It’s Time to Abandon Earnings-Per-Share

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

The most popular way to score corporate performance is with earnings per share, or EPS for short. It’s the authorized, mandated, regulated version of profit as computed according to generally accepted accounting principles. It’s the Big Brother definition of corporate performance. With all the institutional heft and history behind it, it is no wonder that many CFOs and board members consider it to be the bottom line in bottom line profit. But while EPS certainly wins on tradition and establishment connections, it loses on every other count. It is riddled with pitfalls and pratfalls that make it a highly unreliable measure of value and a misleading guide to corporate performance. Its time has come and gone, and it must go.

Granted, there is a superficial case for EPS. Companies that are churning out rapid EPS growth tend to trade for higher earnings multiples than others. But does that correlation imply causation? In practical terms, is it wise for directors to reward managers for stoking up growth in earnings-per-share? Absolutely not. Height and weight are correlated, too, but eating more will not make you grow taller. By the same token, speedier EPS growth is not a reliable sign that a corporation has made progress and is worth more.

Consider a company that is on a 10% EPS growth path and that is earning a 10% return on its equity. It will need to plow back and reinvest all of its earnings to keep its EPS on that track. What about a second, more successful firm that is able to earn a 20% return on its equity? It would only need to invest half of its profits in business assets to match the 10% growth rate the other firm must huff and puff to achieve, with the other half of its earnings available to pay out as a dividend. The second firm is clearly more valuable – it’s able to generate cash while matching the EPS growth rate. It will clearly trade for a higher multiple of its earnings. But you could never detect that it is more valuable, or that the other firm is less valuable, by looking at EPS.

Ironically, even dividends won’t necessarily reveal which of the two firms is really better. The less profitable firm could always borrow against its retained earnings and use the proceeds to pay a dividend to match the dividends the stronger one pays. Even though it is really unable to pay a dividend out of its earnings – how could it, since all the earnings are being reinvested – it could fabricate a dividend by mortgaging future cash flows. It could match the earnings-per-share and even dividends-per-share of the more profitable company, and yet it would still be worth a lot less. Investors, of course, have every motivation to look well beyond superficial appearances. They most definitely consider the underlying quality of earnings as well as the quantity, as well they should.

How, though, does the market—or a CFO for that matter—get to the unvarnished truth? One way would be a recipe to combine EPS growth and return on equity into some overall score. Do that, though, and at best you end up with a complex and imperfect proxy for the measure of earnings that really does matter, a measure of economic profit, or EVA as I call it, standing for economic value added. EVA measure profit net of a full cost of capital charge on all capital, which includes setting aside a minimum competitive return for the shareholders. With EVA, retained earnings are no longer an interest-free source of funds that gives managers a license to bulk up on profit growth with impunity.
There is a now an opportunity cost attached to all capital. EVA thus naturally distinguishes those firms that are generating true quality earnings growth with returns over the market-set cost of capital from those are manufacturing growth with returns at or below it.

Consider again the two firms discussed above. Assuming the cost of equity capital is 10% for both, the first firm is just breaking even on EVA in every year, where the second, more profitable firm is recording a positive EVA and is growing it 10% a year. EVA very simply reveals the truth—the one firm is just treading water, and the other is creating and expanding value—and EVA shows this far more simply and accurately than any concocted recipe to combine EPS and ROE.

Besides confounding the quality and quantity of earnings, EPS is also derelict in mixing operating decisions and financing ones, when the two should be kept distinct. For instance, a common tactic to turbo boost EPS is to borrow and buy back stock. The way the math works, so long as a company is able to borrow at an after-tax rate of interest that is less than the inverse of its price/earnings multiple, its EPS will increase with a debt financed buy back. Many companies can borrow at 3-4% after tax these days, or less. So long as their multiples are less than 25-33x, a leveraged buy back will give their EPS a ride. But will the shareholders, and stock price, go along with it? Probably not. When a firm adds debt to its balance sheet and reduces its equity, it adds financial risk on top of its business risk. It interjects a greater wedge of fixed interest payments that must be paid with priority out of its uncertain operating profits, which makes its bottom line profits riskier and more volatile over a business cycle than they would be absent the added leverage. Investors will respond by discounting the firm’s EPS at a higher rate. Put another way, they will only be willing to come into the stock at a lower P/E multiple. They will want to build in a cushion to increase the likelihood of earning a higher yield on the stock to compensate them for bearing a greater financial risk. The bottom line is, with EPS up, and P/E down, the stock price may well remain unchanged. In that case a bonus plan based on rewarding EPS would end up compensating management for accomplishing nothing of value.

How, again, does EVA arrive at the truth? EVA is based on a weighted average cost of capital, where the weights used reflect a running three-year average debt/equity mix as a proxy for the intended long run target capital structure of the firm. That way, a temporary increase in leverage that leads to a temporary increase in EPS translates into no change in the overall cost of capital or in EVA. The only time EVA is stirred to record a win is if management were to permanently step up its capital structure and reduce its overall cost of capital with a more optimal leverage ratio.

The confounding interaction between EPS and P/E is not just a function of leverage. It arises in the wake of acquisitions. A buyer’s P/E multiple almost always swings to offset movements in its EPS, which makes EPS a wildly unreliable measure of the merits or a proposed transaction. If Amazon, trading for over 100 times forward earnings these days, acquired Exxon Mobil, which now trades for about 10x, Amazon’s EPS would skyrocket, but would that make it a good deal? Of course not. Where are the synergies? Where is the added value to cover the purchase premium? How, though, would Amazon suffer? It would suffer by extreme dilution in its P/E multiple. Its stellar growth outlook and its P/E multiple would be heavily weighted down by Exxon’s far more earth-bound prospects. It’s like diluting high octane gas with lower rated gas; Amazon’s earnings power rating would be squashed. Farfetched? That is just what happened when AOL acquired Time Warner years back. AOL’s EPS went way up, its P/E way, way down, and its stock price suffered quite a bit as the deal was announced and in the face of a tremendous projected increase in EPS. Granted, that is an extreme case, but the fact is, even when the
move is less dramatic, the accretion or dilution in the buyer’s pro-forma EPS says *nothing* at all about the wisdom of any deal.

The right way to think about an acquisition is to ask, will it increase our firm’s net present value? Will we be able to derive more value from the seller than we must pay to the seller? Is there added value left for our shareholders? To answer that, discount projections of EVA to figure out what the seller is worth in the buyer’s hands, including the value of the synergies. Deduct the proposed purchase price – which will end up on the buyer’s books as the added capital stemming from the deal. The difference is the net value added, or lost, accruing to the buyer’s shareholders, assuming the assumptions and synergies pan out. Divide that by the pro-forma shares outstanding, and the answer is the predicted impact on the buyer’s share price, for good or ill. Ignore the EPS impact, because the P/E multiple is a plug figure and will just take up the slack. When you look at deals that way, there are many attractive acquisitions that involve material EPS dilution, and many bad ones where EPS “improves.”

EPS is also flawed because it is based on accounting rules, and accounting is not based on economic reality. As just one example, accountants write off R&D as it is spent—as a period expense, just like cost of goods sold—when R&D is actually and in the main an investment that can pay off for years to come. That’s not just common sense. Academic research has proven that when well-managed companies increase their R&D spending, their stock prices typically increase. It increases because knowledgeable investors factor the expected payoff they foresee into the company’s value, and yet at the same time accountants run the R&D build up through earnings, reducing the firm’s EPS. When the dust settles, the firm simply trades for a higher multiple of its earnings, that’s all. And to parallel the economic reality, and to encourage managers to approach R&D investments strategically, R&D spending is written off over time, with interest, in the EVA measure of corporate profit.

All the shortcomings of EPS can be reduced to this. P/E ratios are not constant, and they are not the same for every company, even in an industry group. Companies just don’t trade for some static multiple of their earnings the market has somehow arbitrarily assigned to them. If that were the case, then, sure, growth in EPS and growth in share price would go hand in hand. In the real world, that is not the case. Price/earnings multiples vary considerably from company to company and they change all the time to reflect changes in the quality of earnings. Quality depends on the firm’s return on capital. It depends on the firm’s leverage and financial risk. It depends on how mature its business model is and how much proprietary growth lies ahead versus how much has already been realized. It depends on whether a seller enhances or undermines the earnings quality a buyer possesses. It depends on how well or poorly accounting rules track economic reality. And for all these reasons, the EVA measure of economic profit is the best and most reliable way to understand how a company or business is really performing and what it is really worth. It systematically extracts a reliable measure of quality earnings from the reported profit figures.

The bottom line is this. CFOs and directors are on the right track when they think that earnings growth is the right way to measure corporate performance and to develop incentive plans that accurately tie pay to performance – but with one big caveat. It is the growth in *economic* profit, not in accounting profit, which fits the bill.
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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.