Economic Value Added

What gets measured gets done—for better or worse. Too many companies chase growth in earnings per share, only to find themselves employing too much capital at too low a rate of return and thereby eroding shareholder value. Economic Value Added\(^1\) offers a beguiling solution: an easy-to-understand measure that recognizes improvements in earnings only to the extent that they exceed the cost of the capital employed to secure them.

Eminently sensible, but for one critical flaw: EVA discourages growth. The conceptual problems have been there all along; the empirical evidence is beginning to mount. At a time when renewing growth represents the major competitive challenge facing most companies, dependence on EVA can become a major obstacle to building shareholder value. Fortunately, there are better alternatives.

Evaluating EVA

The value financial markets assign to a company reflects its prospects for profitability and growth. A change in value is driven by a change in expectations for one or both. CEOs naturally seek to influence shareholder value. The trick is to pick the right metric—one that tracks the market valuation process closely, yet is fairly simple and intuitive—and then drive the management of that metric down through the organization.

EVA is easy to understand and to calculate. But at a cost: it tracks actual market valuations rather poorly (see Figure 1) and introduces three fundamental distortions into managers’ decisions:

1. EVA is biased against new assets. EVA shares the bias against new assets of all conventional accounting-based measures. When an investment is made, its full cost hits the capital charge, and EVA shows artificially low. As the investment depreciates, the capital charge declines proportionally. At maturity, EVA shows artificially high. Inflation exacerbates the tendency, since EVA recognizes its impact on earnings but ignores its impact on the replacement cost of assets.

   This has the perverse effect of penalizing managers who bet on growth by investing. Except for the rare case where an investment has an immediate payback, growth-oriented managers take a short-term EVA hit.

2. EVA encourages managers to milk the business. Even worse than punishing progrowth behavior, EVA rewards antigrowth behavior. Investing aggressively at rates of return exceeding the cost of capital may be the preferred way to move the EVA needle. But managers quickly learn that the easier way, at least in the short term, is to reduce assets faster than earnings—to milk the business.

Pursued long enough, say three to five years, this strategy creates an EVA trap. Lack of investment can leave managers with such a depreciated asset base that any new investment will have a huge negative impact on EVA. The disincentive—whether to grow or to renew with more productive assets—compound over time.

Figure 1.
EVA Has a Low Correlation to Shareholder Value
Total Shareholder Return (TSR) Versus % Change in Economic Value Added 1994–95

\(\text{TSR} 140\)
\(-40\)
\(-60\)
\(20\)
\(40\)
\(60\)
\(80\)
\(100\)
\(120\)
\(140\)
\(-300\)
\(-200\)
\(-100\)
\(0\)
\(100\)
\(200\)
\(300\)
\(400\)

\(\% \text{ Change in EVA}\)

Source: BCG Database; Value Line Industrials: 1122 companies; 360 companies (32%) with positive EVAs in 1994

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\(^1\) Economic Value Added—which we will abbreviate as EVA—is generally calculated as net operating profit (before interest, but after tax) minus a charge for capital employed.
Little surprise, then, that the record of longtime EVA converts is one of delivering enhanced returns but not long-term growth in the capital base. Indeed, several have experienced growth rates in their asset bases close to zero and well below those of their peers.

EVA is biased in favor of large, low-return businesses. EVA is a marginal measure: it represents the incremental earnings above a base level set by the cost of capital employed. This makes EVA heavily biased by size. Large businesses that earn returns only slightly above the cost of capital can have bigger EVA's than smaller businesses earning much higher returns. What's more, the rate of change in EVA is accentuated for businesses whose historical performance hovers around the cost of capital. Small improvements in the performance of a marginal business generate large percentage gains in EVA.

This makes EVA a poor metric for comparing businesses, whether to benchmark performance against peers or to allocate resources across a company's portfolio. Because EVA sends misleading signals about the relative attractiveness of businesses, companies that rely on it run the risk of growing the wrong ones.

Moving Beyond EVA

Companies that want to grow must move beyond EVA. There are two viable alternatives. The simpler approach is to adjust the measure to a cash basis, by adding depreciation and amortization back to net operating profit and accumulated depreciation back to book capital. You might term this measure “cash value added” (CVA). Because it eliminates the worst of EVA's antigrowth or reinvestment bias, CVA takes an important step beyond EVA. It remains inadequate, however, as a means to compare businesses.

For that reason, more and more companies are going even further. They are evaluating business-unit performance in the same way that investors look at a company's stock or executives size up a potential acquisition. Call this approach “total business return” (TBR). By comparing the beginning value of a business with its ending value, plus free cash flow, TBR effectively replicates total shareholder return inside the company at the level of the individual business unit. (For a more detailed treatment of TBR, see "Meeting the Value Challenge" The Boston Consulting Group, Inc., 1995, and “Shareholder Value Metrics” The Boston Consulting Group, Inc., 1996.)

As one might expect, TBR displays a much more satisfying correlation with observed total shareholder return: 40 percent over one-year periods and 57 percent over three years, roughly double the correlations for EVA. The results are sufficiently convincing that some companies are using TBR directly to peg planning and executive compensation targets. Others are using TBR at the corporate level to set objectives, which they then translate into more familiar accounting-based measures for the operating units. The result is to reward executives for expanding businesses that create value for shareholders.

Aligning your managers' interests with those of the company and its shareholders is critical, especially at a time when the chief imperative—to grow—runs counter to the behavior encouraged by accounting-based measures. Recognize the limits of these measures and move beyond them.

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