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Managing for value EVA and portfolio strategy

BY JUSTIN PETTIT

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MANAGING FOR VALUE EVA AND PORTFOLIO STRATEGY

BY JUSTIN PETTIT

With the NASDAQ down 40 percent this past year and many of last year's hottest IPOs already gone or heading off to dot-com heaven, some portfolio managers are feeling a little relieved, if not vindicated, for staying behind in the Old Economy. But misery loves company, and many blue-chip stalwarts like Eaton's, Xerox and GM have either failed or are under serious strain.

The return of rationality to our capital markets once again puts the pressure on companies to perform. We have seen a resurgence of interest among managers and investors alike in the fundamentals. Once again, the value objective lies at the heart of successful business models and strategies, where success is defined in terms of both capital-market and operating performance. And operating performance means not just earning operating profits that can grow and be sustained, but profits that are sufficient to earn a competitive return on the capital employed.

But how can one manage for value? It is not, as I will show, just a case of blindly interpreting and acting on your numbers. Successful cases of managing portfolios for value—Molson, SPX and Herman Miller—show that these companies are careful to apply and interpret their numbers when formulating and executing value-based strategies. In this article, I will look at how a company can do this, and discuss the common pitfalls and how to avoid them.

Why share owner value?

Why all the fuss about share owner value and creating wealth? What about other stakeholders? Asia's economic crisis demonstrated the risks to social and economic stability and standards of living posed by poor market discipline, a general apathy toward value maximization, and weak systems of corporate governance—the measures, incentives, tools and controls that support decision-making. Prolonged periods of pervasive capital misallocation and mismanagement destroy massive amounts of wealth and undermine the economy.

A basic and fundamental tenet of capitalism is the obligation to maximize share owner value. An expectation of a return is created with every dollar raised and invested, or each dollar of profit that is retained rather than distributed. A tacit promise to maximize value is made. The litmus test of any decision to raise, invest or retain a dollar must be whether it will create more value than could have been achieved with an alternative investment opportunity of similar risk.

For example, what would happen if Brick Bank paid only a five percent return on savings accounts, while E-Bank offered 15 percent on money market accounts of virtually equal risk? Obviously, a 15 percent return is much better than five percent, when all else is equal. Consequently, many people will storm into Brick Bank, withdraw their life's savings and march down the street to E-Bank.

This example illustrates the fact that capital is a scarce resource that all businesses, and even government agencies, must compete for and manage efficiently. This means that businesses must provide customer-valued products and services effectively and efficiently to maximize the utility of their invested capital. The limited supply of, and liquid markets for, capital requires that its users maximize its value. They must maximize share owner value, or face the flight of capital to more attractive opportunities.

If managing for value means embracing the interests of owners, what then of the interests of other stakeholders? Let's start with a look at who these owners are, for they are not rich, young professionals on Wall Street. Our mutual funds, pension plans, life insurance policies and many small investor holdings represent the vast majority of stock ownership. Our largest institutional investors represent the savings of everyday citizens. We each invest our life's savings and bear risk in the hopes of getting the best return possible.

But this need not imply a conflict between the interests of customers, employees and owners, and the managers, executives and directors who act as stewards of our savings. Fashionable share owner-stakeholder discussions indicate that there is confusion between the means and the ends. Value maximization, the heart of economic growth, is a long-term proposition that delivers higher economic output and prosperity through productivity gains, employment growth and higher wages. The interests of stakeholders and society are best served when our scarce resources are put to their most productive uses.

As historically insular product, labour and capital markets become increasingly global, companies will continue to face increasing competitive pressures. Under pressure to perform, investors are warming to notions of share owner activism and heightened corporate governance. Market liquidity and the emergence of more sophisticated and demanding institutional investors have made the consequences of destroying share owner value much more important for employees, managers and policymakers.

MANAGE FOR VALUE: WHAT DOES IT MEAN?

A review of annual reports reveals much about the collective view of managers. Rather than a sense of shared purpose, we find that over arching goals vary widely with respect to market share, revenue dollars, gross margins, expense/revenue ratios, earnings growth, price-earnings ratios, returns on capital and share-price performance.

The confusion that this demonstrates helps explain a concern voiced by Warren Buffett: "When managers are making decisions it's vital that they act in ways that increase per-share intrinsic value and avoid moves that

decrease it. This principle may seem obvious but we constantly see it violated." (Warren Buffet, 1998 Berkshire Hathaway annual report)

Income-statement measures still dominate business vocabulary, yet profit and profit-margin measures often drive over production, over investment and vertical integration because they overlook capital and its cost. Furthermore, we are increasingly seeing different businesses and business models consume varying levels of capital at varying costs. Thus, managers are often drawn to businesses that, on the surface, may seem attractive, but actu- ►

ally destroy value. For example, profits are invariably enhanced by newer production capacity and technology, yet they must be enhanced so as to compensate for higher levels of investment. Profit is an incomplete measure that ignores capital and is inappropriate for making the many business decisions that trade off between income statement and balance sheet. Tied to incentive compensation, this

can lead to dysfunctional behaviour among managers.

While ultimately the goal must be seen in terms of share owner returns, an operating measure provides a more useful proxy. The contribution to intrinsic value in any given period is best captured by a measure known as Economic Value Added (EVA), also called residual income, or economic profit—the annual contribution to net present value (NPV).

Economic Value Added (EVA®) and Value

EVA measures profit after the cost of all capital employed. (For a full explanation of EVA, see *The Quest for Value*, Bennett Stewart, Harper Collins, 1991. EVA is a registered trademark of Stern Stewart & Co.) It is the one measure that properly accounts for the trade-offs between the income statement and balance sheet in creating value. EVA is also the difference between a company's return on, and cost of, capital, times its capital employed. For example, the EVA for a \$1,000 investment in a hot-dog stand that produces a five percent return—where other investments of similar risk can earn 15 percent—would be negative \$100 ([five percent minus 15 percent] x \$1,000).

Another way to think of EVA is in dollar terms—operating profit minus a capital charge, where capital charge is the cost of capital times capital employed. For example, although the accounting profit in the above example is \$50, there was an opportunity to earn \$150; thus the EVA is still negative \$100 (\$50 to \$150).

Under EVA, a business is effectively charged for the use of capital by investors through a “line of credit” that bears interest at a rate equal to the cost of capital. Share owner accountability can thus effectively be passed along to the operating units. EVA focuses on the profit and loss statement and the balance sheet simultaneously, and can be tailored to remedy any accounting anomalies that might fail to reflect economic value. Finally, EVA sets a required rate of return—the cost of capital—as a hurdle rate below which performance is unacceptable. EVA companies measure, report and reward performance on the basis of EVA. They use EVA to evaluate, execute and communicate strategies, investments, plans, tactics and decisions.

In simple terms, one can express intrinsic value as the net present value of all future cash flow. (This can also be expressed as the mathematically equivalent sum of capital and the present value of all future EVA.) While present-value concepts are more easily, and therefore more commonly, applied to fixed-income valuation (e.g., the value of bonds), the same concept also holds for a business, albeit with much less certainty in the forward numbers. Therefore, a business generating \$100 per year, every year, can be valued into perpetuity as having a value of \$1,000, assuming a 10 percent cost of capital, or time value of money (\$100 divided by 10 percent = \$1,000). This base, or zero-growth, case implies a “multiplier” of 10 times operating cash flow, and is the Current Operations Value (COV). (The Current Operations Value can also be expressed as the sum of capital invested, plus the present value of current EVA into perpetuity, with no growth. The nominal zero-growth assumption implies decay in real terms.)

Now, let's try a growth case where operating cash flow grows at a rate of five percent per year, forever. While many of us might think that forever is a long time, it may not be long enough to justify some of last year's Internet stock prices! Our simple case can be valued on a present value basis at \$100 divided by (10 percent minus five percent), or \$2,000. This implies a Future Growth Value of \$1,000, which when added to the \$1,000 COV, gives a total intrinsic value of \$2,000. The growth case implies a multiplier of 20 times and happens to illustrate a price level common in today's marketplace, where many stock prices imply a multiplier of 20 times or more. In this example, the market has based one half of the stock price on the present value of current operating cash flows, forever, and the other half on profitable growth expectations above this level, i.e., 50 percent of the value is COV, while the remainder is Future Growth Value (FGV). The FGV term subsumes not only expected growth, but also implicitly values any real options. For example, the five-percent growth assumption might really be a proxy for a 90 percent likelihood of no growth, and a 10 percent chance of 50 percent growth.

But does managing for value—be it a portfolio of businesses, products, brands or customers—then mean that each manager should merely grow his positive EVA businesses (those earning returns above their cost of capital), and sell or shutter all businesses with negative EVA (those earning returns below their cost of capital)? Despite its appealing simplicity, we would strongly argue against this approach to value-based portfolio management for three reasons.

1. INADEQUATE TIME HORIZON

A company often makes a decision or undertakes an investment with negative EVA, declaring the move to be “strategic.” But unlike one executive who once said, “We define ‘strategic’ as holdings that never pay off,” we would instead suggest that strategic holdings or investments are ones that currently earn less than their cost of capital (negative EVA), but that are likely to earn sufficiently more than their cost of capital (positive EVA) at some point in the future.

EVA is a period measure, yet value is determined by the present value of all future periods. Thus, a company, product or customer may represent negative EVA now, yet represent considerable value if it is likely to be sufficiently positive in the future and to offset the cost of holding the negative. The early years of negative EVA might be considered the price of gaining a call option on future years of positive EVA—a real option.

2. MISTAKING BOOK VALUE FOR REAL VALUE

In our experience, confusion between accounting and economics often prohibits managers from making value-creating acquisitions and divestitures in their portfolio of businesses. Bookkeeping entries often create a needless friction that reduces market liquidity for value-enhancing transactions.

For example, idle assets and loss-making businesses that could otherwise be disposed of in return for cash are often needlessly kept in the corporate portfolio to avoid booking a loss on sale—a non-cash entry of no economic meaning beyond signalling an overdue correction.

Just as the distraction of book values should not prohibit value-creating sales, book values need not unduly drive judgment against a business. While earning a return below your cost of capital is by no means desirable, returns are typically calculated on the book value of net assets or capital employed.

Regardless of whether a company has positive or negative EVA, its value is equal to the present value of its future

cash flow generation, or capital plus the present value of future EVA. Therefore, a company should determine the potential for future EVA and compare its ongoing operations to other alternatives (to grow, divest or shut down).

As an example, the liquidation value may be less than the value of continuing operations. The value may be less for a variety of reasons, e.g., shut-down costs, value of current management or strategic synergies. The point is that continuing operations may well be worth more than the shutdown or liquidation of the business. Negative EVA is usually a “flag” which indicates that the strategy of the business should be reviewed to ensure that it is the alternative with the best net present value. The stock of a negative EVA company might also be a strong buy if it is either expected to improve in the future or if the price is sufficiently low to allow you to earn an adequate return on your own investment.

3. PORTFOLIO MEASUREMENT ISSUES

Value-based portfolio management is ideally aided by robust measures of both performance and value at levels deep in the portfolio. Unfortunately, market values are typically absent below the consolidated, publicly traded entity, and performance measurement itself runs into challenges.

The calculation of EVA involves three kinds of data—revenue, expense and capital. The cost of capital can be considered as a given, an economic determination rather than data input. At both the consolidated and operating-groups levels, the EVA calculation is reasonably complete, with fewer issues of data availability and clarity. Similarly, intrinsic value can also be determined wherever financial performance and outlook can be estimated.

However, at lower or granular levels (product, brand, SKU, customer) three important measurement issues arise: unrecognized cross-subsidies and inappropriate transfer pricing, misallocations, and improper costing.

1. Unrecognized cross-subsidies and inappropriate transfer pricing

Unrecognized cross-subsidies and inappropriate transfer pricing often mask true economic performance and value, particularly at the more granular levels of a company's portfolio. Cross-subsidies that are not adequately addressed with transfer prices will invariably create incorrect signals of performance and value in the portfolio. Sub-optimization can occur where we see only part of the ►

picture; decisions might be made that maximize the value of some parts, functions or processes, but where the value of the total is not maximized because of our incomplete view of the economic picture.

We've all heard how Polaroid cameras were used to feed the sale of film, and razor blade profits to subsidize handles. Similarly, casinos regularly lose money on food and lodging in efforts to capture a larger share of gaming profits. Some car retailers nearly give away new cars in order to generate used car, service, insurance and financing business.

Unfortunately, most people don't realize just how unprofitable the business of car financing really is. Our work with both financial institutions and major car retailers who provide new car financing has consistently revealed two important facts. First, that after appropriate cost-of-funds transfer pricing and the cost of the associated economic risk capital, the highly competitive business of car financing might be best left to the majors; it is often used as a loss leader and there are too many players lacking competitive advantage. Secondly, the three activities of the business (origination, servicing, investment) are frequently bundled, without the required transfer pricing that reveals where the company is making and destroying value. Businesses need to know how much they are spending to "move the metal" as well as whether some of the financing activities (e.g., servicing, investment) should be outsourced.

2. Misallocations

The misallocation of indirect costs and assets can also create misleading signals of performance and value in your business portfolio.

These allocations may represent an allocation of fixed costs like overhead burden, which may well not go away when the business is sold. Allocations are often made with-

out any reference to their underlying cost drivers.

Allocations encompass a broad variety of line items including external purchases, overhead allocations and the sharing of joint and common costs, among others. Recall that costs are not only charges from the profit and loss statement, but also the carrying cost of capital employed. Thus, even shared receivables, payables, goodwill and assets can give rise to allocation issues, as illustrated below by the less economic circumstances of product "A."

3. Improper costing

We often find that improper costing of fixed costs and capital, such as the cost of capacity, creates misleading signals of performance and value in a business's portfolio. First, traditional costing systems today ignore the cost of capital. Second, the treatment of excess capacity is often incorrectly treated as a unit cost, instead of the period expense that it truly is.

Indirect overhead costs are often capitalized and recorded as inventory, rather than expensed as period costs. The capitalization of overhead costs where there is no cost for capital actually makes these costs "free," and creates a great short-term incentive to overproduce to inventory rather than make to demand. This characteristically leads to month-, quarter- and year-end production spurts, production-planning problems, excess inventory, trade loading, and stale, discounted product pushed onto the customer.

The following example illustrates how a classic "death spiral" can result from the unitization of fixed costs. (Unitization exists where fixed costs, such as the period cost of excess capacity, are misrepresented as unit costs.)

For example, a U.K. brake-parts facility had \$300 annual depreciation, annual capacity for 100 units, a prior year utilization of 50 percent (50 units), but a budgeted utilization of only 30 percent (30 units). The plant was expected to lose a German luxury car customer due to the strengthening of the pound sterling against the mark. It had a full-capacity, fixed cost per unit of \$3 (\$300/100), prior-year fixed cost per unit of \$6 (\$300/50) and a budgeted per unit cost of \$10 (\$300/30). This perceived rising unit cost further reduced volume, even for internal customers, eventually pricing the plant out of business!

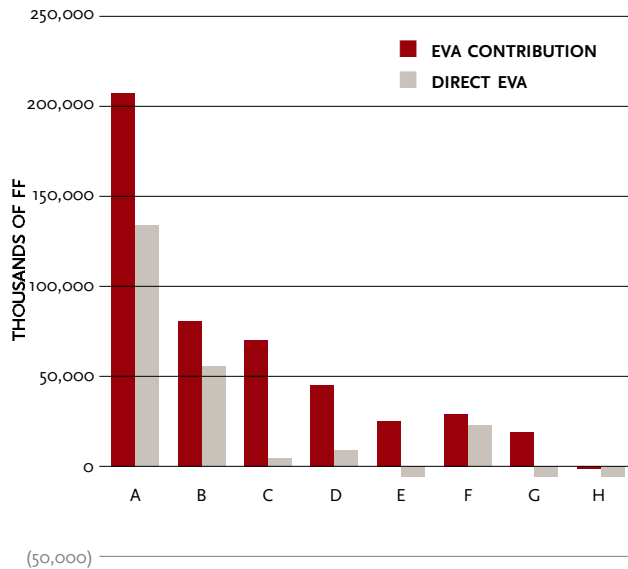
As an example of portfolio profitability determined correctly, Figure 2 is an example of portfolio profitability determined correctly. It illustrates the profitability of the

FIGURE 1

	"A"	"B"
PAYMENTTERMS	SLOW	PREPAID
PRICE/PROMOTIONPOLICY	QUARTERLY TRADELOADING	EVERYDAY LOWPRICES
PRODUCTIONLEAD TIME	2 MONTHS	1 MONTH
ORDER-TO-DELIVERY TIME	4 WEEKS	2 WEEKS
BATCH SIZE	LARGER	SMALLER
PRODUCTIONPLANNING	BUILD-TO-PLAN (PUSH)	BUILD-TO-ORDER (PULLSYSTEM)
DISTRIBUTIONSTRATEGY	3-STEP	1-STEP

PRODUCT "A" CONSUMESMUCHMORECAPITAL.

FIGURE 2



French brands within a multinational company and the complexity a country manager faces in making real portfolio decisions. The lighter bars show the EVA contribution for each of eight products in the portfolio; with the exception of “H,” each contributes positively toward indirect costs and capacity. However, low-margin “H” is unable to cover even its direct economic costs (material, labour and the carrying cost of directly attributable working capital).

While short-term portfolio decisions are likely to include the potential discontinuation of product “H,” the more pressing strategic issue may be the longer-term decision regarding capacity. Direct EVA was determined with full economic costs allocated—but volume variance expensed as a period cost rather than unitized into product cost—still showing many products barely capable of covering their true full cost. Due to a long history of chronic overcapacity and underutilization, the French plants have been filled with business that is marginal. The strategic question now is whether capacity can be more economically utilized, or whether the plant should be closed and production shifted to Eastern Europe, or outsourced to a toll manufacturer.

MAPPING PERFORMANCE AND VALUE IN YOUR PORTFOLIO

Strategically, intrinsic value is not maximized solely by the maximization of Current Operations Value (COV), but by

the simultaneous maximization of the sum of its two components—COV and Future Growth Value (FGV), including the value of real options. Ultimately, this requires business leaders to address, in the context of value-based strategy, both the renewal of future growth value through investments in intangibles and the future, as well as the conversion of opportunities into performance, via execution or operational excellence. The implications for business strategy, financial policy, financial management and compensation are far-reaching.

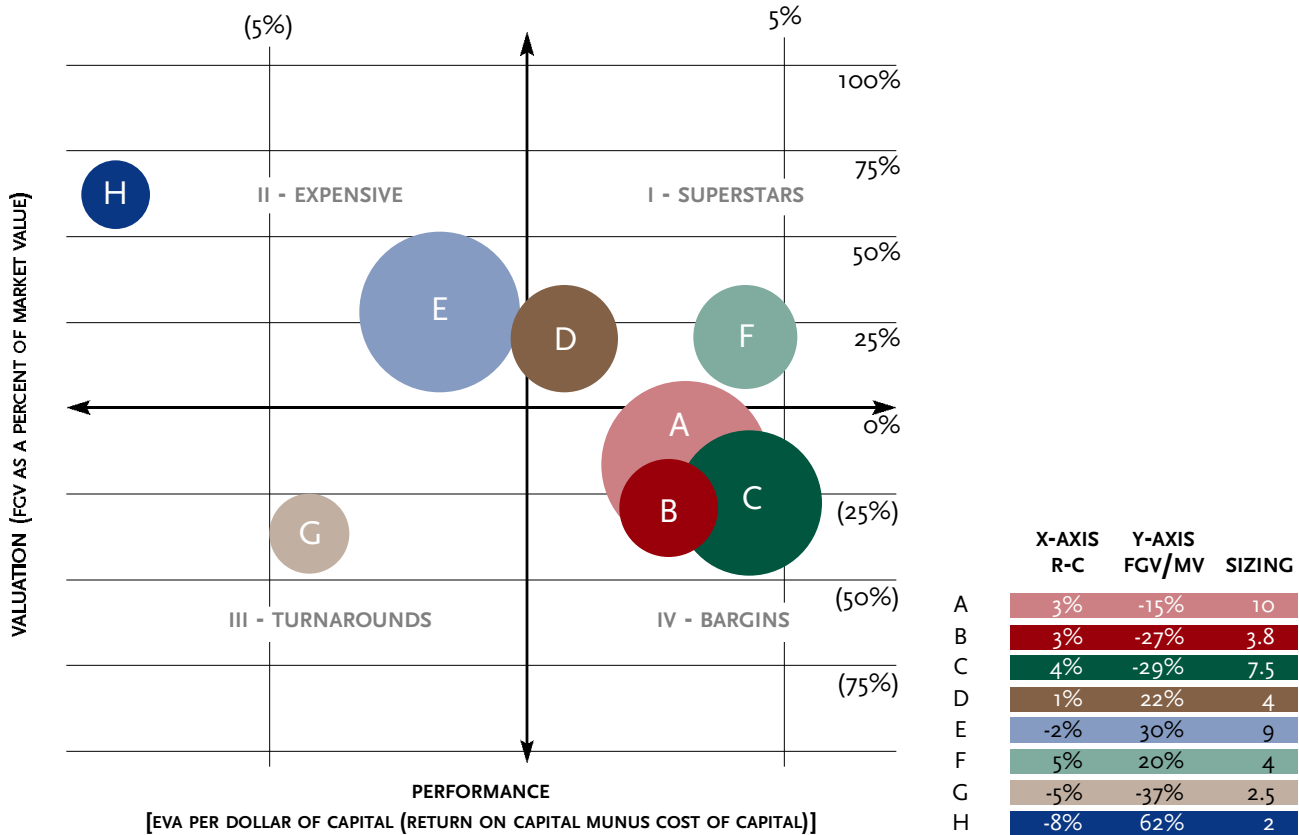
PERFORMANCE-VALUE MATRIX

We have found that a useful tool for framing such challenges is a matrix that maps businesses (companies, SBUs, products, SKUs, customers, etc.) based on their financial performance (EVA) and their valuation (FGV). Both qualities are scaled according to business size for comparability, giving us Future Growth Value as a percentage of total intrinsic value, and return on capital versus cost of capital. As with any tool, this one must be applied dynamically, by considering historical trends and, more importantly, interpolating prospectively.

QUADRANT I Superstars such as Honda, Dell and Southwest are perennial high performers that enjoy full valuations, with strategies to invest in the intangibles that drive FGV, convert FGV to COV through operational excellence and great execution, and perpetually renew FGV for their future. Returning to the French portfolio of our multinational client, product “F” enjoys this position, but it seems to have been neglected because of its smaller size and lower margins. However, it consumes little capital, effectively creating a superior economic profit margin. Product “F” is also highly scalable because of its global brand and ease of contract (“toll”) manufacturing, giving it a tremendous upside. Product “D” also plots here, though its economics might best be improved before investing to scale this business.

QUADRANT II Expensive is often where we find the “hot” stocks and sectors with high expectations for upside, or poor performers (TWA, Polaroid) that would be worth far less except for their minimum valuation floor—often due to the threat of takeover or breakup. Businesses in this quadrant are often candidates for immediate sale or liquidation, unless an aggressive turnaround plan can be developed that would give one reason to believe that the extreme expectations implied by the valuation can be met ▶

FIGURE 3



or exceeded. Within this company’s portfolio, product “H,” with negative contribution, is a legacy brand that needs to be rationalized. Nor does “H” bring any indirect benefits to the portfolio; its highly positive FGV is just the mathematical product of negative profits and a positive liquidation value. Product “E” should be put on watch—its massive size (both revenue and capital) makes any decision critical, yet it is presently not covering its cost of capacity—and is a potential candidate for sale.

QUADRANT III Turnarounds are often perennial disappointments awaiting breakthrough change (Sears, Xerox). Within this company’s portfolio, product “G” is such a case. The prospects for “G” need to be swiftly and realistically evaluated. Its low FGV implies that there is little upside and only a marginal contribution that does not justify the cost of the capacity it consumes. The cost of closure or realizable proceeds may make it a better turn-around prospect than one that could be sold. Can the capacity be moved to a cheaper location, such as Poland?

QUADRANT IV Bargains are often out-of-favour stocks and sectors or cyclicals facing a downturn (automotive), or strong performers with a valuation constraint—an unscal-

able business model—that might be candidates for investment (strong regionals, orphaned brands, unscaled technologies). Within this company’s portfolio, Products “A,” “B” and “C” each exhibit the low-growth values characteristic of such businesses. Strategies are needed to address the root cause of the valuation constraints on these three products (“A,” “B,” “C”). Can slow-growth markets be revived, brands repositioned, or business models and cost structures revisited to develop a more attractive value dynamic?

The return of rationality to our capital markets has once again put the pressure on managers to perform. Value-based portfolio management puts the tools for strategic decisions and tactical execution in the hands of value-oriented managers. Yet the application and interpretation of these tools demand great care. Both performance measurement and valuation are harder to discern at more granular levels in a business portfolio, and the choices are complex, despite the seemingly simple call to maximize value. ■

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