



# The Corporate Imperative: Building Economic Value

Measuring the adequacy of operating earnings against invested capital.

by Michael T. Newsome

**“You only get richer by investing money at a higher return than the cost of the capital to you.”**

Roberto Goizueta, Late CEO of Coca-Cola

It is a stubborn reality that a business that fails to consistently earn its cost of capital returns less than the resources it devours. Senior managers of the firms with whom we work can talk at length about efforts to grow sales or strengthen earnings, but the capital employed to generate those earnings is often neglected. So the question is, how can corporate performance be measured in a way that captures the impact of the two fundamental drivers of shareholder value—operating profitability and invested capital?

Fortunately, there is a financial measurement framework known as “Economic Value Added” (EVA) that simply and effectively couples earnings and capital efficiency. EVA was introduced in the 1980s by Stern Stewart & Co. and has been widely adopted by large corporations and investors. Over the years, that EVA has proven to align management decision-making and shareholder goals around the creation of economic value, which should be the governing objective in both large and small companies.

Stern Stewart coined the term EVA, but it is by no means an original concept. It is firmly rooted in the neoclassical notion of economic profit, which was defined in 1890 by the prominent British economist, Alfred Marshall, as “What remains of his profits after deducting interest on his capital at the current rate.”

EVA can be expressed as net operating profit after tax (NOPAT), less a charge that represents the cost of all of the debt and equity capital invested to produce those profits. As illustrated in the example below, economic (or shareholder) value is only

Income Statement			
Sales			\$ 100,000,000
Operating Profit			10,000,000
Income Taxes	35.0%		(3,500,000)
NOPAT			\$ 6,500,000
Balance Sheet			
Debt Capital (after-tax cost)	25,000,000	4.6%	(1,137,500)
Equity Capital	15,000,000	25.0%	(3,750,000)
Total Capital	\$ 40,000,000	12.2%	\$ (4,887,500)

**EVA** **\$ 1,612,500**

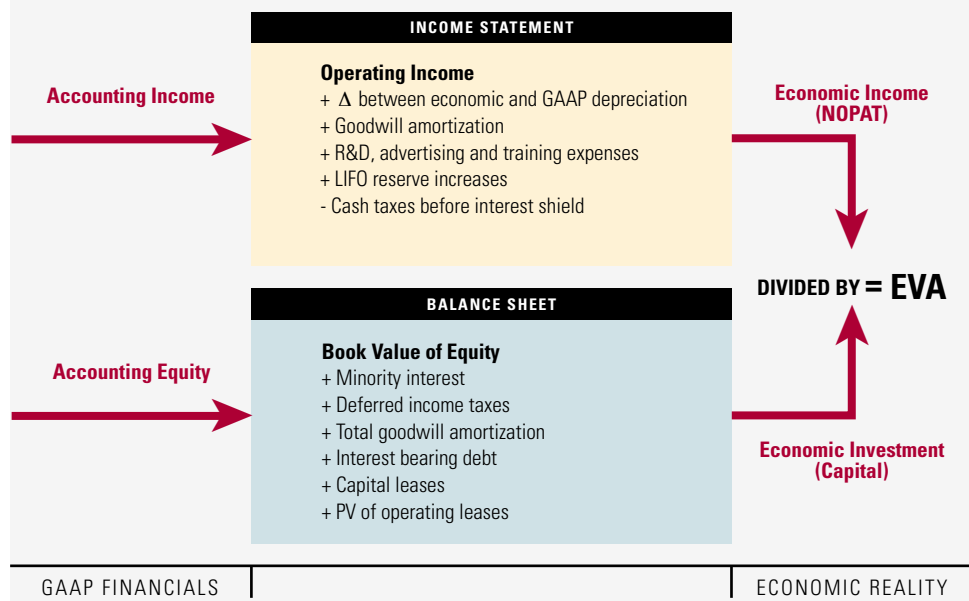
created if profits exceed the business’s cost of capital. Firms that consistently generate positive EVA over time are building shareholder value, a conclusion that has been repeatedly demonstrated in studies of public company share prices.

While EVA is a relatively easy concept to grasp, the actual calculation can be a bit more challenging. There is a meaningful difference in the information presented in financial statements based on GAAP accounting conventions and the economic information

that is most relevant to shareholders. It is usually necessary to adjust certain accounting expenses and balance sheet items in order to better pin down true economic profits and capital investment. A couple of areas that typically merit some refinement include:

**Fixed Asset Depreciation**—from a tax perspective faster depreciation is better. But, accelerated depreciation is seldom an accurate reflection of the useful economic life of a particular asset. So, if corporate assets have longer (or shorter) lives than reflected by

**EVA Adjustments:** Calculating true economic profits and investments.



$$EVA = NOPAT - (K_w \times TC)$$

NOPAT = net operating profit after taxes  
 $K_w$  = weighted average cost of capital  
 TC = total debt and equity capital

the accounting schedule, then depreciation expense should be fine-tuned to reflect the real economic obsolescence of the assets.

**Advertising and Marketing**—accountants are compelled to expense these costs when incurred, because they have no realizable liquidation value. In reality, promotional expenditures often correspond directly to future customer acquisitions or the development of a brand that has long-term proprietary value. Under certain circumstances, it's reasonable to capitalize these expenditures and amortize them over time.

**Research and Development**—the same logic applies to R&D expenditures, as these investments are only made with the expectation of future returns. From an economic perspective, R&D outlays should be amortized over the period of years in which there is an expected earnings impact.

Of course, there are other expenses and balance sheet items, such as deferred taxes, inventory, training and development expenses, restructuring charges, and goodwill amortization, where some adjustment may be justified in order to better to reflect the real economic profit a business generates. For most companies, simple rules, consistently applied, are better.

#### ECONOMIC VALUE CREATION

Top-line growth does not equate to added shareholder value. In the absence of capital discipline, growth (even profitable growth) may erode shareholder value. This is why some high-flying companies fade into oblivion

following a growth binge. Firms that employ EVA find that it is a consistent framework with which decisions can be weighed on exactly the same terms—the incremental shareholder wealth that a particular action will create or destroy.

There is an abundance of familiar measures of corporate performance (Sales Growth, Earnings Growth, EBIT, EBITDA, ROE, RONA, EPS, etc.), yet none offer the clarity of EVA:

- It drives home the necessity of focusing on capital efficiency, as well as revenue growth and profitability.
- With some training, the concept can be understood by all levels of an organization.
- It is adaptable. If revenues, costs, and invested capital can be allocated, EVA can be broken down on a company, division, plant, store, project, customer, or product line level.
- It can be retrospectively measured on an annual basis to evaluate corporate performance or over multiple periods to gauge the benefits of an investment that requires several years to prove itself.
- It is a forward-looking planning tool to evaluate the impact on value of a prospective capital investment or acquisition.
- It is a useful incentive compensation yardstick that puts managers on the same footing as shareholders.

#### VALUE DRIVEN STRATEGY

Successful companies possess one or more of the following attributes: a clear sense of the target customers; a well-honed marketing

strategy; a reputation for exceptional service; or products/services that are unique in terms of cost advantage, performance, or brand perception. In order to have a successful strategy, business leaders are obliged to define competitive advantages and core business and then direct the firm's resources—people, time, and capital—towards building that core business. In the absence of a strategy that both leverages competitive advantage and focuses on the core business, it is difficult to achieve the governing objective of building shareholder value.

EVA is not a substitute for a well-conceived strategy. It is a measurement tool that can be used to guide the decisions and actions of managers towards those activities within the strategy that build economic value. To reap the benefits of EVA, more is required than simply tracking the metrics. Employees must have a clear understanding of the actions that have a direct impact on economic value.

A value-driven strategy requires the discipline to assess the impact of decisions on value and a compensation program that rewards actions that increase shareholder value. ♦

Please visit the Insight page of [www.ZacharyScott.com](http://www.ZacharyScott.com) to access a more detailed example of an EVA calculation.

<sup>1</sup>EVA is a trademark of Stern Stewart & Co.



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Zachary Scott is an investment banking and financial advisory firm founded in 1991 to serve the needs of privately held, middle-market companies. The firm offers a unique combination of in-depth knowledge of the capital markets and industry competitive dynamics, sophisticated analytical capabilities, and proven expertise in structuring and negotiating complex transactions. For more information on Zachary Scott, please go to [ZacharyScott.com](http://ZacharyScott.com).

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