EVA as a Performance Measure in Executive Incentive Plans

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Economic Value Added (EVA) is a measure of a business enterprise’s economic performance based on what is added to that enterprise’s value by its operating earnings (net of tax) reduced by the enterprise’s “capital costs.” The concept of EVA was introduced in the 1980s by the management consulting firm of Stern Stewart & Co. That firm obtained a trademark for the term EVA and subsequently transferred it to Stern Value Management, Ltd. This post discusses recent developments in EVA, how the EVA formula works and the use of EVA as a performance metric in executive incentive compensation plans.

Recent Developments in EVA

On February 12, 2018 Institutional Shareholder Services (ISS), the largest proxy advisory firm in the U.S., acquired EVA Dimensions, an EVA-based research firm founded by G. Bennett Stewart III, one of the co-founders of Stern Stewart & Co. Mr. Stewart currently serves as Senior Advisor to ISS. On March 18, 2019 ISS issued a report, entitled “Using EVA in Pay-for-Performance Analysis.” In that report ISS recommends the use of EVA as a tool to assess the alignment of pay and performance and indicates that during the 2019 proxy season it will be including in its proxy reports to investors a set of metrics based on EVA. (ISS distributes to its subscribers proxy reports providing its voting recommendations in connection with shareholder meetings of public corporations, including recommendations on shareholder votes regarding executive compensation.) In the report, ISS indicates that, at least during 2019, EVA-based metrics will not impact on its proxy voting recommendations and that it also is not taking a position as to whether it favors or disfavors the use of EVA as a metric in executive incentive plans.

The EVA Formula

Following is a statement of the EVA formula:

**EVA** equals **NOPAT** minus **Cost of Capital multiplied by Capital**

The terms used in the formula have the following meaning:

* **NOPAT**, which is the acronym for Net Operating Profit After Taxes, is (i) earnings before interest and taxes less (ii) taxes on the amount derived from (i).
* **Cost of Capital** is the weighted average of (i) after-tax cost of debt (i.e., interest on debt net of tax deduction benefits) expressed as a percentage and (ii) Cost of Equity, also expressed as a percentage. “Cost of Equity” represents what a reasonable investor might expect as a return on investment in the stock of the company in question. The weighting of the after-tax cost of debt and Cost of Equity is based on the capital profile of the company.
* **Capital** is the total capital, comprised of equity and debt, employed in the enterprise.

Following is an illustration of how EVA is calculated. Assume a company’s NOPAT for 2018 was $500 million and its Capital during that year was comprised 7/10 of debt and 3/10 of equity, together totaling $2 billion. Assume further that, during 2018, the company’s after-tax cost of debt was 4.0 percent and its Cost of Equity was 10 percent. On these assumptions, the Cost of Capital would be 5.8 percent (7/10 times 4 percent plus 3/10 times 10 percent). Thus, the company’s EVA for 2018 would be $384 million, determined as follows:

* $500 million (NOPAT) less
* $116 million (Cost of Capital (5.8 percent) multiplied by Capital ($2 billion)) equals
* $384 million (EVA).

**Adjustments Made by ISS in Calculating EVA**

In calculating EVA, ISS makes a number of adjustments in the application of conventional accounting rules. For a list of adjustments recommended by ISS see the ISS report, “The EVA Measurement Formula: A Primer on Economic Value Added (EVA)” (2018), authored by Mr. Stewart.

There is no ultimate arbiter of a company’s EVA. However, ISS’s influence in proxy votes of companies suggests companies will pay careful attention to the EVA numbers published by ISS in its proxy reports.

**ISS’s EVA-Based Metrics**

ISS indicates that it will be publishing EVA-based financial metrics in its 2019 proxy reports noted above. These will include (among others):

* EVA as a ratio of Sales (“EVA Margin”)
* EVA as a ratio of Capital (“EVA Spread”)

These ratios facilitate comparisons of performance among different companies.

Financial-based ratios long used in comparisons of financial performance include, among others, return on equity (net income as a ratio of equity) and Total Stockholder Return (TSR) (gain in stock price plus dividends over the applicable period as a ratio of the stock price at the beginning of the period).

Using EVA as an Incentive Plan Metric

While ISS has indicated, as noted above, that EVA-based metrics shown in its proxy reports during 2019 will not impact its voting recommendations, those figures may impact shareholders’ votes including those on executive compensation. As a result, some companies (in addition to those already using them) may consider using EVA-based metrics in their executive incentive plans, long-term and/or short-term.

Adoption of EVA as the basic metric for a company’s long-term incentive plan would mean, for many companies, a shift from a metric based on stock market price to a metric based on value of the enterprise. Alternatively, instead of EVA being the basic metric, EVA could be used as a factor to adjust an award that is subject to stock price as the basic metric. For example, if an award’s payout is subject to the company’s TSR over a three-year period, the payout level based on TSR as the basic metric for that period could be adjusted, in turn, by a second factor based on the cumulative EVA amount over the same period.

**Example of EVA Used as a Metric in an Executive Incentive Plan**

Following is an example of the design of a long-term executive incentive plan based on EVA.

1. Performance period: 2020 – 2022.
2. Target: cumulative EVA for the performance period equal to a specified dollar amount. (More specifically, the cumulative EVA for the performance period would be determined by aggregating the EVA figures for 2020, 2021 and 2022 and that three-year performance would be measured against the target.)
3. If target is achieved, full payout of the incentive award would be made.
4. If performance is over or under target, adjustments would be made in the payout of the incentive award, with no payout if the cumulative EVA for the performance period was less than a threshold amount. (Some plans also provide a maximum payout on the upside (i.e., for over-target performance.)

As noted above, EVA may be used as an incentive formula for short-term as well as long- term incentive plans.

**Argument Favoring EVA**

In support of EVA as a metric for incentive programs, the EVA formula encourages management to optimize the use of the company’s assets— both operating assets and financial assets. In doing so, it also serves as a “check” on whether current market price of the stock of the company in question reflects the operational and financial performance of the company. EVA also provides a means to measure how the different units of a company are performing relative to one another.

**Argument Against EVA**

EVA involves a complex formula including its application as a metric for executive incentive programs. This is primarily due to the numerous adjustments made in the application of conventional accounting rules in the calculation of EVA (as illustrated by the discussion of EVA in the ISS report authored by Mr. Bennett noted above). The complexity of EVA gives rise to a number of concerns.

1. Will executives and directors understand EVA? An incentive plan metric will not be very effective in driving corporate performance if the participating executives and the directors who oversee them do not understand how it works. Making an explanation of how EVA works that is understandable to management will require a careful, and probably rather lengthy, discussion. Presumably this discussion will be included in the award agreements. Some companies may include the discussion in the applicable plan and incorporate it into the award agreements by cross-reference.
2. Will shareholders be confused by the EVA figures, given that EVA is a non- GAAP financial measure? (In presenting EVA figures to shareholders, companies will have to be mindful of SEC requirements relating to disclosure of non-GAAP financial measures. These requirements are set forth in Regulation G and Item 10(e) of Regulation S-K. Also see Instruction 5 to Item 402(b) of Regulation S-K and Regulation S-K C&DI 118.08 and 09.)
3. Valid comparisons of EVA performance among different companies may be difficult. Different companies may give different interpretations to the numerous adjustments noted above and comparisons among companies doing business in multiple industries will add to the difficulty of making valid comparisons.

Conclusion

As noted at the outset, EVA is an established metric in valuations of enterprises.

The current attention given to it by ISS will provide a currency as well as make it a subject of broader discussion, including inclusion as a metric for executive incentive programs. EVA may serve also as a check on whether award payouts under incentive plans based on TSR or other conventional financial metrics effectively reflect corporate and/or management performance. The challenge facing those who adopt EVA as a metric for executive incentive programs is to make it understandable to executives and directors in the management of an enterprise and to shareholders as owners of the enterprise.