

EVA: The Good, the Bad, and the Complex

Compensation Committee Series Webinar
Presented by Pearl Meyer

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Meet the Presenters



Barton Edgerton (moderator) is NACD's Senior Manager of Governance Analytics where he is responsible for generating insights to elevate board performance through data. His team produces NACD's survey reports and benchmarks. Over the past 20 years, he has worked with a variety of boards, private equity firms, and Fortune 500 executives. His research experience includes nearly 10 years at CEB and as an academic at Tufts University.



Matt Turner is a Managing Director in Pearl Meyer's Chicago office. He specializes in executive compensation strategy, incentive plan design, tailoring of performance measures, and the setting of shareholder-focused performance objectives. With 25 years of experience, Mr. Turner has worked with public and private companies in a range of industries. In addition to ongoing advisory services, he has also worked extensively with companies undergoing changes in ownership structure, business transformation, and other strategic events.



Brett Herand is a Principal in the Chicago office of Pearl Meyer. He works with boards and management on executive compensation issues related to performance measurement and value creation, incentive plan design, and technical advisory work with respect to tax, accounting, and SEC regulatory issues. Brett works with public and private companies across many industries and has been widely quoted in various publications.

Submit a question and receive your answer directly from Pearl Meyer, either during today's webinar or as a follow-up. You will also be opted-in to receive future executive compensation thought leadership from Pearl Meyer.

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- Presentation slides are available today at www.pearlmeyer.com/eva-good-bad-and-complex and within the webinar console.
- The replay will be available early next week at www.NACDOnline.org and www.pearlmeyer.com/eva-good-bad-and-complex.

Today's Agenda



- What is EVA?
- Why are we talking about EVA?
- What are the benefits and challenges of EVA?
- What must boards do?

What is EVA?

- EVA stands for Economic Value Added. May also be referred to as Economic Profit, Shareholder Value Added, or simply Value Added
- EVA is a measure of financial results that deducts the opportunity cost of *all* invested capital—debt and equity—from a company's after tax operating income

Revenues
- Cost of Goods Sold
<hr/> <hr/>
= Gross Profit
- Selling General & Admin Exp.
- Depreciation & Amort.
<hr/> <hr/>
= Operating Income
- Interest Expense
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= Pre-tax Income
- Taxes
<hr/> <hr/>
= Net Income

1. The cost of debt is on the income statement here

2. Where on the income statement is the cost of equity???

What is EVA?

- EVA is not on the income statement. The EVA calculation requires additional inputs and assumptions from both the balance sheet and the market
- $EVA = NOPAT$ minus a capital charge
 - The capital charge reflects a carrying cost for all invested capital
 - Weighted average cost of capital (WACC) x invested capital
- Alternatively, $EVA = (ROIC - WACC) \times$ invested capital

EVA is an appealing performance measure because it holds managers accountable for earning an “economic” return on the invested capital, rather than merely an accounting profit.

What is EVA?

- A trademarked term of Stern Stewart—a financial consulting firm that popularized the concept of economic profit in the 80s and 90s
- A financial planning tool that can be used along side of, or in place of, discounted cash flow (DCF) to evaluate businesses, investment opportunities, and strategic planning alternatives
- Can be shown to correlate with shareholder value creation and share price performance
- Has found its way into incentive pay frameworks in some companies

Why are we talking about EVA?

- ISS and Glass Lewis both conduct pay-for-performance analysis as part of their say-on-pay evaluation

ISS

Performance Assessment Framework

Two performance tests:

1. Absolute and Relative TSR
2. Secondary test covering 3-4 financial metrics, with different weights, depending on industry:
 - ✓ Return on invested capital
 - ✓ Return on assets
 - ✓ Return on equity
 - ✓ EBITDA
 - ✓ Operating cash flow

GL

Performance Assessment Framework

Single performance scorecard:

- ✓ TSR
- ✓ EPS
- ✓ Operating cash flow
- ✓ Return on assets
- ✓ Return on equity

Why are we talking about EVA?



- In February 2018, ISS acquired a firm called EVA Dimensions
- EVA Dimensions is an equity research firm that uses EVA-based performance assessments in making investment recommendations
- On the issuer side, it provides consulting services focused on the implementation of EVA measurement frameworks
- ***It is assumed that ISS will replace the GAAP-based financial performance measurement framework from the prior page with an EVA-based measurement framework when evaluating relative performance***

Companies adopted rTSR plans, in part, to align with ISS concerns. Will companies feel compelled to similarly adopt EVA-based incentive plans?

How is ISS using EVA?



- EVA Profile Reports are being included with ISS Proxy Analysis & Benchmark Policy Voting Recommendations and cover four key EVA calculations
 - $\text{EVA Margin} = \text{EVA} / \text{Sales}$
 - $\text{EVA Spread} = \text{EVA} / \text{Capital (or ROIC-WACC)}$
 - $\text{EVA Momentum - Sales Trend} = 3\text{-year } \Delta \text{ scaled to sales}$
 - $\text{EVA Momentum - Capital Trend} = 3\text{-year } \Delta \text{ in EVA scaled to capital}$
- Performance compared to Russell 3000
- ISS intends to make 15 specific adjustments to GAAP financials in calculating EVA
- There is no GAAP to EVA reconciliation currently available (and a simple reconciliation is all but impossible)

How is ISS calculating EVA?



- ISS's 14-page technical primer explains in more detail the numerous adjustments ISS makes to GAAP data to calculate EVA
 - ✓ Treat R&D and advertising as investments
 - ✓ Reverse impairment charges
 - ✓ Capitalize restructuring costs
 - ✓ Use cash accounting for losses and gains on sale
 - ✓ Capitalize unusual and non-recurring items
 - ✓ Eliminate the impact of holding surplus cash
 - ✓ Treat leased assets as if they were owned
 - ✓ Smooth taxes
 - ✓ Recognize the value of deferring taxes
 - ✓ Recognize the tax benefit value of deducting stock options
 - ✓ Exclude AOCI hedge gains (losses) from capital
 - ✓ Deduct actual NCOs instead of provisions
 - ✓ Convert LIFO inventory costing to FIFO
 - ✓ Eliminate retirement cost distortions
 - ✓ Non-controlling interests adjustments

How is ISS calculating EVA?

EVA Computations	2016TFQ3	2017TFQ3	2018TFQ3
EVA (NOPAT - Capital Charge)	-\$119	\$36	\$1,257
= Net Operating Profit After Tax (NOPAT)	\$1,268	\$1,383	\$2,924
- Capital Charge (COC x Capital)	\$1,387	\$1,347	\$1,667
= Capital (4 Qtr Average)	\$17,956	\$17,731	\$21,253
x Cost of Capital (COC)	7.7%	7.6%	7.8%
EVA Margin (EVA/Sales)	-0.5%	0.1%	3.9%
= EVA	-\$119	\$36	\$1,257
/ Sales	\$23,669	\$24,441	\$32,102
EVA Spread (EVA/Capital or ROC-COC)	-0.7%	0.2%	5.9%
= Return on Capital (ROC, = NOPAT/Capital)	7.1%	7.8%	13.8%
- Cost of Capital (COC)	7.7%	7.6%	7.8%
EVA Momentum - Trend vs. Sales (EVA/Prior Sales)	-2.91%	-2.16%	0.85%
= Trend Change in EVA (over past 4 years)	-\$941	-\$613	\$215
/ Average Sales (over first 3 TFQs)	\$32,332	\$28,391	\$25,303
EVA Momentum - Trend vs. Capital (EVA/Prior Capital)	-4.73%	-3.12%	1.17%
= Trend Change in EVA (over past 4 years)	-\$941	-\$613	\$215
/ Average Capital (over first 3 TFQs)	\$19,891	\$19,656	\$18,383

At my company, EVA.....
(choose all that apply)

- A. Is already an integral part of our compensation programs
- B. Is not in our compensation programs, but a primary tool used by corporate finance
- C. Is not being used, but we are seriously evaluating EVA for future use in compensation programs
- D. Is becoming a topic of conversation with the compensation committee
- E. Has not been part of any meaningful discussions and we have no serious interest (other than preparing for the ISS changes!)

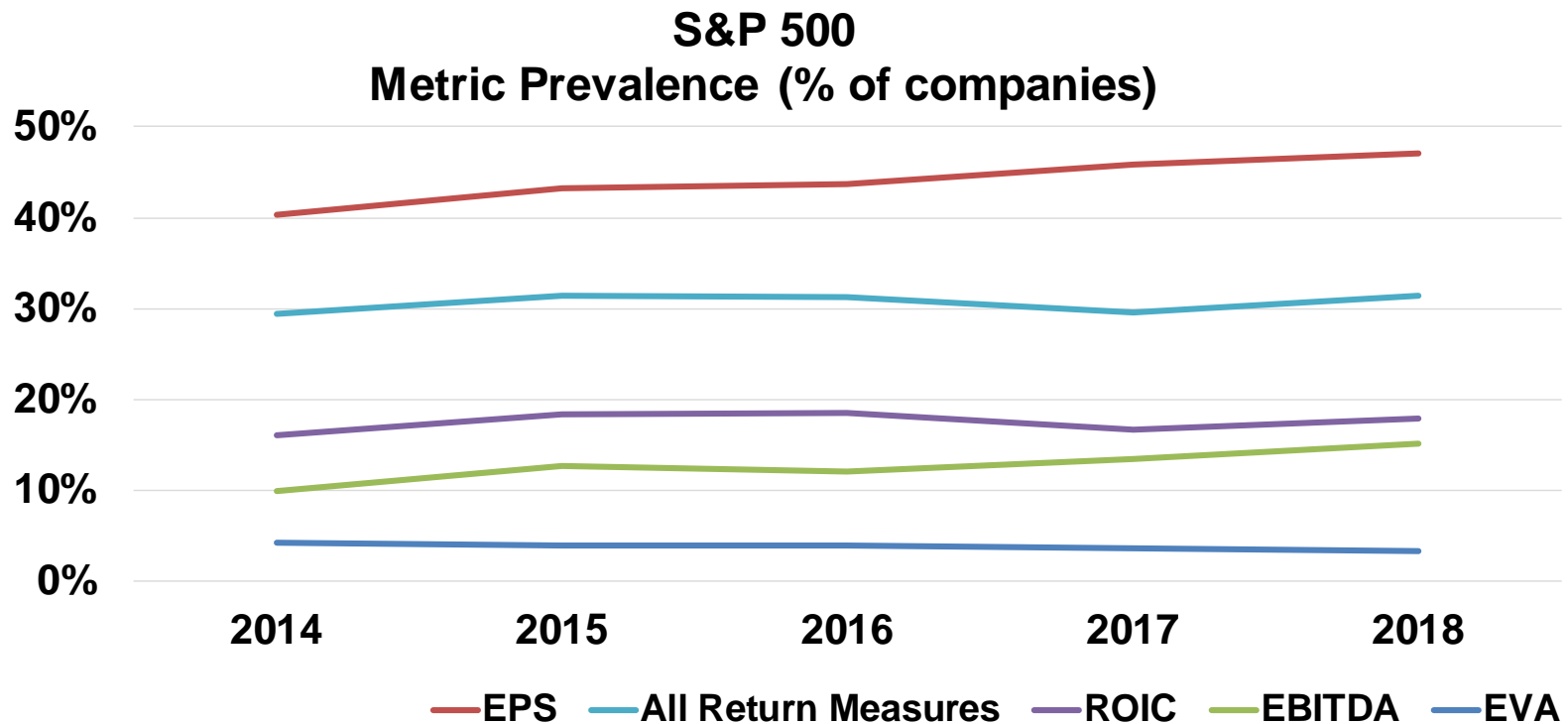
What are the benefits and challenges of EVA?



- At an intuitive level, the concept is valid and robust...
 - Strongly aligned with shareholder value
 - Holds managers accountable for earning a return on all capital
 - Corrects accounting-driven distortions in measuring economic profit
 - Can be scaled to better enable company-to-company comparisons
 - Can be an effective corporate planning tool
- But it does have its drawbacks...
 - Complexity
 - Lack of familiarity
 - History of poor implementation in compensation plans
 - Can be viewed as a panacea by true believers
 - For broad-based comparative purposes, EVA is no better than the other metric combinations, but comes with complexity and the black box phenomenon

What are the benefits and challenges of EVA?

- Despite its benefits, EVA is not a widely-used metric...



What are the benefits and challenges of EVA?



...nor do we believe there is deep investor interest in EVA-based incentives

Have your investors discussed EVA-based incentives?

% of Board Responses	Response	% of Management Responses
4%	Yes, there is broad support from our investors for EVA-based incentives	10%
4%	Yes, a minority of our investor base supports EVA-based incentives	3%
25%	A small minority of our investors, representing a very small portion of our ownership base, supports EVA-based incentives	4%
68%	We have received no feedback from investors indicating a preference for EVA-based incentives	67%
0%	Possibly, it hasn't been on our radar screen.	15%

An example of a traditional EVA incentive plan: a “banking” plan



- Plan based on a % of absolute EVA and % of EVA growth
- Executive receives payouts from a notional account, which helps to smooth otherwise volatile results

EVA Banking Plan based on absolute EVA and EVA growth

Executive target incentive: \$100
 Executive bonus formula: 0.05% EVA + 1.67% Δ EVA

	2016	2017	2018	2019	2020	2021	2022
Company EVA:	\$98,425	\$101,378	\$104,419	\$107,552	\$110,778	\$114,102	\$117,525
Δ EVA:	-	\$2,953	\$3,041	\$3,133	\$3,227	\$3,323	\$3,423
Beginning bank balance:		\$200	\$200	\$202	\$205	\$210	\$215
Earned award:		+ \$100	\$103	\$106	\$109	\$113	\$116
End of year bank balance:		\$300	\$303	\$308	\$315	\$322	\$331
End of year paid award: (1/3 of bank balance)		\$100	\$101	\$103	\$105	\$107	\$110

An example of a traditional EVA incentive plan: a “banking” plan (cont.)



Executive target incentive:	\$100								
Executive bonus formula:	0.05%	EVA +	1.67%	Δ EVA					
VOLATILE EVA			2016	2017	2018	2019	2020	2021	2022
Company EVA:	\$98,425	\$101,378	\$135,000	\$110,000	\$85,000	\$95,000	\$100,000		
Δ EVA:	-	\$2,953	\$33,622	(\$25,000)	(\$25,000)	\$10,000	\$5,000		
Beginning bank balance:		\$200	\$200	\$553	\$127	(\$165)	\$33		
Earned award:	+	\$100	\$629	(\$363)	(\$375)	\$215	\$134		
End of year bank balance:		\$300	\$829	\$190	(\$248)	\$49	\$166		
End of year paid award: (1/3 of bank balance)		\$100	\$276	\$63	(\$83)	\$16	\$55		

Executive target incentive:	\$100								
Executive bonus formula:	0.05%	EVA +	1.67%	Δ EVA					
DECLINING EVA			2016	2017	2018	2019	2020	2021	2022
Company EVA:	\$98,425	\$101,378	\$104,419	\$99,198	\$94,238	\$89,526	\$85,050		
Δ EVA:	-	\$2,953	\$3,041	(\$5,221)	(\$4,960)	(\$4,712)	(\$4,476)		
Beginning bank balance:		\$200	\$200	\$202	\$110	\$49	\$10		
Earned award:	+	\$100	\$103	(\$38)	(\$36)	(\$34)	(\$32)		
End of year bank balance:		\$300	\$303	\$164	\$74	\$15	(\$22)		
End of year paid award: (1/3 of bank balance)		\$100	\$101	\$55	\$25	\$5	(\$7)		

An example of an incentive plan that captures EVA without using “EVA”



- Three-year plan, measures average ROIC and cumulative profit (NOPAT)
- Executive earns a number of shares (PSUs) equal to a target times the multiplier
- Horizontal captures profitable growth
- Vertical captures capital returns
- Cost of capital (WACC) is 7.00%
- Approach may be modified to emphasize strategic imperatives

		Cumulative NOPAT				
		\$600,000	\$650,000	\$700,000	\$750,000	\$800,000
ROIC	11%	1.00x	1.25x	1.50x	1.75x	2.00x
	10%	0.75x	1.00x	1.25x	1.50x	1.75x
	9%	0.50x	0.75x	1.00x	1.25x	1.50x
	8%	0.25x	0.50x	0.75x	1.00x	1.25x
	6-7%	0.00x	0.25x	0.50x	0.75x	1.00x

No payout if three year average ROIC < 6%

How comfortable are you with your executive compensation program when ISS begins including EVA in its assessment?

- A. No problem. Our plans already consider economic profitability in the measures or, at least, in the way we set performance goals
- B. We feel good about it. We'll have a little work to do get comfortable with the ISS EVA calculations but don't feel compelled to make changes to our programs
- C. Our performance measurement framework needs to be updated as it poorly assesses the relevant dimensions of performance
- D. Still very confused. What is EVA?

- We have learned much from companies that have successfully implemented EVA-based pay and performance frameworks. Success requires some key conditions:
 - Leadership commitment
 - Adequate internal financial reporting systems
 - Deep participant education
 - Broad agreement on key inputs
 - Robust goal-setting processes
 - Supportive and knowledgeable compensation committee

What should you be doing?

1. (As with rTSR and the existing ISS and GL financial scorecards) understand your company's EVA performance according to the ISS definitions
2. Review your current compensation programs and the performance measurement framework. Ensure a robust linkage between the framework and your business strategy and economic context
3. Review your goal-setting process and ensure the concept of economic profitability is given sufficient consideration
4. Review disclosure narratives and ensure there are no blind spots for criticism of a lack of concern for economic profitability

1. EVA, or economic profit, is an important concept for corporate planning, valuation, and, for some, incentive compensation
2. Companies need to be fully familiarized with the coming ISS EVA-based evaluation of pay-for-performance, and be prepared to engage investors and other stakeholders on it
3. If you do not change your compensation programs to include EVA, you will not be alone

Questions

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