

Why EVA is better than ROI (ROCE, ROIC, RONA, ROA) and earnings, operating profit etc.

Equity investors should earn on their capital a return far over risk-free interest rate in order to induce and maintain capital in the company

Therefore earnings should always be judged against the capital used to produce these earnings

Earnings can be easily increased simultaneously worsening the position of shareholders e.g. if more capital is poured into a company although the return on capital is 5% or less (even lower than long-term government bond)

Thus it is clear for most people that any earnings figure can not alone be a reliable performance measure (still some companies use EPS !?)

→ Following slides focus on explaining why also return on capital alone is often an unreliable performance measure

EVA vs. rate of return

There are two very good reasons why EVA is much better than ROI (RONA, ROCE, ROIC) as a controlling tool and as a performance measure

1. Steering failure in ROI

Increase in ROI is not necessarily good for shareholders i.e. maximizing ROI can not be set as a target. (Increase in ROI would be unambiguously good only in the companies where capital can be neither increased nor decreased -> however we leave in a world where both operations are easily executed in almost all companies)

2. EVA is more practical and understandable than ROI

As an absolute and income statement -based measure EVA is quite easily explained to non-financial employees and furthermore the impacts of different day-to-day actions can be easily turned into EVA-figures since an additional \$100 cost decreases EVA with \$100. (ROI is neither easy to explain to employees nor can day-to-day actions easily be expressed in terms of ROI)

This latter benefit is often totally forgotten in academic discussion since it can not, of course, be visible in desk studies or empirical studies which try to trace the correlation of EVA and share prices

Both points are explained in detail in the following slides

Reason 1: Steering failure in ROI

Suppose of a SBU earning currently a return (ROI, ROIC, ROCE) of 30% and suppose that this SBU faces an investment opportunity producing a return of 20%

What happens to the ROI of the SBU if the investment is executed?

- Before investment: Capital 100, Operating profit 30, Capital cost 10%
- $ROI = 30/100 = 30\%$, $EVA = 30 - (10\% \times 100) = 20$

- Investment's capital requirement 20, return 20%/year: Thus increase in yearly operating profit is $20\% \times 20 = 4$

- After investment: Capital 120, Operating profit 34, Capital cost 10%
- $ROI = 34/120 = 28\%$, $EVA = 34 - (10\% \times 120) = 22$

In this case decreasing ROI is good for the shareholders, thus ROI should not be maximised and therefore it is problematic controlling tool.

Usually large corporations have at least some very profitable units and particularly these units are steered wrongly with ROI

Reason 2: EVA is more practical and understandable than rate of return (ROI..) (1/4)

Usually the rate of return is not used and totally understood at the lower levels of organizations in the companies using ROI as the prime performance measure. I.e. operating people like sales people, production engineers and supervisors etc. do not use ROI while making day-to-day operating actions (they use operating profit and perhaps also some turnover times instead)

This kind of behaviour is obvious since cost reductions, revenue increases, capital increases and reductions etc. are too difficult to convert into change of ROI with day-to-day activities

- 3 Furthermore those percentages would not be so informative or illustrative to operating people than absolute dollar changes in operating profit

This is even more understandable when we keep in mind that ROI is not an unambiguous measure (slide 2: steering failure)

Reason 2: EVA is more practical and understandable than rate of return (ROI..) (2/4)

Thus in ROI-steered companies the capital base is left to very little attention in operating activities and operating profit is emphasized

Therefore the meaning of capital efficiency is often forgotten and some operating people do not even realize that tying money in inventories or sales receivables is costly

I have heard comments that inventories are not very costly because short interest rates are only 3% per annum...

EVA, in contrast to ROI, is as an absolute measure easy to integrate into operating activities since all cost reductions and revenue increases are already in terms of EVA (reduction in costs in one period = increase in EVA in the same period). In the similar fashion capital increases / reductions are also fairly easy to turn into change of EVA

Furthermore EVA is (in contrast to ROI) an unambiguous measure i.e. increasing EVA increases always the position of shareholders

Reason 2: EVA is more practical and understandable than rate of return (ROI..) (3/4)

It is also very common that in ROI-steered companies many employees do not really know what profitability is

Often many educated employees know something about the flaws of ROI and therefore they have some vague conception that real profitability might also improve although ROI decreases

- Since the company does not have any better profitability measures it is admittedly very difficult to get the whole picture about profitability

ROI is also too complex concept to explain to all employees (not many companies have succeeded (or even tried) to explain to factory employees what is ROI and what is real profitability and how they can influence them)

- I have also met some financial accountants and account managers that do not have comprehended completely what profitability is and what pitfalls ROI include so it is not wonder that these things are difficult to explain to other employees

⇒ Therefore ROI-steered companies and their employees do not always know how to operate to improve the real profitability i.e. the position of shareholders

Reason 2: EVA is more practical and understandable than rate of return (ROI..) (4/4)

Profitability is often viewed as a difficult construct belonging to financial professional although it is in general outline an easy concept understandable to all employees - the question is ultimately whether a company can cover all its costs or not and how much is the excess or deficit

EVA clarifies the profitability into one unambiguous and absolute figure. Thereafter improving profitability is simply increasing EVA

After implementing EVA it is fairly easy to explain to all employer groups what is profitability and where should the company aim at financially

The reason for difficulties for operating people to understand profitability have not been in the concept itself but with the performance measures (like ROI) used so far