Applied Corporate Finance

Session 17
EVA & Compensation

EVA & Corporate Governance

Read the handout entitled:

EVA: A New Approach to Corporate Governance

It includes two articles

Pay particular attention to the “Total Compensation Strategy” article.
MVA & Management

Although MVA is the best measure of value, it has three problems for performance measurement:
- Volatility due to relationship with share price
- Difficult to link with operating and financial metrics
- Can’t measure divisions, sectors, or other business units

Thus, use EVA.

Why Use EVA?

EVA is an estimate of the true economic profit after subtracting the cost of capital employed

Shortcomings of typical mgmt systems
- Multiple performance measures create confusion
- They don’t account for the full cost of capital
- Budget driven strategies instead of strategic budgets
- Poor alignment between managers & owners
- Weak linkage & inadequate accountability for value.
A Tale of Two Managers

Two division managers have the following performance for 1997:

<table>
<thead>
<tr>
<th></th>
<th>Sales</th>
<th>Operating Profit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Manager A</td>
<td>$50mm</td>
<td>$5mm</td>
</tr>
<tr>
<td>Manager B</td>
<td>$50mm</td>
<td>$5mm</td>
</tr>
</tbody>
</table>

Have the managers achieved equal results? Should they be evaluated equally?

Four Fundamental Strategies

- **EVA**: ? \( \frac{\text{NOPLAT}}{\text{Capital}} \) ? Cost of capital \( \times \) Capital

- **Operate**: Improve the return on existing capital
- **Build**: Invest as long as returns exceed the cost of capital
- **Harvest**: Redeploy capital when returns fail to achieve the cost of capital
- **Decrease**: WACC
Strengths of EVA

- Single performance measurement
- Accounts for the cost of capital
- Breaks the linkage between budgets & performance targets
- Aligns management goals with owners’
- Creating EVA builds a valuable company.

Duckworth Case

- Discuss the incentive compensation model.
The End