THE EVA CHALLENGE

Implementing Value-Added Change In An Organization

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MAIN IDEA

Economic Value Added (EVA) is the best and most direct measure of whether a business is creating wealth when the cost of its capital has been taken into account. EVA also aligns precisely the interests of the company's owners (its shareholders) with the interests of the managers in a way that is free of the distortions and vagaries of accounting conventions.

The challenge is to harness EVA effectively to increase true economic profitability. That will require three components – a measurement system, an incentive system and a financial management system which are all EVA based. Without those components, it will be impossible to tell whether or not a business is succeeding in making its capital worth more over time. With those elements properly implemented, EVA principles will unerringly guide the company onwards and upwards as managers and employees focus on one specific objective: "How do we improve our EVA?".

In the final analysis, EVA is the best and most definitive financial performance measure. Smart companies worldwide are harnessing EVA to optimize their creation of shareholder wealth over time by making it the focal point for all reporting, planning and decision making functions.

Section 1 – The Problem With Conventional Valuations. . . . . Page 2

How do you value a business? The conventional measures are to use:
- Profitability – the existence of excess cash flows.
- Earnings per share (EPS).
- The price / earnings ratio (P/E).
- Return on equity (ROE), investment (ROI) or net assets (RONA).

The problem is all of these measures can be distorted in the short term by management accounting practices which are perfectly within the law. The situation becomes even murkier in one-off situations like acquisitions and leveraged buy-outs. Thus, a consistent, unambiguous and rational way to value a business is required in order to gauge whether or not the management is actually creating more value over time.

Section 2 – The Solution – EVA . . . . Page 3

A better way to value a business is to use economic value added (EVA) to measure what the true economic profit is. EVA is the profit that remains after the business has deducted the cost of all the capital utilized in generating that profit. As such, EVA reflects the true profitability of a business better than any other measure because it takes into account the opportunity cost of capital – the return shareholders could have realized had they invested in other securities of comparable risk.

Section 3 – The Six Keys of EVA Implementation . . . . Pages 4 - 6

EVA is not simply a "plug-in program" – where management can take the theories and practices that have worked elsewhere and apply them in a different context. Instead, to be a workable system, EVA must be implemented properly.

The six keys to implementing an EVA program successfully are:

The Six Keys To Implementing EVA

1. Viable strategy and organization
2. Have all three EVA components
3. A deep EVA incentive plan
4. A comprehensive training program
5. The backing of the CEO
6. The support of the CFO

Section 4 – A Working Example. . . . . Pages 7 - 8

An excellent EVA case study is Briggs & Stratton Corporation, the world's largest producer of air-cooled, gasoline engines. The company was founded in 1908, achieved sales of $1.3 billion in 2000 and adopted an EVA program in 1990.

Since that time, Briggs & Stratton has:
- Seen its share price grow from $10.25 per share in 1990 to more than $70.00 per share by May 1999.
- Moved from negative EVA of $62 million in 1989 to positive EVA since 1993, with $50.9 million in1999.
- Grown to the stage where it now earns a 12.9-percent return on capital.

In short, Briggs & Stratton are one of the most successful implementors of EVA.