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# Don't Just Cut Costs, Create Value

**By Bennett Stewart**

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**Summary:** *Even though times are tough, and will get tougher, maximizing value is still the goal. Across the board cost cutting or capital rationing mandates to preserve book profit and generate cash are the refuge of the weak. Smart managers will seize the moment and continue to position their firm for long run value. Making decisions to maximize the present value of real economic profit, or EVA as I call it, is still the right answer, and now more than ever.*

With the economy swooning and credit tight, it will be tempting to grab an axe and start chopping costs. Some companies may have no choice but to flail away. But for most, the far smarter answer will be to continue to base decisions on maximizing per share intrinsic value, and to set the stage for even greater value as the economy recovers – subject, however, to some important constraints in the near term.

Value, as finance textbooks remind us, is measured by the present value of expected future cash flows, net of total investment spending, and adjusted for risk. It is also the present value of economic profit, or EVA as I prefer to call it, standing for "economic value added." Rather than deducting capital as it is invested, which is the rule in measuring "free" cash flow, EVA stretches out the cost of capital over the life of an investment, converting it into a series of "rental charges" that contain the depreciation or amortization of wasting assets plus a capital charge that one computes by applying the weighted average cost of capital to the net operating assets in the business. Discounting "free" cash flow or discounting EVA always compute to the same "net present value," but unlike cash flow, EVA offers a way for managers to measure and analyze performance period by period, and it serves up a number of messages that are relevant for the current tough times.

One is that managers should not aim to maximize the amount of cash flowing into the corporate coffers this year or next, or over any period, for that matter. The correct answer is always, and even in the midst of recession, to invest capital that earns more than it costs, and to release capital only when it earns less. The goal remains to maximize EVA and NPV.

Wal-Mart did that. Over the 1980-90 decade, and through the Regan recession of 1982, the retailer's sales surged from $1.6B to $32.6B, a 35% compound growth, and of more importance, shareholders realized a

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compound annual return of 43%, making Sam Walton the world's wealthiest individual by 1990. Yet, in 8 of those 10 phenomenal years, "free" cash flow after all investment spending was negative, and it was cumulatively quite negative, which forced Wal-Mart to tap external capital and dilute its equity. But EVA was increasing all the while, from $60 million in 1980 to $720 million by 1990, a twenty fold improvement as Wal-Mart invested capital for returns well over the cost of capital. And with that performance, Wal-Mart's shareholders were actually better off owning a smaller share of a larger pie of value, than by forfeiting the growth and holding onto a larger share of a smaller pie. As Wal-Mart demonstrates, a firm's cash flow, however measured, and over any period of time, can never reliably indicate whether it is increasing or decreasing its per share value. Only EVA can do that.

If managers ignore the rule and simply endeavor to free up as much cash as possible in response to the current contraction, they are apt to wantonly slash all costs and all capital that are not completely necessary to operate the business, which are decisions that will slay the innocent along with the guilty to the detriment of value. They will anger customers with inventory stock outs, truncate valuable options, forfeit organizational capital, lose technological edges, and incur closing and start-up costs that should be avoided. They will make decisions they will soon come to regret.

Some will say that managers today have no choice but to abandon the value maxim, as new capital is simply unavailable at any price. But no, even now managers should aim to maximize value, just with the added constraint that internal sources and uses of cash must balance. And to do that, rather than arbitrarily slashing or rationing capital, it is far preferable to raise its price, to increase the cost of capital used in the EVA computation above the usual rate. If in normal markets a firm's cost of capital is 10%, in today's illiquid market that may need to be stepped up to 12-13% at least for the next year or two, before projecting it will reverse to the long-run normal rate.

Increasing the price of capital has the effect of generating more free cash while optimally allocating scarce capital. By applying a higher than normal rate to measure the capital charge, managers will reject or at the least postpone projects that would normally pass muster. The higher rate also encourages managers to wring even more cash out of operations, to pare inventories, defer replacement, and even sell assets worth more to others, because under EVA, a charge for using capital is also a credit for releasing it. Moreover, any firm that has traditionally focused on growth in EBITDAR or earnings-per-share will find that adopting EVA bring in a gusher of cash as managers become extra vigilant in turning assets faster, speeding up operations cycles, and freeing up balance sheet capital.

Here's an excellent example. In 1991, the last full year in which the economy actually contracted, Victor Rice, the CEO of Varity Corporation, a large agricultural products company, faced a situation almost as dire as General

Motor's CEO Rick Wagoner does today. Aside from facing a cyclical slowdown in demand, with farms consolidating and TQM extending the lives of farm implements, the sector had been in decline for so long that corporate executives would kid that a typical year was worse than the year before but never as bad as the year to come!

With EVA running at a negative $150 million annual clip, Victor and his team had their backs to the wall, and were about to adopt goals for maximizing cash flow when following a meeting with me they decided instead to base all decisions, all targets, and all incentives on increasing EVA profit measured against a demanding cost of capital hurdle. Over the next two years, as every product, every plant, every decision was put to the EVA test, management was so successful at pruning unprofitable lines and purging unnecessary capacity and shrinking inventory, with the EVA mandate at the fore, that EVA increased by $125 million, leading to sizable bonuses and common shares that more than doubled in value. So successful was Varity in its improving efficiency and generating cash with its EVA focus that several years later it was able to acquire British auto parts maker, Lucas, and to continue to consolidate the auto parts sector and create long-run value for its shareholders.

The Varity "EVA story" thus points to another theme apropos these times. Cutting "costs" is not only or even principally about paring income charges. It is as much or more about releasing capital, rightsizing capacity, increasing logistics efficiency, outsourcing, and pruning product lines, locations, customer segments, and even entire lines of business that the new economic conditions have turned into unrewarding propositions. It is as much or more about managing the balance sheet as the income statement. But managers that are focused only on the income statement are missing one of the most important weapons to fight through the economic compression – superior management of balance sheet capital. But because it converts balance sheet capital into the equivalent of income statement "rental charges," EVA enables managers to see their costs in totality and in proportion, and to make sensible tradeoffs and focus on performance improvement opportunities that range over the entire income statement and balance sheet.

In the process of rightsizing and pruning, managers may be required to write-down assets and recognize restructuring charges. Certainly, that was true at Varity, which led CEO Rice memorably to ask the question: "Bennett, how can we really tell we are winning when the accounting tells us we are losing?" EVA helps once again, because rather than passing the charges through earnings, a restructuring is treated as an investment by leaving the assets on the balance sheet – net of any disposal proceeds – and capitalizing any related out-of-pocket outlays such as severance and other expenses. When the dust settles, EVA is immunized from the jarring distortion of one-time charges, but in exchange, it increases only if management is able to reduce the firm's cost structure and increase its profit by more than any added capital charge. Restructuring decisions are thus evaluated like any other capital project – do they return more than the cost of incremental capital and add to the firm's EVA?

"Capital" in the EVA world is thus never a balance sheet accounting concept. It includes all current cash outlays intended to produce benefits over time. And by that definition, a lot of what passes through the income statement is in fact capital spending, whether for research, product development, new market launches, training, and advertising and promotion to create or support a brand, for example. With operations profit underpressure, managers will be tempted now more than ever to slash these vital strategic outlays in order to provide relief to book earnings. But what an incredible mistake, and lost opportunity, that would represent!

One answer, which EVA supports, is to "capitalize" these strategic outlays, to remove them as an immediate and misleading book earnings charge, add them to capital, and amortize them over time, subject to a capital charge on the deferred capital balance. The idea is precisely to discourage managers from myopically mortgaging the crown jewels just to book more earnings now, and instead to treat all capital outlays as subject to the same EVA/NPV standard. Study after study has shown that the best companies capitalize on recessions to gain share and enhance their capabilities and distance themselves from peers. In other words, they think as EVA computes.

Surprisingly, too, stock prices don't suffer when managers make long-term payoff decisions that reduce near-term earnings. In fact, they tend to increase – and right away. NYU's Baruch Lev, the acknowledged leader in the measurement and valuation of intangibles, concludes "Despite widespread allegations of stock market "short-termism"… the research indicates *'unequivocally'* that capital markets consider investments in R&D as a significant value-increasing activity." Translation. The market attaches higher price multiples to earnings that are temporarily depressed by spending on intangibles. How can that be? Because the investors who actually set stock prices think like Nick Calamous of the top-rated Calamos Growth Fund, who states: "We analyze a business by figuring the present value of its free cash flow discounted over the life of the company. We throw out GAAP accounting, which is accounting for accountants, not investors. We capitalize R&D, for example…" (as quoted in *Fortune*, June 27th, 2005). Whether it is for R&D, restructuring charges, advertising and brand spending, or IT outlays, the smart money values the long run payoff, now as much as ever, and the smart corporate manager follows suit.

Another sensible response to a slowing economy is to merge firms where the combined entity can better rationalize costs and right-size capacity, or where a well-positioned buyer can scale the technology, brands and growth opportunities of the seller. Either way, managers may fail to transact even strategically appealing deals if they permit irrelevant consequences to stand in their way.

Some sellers may balk at selling at today's "depressed values," for instance. But since sellers can reinvest the sale proceeds at equally depressed values, what's to lose? If a year ago $14000 bought one unit of the Dow, today the same slice of the American economy can be purchased for $8-$9,000 or so, depending on the day of

the week. Today you can sell a business for 35% less than a year ago, but still reinvest the proceeds to own the same Dow shares as then. Correction. You may be able to own more shares, because selling when prices are generally depressed reduces the gain to be taxed, in which case a seller today can end up with even *more* Dow shares by investing after-tax proceeds than they could a year before. Many managers (and homeowners) have a hard time doing that. They are "anchored" in unrealistic expectations of what property is worth today based on what it was recently worth. But they should make the right decisions, not the emotional ones.

Once again, EVA helps, because any loss on sale of a business unit is not run through the income statement, but is instead taken after tax as an addition to capital (or a deduction for a gain). EVA, in other words, uses cash accounting, as if accountants had simply debited cash for after-tax proceeds, and credited "capital" in like amount, with nothing passing through the income statement. The question EVA poses is thus straightforward and sensible: Would the after-tax sale proceeds, reinvested at the cost of capital, provide more earnings than the business provides? If so, then a sale makes sense, regardless of any bookkeeping loss, or gain for that matter.

A second concern these days is that with credit hard to come by, the only way to transact may be to exchange shares. Buyers most generally prefer to use cash, because that offers a greater per share earnings lift. But the fallacy in that reasoning is that using cash or adding to leverage adds to financial risk, which increases per-share earnings volatility, and reduces the price/earnings multiple compared to issuing shares. There is thus no penalty to consummating transactions by issuing shares that are fairly valued, for the firm will simply sell for a higher multiple than otherwise, fully, if not more than fully countering EPS dilution.

One example: in December of 1998, when Exxon acquired Mobil in a stock swap, Exxon's EPS fell 17%, but its p/e multiple expanded so considerably that its stock price did too. And when AOL acquired Time Warner in a stock exchange in January 2000, the opposite occurred: with a far higher p/e multiple, AOL's per share earnings soared in the wake of the stock exchange, but its multiple crashed, as Time-Warner's lower multiple diluted AOL's, leaving on net a far lower stock price in the wake. And in both cases the market's immediate reaction was prescient, as it typically is. Exxon-Mobil is thriving as the low cost and globally dominant player in the oil patch, and Time Warner is struggling with the AOL albatross to this day. Contrary to popular perception, research shows the near term price reaction is correlated to long run value, and it shows that that p/e multiples tend to offset *105%* of the EPS, so ironically, statistically, the best deals are when the buying company "suffers" EPS dilution. At the least, the evidence says that managers should estimate the value of the synergies as the present value of the expected increase in EVA stemming from the combination, and pay less. Their stock price will benefit by the spread, per share, regardless of what happened to their EPS.

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A final lesson is to use today's depressed economy as an excuse to conserve cash by cutting your dividend. First, if Obama lives up to his word, the tax rate on dividends will soon be hiked, so why impose a tax burden on your owners that you can reduce by cutting the dividend? Second, recognize that when dividends are paid, your stock price falls by the dividend, never in effect to be recouped. Its not that if you don't pay a dividend there is a capital gain for sure. The trouble is, if you do pay a dividend there is capital loss for sure. So why pay the dividend? Granted, investors may misconstrue why it's being cut, and so carefully crafted explanation will be important. One idea – announce you are eliminating your dividend, starting one quarter from now. Pay one, so they can see it's possible, and then cut.

The point is, you can not support your share price by paying a dividend or buying back shares for that matter. Companies are valued for what they do, not what they don't do. And shares do not trade based on supply versus demand, but on the expected intrinsic value of the EVA profit to be earned over the life of the business. Now is the time to revise your dividend and share repurchase strategies to what will give you the most flexibility to ride out the current storm and emerge in the strongest possible condition when it is over.

To summarize, then, in times of economic stress, it is more important than ever that managers make truly excellent, value adding decisions. Continuing to focus on book profit, or instituting across the board cost cuts and capital rationing mandates, are simplistic formulas guaranteed to squander resources when they are most expensive and hard to come by. What managers need more than ever is a surgical tool that enables them to dissect their business model, and obtain the financial intelligence they need to discover where and how to cut, to invest, and to create the greatest value for investors. EVA, and the Financial Radar Screen software from EVA Dimensions that turns raw financial data into real financial intelligence, are two vital tools to help managers do just that. Now more than ever!

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