EVA

Economic Value Added

Synopsis of "<u>The Real Key to Creating Wealth</u>" an article from FORTUNE Magazine dated September 20, 1993

What is Economic Value Added (EVA)?

Simply stated, EVA is just a way of measuring an operation's real profitability. What makes it so revealing is that it takes into account a factor no conventional measure includes: the total cost of the operations capital. The capital is all the money tied up in such things as heavy equipment, real estate, computers, and other stuff that's expected to be productive for a while after it has been purchased, plus so-called working capital, mainly cash, inventories, and receivables. EVA is simply after-tax operating profit, a widely used measure, minus the total annual cost of capital.

Former Coca-Cola CEO Roberto Goizueta explains EVA:

“We raise capital to make concentrate, and sell it as an operating profit. Then we pay the cost of that capital. Shareholders pocket the difference.”

Goizueta has a slogan in his office:

“The one with the biggest cash flow wins.”

Goizueta also stated he lowered his cost of borrowing capital to improve the profitability of Coca-Cola.

This turns out to be profound. Incredibly, most corporate groups, divisions, and departments have no idea how much capital they tie up or what it costs.

True, the cost of borrowing capital shows up in a company’s interest expense. But the cost of equity capital, which the shareholders have contributed, typically appears nowhere in any financial statements – and equity is extraordinarily expensive capital. Until managers figure all of this out, they can’t know whether they’re covering all their costs and adding value to a company.

Earning more than the cost of capital is about the oldest idea in enterprise...the idea behind EVA has often been lost in ever dark muddles of accounting.

Former CEO of CSX John Snow introduced EVA to CSX in 1988 and had this to say about EVA:

“EVA is anything but theoretical.”

"How we use capital determines market value."

One of EVA's most powerful properties is its strong link to stock prices. The two numbers show a remarkable tendency to move up and down together.

EVA shows what investors really care about – the net cash return on their capital – rather than some other type of performance viewed through the often distorting lens of accounting rules.

Oppenheimer Capital stated:

"We like to invest in companies that use EVA and similar measures. Making higher returns than the cost of capital is how we look at the world."

Former CEO of Quaker William Smithburg stated when taking over:

"Our biggest problem was using too much capital."

Former Quaker plant manager Steven Brunner stated:

"I used to treat inventories like they were free."

What's Your EVA?

The power of the EVA concept comes from the insight that you can't know if an operation is really creating value until you apply the true cost of capital to all the capital employed. Most operations within companies – and some companies themselves – have no idea what either amount is.

1. What is the true cost of your capital?

   Most companies know at least in the short term their cost of capital is the interest they pay when adjusted to reflect tax deductibility.

   What most companies do not take into account is the equity capital the owner, partner(s) or stockholders invest into the company.

   The true cost of equity capital is what an owner, partner(s) or shareholders could be getting in price appreciation, dividends or growing interest in the company had they invested their money into a portfolio of other risky businesses as well.

   What true cost of equity capital boils down to is ***the lost opportunity cost*** (loss of interest, ownership or dividends) of investing in a profitable business versus a non-profitable business.

   Since equity capital typically does not have a monthly bill to pay for the cost to use the money in the company most owners/managers think it is free money.
   Talton Embry of a New York investment firm has this to say about EVA:

   “Capital looks free to a lot of managers. It doesn’t look free to investors who hand them their money.”

   To give an idea of what investors expect, on average a return over time is six percentage points higher on stocks than on long-term government bonds.

2. How much capital is tied up in your operation?

   Even if an owner/partner(s) do not know the answer they know what it consists of such as real estate, machines, vehicles, etc. plus working capital.

Proponents of EVA say there is more to the capital in a company such as money spent on R&D or employee training that typically meant to pay off for years yet accounting rules say the cost has to be an expense like an electric bill.

EVA proponents encourage you to forget accounting rules and for internal purposes call those expenses capital investments as they should be when calculation EVA.

No one can determine what the useful life is of a capital investment so use your best guess because it is truer than calling them expenses.

When you have answered Questions 1 and 2 you can multiply the capital from Question 2 by the rate from Question 1 and get the dollar cost of the capital in your operation.

The simplest way to calculate EVA is to subtract taxes from your operating earnings then subtract the capital cost and that is your EVA.

If your EVA is positive then you are creating wealth if it is negative you are destroying capital.

One key point is to not think that because capital costs are high that is a bad thing.

How To Raise Your EVA

The power of the EVA concept cannot be realized if an operation is not aware of the fundamental return on capital.

There are just 3 ways to increase EVA:

- **Earn more profit without using more capital**

  Example is CSX had been using 150 locomotives but reduced to 100 locomotives by finding areas to reduce the need for locomotives.

  One such strategy was during their route from New Orleans to Jacksonville they were using 4 locomotives at 28 MPH and arrived at midnight long before they were to be unloaded onto trucks and freighters. CSX decided to only use 3 locomotives at 25 MPH arriving later at 4 to 5 AM and using 25% less fuel.

- **Use less capital**

  Examples are CSX using less locomotives, Coca-Cola using plastic containers for concentrate over the more costly metal containers and Quaker reschedules production to require fewer warehouses.

  When you save capital you improve the value of your company, the capital can be used for more growth or reduce any debt load.

- **Invest capital in high-return projects**

  Always make sure the projects earn more to exceed the cost of capital for the project.

The bottom line with EVA is the most efficient method of seeing and understanding what is really happening to the performance of a business.

Owners, partner(s), managers and investors see for the first-time important factors of an operation by utilizing EVA.

In the end EVA is validated by a quote from the author of **"The Real Key to Creating Wealth"** Shawn Tully:

"*If you understand what's really happening, you'll know what to do*."

While this article is geared toward the business owner, at Tivaldi we recommend that the individual and household treat their finances just like a successful business.

What Tivaldi brings to table for individuals, households and business owners with EVA - we provide a review of your estate and succession plan and provide solutions for building tax-free working capital.

Please reach out to John Stockwell and Joe Myers to schedule a consultation at Admin@Tivaldi.com