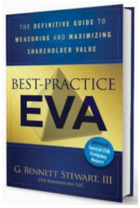
How to Measure Earnings for Long Term Value



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

What would you think about a company whose reported earnings per share tumbled from a peak near $2.50 to a 33-cent loss over five years, whose operating margin and ROI collapsed, and where cash flow from operations was so negative that the company had to import boatloads of capital? Oh, and toss in 11 straight quarters of earnings misses and "guide-downs" about future results for good measure.

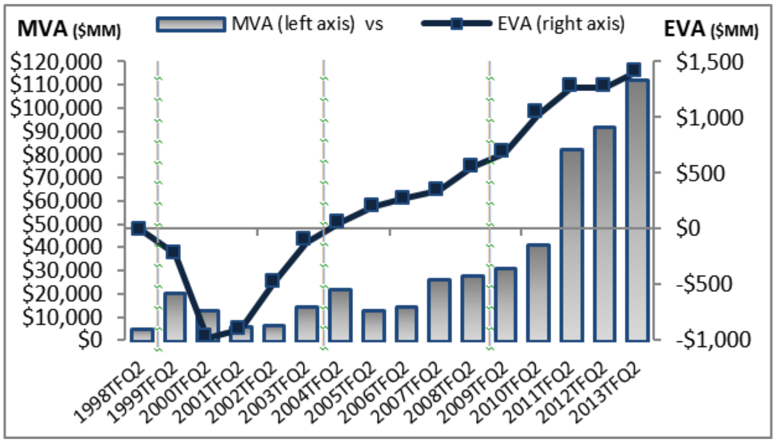
Investors must have pummeled the stock, right? Wrong. The company is Amazon, and it was a top performer among large-cap U.S. stocks, soaring from $73 a share to well over $300 over the five years. Scrambling to explain the Amazon "anomaly," market pundits claim Amazon enjoys a unique status as a "story stock"—one where investors are singularly patient about and trusting in the visionary strategy of CEO Jeff Bezos and his team.

But that's just not the reason. The popular explanations miss the correct one—namely, that short-term earnings and related bookkeeping metrics simply are not what investors use to set stock prices. The truth is, the investors who count—we call them the lead steers in the market—look right through *accounting* profits and focus on true *economic* profits. Properly measured, EVA fully accounts for Amazon's success and closely tracks with its actual stock price performance. With EVA, you can manage for the long term—and be amply rewarded for it.

EVA Up, Stock Price Up, Even With EPS Down

While Amazon was faring so poorly by conventional measures, its EVA profits nearly tripled over the five years ending mid-2013, from $551 million to $1,415 million, and tracked quite closely with a sister stock-price measure called MVA, for market value added.

MVA is the spread between a firm's enterprise value and the capital invested in its net business assets. It measures the owners' wealth, the firm's franchise value, and its aggregate NPV. In principle, MVA equals the present value of expected EVA profits, because EVA deducts the profit required to retrieve the value of the invested capital. It sets aside the full cost of capital, including the cost of giving shareholders a decent return. Increasing EVA is thus what it takes to increase MVA and create wealth and generate an outstanding shareholder return.



Amazon illustrates the rule: The increase in EVA fired its MVA to a lofty premium, lifting it from $5 billion to over $112 billion by mid-2013 (and $165 billion today!). Clearly, the market ignored the firm's book profits and responded to its EVA.

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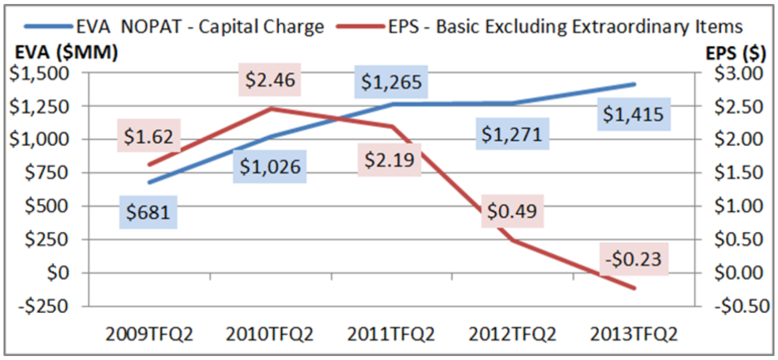
What accounts for the discrepancy between Amazon's book profits and EVA? Start with the fact that EVA charges for all capital. Unlike EPS, EVA fully and correctly increases when balance-sheet assets decrease. And a large reason Amazon is so successful is its ability to turn assets very quickly. It concentrates inventories in hyper-efficient warehouses and fulfills so rapidly that management can snag a very high return on assets even while operating with razor thin margins. In fact, the lower the margins and the faster the turns, the better the business model is for shareholders and customers alike, which is a key insight EVA gets and others don't.



A second reason is that EVA treats R&D and advertising outlays as strategic assets, not expenses. Spending in any one period is written off over time (5 years for R&D, 3 for ad spending), with interest at the cost-of-capital rate charged on the unamortized balance. This better matches the period cost with expected benefit, creates accountability for actually getting a return on investments in innovation and customers, and it neutralizes buying intangibles or creating them in-house. Ironically, accountants capitalize intangibles if bought but not if built. This adjustment levels the playing field and removes the bias to buy.

It also dramatically improves Amazon's profit picture. Amazon hiked its R&D and advertising outlays from 7.3% of sales to 11.3% over the 5 years, all of which was deducted from reported earnings. And in a business that operates with margins as meager as Amazon's, that's all it took to turn accounting profits from black to red.

But not its EVA. By spreading the spending hikes over time and by *pushing the costs into subsequent periods* when Amazon's sales were much higher (itself an indication of the return on the investment), the annualized pre-tax charge to economic profit increased from just 5.3% of sales to only 6.6%, a materially lower charge that enabled EVA to stay in the black and on the rise and in step with the firm's actual valuation.

The implication is obvious: reported earnings measures discourage managers from boldly transforming their business models and seizing opportunities—but EVA supports them.

EVA Up, ROI Down

Amazon's return on capital was also a very poor measure of its performance. In recent years Amazon accelerated investments in acquisitions, robotics, distribution centers closer to customers, in cloud computing, even, gulp, drones. Those are unlikely to match the very high ROI that Amazon was able to earn at a smaller scale. But ROI dilution is irrelevant. So long as the new investments cover the cost of capital set in the market to compensate for risk and the time value of money, EVA will increase and MVA will increase, too, and the firm's owners will be rewarded with a higher TSR, not a lower one. This is not just theory. Studies show that the change in EVA does the very best job of explaining the actual change in MVA. So ignore ROI, and ignore profit margins. The market does not want ratios. It wants results as measured by an increase in EVA.

EVA Up, Cash Flow Down

Amazon's cash from operations net of investment spending was also very negative. But that was a big plus for the shareholders. Cash flow was negative only because Amazon was pouring so much money into EVA-positive, value-enhancing investments. The market does not want cash—it only has to find another place to invest it. The market wants more EVA. Period.

The bottom line is that EVA provides better decision guidance and a stronger tie to value than any other financial measure. Which means you can make your life simple: Just focus on increasing EVA and let the other measures fall where they may. That's the best way to make sure you are managing for long-term value.

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