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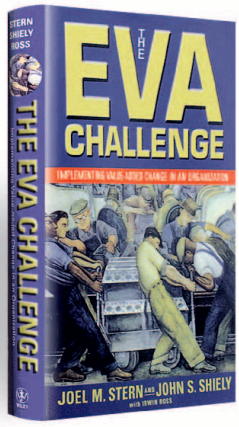

By Joel M. Stern and John S. Shiely

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Implementing Value-Added Change In an Organization

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THE SUMMARY IN BRIEF

What is a company worth? Another way to pose the question: What is the expected return on capital invested in one company as opposed to the return on capital invested elsewhere (at the same level of risk)? The calculation is not a simple one. The reason is two major developments in American capitalism: 1) the split between ownership and control of publicly held corporations and 2) the widespread acceptance of accounting measurements to gauge corporate value — a use for which accounting measurements were not designed.

Economic Value Added (EVA) is a measure of the true *economic performance of a company — as well as a strategy for creating shareholder wealth. It is also a method of changing corporate priorities and behavior, right down to the shop floor. Properly implemented, EVA frees the measurement of corporate performance from the vagaries of accounting principles and aligns the interests of managers with those of shareholders, ending a decades-long conflict of interest.*

What You'll Learn In This Summary

- **Standard accounting measures don't give the true picture.** They distort what is really happening and allow manipulation of the profit picture.
- **EVA is the answer.** Economic Value Added (EVA) is the profit that remains after deducting the cost of the capital invested to generate that profit. By adopting EVA, companies give everyone a clearer picture of the value being created by a company.
- **EVA is more than a measurement system.** EVA should be the foundation of a performance-based incentive plan.
- **EVA works in the New Economy.** New Economy businesses make heavy capital investments without immediate profitability. EVA gives such companies a way to measure the value they are creating.

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The Problem: Accounting Distorts Actual Value

Today's corporations are professionally managed; the true owners of the corporation — the shareholders — are divorced from the actual operations and control of the enterprise. In an attempt to monitor their companies' performance, shareholders use presumably objective criteria — the ones accountants use. Specifically, they look at the company's net earnings as reflected in earnings per share. As EPS grows, a company's share price is supposed to rise, on the assumption that its price/earnings ratio will remain relatively constant.

Misleading Assumptions

The problem is that as accountants work their way to the bottom line, they make several calculations on a company's profit-and-loss statement that distort economic reality. Specifically, as accountants prepare profit-and-loss statements, they make assumptions that undervalue the company's true economic value.

First, the "expense" (deduct from revenue in the year costs are incurred) research and development outlays. This has the effect of lowering profitability in the year the costs are "expensed" even though the benefits of R&D activities will impact the company's profits for years to come.

Accountants also "expense" advertising and marketing costs in the year they are incurred, even though the effect of those ads may be to build a brand that will pay dividends for years to come.

Finally, accountants list assets at the lower of original cost minus depreciation, or market value. For example, a building that cost $10 million may now be worth $20 million, but will be listed on the balance sheet as $9 million (purchase price minus depreciation).

Manipulating EPS

In addition to accounting practices that distort reality, earnings per share can be easily manipulated, especially by senior executives whose bonuses may be tied to earnings improvements. One of many ways, for example, is to cut back on advertising and R&D, and thus lower costs and raise apparent profits.

In sum, as a result of standard accounting practices or even outright manipulation of the numbers, earnings per share don't really present the whole picture for the investor who simply wants to compare the cash he can take out of the company with the cash he invested. ■

For another example of how EPS can be manipulated, go to: http://my.summary.com

The Solution Is EVA

Properly implemented, *Economic Value Added* (EVA) aligns the interests of the shareholders with those of the managers, ending the inherent conflict of interest that has long plagued corporations. EVA lets this happen because the measurement of corporate performance is no longer affected by the caprice of accounting conventions or the manipulation of managers looking for a larger bonus. Real economic profit is now the measure of corporate performance.

Already, more than 300 companies worldwide have adopted EVA, including Coca-Cola, Siemens, and the U.S. Postal Service.

The EVA Formula

What exactly is EVA? EVA is simply the profit that remains **after deducting the cost of the capital invested to generate that profit.**

For example, a new company starts off with $5,000 borrowed at a 12 percent interest rate. In this case, the cost of the company's capital, known as the *capital charge*, is $600 (12 percent of $5,000). If the company makes a profit of $1,000, the $600 capital charge is deducted and the result is an EVA of $400.

Thus, the exact formula for calculating EVA is net

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The Solution Is EVA

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operating profit after tax (NOPAT) minus capital charge.

Calculating the Capital Charge

To calculate the capital charge part of the EVA equation, you must first determine your company's *cost of capital*, often referred to as the required rate of return. This is the rate that compensates investors for their perceived risk, and varies from industry to industry. If the company's profits equal the required rate of return, the investor hasn't made money.

To calculate your company's cost of capital, you have to take into account both the cost of *debt* capital and the cost of *equity* capital.

The cost of debt capital is simply the interest on the company's borrowing. Since interest is tax-deductible, the after-tax rate is used.

Calculating the cost of equity capital is a bit more complicated. Equity capital starts with the interest an investor could earn on a safe investment such as a long-term government bond. You then add the equity risk premium — the percent of risk associated with investment in your company or industry.

After the cost of equity capital and the cost of debt capital has been calculated, you can calculate your company's blended cost of capital. This is achieved by determining the proportion of debt and equity capital in its capital structure. In 2000, the typical blended cost of capital (based on 2000 interest rates) came in between 10 percent and 13 percent.

Once you have the blended cost of capital, you can calculate the capital charge that is to be deducted from your company's profit. The capital charge is your company's total capital multiplied by its cost (in the example above, we had a $5,000 total capital multiplied by the 12 percent cost to give us a capital charge of $600).

Calculating NOPAT

Now you must calculate NOPAT. You will have to make adjustments for those accounting anomalies discussed earlier. There are more than 120 possible adjustments, but most companies will adjust just the following costs ordinarily expensed by accountants:

1. Research and development costs. These are considered investments that will yield future results. Under EVA, R&D costs are included on the balance sheet and amortized over the years these outlays are expected to have an impact. Only the yearly amortization charge is included as an expense.

2. Advertising and promotion costs. These are investments in trademarks and product recognition. Only a portion of the cost is an expense in the current year.

3. Staff training and development. These costs are also an investment, and only a portion is expensed in the current year.

4. Depreciation costs. EVA allows depreciation to be subtracted in the current year, but only straight depreciation. Using accelerated depreciation creates an unrealistic view. ■

The Other Value-Added Measure

Along with EVA, another measure captures the gains or losses accruing to a company's shareholders. This measure is called Market Value Added (MVA) and is defined as the difference between the market value of a company and the sums invested in it over the years. It works like this:

✓ **Present Market Value** = equity at market price + debt at book value.

✓ **Total Investment** = equity + interest bearing debt (including retained earnings).

If Present Market Value is greater than Total Investment, then the company has created wealth. If it is less, it has destroyed wealth.

There is a significant link between EVA growth and growth in MVA. Rising EVA tends to foreshadow increases in MVA.

EVA Is More Than A Measurement System

EVA is far more than just a measurement tool. EVA should become the basis of an incentive plan that rewards managers for actions that increase shareholder returns — and penalize them for failure.

Specifically, companies should implement a plan that sets certain goals and timetables for EVA improvement. If a company, or a division in the case of a business unit manager, makes 100 percent of the targeted EVA improvement, the manager receives 100 percent of the "target bonus" promised. Lower results lead to proportionally lower bonuses. On the other hand, if the company or division does better than the target, then managers should receive a bonus in excess of the target bonus.

An EVA incentive plan can also feature a bonus "bank" — in which a portion (or all) of the bonus is banked to be distributed in later years, depending on ongoing performance.

The EVA bonus system usually begins with top managers, and eventually moves down to middle managers — and in some cases, all the way to the shop floor. ■

The Need for a Winning Strategy and Organization

The adoption of a fully articulated EVA program — a measurement program, a management system, and an incentive compensation plan, together with thorough training — is crucial to a corporation's success. However, EVA can't perform miracles. The organization must also have a winning strategy and an appropriate organization to carry out that strategy. A sophisticated EVA system won't help if the company's products lack a niche or other competitive advantage, if the company lacks a marketing plan, or if the company suffers from a dysfunctional organization.

EVA and Strategic Innovation: A Case Study

With $1.3 billion in sales, Briggs & Stratton is the world's largest producer of air-cooled gasoline engines. The Milwaukee company was founded in 1908. Its engines propelled millions of lawn mowers as the post World War II population migrated to suburbia. It grew rapidly, employing more than 10,000 unionized workers by the mid-1980s. By then mass retailers like Home Depot and Wal-Mart insisted on getting the lowest possible price, and the company began running in the red. It was time for a dramatic change.

The company reevaluated its entire strategy and organization and adopted a full EVA program. It decided to concentrate on the low-end of the industry, where it had few competitors and where the entry barriers were high. For the first time in its history, the EVA discipline focused attention on the total cost of capital.

In 1989, [Briggs & Stratton] had a negative EVA of $62 million. By 1999, it had a record positive EVA of $50.9 million.

The company reorganized into seven separate operating divisions. Each division was given autonomy for operational decisions and capital expenditures. By pushing decision-making down, the company saw a dramatic improvement in cash flow and capital management. Divisional EVA results provided 40 percent of managers' bonuses. Now even hourly-rate workers have a modified form of EVA written into their union contracts.

It has worked very well. By reorganizing and focusing its strategy while developing its EVA program, the company has made a dramatic recovery. In 1989, the company had a **negative** EVA of $62 million. By 1999, it had a record **positive** EVA of $50.9 million. Anyone who bought $100 worth of stock in 1989 would have had $673 in 1999. ■

The Road Map To Value Creation

Today, companies struggle with the idea that they must create value for shareholders, employees, customers, suppliers and the communities in which the company is located. The traditional view that only the shareholders mattered, and that other stakeholders would benefit as long as the shareholders made a profit, is no longer accepted by many.

The interests of shareholders and other stakeholders are sometimes at odds. In the long run, however, their interests are mutual. A company cannot prosper over a long period of time if it antagonizes its work force, develops low-quality products, treats suppliers poorly or pollutes the environment.

The goal of top managers is to align shareholders' interests with those of the other stakeholders. How can value be increased for shareholders **and** stakeholders? One solution is to adopt the **holistic model of value creation** (see illustration below).

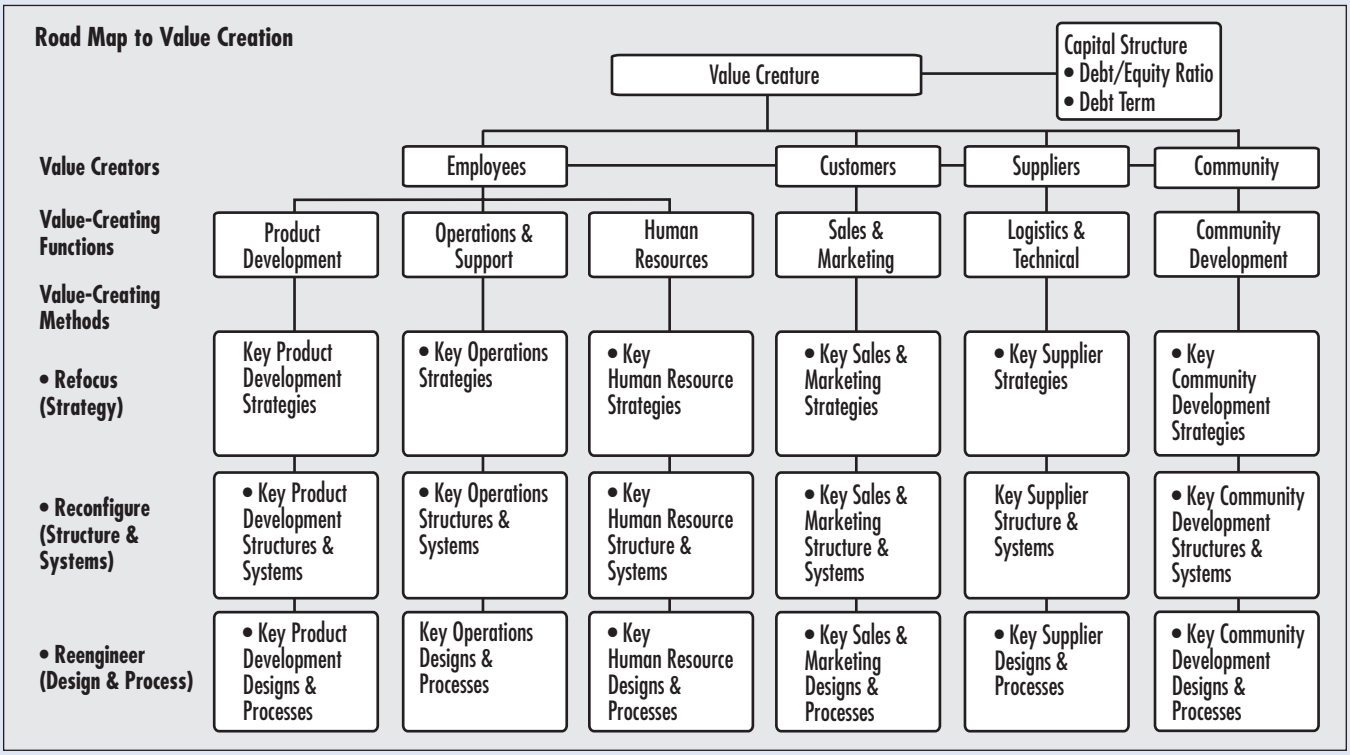
The functions associated with each group are set forth in the model. The most important functions are those that integrate employees into the value-creating process — new product development, operations and support, and human resource development. As you move across the model, you see that the function that drives customer value is sales and marketing while the key to value-adding supplier relationships are logistics and technical capabilities. Community development consists in working out cooperative agreements between local political entities and the company for their mutual benefit. ■

Briggs & Stratton Model: Managing for Value Creation

Creating a Road Map to Value Creation

Employees may understand the reasons for their company's success, and readily buy into the idea of EVA, but sometimes wish management would clearly communicate to them the company's *vision* of value creation. To communicate the strategy, companies can create a one-page "Road Map to Value Creation."

By viewing the model vertically, each employee can see how the firm intends to create value in his or her primary functional area. For each function, the map describes the underlying strategy, the supporting structures and systems, and the key designs and processes. By viewing the model horizontally, employees can see how the company's strategies, structures and systems, and designs and processes are integrated along functional lines.



The Dramatic Results of EVA

The implementation of an EVA program can impact both the top-level strategy of a company as well as day-to-day management decisions, as demonstrated by the case studies in this article.

Phantom Profits at International Multifoods

The turnaround of International Multifoods, a diversified food company based in Wayzata, Minn., illustrates the effectiveness of applying EVA guidelines to strategic planning.

When new CEO Gary Costley was installed in January 1997, he declared that "the company was a mess." Costley, who had worked for the Kellogg cereal company before becoming a business school dean, concluded that International Multifoods had bounced from strategy to strategy without much thought. The company's activities had moved from milling wheat to manufacturing consumer goods to distributing other companies' food products to exporting chicken parts to Russia.

In addition to a rudderless strategy, the company's balance sheet was a disaster.

Before Costley took the job, he insisted that the board of directors authorize an EVA program.

One of the first areas to be examined was the Russian chicken business. The export of dark meat was the company's fastest growing contributor to operating profits. However, while the export of dark meat was profitable on an earnings per share basis, it was an economic disaster from an EVA point of view.

The business gobbled up working capital. Each boatload of chicken shipped from New Orleans sat on the company's balance sheet for six weeks until it was transported and sold. When the cost of capital tied up in drumsticks was deducted, the profits evaporated.

Based on its rigorous EVA evaluation, the company exited the chicken business and several other equally capital-eroding sidelines, such as shipping used tele-

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The Dramatic Results of EVA

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phone poles to Third World countries. Within two years, the company was recovering and its share price doubled.

Store-Level EVA at JD Group

South Africa's JD Group, a chain of more than 500 furniture, appliance and consumer electronic stores also experienced great results from the implementation of EVA. The company took EVA down to the store level by measuring the EVA performance of each branch, and rewarding managers accordingly. Because it now mattered, branch managers no longer routinely replaced delivery trucks, but refurbished the ones they had. They stopped completely revamping stores and voted instead to spruce them up with fresh paint.

Analyzing Capital Expenditures at Herman Miller

EVA doesn't always mean that capital expenditures are rejected, however. Instead, those who understand EVA well analyze each expenditure to see whether it contributes to value creation or not.

For example, when one division of Herman Miller, the office furniture manufacturer, debated whether to repair a piece of equipment or buy a new one, they considered factors such as reliability and the effect downtime has on production. In one case, they opted to replace a piece that could have been refurbished at lower cost, but which would not be 100 percent reliable. The component would halt the entire line while down. On the other hand, they refurbished a stand-alone piece because it would have no effect on the production line while it was down. ■

Extending EVA To the Shop Floor

Bringing EVA to the shop floor isn't always easy. This has been especially true in work environments that have been unionized.

Briggs & Stratton ran into just such a problem during its implementation of EVA. Management asked the union to negotiate the next contract early because it intended to restructure operations and create new "focus factories," each devoted to a single product. The intent was to make operations more efficient, and thus the company more competitive.

The union viewed the plan with suspicion, refused to negotiate early, and staged an expensive work slowdown. But the company persisted, and opened four focus factories in other states. Meanwhile, distressed at the loss of jobs, the union opened negotiations.

The contract eventually adopted calls for an EVA measurement as a variable component of shop workers' pay. Workers receive 3% bonuses if the company makes its EVA target. The bonuses can reach even higher, depending on how much value is built in a given year.

Communicate Directly With Your Work Force

Clearly, it can be difficult to persuade workers accustomed to antagonistic labor-management relationships that everyone will benefit from implementation of an EVA plan.

Union leaders have traditionally been instilled with the belief that 'fair" means "equal" and that all performance-based compensation should be viewed with suspicion. How, then, can you negotiate an EVA-based compensation program — an incentive system that relies on sophisticated microeconomic principles — into an agreement with an organized work force?

One important step is for management to communicate directly with its work force. Winning over the rank and file is the key. Though you can't directly discuss wages and benefits, you can certainly discuss EVA as a performance metric and train workers in the basics of EVA. And you can certainly explain that a positive EVA is essential to the continued viability of the company.

Take the time to explain to workers what you have decided to do to create value. Describe your operational model, and give all employees an opportunity to refine

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Briggs & Stratton Workers Innovate to Raise EVA

When workers on the shop floor buy into EVA, the savings they can achieve are remarkable. Here are two examples of what workers at Briggs & Stratton have been able to achieve.

A group of workers was formed to reduce the cost of making tappets — the sliding rods in engines. The group discovered that the problem was the thickness of the wire used to produce the rods. It took too long to heat the metal. The solution they conceived was to use thinner wire. It worked, and saved more than $220,000 annually.

Another group took on the task of reducing the changeover time needed to ready a metal stamping press to handle a new job. When the team started on the problem, it took two workers 22 hours to make the changes. After moving the press to a better location and making other changes to the process, the time was reduced to less than two hours, for an annual savings of $64,000.

Extending EVA to the Shop Floor

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it through suggestion programs and business improvement teams. If a successful effort has been made to reach the rank and file, it will be easier to persuade the union leadership to adopt EVA as a basis for incentive compensation. ■

Getting the Message Out: Training and Communication

There is no more important aspect of installing an EVA program than training the troops. EVA represents a decisive change in every aspect of how a company conducts its business. With the focus on improving EVA as the new bottom line, traditional practices will be altered, from incentive systems to the allocation of capital to production processes on the shop floor. Change — often drastic change — is the name of the game, and it is rarely popular. To those in the trenches, the new and unfamiliar seem threatening. Fear prompts resistance.

But if employees are given a clear, detailed description of changes and the reasons for them, a good deal of anxiety can be erased. They need to be told why EVA is necessary. Workers who know the new program is necessary for the long-term survival of the company are more likely to support it.

Three Years of Training

At Briggs & Stratton, training took three years and involved more than 3,000 workers. In groups of 16 to 20, salaried workers received four hours of training in "Managing for Value Creation." Production workers received two hours of similar training.

Each session started with a written test on what each worker knew about EVA. The test was followed by a description of the company's strategic restructuring. The instructor highlighted the company's reversion to a low-cost, high-volume producer of multi-purpose engines. This was followed by a detailed explanation of the company's "Road Map to Value Creation," which directly shows how the company's design and processes, structure and systems and strategy help value creators (not only employees, but also suppliers and customers) create value. The instructor also showed how EVA is calculated.

The discussions that followed stressed three fundamental ways to enlarge EVA: (1) "build" it by committing new capital to initiatives that promise a return in excess of the cost of capital; (2) "operate" in a way that increases the cash rate of return without tying up new capital; and (3) "harvest" by withdrawing capital from strategies that aren't expected to provide an adequate return.

The participants then practiced finding ways to increase EVA through a hypothetical business case study, and were finally asked for ideas for increasing EVA for their own company. ■

Continual Communication Keeps EVA Alive

At Herman Miller, training in EVA didn't end with the initial sessions. Every month the company produces a 15- to 30-minute video called the *Business Exchange*. It features a full report on how the company is doing, from net sales to the month's EVA.

The rest of the video is devoted to other corporate news, such as prizes won by the company at trade shows and charitable activities taken on by employees. Every month, the videos are viewed by all employees with their supervisors. For those who want more information, it is available on the company's intranet. Workers can view the information from their computers. Those who don't have one at work can access the same information from computer kiosks set up on the shop floor.

EVA and Acquisitions

Much of the history of American capitalism is the history of mergers and acquisitions. First, a new industry emerges with many players. Then winnowing occurs — a process of consolidation through failure and the absorption of the weak by the stronger, better financed, and more aggressive competitors. In times past, the goal of consolidation was to create a monopoly, with obvious benefit to shareholder value.

Today, monopoly power is beyond the aspiration of most companies. In its place, the motivation for consolidation is the creation of additional value for the acquiring company. EVA valuation is an excellent tool for calculating the impact of a proposed acquisition. It does not, however, provide the nonfinancial criteria for evaluating the wisdom of an acquisition.

Do Your Homework

Acquisition is still a viable option for creating additional value, but only if the acquiring company does its homework. Before identifying a target, focus on your own corporate skills, competitive strengths, and strategic aspirations. Next, create a set of criteria to define the universe of candidates. Your company must be able to identify any lurking problems, such as pending litiga-

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Identifying Acquisition Targets

When looking for acquisitions that have a high potential for increasing value, consider companies in this order of preference:

1. Companies with comparable product lines. The greatest potential for integrating efficiencies is in acquisitions of companies with comparable product lines. If that's the case, the acquirer can quickly realize economies of scale, distribution and product development.

2. Companies producing related product lines. Next in line for consideration are companies that produce related products. For example, a producer of golf course mowers might acquire a company that makes golf course irrigation equipment to leverage its knowledge of the turf-care business and its established relationships with greens keepers to create value.

3. Companies that make linked products. Next consider the acquisition of a company making linked products — products that exist in totally unrelated businesses but are somehow linked in terms of technology, production or distribution. For example, a company producing commercial aviation equipment might acquire a company making auto global positioning units, and apply the technology to aviation.

4. Companies that make unrelated products. It's unlikely such an acquisition will create value. Proceed with care.

EVA and Acquisitions

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tion, environmental concerns, or other hidden liabilities.

There are two parameters that help predict whether an acquisition will have a positive effect on EVA once the companies are one. The first is whether the target company has products that are in the company's existing product base. If so, it will be much easier to integrate the company and create additional value through operational synergies. The second parameter is the nature of the potential integrating efficiencies. For example, if two companies can consolidate production facilities, there is great opportunity for cutting production costs and therefore creating more value. ■

For information on why conglomerates fail to create value, go to: http://my.summary.com

How EVA Can Fail

Sometimes companies try to adopt EVA, but fail. When that happens, the reason is almost always that there was either a lack of full support or the appearance of a lack of support for the program by the company's chief executive. Without question, the attitude of the chief executive is the primary determinant of the success or failure of the program. EVA is such a radical departure from the traditional way of measuring success and motivating people that it requires unremitting pressure from the top to assure compliance.

Don't Even Try It!

There are also circumstances in which moving to EVA will fail and shouldn't even be tried.

For example, if the top executives are overpaid for poor performance so that it would be likely they would receive far less under EVA, it won't work. The same thing happens if the talent in the company pool is mediocre. If so, EVA incentives won't work because the talent just isn't there in the first place and the goals set under EVA are unattainable.

EVA will also have trouble working in an environment where jobs are secure and promotions come from seniority. Employees in such companies prize an unstressed work environment and can't or won't change. ■

For another example of an environment unconducive to EVA, go to: http://my.summary.com

EVA in the New Economy

We are in the midst of a new era heralded by many as the knowledge revolution. There are some who have proclaimed that this so-called new economy means the death of EVA. They claim EVA is useful for old world companies with heavy investments in fixed assets, but that today there is no need to worry about capital charges.

They are wrong. There may be a new economy with products and services available in revolutionary ways, but there are no new "economics." The principles of economic valuation remain the same.

EVA analysis is particularly appropriate for some new economy businesses that are investing heavily in infrastructure now for an anticipated profit later.

EVA treats cash outlays that represent investments as capital rather than expenses. It tells us what contributions are being made to value each year. The capital in the new economy consists of research, development, marketing, advertising and start-up costs. Accountants view these expenditures as expenses to offset against current profits. But it is more realistic to capitalize these investments and amortize them over their expected useful life, as EVA does. ■