Economic value added

EVA or Economic Value Added is the proprietary tool, Stern Stewart & Co. have developed to end insufficient use of capital. The crux of EVA is to effectively put a cost to equity capital and make it a pre-tax charge while calculating returns. In effect, a company is said to be EVA-positive as long as its net operating profit after tax (NOPAT) is higher than the cost of the capital

The EVA presents the analysis of the Economic Value Added. It is an advance evaluation method that measures the performance and the profitability of the business by taking in to account cost of capital that business employs. This method is invented by Stern Stewart & Co. is used by more and more companies to framework of their financial management and their incentive compensation system for the manager and the employees.

Calculating EVA

Internationally, multinationals like Coca-Cola, Siemens, Bausch & Lomb and Dun & Bradstreet have been sold on EVA for long. Back home, though, EVA’s allure is less than captivating primarily because it is a difficult animal to understand. Most companies probably can’t make it effective on their own. It begins by looking simple, but as you get deeper into it the calculations begin to look daunting. EVA is defined as a company’s net operating profit after tax (Nopat) minus the weighted average cost of capital (WACC). Nopat is a no-brainer, and the cost of debt (the interest rate) is simple to understand. So far, so good.

But try calculating the cost of equity. The real cost of equity is the expected return on it, after working in the risk premium. Clearly, it has to earn more than debt, or else shareholders wouldn’t be investing in it. So you have to add the risk premium to the equity part of capital. But this premium would again depend on the kind of industry you are in: if you run a pharma business, the risk premium may be higher than if you were running a cement business.

The EVA is calculated by following method.

EVA = NOPAT – (WACC)*TC

Where,

NOPAT = Net Operating Profit after Tax

WACC = Weight Average cost of capital

TC = Total capital employed

From the above method we can calculate EVA of the company and find out profitability of a company. If EVA is in negative than company is in trouble and they have to concentrate on the basic fundamentals and trading of the company on their basic operation of the company.

If you seek to maximize EVA in the long run, the fundamental performance of the business improves. Capital efficiency will improve because there is a more explicit capital charge; the capital structure will be more optimal because there is greater awareness of the cost of equity. People will be much more bottom line conscious – and conscious about sustainable results – because their own incentives are tied to getting a part of the action.

Following are the example of companies who is implementing EVA

Godrej

Many companies are beginning to be convinced. We have example like The Godrej Soaps group of six companies, headed by Adi and Nadir Godrej, is of them. The group's experience in just one year: four of the six companies have outperformed on stretch targets, and most employees are awaiting huge bonus payouts. As EVA aligns employee goals with shareholder interests, flagship Godrej Consumer Products has been busy handing over dividends hand over fist and buying back shares to bring down the cost of capital.

TCS

Tata Consultancy Services has put almost all its 15, 000-plus employees into EVA-linked variable pay under which performance above EVA targets fetches you bonuses every year. The only employees excluded are entry-level employees who are yet to complete a year in service, says S Mahalingam, executive vice-president of TCS, and the main spearhead for the EVA initiative in the organisation.

Infosys

Others have customised EVA for their own purposes. Marico Industries, makers of Parachute coconut oil, has worked out a simplified version of EVA (styled Seva) but uses it more as a signalling device to tell people that capital is important, that investments and acquisitions must have a justification in terms of shareholder value. At Infosys, EVA is used as a tool to calculate the value delivered to customers. Infosys reasons that if it can tell its customers that what it is delivering in terms of value is higher than what the customer pays Infosys for the service, the customer will be less worried about price alone.

Dr. Reddy

Pharma major Dr Reddy's Laboratories does not use EVA as a measuring device to reward performance. However, it uses EVA as a qualifying criterion for granting performance-based rewards such as variable pay, performance bonuses and stock options (ESOPs), says Saumen Chakrabarthy, senior vice-president (HR). " We use EVA as a qualifying criterion for the grant of ESOPs. Maximising EVA is the basic objective of a business," says Chakrabarthy.

Implementing EVA

When a company decides to adopt EVA as a corporate performance measure, here is what it must do:

Step 1: Run an EVA analysis of the company, its publicly traded peers and business units

Step 2: Draw up a definition of EVA that is simple and meets the company's information needs, existing accounting data, organization and management

Step 3: Work out a compensation scheme that fits into the company's business and culture. The incentive plan has to marry the EVA design with traditional concerns of shareholders and directors

Step 4: Train all employees on the basics of EVA and how it affects shareholder value

Step 5: Demonstrate the difference between EVA-led decisions vis-à-vis conventional methods through computer simulation exercises

Positives of EVA

No ceiling on the amount managers can take home as incentive pay

Managers think like, act like and are paid like owners.

Targets are set over a time horizon that is more than one year – usually three to five years – forcing a long-term view into managerial decision-making

Cuts capital cost and inculcates financial discipline among employees

Increasing EVA directly benefits the shareholder and has been found to have a positive influence on a company’s stock price

Negatives of EVA

Involves lots of complexity. Globally, Stern Stewart is said, in some cases, to make as many as 165 adjustments to work out the weighted average capital cost of companies

Works better at the individual level than team level, unless goals are appropriately structured.

May make companies risk-averse. New investments that look risky or difficult to quantify in terms of expected payback may never be made using EVA.

Keys to make EVA successful.

For successful implementation of EVA, top management commitment, patience and perseverance to see through a complex implementation process is important. TCS is going through this. Failure of implementation is hard to define. Some large software companies publish EVA in their annual reports. They do not allow EVA to influence any decisions internally. For such companies there is no question of any failure.

Infosys

Infosys Technologies Limited is a multinational information technology Services Company headquartered in Bangalore, India. It is one of India's largest IT companies with 103, 905 professionals (including subsidiaries) as of Jun 30, 2009. It has offices in 22 countries and development centers in India, China, Australia, UK, Canada and Japan.

In this EVA approach Infosys's Economic Value Added (EVA) grew 55. 9% in Fiscal 2009, according to the company's Annual Report 2008-09.

Economic Value Added is a performance metric developed by Stern Stewart & Co. that measures all operating and financing costs of running a business. It is a measure of economic profit that is most closely aligned with the creation of shareholder value.

So we can say that up to 2008 it is continuously declining and reached to 8% but after that because of the concentrating on basic operation it increases and reaches to 55. 6% and that shows that they are concentrating on basic operation and their profit increase because of increase in NOPAT.