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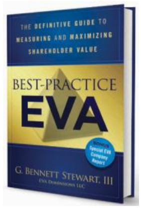

What *Really* Determines Total Shareholder Return?

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

Linking pay to performance is one thing. Driving performance, another.

The real challenge directors face is how to motivate managers to make the decisions that will actually produce the greatest total shareholder return – or TSR – over time.

Ironically, TSR isn't the answer. TSR itself says nothing about how to increase TSR, and it can't be measured for business lines or specific decisions. Hitching pay to TSR is also a great mistake because a far better answer now exists.

The breakthrough we have achieved is to draw a straight line from TSR to the underlying corporate financial measures that any management team can use to manage the business and maximize the shareholders' return.

Now you can have your cake and eat it, too. Now you can tightly align incentive pay to TSR performance, and you can have the management team clearly aiming at the decisions that will drive shareholder value.

The Conventional Wisdom is Wrong

Defining TSR is easy – it's just is the sum of dividend yield and share price appreciation. But managing it, that's harder, especially when every one of the standard financial metrics most boards use is flawed.

For instance, it's easy for managers to stoke up earnings growth with investments that do not earn decent returns, and that send share prices lower by sending p/e multiples lower. And managers that are asked to improve ROI will behave like basketball players who concentrate so hard on shooting percentage that the only shots they take are sure layups. They'll undersize investments, under-innovate and under-achieve their growth potential. How about a combination of measures? In theory that's a good idea, in practice, not— it's complex, ambiguous, and fraught with difficulty in setting goals for multiple metrics.

A Better Answer Exists

It's EVA, standing for economic value added. It measures a company's profit after setting aside a priority return for all investors, including shareholders. It puts a premium on turning assets quickly and investing capital carefully. And unlike ROI, it rewards all growth investments that earn returns above the full cost of capital. It optimally combines a carrot and a stick in a single net profit score.

The real clincher is this: the present value of a forecast for EVA is *identical* to the net present value of discounted cash flows. The reason is simple: EVA sets aside the return that must be earned to recover the value of the capital that has been or will be invested. This is crucial. Managers can forecast EVA to choose the strategies that will maximize NPV. But more to the point, the EVA link to NPV is what links it to total shareholder return.

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TSR Comes from EVA

The fact is, TSR is always just a leveraged version of the return that comes from underlying business performance, which in turn comes from earning EVA and increasing it to increase the corporate NPV.

The insight we derived is that TSR does not come from increasing a firm's value, but from increasing its market value *above and beyond* the resources invested in its business. It takes an increase in *net* present value to drive TSR, which is why *increasing* the EVA profit that discounts to NPV is so crucial. This is true not just on paper; an S&P 500 study confirmed it. The implications are far-reaching:

- The very best way to score corporate performance is by the growth rate of economic profit, which we call EVA Momentum. That's computed as the *change* in EVA over an interval, divided by base period sales. It's the only ratio statistic where bigger is always better, because more Momentum is more EVA, NPV, and TSR. Make it your firm's principal financial goal, and benchmark it against peers.

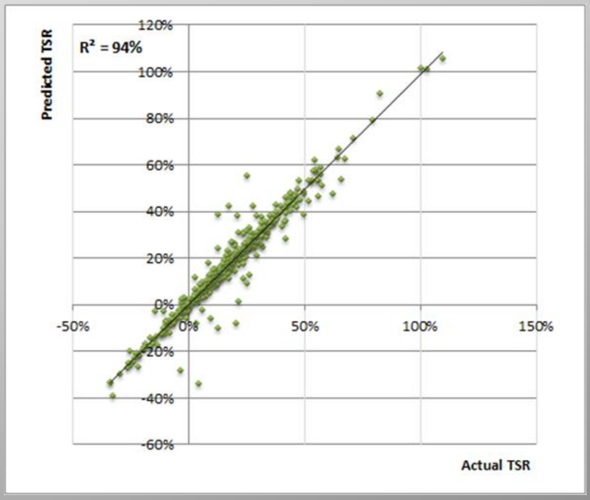
- Use EVA forecasts to measure and improve the NPV of plans and decisions. Use it *instead* of discounted cash flow for greater simplicity, insight, and accountability for the capital.

- Structure incentives to reward management for generating EVA Momentum—either absolutely or against peers. That motivates them to use EVA to run the business, and it links their pay to TSR performance as a natural by-product. It's also quite simple to explain and administer.

Simply put, if TSR is the question, then EVA is a very good answer that every board and management team should consider.

Case Closed: EVA is *really* the real key to creating wealth and driving TSR

TSR computed the classic way, from dividend yield and price change, is plotted left to right for the S&P 500 companies. A predicted TSR is plotted north and south. The prediction is that TSR is a leveraged version of the return earned in the business, coming from three EVA components: (1) reversing the discounting process, and realizing a built-in cost-of-capital rate of return, (2) from the EVA profit earned in the period, and (3) from increasing the corporate aggregate NPV over the period, which comes from increasing the firm's EVA over time. The R-squared is 94%. The math works. Above recovering an expected return on capital, and the effect of debt/equity leverage, TSR really is a function of earning and increasing EVA.



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