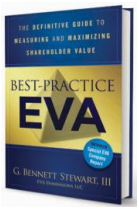
The Statistics of Wealth Creation—How High is Up?



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

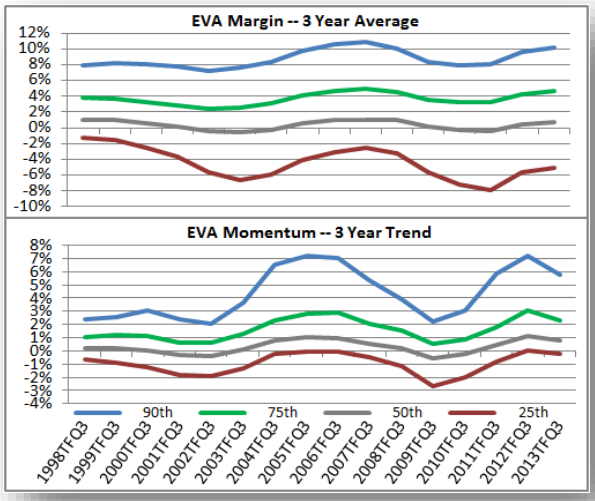
Two financial metrics elegantly summarize the overall performance and value added of a business. Both are based on the EVA measure of economic profit. Taken together, the metrics give the top team and board of directors a reliable bird's eye view of how well the firm is doing, and how well the distinct lines of business are performing, too. The metrics are far better than old standbys like EPS growth, profit margin, ROI or cash flow.

EVA Dimensions updates the 20-year history of the metrics for over 10,000 companies the world over each day. It is now possible to benchmark the EVA metrics for any one company against public peers, and to use the percentile standing in grading incentive pay plans that are tightly aligned with total shareholder returns. In short, EVA is no longer just a money measure of economic profit, personal to each company. EVA is now a full-fledged statistic that can and should replace other financial metrics in the business lexicon.

Ideally, the metrics should be compared with a group of at least 20 companies that are operating in the same or similar business lines. In this memo, though, we will furnish insights into the typical results generated across the entire Russell 3000 companies. This is more relevant than you may think. The EVA metrics are so effective at neutralizing business model differences they make close cousins of even distant relatives.

It All Starts With EVA

EVA is simply a better way to measure profit. It is sales, less operating costs, less the full cost of capital times the money tied up in the firm's net business assets. It consolidates operating efficiency, asset management, and profitable growth into a single net profit score. EVA always discounts to the exact same NPV as cash flow does, because the profit required to recover the invested capital is naturally set aside. Managers should forecast EVA to help find the most valuable decisions, which are the ones that will create the greatest stream of EVA over time.



EVA is also measured after excluding excess cash, treating leased assets as if owned, writing off R&D over 5 years and ad spending over 3, with cost of capital interest on the unamortized balance, and after treating restructuring charges as investments. EVA also recognizes the cost of capital saved by deferring taxes and the cost of capital charge to close a pension funding gap. EVA is thus a surer, more comparable measure of true profit performance than any other. And now, armed with ratio statistics, EVA is a better way to grade performance and set targets.

EVA Momentum

The first ratio is EVA Momentum. It's the change in EVA, divided by prior period sales. If sales were $100 in 2012, and if EVA increased from $4 to $5 from '12 to '13 (or from -$5 to -$4, same thing), then EVA Momentum would be 1%. It's essentially the growth rate in EVA, scaled to sales. The big deal is, EVA Momentum is the *only performance ratio where more is always better than less*— more

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Momentum is more EVA, which implies a greater NPV and stock price for the company. Maximizing EVA Momentum should be every company's most important financial goal, applicable to all lines of business.

By focusing on change, Momentum ignores legacy assets and liabilities. It's purely forward looking, and works for laggards as well as leaders. A business that is turning a negative EVA less negative is making positive progress. And the only way a great business can score Momentum points is by becoming greater still. Simply maintaining high returns without much growth is a formula for lackluster Momentum.

Here's a statistic you should know: EVA Momentum has averaged just 0.3% for the median firm in the Russell 3000. That's it. The firm running in the middle of the pack has just eked out a slight rise in EVA. Markets are quite EVA competitive, and over time competition, saturation, substitution, disruptive technologies, fading fads, bureaucratic creep and overpriced acquisitions tend to erode the incremental returns available in even the best businesses.

The 75th percentile firm averaged 1.6% Momentum a year, which sums to 8% over 5 years. Want a 75th percentile quality plan? The stats say you must increase EVA by $80 million over the next 5 years for every $1 billion in current sales. The 90th percentile firm generated 4% to 5% Momentum on average (but almost invariably produced less Momentum over the next 3-5 years). Which begs the question: what's your Momentum and how does it stack up?

EVA Margin

The second ratio is EVA Margin, or EVA divided by sales. It measures the firm's true economic profit margin, net of all costs, consolidating operating efficiency and asset management into one performance productivity score. With it, even Intel and Wal-Mart can be fairly compared. Intel has a giant operating margin, but ties up so much risky capital in chip-making equipment and R&D that its net EVA profit margin is much lower and much more intrinsically comparable to even Wal-Mart Stores, which operates with a paper thin margin, but correspondingly wafer thin capital. You can't compare them by operating margins, but you can by their EVA Margins.

The median EVA Margin has run at only 0.4%. Low, but there are no mulligans here–restructuring costs, and R&D and ad spending, are part of capital, and all capital, even equity capital, bears a full market rate of interest. On that score, the median firm is really just breaking even. It and many firms near it may grow sales, EPS and EBITDA a ton, but if their EVA Margins are zero, or close to it, EVA is going nowhere fast and their stock prices will be dead in the water.

The 75th percentile Margin runs near 4%, and the 90th percentile close to 9%. Stepping back, an EVA Margin over 5% is quite good, upper quartile; even 2% is acceptable in that it is large enough to turn sales growth into growth in EVA.

In fact, there are really only two strategies to create Momentum and add value. One is to produce profitable sales growth at a positive EVA Margin, and the other is to increase the EVA Margin, to drive more EVA to the bottom line out of the top line. Take an EVA Margin of 3.6% and improve it to 4%, and couple that with 5% sales growth. EVA Momentum will be 0.6%, or 60th percentile—0.4% from productivity gains and 0.2% from adding 5% to sales at the 4% Margin. With the Momentum math, you can easily size up corporate goals and see how they stack up against the statistics of wealth creation.