see all the possible projects. Most projects are proposed by operating managers. A company that instructs non-financial managers to look first at project IRR's prompts a search for those projects with the highest IRR's rather than the highest NPVs. It also encourages managers to modify projects so their IRR's are higher. Where do you typically find the highest IRR's? In short lived projects requiring little up-front investment. Such projects may not add much value to the firm.

The bottom line is this: When there are decisions about how many SKUs to carry, how much advertising to do or research to perform, how big to build a warehouse, plant, or building, how many stores to open and how much working capital to stock, whenever questions of scaling and growing must be weighed against margins and returns, or even, how should a product be configured and priced, or a production function fulfilled, then RONA- and IRR-minded managers are always apt to under-scale and under-invest and under-innovate compared to managers that are aiming to maximize EVA and NPV.

I was going over all this recently with Mike Archbold, the President and Chief Operating Officer of the up-and-coming specialty retailer, Vitamin Shoppe, where he was instrumental in establishing a financial focus on EVA. "Bennett," Mike said, "your building example resonates with me, but we call it the "S" curve. We see it all the time. Declining returns, followed by ramping returns, followed by cresting returns. When I was CFO at Autozone, we got EVA so embedded as a financial discipline that even the marketing department got quite sophisticated at projecting the "S" curve on marketing campaigns and we'd always look for the point to maximize the EVA profit.

"And here at Vitamin Shoppe, we've used an outside vendor to help us with automatic inventory restocking, which is actually a complicated problem, or at least we think so, because we look for the solution that maximizes our EVA, taking account all the tradeoffs. You've got to balance lead times, order size, inventory investment, warehouse and shipping costs, and the risk you are stocked-out and lose a sale and disappoint a customer, which means that cost is more than just the lost sales, but a bad customer experience. But we told our vendor, we want to put a price on everything and solve the program to maximize the expected net EVA profit, and it worked fabulously for us."

"The vendor, though, was quite surprised by our request, because their clients almost always ask them to just maximize the in-store stocking rate, to make sure they have the product on the shelves to never miss a sale. But that uni-dimensional focus is just as wrong as focusing on the return on capital or RONA. I mean, if RONA was the answer, it would really discourage us from ever making labor saving capital investments. Why invest capital, even if it's cheaper than the labor it replaces, when the capital goes into the denominator of the RONA computation and labor doesn't. That's nuts. And that's how I can tell if a business operator is really business savvy. If they get EVA, they get value, and I can trust them to get the right decisions done. And if they don't get EVA, what does that say?"

RONA can also be severely criticized for a number of mundane but very practical deficiencies. For example, RONA critically depends on how management decides to define the "net assets" in the

denominator. Should excess cash or retirement “assets” or deferred tax accounts be left included? How about off-balance-sheet-leased assets? Should assets be measured net of impairment charges or at original value? Should assets be revalued or at historic costs? Should capital include all debt and equity or just equity? The answers to these questions can profoundly swing a RONA or ROI computation, and while EVA is not totally immune from these choices, it is far more resilient because capital is a cost, and not a denominator. For instance, EVA is essentially the same whether leases are capitalized or expensed or whether capital is defined as debt plus equity or just equity alone. You can either pay for capital explicitly, by deducting rent expense or interest expense from the profit, or implicitly, as part of the weighted average capital charge deducted from EVA, and the resulting EVA is the same either way, whereas the RONA would be very different. And besides, the emphasis should always be on the *change* in EVA, and not EVA per se, which also makes it even more immune to how the capital base is defined.

RONA is also highly distorted and essentially meaningless for new economy companies that tend to employ trivial amounts of capital. Apple’s RONA, for instance, has been phenomenally high and extremely volatile and basically useless as a performance indicator over the past decade, because its new-economy capital base is so lean and variable. By contrast, its EVA steadily increased, from 4% of sales to 18% of sales, as a clear indication of the increasing productivity and profitability of the firm’s business model. Another example is Blue Nile, the discount internet jeweler, which effectively has negative capital. Cash from sales and trade funding is so prodigious it exceeds the firm’s meager investment in inventories and fixed assets. And with negative capital, its RONA is truly meaningless. Under EVA, though, negative capital simply counts as a profit rebate. EVA is credited with the value of investing the capital float at the firm’s cost of capital. As a result, Blue Nile’s EVA has been positive and generally increasing, and as a percent of sales typically runs in the range of 3% to 4.5%, which puts Blue Nile’s business model around the 65th to 75th percentile in terms of how capable it is of driving EVA profit to the bottom line per dollar of sales.

The key point once again is that EVA makes capital a cost, an understandable charge to earnings just like cost of goods sold, and not into a ratio denominator, so once you’ve computed EVA, and accounted for the cost of capital, you are no longer obliged to divide by capital to bring capital into the picture; that would be redundant. You can instead divide EVA by sales, say, to compute an “EVA Margin,” and then say that EVA is our EVA Margin multiplied times our sales. You can make the management and maximization of value into a profit-margin and sales-based system, which is a heck of a lot more understandable to operating folk than a return on capital times capital approach.

And while we are on the subject, the EVA profit margin turns out to be generally a far better, more comparable and more universally applicable summary measure of business model productivity and profitability than RONA. You’ll see this in an outsourcing question I discuss a little later on, for instance. Also, when you take the EVA Margin apart and trace it to the underlying performance drivers that explain it, to indicators like gross margin, working capital days, plant turns, tax rates and the like, as we do on the so-called EVA Margin schedule, you end up with an analytical tool that is way better than the Du-Pont ROI formula. The EVA Margin schedule puts all costs, operating costs and capital costs, on the same footing, as a percent of sales charge to the margin. It uses simple plus and minus math to measure the impact of all performance drivers, where DuPont ROI is multiplicative -- you multiply the operating margin times the asset turns -- which is fuzzy logic indeed. The incremental impact of improving the margin depends on the asset turns, and vice versa, which confounds all but the mathematicians. Understandably, CFO’s are now moving in droves to using custom EVA Margin schedules as their main analytical tool to replace DuPont ROI analysis, because it makes it easier for them and their line teams to

size up the relative significance of individual performance drivers, to make decisions involving tradeoffs, to spot notable trends, gaps and opportunities, and to benchmark with peers.

Another practical problem with RONA is that it is very tricky to apply to internal divisions that must be assigned assets. The knee jerk reaction of line operators is to reject the allocation of assets to their business units in order to keep their RONA up. But when the emphasis is instead placed on *increasing* EVA, managers shift gears and want to be assigned all the assets that they can legitimately manage. An initial assignment of assets reduces their division's initial EVA, but that does not matter. What matters is whether they are able to better manage the assets they are assigned and by so doing to improve their EVA going forward. EVA depoliticizes the management of the assets, and focuses on performance at the margin, ignoring irrelevant sunk costs. RONA by contrast is inherently based on an accumulation of irrelevant sunk costs, and it encourages endless arguing over the internal allocation of assets.

I must toss one last grenade in the RONA direction before discussing "what's better" (I did come to bury it, after all). RONA is so inherently biased against integration and generally so in favor of outsourcing it pushes activities out that should stay in.

Let's take a company that is considering moving computer systems and services from in-house management to the cloud. The company currently has \$1000 in capital, and is earning \$150, for a 15% 15% return. With a 10% cost of capital, its EVA is \$50. Suppose the company is able to remove \$200 in computer assets to the cloud for the same total cost, so that the firm's EVA and the EVA/Sales Margin remain the same. It's a pure break even exchange. The outside cost and the inside cost, including the cost of capital, are identical, let's say.

Even so, the firm's RONA automatically and misleadingly increases to 16.25% (because $16.25\% - 10\%$, times \$800 in capital, is the firm's \$50 EVA, which has not changed, by definition). In other words, the outsourcing maneuver leads to a higher rate of return, but on less capital, for the same EVA. It's truly value neutral, but RONA was tricked into paying the decision a compliment it did not deserve.

RONA is so biased in favor of outsourcing that it motivates firms to go bulimic, to become so lean and hollowed-out they eventually cut beyond the fat and into muscle, giving up essential long run sources of competitive advantage, and really paying more for services they could perform more cheaply in house, all costs included. EVA, by contrast, favors outsourcing only where a third party partner has clear advantages that enable it to perform a function at such a truly lower total cost that it overcomes the disadvantages of having to contract and deal with an outside vendor.

I'll give you an example. One of my EVA clients in the early 1990s was Equifax, the credit reporting bureau. It was then run by Jack Rogers, a former IBM senior officer who was intimately familiar with IBM's computer capabilities, so he thought that outsourcing Equifax's extensive computer operations to IBM could make sense, if properly structured, even though the move would be quite counter-cultural. But to his credit, rather than mandating the decision, or asking his team to simply trust his business judgment, which was by the way considerable, he said, "we have to run the EVA on it -- It could be good, it could be bad, it's EVA that will tell us." As it happened, the facts and figures clearly showed an EVA advantage to turning over the company's computers and operations to IBM, while Equifax retained its real franchise value in its hold on personal credit statistics and market presence. That was the very first large outsourcing transaction of its kind (which is why IBM for years used Equifax's decision to showcase the merits of its outsourcing solution, based on the EVA analysis). As Equifax demonstrates, moving assets into the cloud or offshore for that matter *can* make sense -- if it generates more EVA, but never

because it increases RONA. An improved RONA is at best a by-product of making the right NPV/EVA decision, but should never be the prime motivator.

To say it one last time, only EVA always gives the right answer, to sourcing decisions or any other, because it's the only measure that literally discounts to the net present value of discounted cash flow. There is no *a priori* reason to expect RONA to give the right answer, and it frequently doesn't, and there is every reason to think EVA will give the right, value maximizing answer, and in my experience, it does, and it does with more clarity, simplicity and accountability than any other approach.

So then, why do so many CFOs persist in using RONA and related rate-of-return metrics, when they are so bad? I think there are two reasons. For one, RONA's a ratio. It permits performance comparisons and investment rankings regardless of size. Its very defect is an advantage in giving CFOs a way to rate performance across divisions that differ in scale and to compare projects that vary in investment commitment. It "common-sizes" the comparisons. Another reason is that a ratio replacement for RONA has not existed. For all its shortcomings, it was the best ratio kid on the block for ranking performance and investments. What was better?

Until recently, nothing. But now, a set of new ratio metrics developed by EVA Dimensions offer CFOs all the advantages of size-adjusted performance indicators without sacrificing the critical link to maximizing the money value of NPV and owner wealth and overall corporate profit performance. The new ratios are, unsurprisingly, all based on EVA. The very good news is that the new EVA ratios can completely replace RONA and IRR and even operating margins with a management framework that is fundamentally more accurate, simpler to use and understand, more informative, and considerably more effective as a practical framework for value-based corporate planning and decision making. Accept my premise, and there is no longer a reason ever to look at RONA, or ROI, ROE, or IRR, ever again.

I explain this "second-generation" EVA framework in companion papers, and I've already alluded to one of them, the EVA Margin, in this discussion. But the most important new EVA ratio is a real breakthrough in the art of value-based corporate financial management, superseding even EVA Margin as the key metric that matters. It is called EVA Momentum. It is the *change* in EVA divided by *prior-period* sales. It is the size-adjusted growth rate in EVA, scaled to sales. It can be measured quarter to quarter, year to year, over multiple years as a trend, and even better, over the life of a business plan. It is a statistic. However viewed, it is the only ratio where bigger is always better, because it gets bigger when EVA gets bigger, which means NPV and MVA are getting bigger too.

It is the sole ratio measure that totally and correctly summarizes the performance of any business in all ways that add value or that subtract from it. It solves the innovator's dilemma, and correctly guides all decisions by correctly incorporating all tradeoffs. Most important, it can serve as every company's most important financial goal, applicable to all lines of business, regardless of their capital intensity and inherited performance conditions.

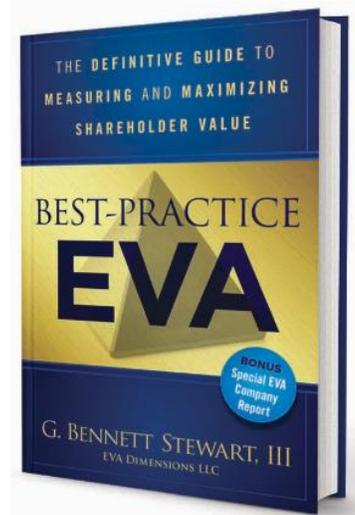
For example, it gives managers in turnaround businesses the opportunity to shine by making their negative EVA less negative. At the same time, it does not reward managers in stellar businesses that just tread water and maintain a positive EVA profit. Instead, it puts a Bunsen burner under the behinds of managers in those well-endowed businesses to keep scaling, growing and innovating rather than just resting on their laurels, and perhaps to even reduce their margins and returns if that is what it takes to increase EVA and maximize value.

The point is, unlike all other ratio indicators, managers can legitimately aim to maximize EVA Momentum without being misled into making dumb decisions. It can be used *instead* of RONA as *the* key measure of performance and *the* arbiter of the quality and value of business plans. Put simply, a business plan is better if it can credibly generate a greater EVA Momentum growth rate over the 3-5 year plan horizon, for the greater the planned Momentum, the greater the NPV of the plan and contribution to the firm's share price. CFO's are now using EVA Momentum to help their line teams develop better, more valuable plans, by seeing how they can generate more EVA Momentum. And they are tracing EVA Momentum to underlying metrics and milestones, including the EVA Margin, and Margin schedule, to end up with scorecards that are more comprehensive, value-based, and topped with an actual score.

When you pull together the complete set of new EVA ratio metrics, and use them as the key performance statistics, financial goals, plan targets, and financial analytical tools, and, when you stop discounting cash flow and instead forecast, analyze and discount EVA to measure and improve the value of plans, projects, acquisitions and decisions, you have the simplest and most effective way to run a business for maximum performance and added market value. And with new software tools, data bases, and training and support services from EVA Dimensions, you can get there faster and more effectively, and at a lower price point, than ever before possible.



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EVA Dimensions has transformed EVA into a complete ratio-based management and valuation framework under the banner of EVA Momentum, which is a special way to measure the growth rate in economic profit. The new Momentum measure accurately consolidates overall improvements in business model productivity and the pace of profitable growth, and it unfolds in steps to reveal all the underlying factors that managers can use to improve performance and increase shareholder value and drive total shareholder return. The new EVA ratios replace other ratio indicators – such as profit margins, growth rates and return on investment -- with a management framework that is simpler to understand, more informative, and more inherently value-based.

EVA Dimensions' software tools, global data bases, and valuation and stock rating models, coupled with its training and support services, provide corporate clients with better techniques to increase shareholder value and institutional fund managers an edge in earning alpha.