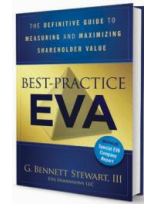


Introducing Best-Practice EVA

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



Genuine innovations in corporate financial management are rare. Nevertheless, a revolution is now underway that demands the attention of every serious finance professional. A new and significantly better way to measure performance, allocate capital, set goals, price acquisitions, meter bonus pay and maximize shareholder value is about to take root. It involves replacing traditional financial metrics and valuation tools with new ones. Accept my premise, and old standbys, like cash flow and discounted cash flow, IRR, ROI, and the DuPont ROI formula, even profit margins, earnings-per-share growth and P/E multiple, can be retired from service, and for good and valid reasons.

The framework I will describe can be used profitably by finance leaders, business operators, board members and institutional investors alike. In fact, one of my prime objectives is to forge a common ground—a new standard and shared vocabulary that will bridge value-based corporate management and stock market equity research and give all stakeholders in the corporate governance debate a better way to carry on the conversation. Right now, finance is a mish-mash of measures that tell half the truth or hide the truth, with no agreement on any one of them. The market and management talk past each other, and directors and the media are caught in the cross fire. What is desperately needed is one measure and one framework that can accurately weigh all businesses and business decisions on a single scale, and gain common currency. That scale is EVA – actually, a new and greatly improved version of it.

For the reader who may be unfamiliar with it, EVA (standing for economic value added) is a way to measure corporate profit that is better than all others. It measures profit according to economic principles and for the purpose of managing a business and maximizing value, and not by following accounting conventions. It first broke onto the scene with publication of my book, *The Quest for Value*, in 1991, and then went on to gain wide adoption in management and academic circles after a September, 1993 appearance on the front cover of *Fortune* magazine, which declared EVA was “the real key to creating wealth” and later, “today’s hottest financial idea and getting hotter.”

Still, for all its successes in the 1990s, the EVA revolution stalled a little over a decade ago. One reason was the Sarbanes-Oxley legislation that put finance staffs back on their heels and made them risk averse and accounting prone. But I also began to see that there were legitimate reasons why EVA was harder to adopt and use than it should have been. I made a list and we tackled them one by one.

What you will find today is that a set of major advances have made EVA considerably easier to understand and way more effective as a corporate management tool. At the same time, EVA has also become much more wide ranging in its applications. As one example, EVA is now the foundation of a global equity research service that is gaining considerable attention with influential fund managers and major investment houses. I call this flourishing new version *Best-Practice EVA*, and it represents such a quantum leap that I have written a new book by that title to explain it in full (John Wiley & Sons, March, 2013). The purpose of this article is to summarize the path breaking innovations and make the case that EVA deserves a fresh look.

Let's roll back the clock and start with a brief primer on EVA before discussing the recent innovations. The main difference between EVA and accounting profit is that it deducts a full weighted-average cost-of-capital charge for the money tied up in the firm's business assets, which includes setting aside a minimum competitive return for the shareowners. It measures the profit the firm earned net of a priority return for that owners, a profit that is above—or below—the profit that could have been earned had the firm's debt and equity capital been passively invested in diversified bond and stock funds of the same risk class. EVA consolidates income efficiency and asset management into one net profit score. It makes the balance sheet into an understandable charge to profit and a charge to be managed like any other operating cost. It separates companies and divisions that are truly prospering and growing with returns over their cost of capital from those that are inflating sales and earnings growth with investments at or even below their full cost of capital. It systematically harvests quality earnings from reported earnings figures.

EVA's most important property, though, is that it always discounts to the exact same net present value as discounted cash flow. With the capital charge, EVA automatically sets aside the profit that must be earned to recover the value of the capital that has been or will be invested, and so it always discounts to the *net* present value of the cash flows. Intuitively, it makes sense that, if EVA is zero, then NPV is zero, and if EVA is positive and increasing then a firm is developing a positive franchise value and will trade for a market value premium over its invested capital. As a result of this predictable, actually mathematical, link between EVA and NPV, managers can use EVA not only to measure performance period to period. They can project, analyze and discount EVA to measure the NPV of plans, projects, acquisitions and decisions, and use it to help them to improve the NPV, and they can do that *instead* of discounting cash flow. That way, there is an easy consistency between how plans and decisions are evaluated looking forward and how performance is reviewed after the fact. It's all EVA-based. That makes the entire management process far simpler, more cohesive and accountable, and inherently more value-based.

The mission of an EVA firm is not EVA per se, but to *increase* EVA. The level of EVA reflects a by now irrelevant accumulation of past sins and wins. Increasing EVA is a purely forward looking endeavor and is what it takes to increase NPV and drive share value and TSR higher. If EVA is negative, the objective is to make it less so, and if it is positive, to make it more so. This goal produces all the right incentives in any business. It tells managers to intelligently cut costs, to allocate and invest capital wisely, to fund all profitable growth over the cost of capital, and to turn assets faster and release capital from non-productive assets and activities. All the right incentives are contained in a mission to increase EVA. It gives laggards every chance to shine and compete for resources, if they can reverse or even begin to reverse the negative EVA. And, it puts a Bunsen burner under the behinds of the best businesses to keep scaling and growing and innovating in order to increase their EVA. They cannot just rest on their laurels and coast as they are encouraged to do with profit margin or ROI type measures.

EVA is unique in this. Indeed, it is the *only* performance measure where bigger is always better, where more is always better than less, because more EVA is more NPV – *by definition*. And just as NPV adds up, EVA is also uniquely the only additive performance measure. If the EVA of a decision—a plant expansion or product extension, for example—is positive, then that decision will add to the EVA of the sponsoring division and to the corporate consolidated results in like amount. As a money measure of value-added profit, EVA adds from the bottom to the top and harmonizes decision making. A division president and headquarters CFO will reach the same conclusion about the merits of a decision, given the same assumptions, if they are looking at EVA.

That is not true of any of the conventional financial indicators. A division already earning a very high ROI, for instance, might turn up its nose at an EVA-positive project that produces a return that is lower than the one it already has, if its management is concerned with maintaining or expanding ROI. That would be a mistake, of course. Management should take on all positive NPV projects, regardless of the impact on conventional ratio metrics, like margins, returns, or sales growth rates. Those are situational metrics. They depend on how the new decision overlays on the existing ratios, which is a totally irrelevant consideration.

Hundreds of companies adopted EVA in the 1990s and tied incentive pay to increasing it, and the results were usually quite stunning. After all, what gets measured gets managed, and you do tend to get what you pay for. Confronted with the balance sheet charge that EVA imposes, managers devoted tremendous energy to animating the value of their assets. They also started to generate more growth in profitable business lines that had been treading water just to maintain high margins or returns. Managing for EVA was, and remains, a proven and universally applicable formula for running a business for greater value. But again, good as it was, and is, there were chinks in the armor that needed to be repaired before EVA could legitimately become the gold standard in corporate financial management.

The first and most glaring problem was that EVA was just a money measure. It lacked a companion ratio indicator or, better, an entire ratio framework, to bring it to life. Let's face it: Ratios rule the business world, and the absence of EVA in a ratio format was a severe handicap. CFOs were frustrated that they could not use EVA to rank and compare their lines of business against each other or against public peers. Directors, too, were frustrated by EVA because it was not in the form of a statistic that they could use to rate management's performance or to set appropriately challenging compensation performance targets or to judge the adequacy of the business plans that management had submitted. And although the notion of EVA as a profit performance measure was intuitively appealing to them, many line teams were stymied by an inability to trace EVA to familiar performance drivers like sales growth, gross margin, working capital days, plant turns and the like. As a money measure, EVA was opaque when transparency was really needed.

To an even greater degree than corporate teams, investors require ratio indicators to compare, rank, sort, screen, and discern which stocks to buy or sell across a universe of ever shifting opportunities. But since the ratios did not exist, investors eventually lost interest in EVA. Their unfamiliarity with it discouraged a healthy dialogue with EVA-inclined companies. Even EVA-committed CEOs and CFOs grew reluctant to speak to investors in an EVA language for fear they would not be understood. EVA was also set back by a number of practical hurdles. Every company had to create its own software plumbing to calculate, track, analyze and value EVA, which was time consuming, expensive to maintain and error prone. An authoritative data file of EVA metrics covering public companies did not exist. EVA was a data point particular to each company. It was not a statistic computed according to a standard set of rules that boards, managers, investors and consultants could trust and use with confidence.

My goal when I formed EVA Dimensions in 2006 was to overcome all these drawbacks and produce a new and superior version of EVA. I believe we have succeeded in every respect. The biggest advance is a set of three headline EVA ratio statistics and a way to take them apart and trace them in steps to all the business performance factors that are moving the EVA needle. Together, the EVA ratios replace and subsume traditional ratio metrics with a superior and simpler framework. Let's be clear. The innovation is not making EVA more sophisticated or academically appealing. The value is purely practical. It lies in making EVA fundamentally easier to understand and way more effective as a diagnostic framework and decision support tool. EVA is now an open book brimming with managerial and valuation insights. The

new ratio-empowered EVA model is fully transparent and connected to business drivers in ways that are gaining a lot of converts where before there was resistance.

The most important of the three new ratio metrics is EVA Momentum, which I define as the *change* in EVA over a period divided by sales in the prior period. It measures the growth rate in EVA scaled to the sales size of the business. For example, say that a company had \$1 billion in sales in 2010, and that its EVA increased by \$20 million in 2011 (from \$30 to \$50 or from -\$50 to -\$30; it wouldn't matter because the change is what counts). Then its EVA Momentum for the 2011 year would be 2 percent. That's the \$20 million increase in EVA over the \$1 billion in prior-period sales. EVA Momentum can be measured quarter to quarter, year over year, over the past three to five years as a trend and, importantly, over the forecast life of a business plan. However measured, it is a simply magical metric in many ways.

First of all, and this is a real big deal, it is the *only ratio indicator where bigger is always better*, because it gets bigger when EVA gets bigger, which means that a firm's NPV and shareholder return are getting bigger, too. It is the one ratio measure that is totally consistent with increasing EVA, which all along was the right goal. And just as is true of the change in EVA, EVA Momentum completely and correctly summarizes the total performance of a business in all ways that it can add value or subtract from it. Managers in all lines of business can aim to maximize EVA Momentum without fear of being misled into making dumb decisions. It can serve as every company's most important financial goal and the overarching measure that matters.

To be specific, EVA Momentum should be used instead of ROI, operating margin, or EPS growth as the key measure of corporate performance and the decisive score of business plan quality. Put simply, a business plan is better and more valuable if it can credibly generate a greater EVA Momentum growth rate over the plan horizon. The greater the planned EVA Momentum, the greater is the projected growth in EVA, and the greater is the NPV of the plan and the contribution it will make to the firm's share price.

A second key attribute is that EVA Momentum focuses on change, on turning points, on the news in the data, on performance at the margin. By highlighting change, EVA Momentum helps management to zero in on and magnify worrisome trends and be more alert to emerging risks. Sales, net income, EPS, and certainly EBITDA can all continue to expand long after a business has really started to lose its economic vitality, but EVA Momentum slows down or goes into the red at the earliest stages when a business is maturing or facing competitive pressures, or when its managers are overinvesting in incrementally undesirable growth opportunities. EVA Momentum brings all the pressure points to bear in one net score of performance progress. It is like the proverbial canary in the coal mine, sniffing out trouble and raising a red flag before other measures get in the game. It belongs on every company's risk management scorecard, if nothing else.

For all these reasons, EVA Momentum is the ideal spanning measure, the one and only metric that CFOs and directors can apply right across even a diverse set of individual business units to fairly compare their performances and appropriately challenge them, regardless of the current state of their profitability or inherited assets or liabilities, which become irrelevant on the EVA Momentum scoreboard. On the one side, it motivates managers in profit-challenged lines of business to turn them around, to increase EVA by making it less negative. On the other side, it tells the managers in the best businesses that if they simply maintain existing high returns and margins and replicate the prior year, their EVA Momentum score is zero. EVA Momentum puts a Bunsen burner under the behinds of the managers in the best business lines to keep scaling, growing and innovating, possibly even to forfeit some of the existing

margin and rate of return that they currently enjoy, if that is what it takes to keep EVA marching ever higher.

Let's state the obvious. Unlike EVA, EVA Momentum is a ratio statistic. Norms and trends can be established. Data from many companies can be pooled and studied. Questions like what constitutes good EVA Momentum performance can be answered. For example, the EVA Momentum for the median Russell 3000 firm—the company swimming in the middle of the EVA performance pack—has been just 0.2% per year on average over the past 20 years. The typical firm just ekes out a slight rise in its EVA profit over time, once the full cost of capital is considered and accounting distortions are eradicated. As economic theory predicts, competitive forces tend to drive returns to the cost of capital over time and at the margin.

Another expected tendency, call it convergence, is also borne out by the data. Firms that generate above or below normal EVA Momentum growth over one period tend to generate EVA Momentum closer to the median rate over the next period of time. Competition, saturation, substitution, fading fads, overpriced acquisitions, management blunders, and bureaucratic creep tend to seep air out of the EVA tire of the best businesses over time and slow it down, and EVA deficient firms are galvanized to restructure and improve and revert to norm. Simply knowing this can temper and shape the expectations of top management and a board of directors when they set Momentum targets as performance or compensation bogeys.

Not all firms are just treading EVA water, of course. Over almost any five-year interval about 40 percent of all firms increase EVA at a meaningful pace, and the better-managed or more fortunate firms increase it by quite a lot (again, though, subject to convergence over the next round). The 75th percentile performer tends to run with an EVA Momentum growth pace of around 1.2% per annum on average over moving five-year windows. That would be equivalent to generating cumulative EVA Momentum of 6 percent over a five-year stretch, meaning that a 75th percentile quality forward plan would have to produce a \$60 million *increase* in EVA for every \$1 billion in sales. (One attraction of EVA Momentum statistics is that they can always be converted to a money target or benchmark for any one company or business division.) The 90th percentile EVA Momentum performance has been quite impressive, running at a 3 percent to 3.5 percent per year average rate over the course of rolling five-year spans.

The second EVA ratio is called EVA Margin. It is a headline statistic in its own right, but it is also a cog in the EVA Momentum wheel. It is the ratio of EVA to sales—the percentage of sales that falls to the EVA bottom line after deducting all operating costs and capital costs. Put simply, it is a firm's true economic profit margin. It is a key summary measure of profitability and productivity, consolidating operating efficiency and asset management into a reliable and comparable net margin score. Unlike operating margins, it neutralizes the capital differences across business models or product lines, and produces an inherently fairer, purer and more comparable measure of performance.

Consider Intel, a firm with a massive operating profit margin, but one that ties up so much risky capital that its net EVA profit margin is much lower and much more inherently comparable with the EVA Margin of, say, Wal-Mart Stores, which operates with a paper thin operating margin but also with paper thin capital. The two companies cannot by any means be compared on operating margins. But they can be legitimately compared on their EVA Margins. Like EVA Momentum, EVA Margin tends to make even unrelated businesses into close cousins for the purpose of benchmarking performance because, ultimately, all businesses are in the same business, the business of earning and increasing EVA. Because of this universal comparability, CFOs and boards can widen the net and develop performance targets

and financial goals by consulting the EVA ratio statistics for a far broader group of peers than they would be able to use when looking at the other flawed, incomplete ratio indicators.

A firm's EVA Margin measures its overall performance productivity in one period, but it is also a key to helping managers to think of ways to increase EVA and drive Momentum over time. In fact, it figures in both of the fundamental strategies that management can pursue to rack up more Momentum points. The first way is through "productivity gains," that is, from generating an increase in the EVA Margin. It is making the business engine run stronger, with more torque and spark. The second way is through "profitable growth." It is from adding sales that can earn positive EVA Margins. It is from scaling a profitable business model and adding value through innovation and growth. The point, though, is that EVA Margin is a factor in both of the main Momentum drivers, which is why I refer to it as the Momentum Up-Shifter.

The new "best-practice" model conveniently reduces EVA to a sales-based, margin-based model of value-based management, which is a formulation that is highly intuitively appealing to line teams. Attractive as that is, it is reasonable to ask, where do balance sheet investments and asset management and cash flow come into play? The answer is, they come in through the capital charge that is deducted from EVA and thus from the EVA Margin. The cost of capital that has been or will be invested is already a charge taken against the EVA Margin. Corporate value can be fully managed and maximized without ever having to forecast or analyze balance sheets or compute cash flow. It's a very neat trick that pays big dividends in practice, we are finding.

Note that it does take an *increase* in the EVA Margin to add to value. It requires an *improvement* in the productivity of the business model, not just maintaining it, even at a high level. The opportunities to enhance the EVA Margin can be reduced to what I call the "3-Ps"—price power, product mix and process excellence. Managers can expand their EVA Margin and add Momentum by earning and exerting price power, by fielding an outstanding, all-star, EVA-attuned product lineup (and benching EVA losers) and, third, by running a tight ship and minimizing the sum of operating and capital costs spanning income efficiency and asset management. If some combination of leveraging the "3-Ps" enables management to increase the firm's EVA Margin from 4% to 5%, let's say, then it has produced 1% EVA Momentum from that one source in that period.

The other opportunity for producing EVA Momentum is with EVA positive sales growth. For instance, if the firm adds 20% to its sales, and if the sales it adds add to its EVA at the 5% Margin rate, the combination accounts for another 1% EVA Momentum in the period. This factor is multiplicative. It is sales growth *times* the EVA Margin that adds to EVA Momentum. This is a legitimate and crucially important value driver that pure productivity measures like ROI or gross margin neglect to measure and may even oppose.

Considering both sources, the example firm produced EVA Momentum of 2%, of which 1% came from increasing its EVA Margin, that is, from making its business engine run stronger, with more torque and spark, and the other 1% derived from profitable growth, from stepping on the gas and fueling growth through a profitable business model. EVA Momentum thus naturally and correctly combines productivity gains and profitable growth in one score and weighs both elements on the same scale—as a percent of sales. The two elements can thus be directly compared, and intelligent tradeoffs made, directly in terms of added value. A manager running a profitable business would thus see the merits in forfeiting some of the existing profitability for more profitable growth—if that is what it takes to increase EVA overall, for example.

With a better appreciation for the critical role that EVA Margin plays in EVA Momentum, let's examine the EVA Margin statistics for the Russell 3000 universe. The average EVA Margin earned by the median Russell 3000 public company over the past 20 years has been just 0.4%. It's low, very close to zero, but this is the major leagues, and so producing a winning percentage over break-even baseball is actually not bad. Product markets are quite competitive at the margin, way more than most people appreciate.

Most managers think in terms of EBIT or EBITDA margins, which give them a highly inflated impression of profitability and how well they are doing, as opposed to EVA Margins, which are fully loaded with all capital charges and do not allow mulligans. For example, an accounting impairment charge to write down an asset is reversed in EVA, just put right back on the capital books, so it has no effect on. A restructuring charge, too, is reversed and added back to capital. That way, managers have an incentive to fail fast (no charge to profit stands in the way of exiting or restructuring) and to fail well (any money invested in the restructuring is an investment subject to the cost of capital charge, like any other).

EVA also differs from GAAP accounting by taking R&D and ad spending and writing it off over time, typically over three to five years, with cost of capital interest applied to the unamortized balance. That rule discourages managers from myopically cutting back on the spending just to make a short term earnings goal, and it gives them the time they need to make transformative investments pay off. The overall effect of these adjustments is that the EVA Margin is a far more accurate, honest, and demanding assessment of true business profitability than financial metrics that are accounting based. And when the full cost of doing business is considered, the EVA Margins that surface are right on the razor's edge and quite close to zero for the middling firm, again just as an economist would expect.

The implications, though, are unsettling. If EVA Margin is zero or close to it, as is true of the median firm and many others on both sides of it, then all the sales growth and book profit expansion in the world do no good for growing EVA and NPV. There is no EVA Momentum without a positive EVA Margin. By focusing attention on EVA Margin, therefore, top management is better able to direct resources to where they truly can add value and not just spin wheels. Management is better able to impress line teams with how close the game score really is in most cases, and galvanize them to stretch for every advantage across the full income statement and balance sheet. Operating margins and EBITDA are complacent and induce complacency where EVA Margins are lean and spark urgency.

As with EVA Momentum, the evidence shows the best firms are able to run with EVA Margins far ahead of the pack. The 75th percentile firm has tended to earn an EVA Margin of around 4% to 4.5%, and the 90th percentile performers operate at another great leap ahead, typically racking up EVA Margins of 9% to 10%. Interestingly, there are EVA winners and losers in almost every industry. Management, strategy, innovation, operational excellence and hustle make a big difference. Industry is not destiny.

As a rule of thumb, maintaining a bottom-line EVA Margin over 4% on average over a business cycle is darn good and certainly value enabling. In fact, I would venture to say that any company that sustains an average EVA Margin over 2% is in a position to create value through profitable growth, but short of that, the name of the game must be to strive for improving the EVA Margin through the 3Ps. Profitability must take precedence over growth, or the game is not worth playing.

EVA Momentum can continue to be dissected and ultimately connected with the full array of performance indicators that are familiar to line teams. One path down the Momentum pyramid, for example, is to expand the firm's EVA Margin and to trace it to a series of line-item financial drivers that

open a window into the full range of business model productivity levers. Briefly, this new schedule involves merging the firm's balance sheet capital charges into its operating income statement in stages and then expressing each element as a percent of sales, as a charge or credit to the EVA Margin if you will. And for this purpose the capital charges for the firm's working assets are all computed using a grossed up, *pre-tax* cost of capital to make them perfectly equivalent to an operating cost, like cost of goods sold, which is also presented pre-tax.

For example, the Fifth Avenue jeweler, Tiffany, typically runs with over 200 working capital days on hand and it ties up about \$1 in property and equipment assets per \$1 of sales. On its EVA Margin schedule, that translates into about a 6% pre-tax capital charge for the working capital investment and a charge of about 18% of sales for its fixed assets, including depreciation expenses. All told, Tiffany has to set aside a whopping 24% of sales, pre-tax, just to cover the investment in its supply chain. Abstracting from Tiffany, the point is that this format enables managers to understand the relative importance of all the cost elements incurred in running the business, whether emanating from their balance sheet or income statement, on a common percent-of-sales scale, and therefore to concentrate on trends and opportunities that are truly material to the company's market value. For instance, if Tiffany could turn its working capital one-third faster, that would slash the charge from 6% to 4% of sales, and add the equivalent of 2% to the firm's pre-tax profit margin. That would tend to get management's attention.

Most companies do not operate with a schedule anything like this. Most report a bewildering array of metrics on a flat landscape. They display a desiccated and disorganized jumble of statistics, like sales growth, gross margin, working capital days, plant turns, cash flow, or what have you. The typical management report is derelict in not providing an overall score of the performance in the period—there really is no overarching indicator, like EVA Momentum—and second, in making it extremely difficult for line teams to compare the significance of one statistic to another, because each of the dashboard indicators is expressed on its own scale—in its own currency, if you will. How is one to rate and compare a strategy that increases the gross margin by 20 basis points against a required 10 day increase in inventory days on hand, for instance? But with the EVA Margin schedule, managers are no longer required to perform mental FX transactions to convert one metric to another. All productivity drivers are conveniently expressed on the same scale, as a percent of sales.

The new EVA Margin schedule makes the standby DuPont ROI formula obsolete. In it, ROI is expressed as a *multiplicative* product. It is put as operating margin *times* asset turns. The effect of each factor—of increasing asset turns for instance—confusingly depends on the other—the size of the margin, for example. In contrast, the EVA Margin schedule uses simple plus-and-minus math to represent the income statement margin and balance sheet turns, and without a confusing interdependency, which makes it considerably easier to understand and manipulate as a productivity management tool. It is time to retire ROI and to use EVA Margin and the EVA Margin breakout schedule in its place. Our clients are finding five major applications to the new ratio-infused EVA framework I've described: The first is simple but crucial. It is merely to establish that EVA Momentum is the company's overarching financial mission, applicable to each line of business, and then asking everyone to maximize it as the key measure of financial success. The second application, and in many ways most important, is to use EVA Momentum to summarize the overall quality and value of business plans and use it as a diagnostic tool to help management isolate the value drivers and spur development of better, more valuable, more EVA capable, business plans.

The third application is setting and communicating targets. The business plan and budget essence can be reduced to long-run and year-ahead goals for EVA, EVA Momentum, EVA Margin, and then actual

performance can be judged against the budget goals by quarter by line of business. In fact, the fourth application is just that. It is to use EVA Momentum and its faithful companion, EVA Margin, to summarize, dissect and benchmark actual performance against the budget, against the prior period, and against public peers. The EVA ratio metrics become the heart and soul, and organizing architecture, of the quarterly and annual management reviews, as opposed to the disjointed displays that are commonplace. Last, but not least, bonus plans can be calibrated to pay a base bonus for reaching an expected EVA Momentum target and to ratchet it up and down as EVA Momentum exceeds or falls short of the target. The target can be an absolute EVA Momentum goal or one that tracks with the median EVA Momentum generated by a peer group of firms, for example.

It is as an aid to setting targets that the final member of the EVA ratio trio comes into play. It is called Market-Implied EVA Momentum or “MIM” for short. It is the EVA Momentum that investors expect a company to produce in the coming years, and that is baked into its stock price. It is derived by reverse engineering stock prices to solve for the EVA stair-step increase that discounts back to the current share price, and then dividing that by current sales. For example, suppose the math shows that EVA must increase by \$10 million a year over 10 years to discount back to the firm’s current market value. If its sales are currently running at \$1 billion, then its MIM rate is \$10 million/\$1 billion, or 1%. That’s the EVA Momentum growth forecast that investors have implicitly impounded into its stock price. With that in hand, management can work the Momentum math, and ask what combination of expansion in our EVA Margin and sales growth at the Margin should we target to meet that market-mandated goal?

MIM is a far more reliable and useful statistic to quantify investor expectations than so-called consensus EPS, which (let’s face it) is not really a consensus. It is an opinion survey of sell-side analysts that ignores the buy-side investors who actually buy and sell stocks and set the prices. It is also based on earnings-per-share, which in no way discounts to present value and hardly tells the whole value story. MIM, by contrast, literally discounts to the consensus stock price, and it provides a direct reading of the expected growth in the firm’s EVA profit that is useful in three ways.

First, it reflects the degree of confidence that investors are registering in the quality and value of management’s forward plan. CFOs and board members should monitor MIM over time to understand how well the company’s forward plan value is being received in the market, and to be alert to any unfavorable trends in investor expectations. Second, MIM provides a concrete bogey against which a firm’s actual EVA Momentum performance can be judged. A company that persistently underperforms the market’s expected EVA growth rate is asking for trouble. Tectonic pressure is building and eventually will take the share price for a tumble. Third, CFOs can use MIM readings for their company and for publicly traded competitors to establish a minimum EVA trajectory for their consolidated forward plan and as an input to setting compensation targets.

The new EVA ratio framework is not just an interesting idea. It is a fully operational solution. My firm, EVA Dimensions has developed a set of software tools that automatically convert the actual and projected financials for a company, line of business, or acquisition candidate into the Best-Practice EVA model. EVA Dimensions also maintains a comprehensive data file of all the EVA metrics and ratio drivers covering 9,000 global companies over a 20 year history, with daily updates. The data file provides reliable reference points that turn EVA into a legitimate statistic for the first time, as illustrated by the median and percentile markers for EVA Margin and EVA Momentum cited above. With this data, CFOs and directors can rate business plans, judge results and set goals through an EVA lens with trust and confidence. They can challenge management to perform up to a defined and documented market standard. CFOs can assess their company’s EVA performance in light of the trends and

accomplishments of public peers. They can harvest irrefutable evidence about their company's relative standing and spotlight specific trends and improvement initiatives—ranked in terms of impact on value—to spur their line teams into action.

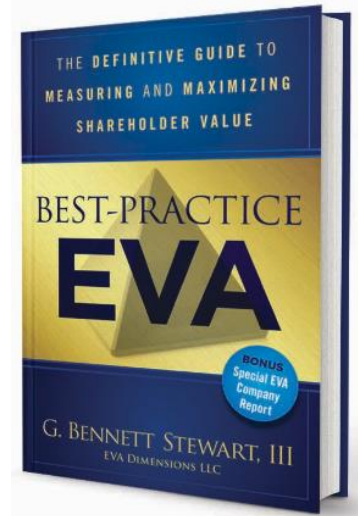
The data file is also the foundation for a stock rating and analysis system from EVA Dimensions that is gaining considerable traction in the professional investment community. Known as PRVIt (pronounced “prove-it” and standing for the performance-risk-valuation investment technology), the model first assigns a percentile score for some 24 key metrics that depict the essence of a company's performance, risk and valuation multiples through an EVA lens, and then it develops an overall buy-sell score that anticipates stock price movements on the premise that they are magnetically drawn to their fundamental EVA values.

The ratings have been featured on Bloomberg since 2006, and Fidelity has made an abbreviated version available to on-line retail customers since 2009. More important, a rapidly growing number of institutional investors at the largest active U.S. equity managers are using EVA analysis in their buy and sell decisions. An institutional equity research service that EVA Dimensions launched at the beginning of 2012 and staffed with a team of experienced Wall Street professionals has already established regular conversations with over 200 portfolio managers and research analysts at leading investment houses, and its client roster is growing weekly. In the process of delivering valuation insights to clients, the team is educating the buy-side community about EVA and helping to close the communication gap. This, and the publication of the new Best-Practice EVA book, is paving the way for new adopters of the Best-Practice EVA program to gain market recognition. Pepsico is a recent example of this.

Most companies today rely on a mish-mash of conventional metrics and textbook finance methods, when a far better alternative now exists. Most companies use cash flow analysis for capital allocations, turn to earnings growth and P/E multiples for communicating with investors and pricing acquisitions, consult sales growth, margins, ROI and the like for reviewing performance and making corrective adjustments, and tie bonuses to beating negotiated budget goals. As I have argued, there is now a far better way to go. It's time to retire the old warhorses. It's time for Best-Practice EVA.



*Bennett Stewart is an expert in shareholder value and corporate performance management, author of **Best-Practice EVA** (John Wiley & Sons, March, 2013), and CEO of EVA Dimensions, a financial technology firm that provides software tools, data bases and training and support packages that help CFOs to test and automate Best-Practice EVA and investors to make better buy-sell decisions. He can be reached at gbstewart@evadimensions.com*



EVA Dimensions has transformed EVA into a complete ratio-based management and valuation framework under the banner of EVA Momentum, which is a special way to measure the growth rate in economic profit. The new Momentum measure accurately consolidates overall improvements in business model productivity and the pace of profitable growth, and it unfolds in steps to reveal all the underlying factors that managers can use to improve performance and increase shareholder value and drive total shareholder return. The new EVA ratios replace other ratio indicators – such as profit margins, growth rates and return on investment -- with a management framework that is simpler to understand, more informative, and more inherently value-based.

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.