



INSIGHT

EVA for Middle Market Companies

Adopting Economic Value Added (EVA) concepts by smaller and middle market companies could help prevent unwise business decisions.

by William Hanneman

“Until a business returns a profit that is greater than its cost of capital, it operates at a loss. Never mind that the business pays taxes as if it had a genuine profit. The enterprise still returns less to the economy than it devours in resources. Until then, it does not create wealth: it destroys it”¹. Peter Drucker

In the nineties, value based performance measures gained immense popularity. In particular, Economic Value Added, commonly known by its registered trademark EVA², was adopted by many large companies as the guiding principle for their corporate policy.

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While there are numerous studies concerning the implementation of EVA in large companies, there is not much evidence of its use among smaller, middle market size businesses. Indeed, few of our clients have adopted the principles of EVA, mostly it seems, because it is perceived as too complex. That is unfortunate.

Over the years, we have observed that the management and financial practices of many privately held companies often lead otherwise smart managers to make unwise decisions. Adopting EVA concepts could remedy that.

EVA differs from traditional income state-

THE CHANGING LANDSCAPE

Twenty years ago, local banks had a near monopoly grip on borrowing needs of the Pacific Northwest business community. Local banks protected their market share over a wide credit risk spectrum. Since that time, the banking industry has changed radically in a tidal wave of rationalization and consolidation. Those local lenders that dominated the market - Seafirst, Rainier, Peoples, Pacific, Seattle Trust - have been assimilated into the mega banks. This has resulted in the centralization of decisions and policymaking and the emergence of national, rather than regional and local, market perspectives. In many cases, that has meant new and improved financial products and services. It also has meant less customized approaches to credit.

As discussed in this issue's Credit Market Update, pricing and terms of credit are currently leaning in favor of the borrower, especially if some element of competition is introduced. The nature of the competition for commercial credit in the Pacific Northwest has changed. In addition to the national banking powerhouses (e.g., Bank of America, U.S. Bank, Wells Fargo, and KeyBank), a host of recent and new entrants, staffed by experienced professionals who previously worked for the big banks, are making themselves known as real alternative sources of credit, especially in the \$10 million and under range. Some are reasonably well-known, like Washington Mutual and Columbia Bank, but others such as Washington Trust, Banner Bank, Sterling Bank, and First Mutual, may be less familiar names. As a result of these changed conditions, borrowers are apt to benefit by assessing the full range of alternatives now available in the market. ❖

ment measures by assessing a cost for all of the capital that is invested in an enterprise. Implemented correctly, EVA does more than

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just measure corporate performance; it is a framework that can be used to guide every management decision, from annual operating budgets to capital budgeting, strategic planning, and acquisitions and divestitures. It is also often used as a corporate performance measure to align the objectives of managers with the interests of shareholders.

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FOUR STEPS TO CALCULATE EVA

The implementation of EVA by smaller companies need not be complex. In fact, in many cases, it is actually simpler than for larger businesses. Nearly all of the information needed to perform EVA calculations can be obtained from the company's income statements and balance sheets. Using this information, there are four steps to calculate EVA.

Step 1: Determine the Total Amount of Invested Capital

Invested Capital is all of the money invested in a company by debt holders and equity

¹ Drucker, Peter F., "The Information Executives Truly Need." Harvard Business Review, Volume 73, Number 1, pp 54-62.

² EVA is a registered trademark of Stern Stewart & Co.

investors. Invested Capital can be estimated by adding all of the interest bearing debt to the amount of the owner's equity or, alternatively, by subtracting all non-interest bearing liabilities from total assets.

Step 2: Determine the Company's Cost of Capital

The cost of capital represents the total return required by all of the suppliers of the Invested Capital. That cost depends upon the predictability of business performance, the size of the business, and the general level of interest rates. A common measure is the weighted average cost of capital (WACC). This figure (expressed as a percent) is then used to develop a capital charge (Invested Capital * WACC) over which the business must earn to create shareholder value.

Step 3: Calculate the Net Operating Profit After Tax (NOPAT)

NOPAT is a measure of the company's ability to generate cash from recurring business activities without regard to its capital structure. NOPAT may require certain adjustments to the GAAP profit and loss or cash flow statements for such things as non-cash charges, the substitution of economic depreciation for book depreciation, or to reflect the multi-period benefits from single-period expenses.

Step 4: Calculate Economic Value Added

Finally, EVA can be calculated by subtracting the capital charge from NOPAT. If the result is positive, value has been created for the owners; if negative, the owner's wealth has been reduced.

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AN EXAMPLE

As a practical example of an EVA calculation for a small manufacturing firm, we illustrate the methodology using data from one of our clients. The financial data has been simpli-

fied to allow the reader to concentrate more on the calculations rather than on the accounting details. A summary of the income statement and balance sheet is presented below.

Income Statement (000s)	
Revenues	\$ 50,000
Operating Profit	4,500
Interest Expense	(900)
Net Income before Taxes	3,600
Income Tax	(1,260)
Net Income	\$ 2,340

Balance Sheet (000s)			
Assets		Liabilities & Equity	
Receivables	\$ 7,500	Payables	\$ 6,000
Inventory	2,500	Accrued Liabilities	4,000
		Debt	18,000
Net Fixed Assets	30,000	Equity	12,000
Total Assets	\$ 40,000	Total Liabilities & Equity	\$ 40,000

Most managers would conclude that this is an attractive business, with a strong operating profit and margin (\$4.5 million and 9%, respectively), and a net return on assets of 5.9%.

Let's see how these conclusions stand up under the application of EVA metrics. The following tables show the calculations for each of the four steps outlined above.

Table 1 shows the calculation of the amount of Invested Capital.

Table 1 An Estimation of Invested Capital	
Total Assets	\$ 40,000
Less: Payable	(6,000)
Accruals	(4,000)
Invested Capital	\$ 30,000

The firm's after-tax Weighted Average Cost of Capital is estimated based on the book balances of debt and equity in the capital structure. This calculation is shown in Table 2. A more sophisticated adjustment would measure the market values of this capital and would more precisely estimate the cost of equity as a function of the expected variability of the cash flows.

Table 2 An Estimation of Invested Capital				
	\$000's	%	A-T Cost (%)	Weighted Average (%)
Debt	\$ 18,000	60%	3.25%	1.95%
Equity	12,000	40%	25.00%	10.00
Total	\$ 30,000	100%		11.95%

The product of the Invested Capital and the WACC is the Capital Charge, the amount or hurdle over which the business must perform to create value for its shareholders.

Assuming that book depreciation is equivalent to economic depreciation, Table 3

Table 3 An Estimation of Net Operating Profit After Tax (NOPAT)	
Net income after tax	\$ 2,340
Interest Expense	900
Interest tax-shield	(315)
NOPAT	\$ 2,925

shows an estimate of NOPAT for the period.

Deducting the Capital Charge from the firm's performance (NOPAT), demonstrates that this "attractive" business actually deteriorated shareholder value by \$660,000 during the period as shown in Table 4.

Table 4 Economic Value Added	
EVA	= NOPAT - [INVESTED CAPITAL * WACC]
EVA	= NOPAT - [CAPITAL CHARGE]
(\$660)	= \$2,925 - [\$30,000 x .1195]

As might be obvious from this example, this business could generate value for its shareholders either by improving its profitability, by reducing the amount of Invested Capital, or both.

SUMMARY

EVA's capital charge causes managers to consider the effect of all decisions on the balance sheet as well as the income statement and it provides a clear, objective basis

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The unique challenges facing middle market size firms do not change the economic principle that in order to prosper and grow successfully, a company must generate average returns that are consistently higher than its capital costs.

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for weighing tradeoffs between the two. For example, production managers could use EVA to optimize the tradeoff between long production runs and the higher inventories that long runs require. Salesmen can learn that generous payment terms can actually eliminate the economic profit in a sale. If implemented correctly, an EVA mentality can turn managers into genuine owners, causing them to lengthen their horizons and constantly seek out sustainable competitive advantages.

The unique challenges facing middle market size firms do not change the economic principle that in order to prosper and grow successfully, a company must generate average returns that are consistently higher than its capital costs. Implementing EVA in small and middle market companies can be a powerful step in that direction. ♦

Spring 2004 Credit Markets Update

The U.S. economy is staging a robust recovery. Don't listen to election year hyperbole, jobs and payrolls are growing, but growth still lags a little in the Pacific Northwest.

by Michael Newsome

The evidence is in—the U.S. economy is staging a full throttle turn around. Virtually every economic indicator reflects strong and sustained momentum. Real Gross Domestic Product growth was an extraordinary 8.2 percent in Q3 and a respectable 4.0 percent in Q4 of 2003, major corporations are announcing solid profitability gains, capital spending is growing, and business and consumer confidence have steadily strengthened. Moreover, job growth seems to be rebounding. In contrast to the election year political hyperbole regarding two million “lost jobs”

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and outsourcing, household employment has hit an all time high according to the U.S. Labor Department. Large corporations that shed jobs during the downturn have been slow to recall laid-off workers or create new jobs, but the payrolls of small and medium sized businesses are expanding. Personal incomes are growing, as well. The Pacific Northwest is a little less glowing, but we are on the upswing nevertheless.

CREDIT DEMAND REMAINS WEAK

Given the widespread positive economic tidings and bullish expectations, it would be reasonable to expect that the demand for capital would be burgeoning. Corporate borrowers typically tap the loan market when activity is hopping in order to invest in working

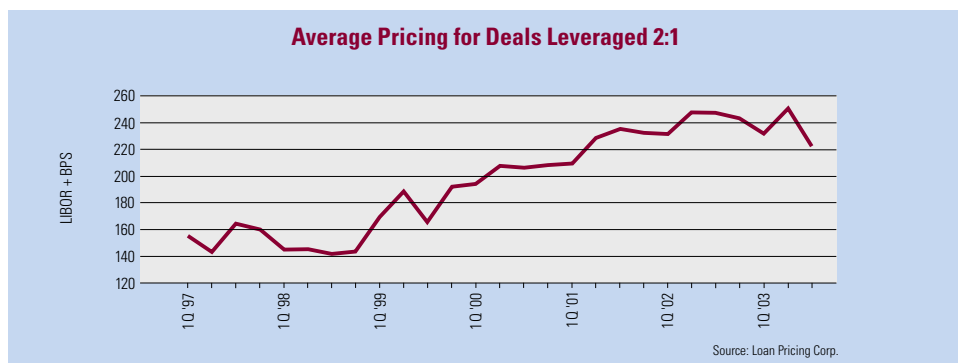
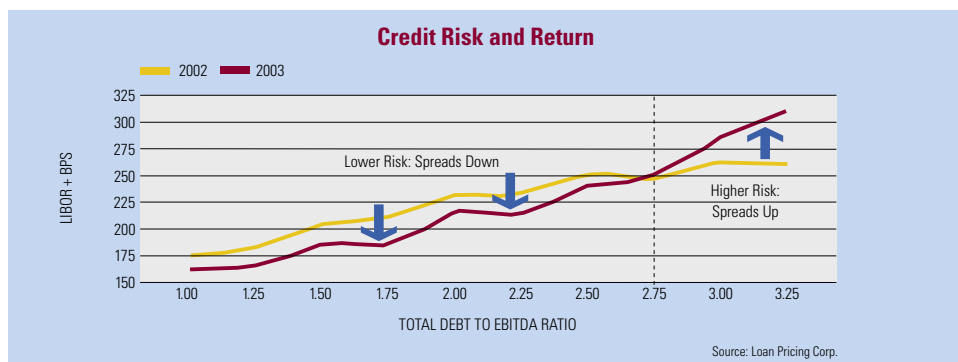
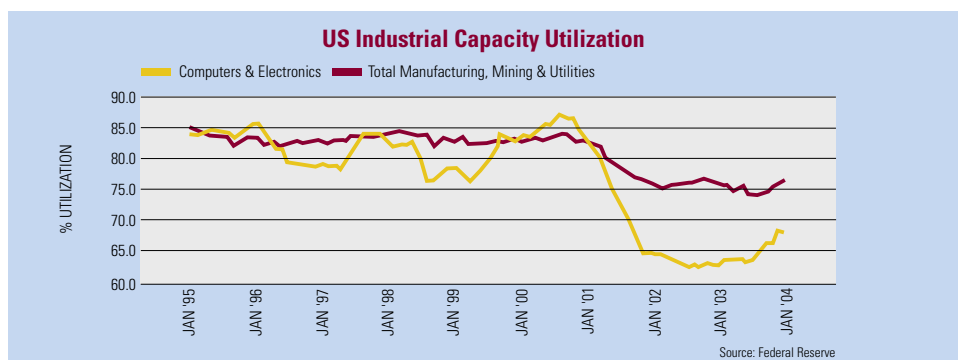
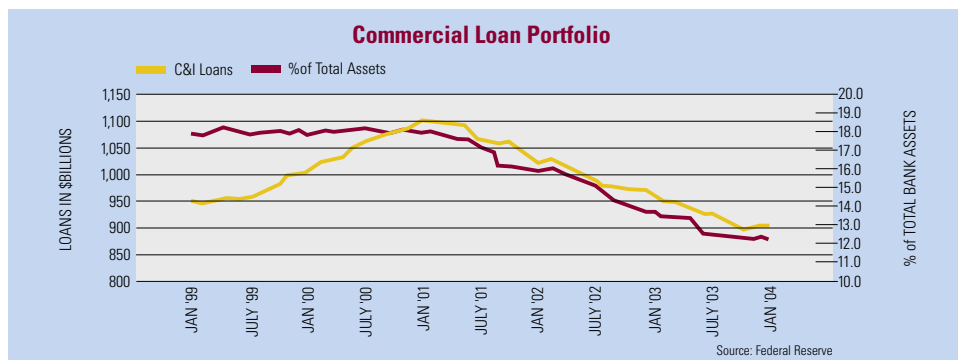
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capital (receivables and inventory), people, facilities and equipment needed to sustain growth. Even with the strong economic news, demand remains rather anemic for business capital or, more specifically, bank credit.

According to the Federal Reserve, commercial banks reported \$898 billion in outstanding commercial loans as of the end of



February. As indicated in the adjacent chart, commercial loan portfolios have steadily dwindled for the past three years—from \$1,100 billion three years ago. Commercial credit averaged 17-18 percent of total banking assets in the latter years of the 1990's. It

now amounts to a little less than 12 percent of the total banking balance sheet.

The question is why credit demand is so soft at a point in the cycle when it should be robust? There are a couple of contributing factors. First, there is an issue of excess capacity

Credit Markets Update *continued from p.3*

—an enormous amount was put in place during the boom, not only in the U.S., but worldwide. This has led to a slow recovery in overall industrial capacity utilization, which remains below 80 percent. In certain sectors, such as computer and electronics manufacturing, utilization is less than 70 percent. The accompanying chart only reflects the U.S. situation; however, excess capacity is a worldwide phenomenon.

A second factor contributing to weak credit demand is the sizeable productivity gains that are being realized. It is clear that businesses continue to figure out how to produce more with less. In large part, the surge in productivity is the real fruit of the improvements in communications and logistics that internet and wireless technologies have provided. The majority of the benefits were not reaped by flash-in-the-pan dot.com firms, but by mainstream businesses, large and small, that have adopted technology to become closer to suppliers and customers. Productivity has also been enhanced by short-term cost cutting behaviors that inevitably happen when times are tough. As the economy grows, these kinds of behaviors tend not to keep pace. This productivity growth has slowed the absorption of excess capacity and muted credit demand. As long as business needs can be funded from internal resources, bank credit demand will remain weak.

Finally, this trend of weak bank credit demand is due in part to large corporate borrowers tending to their capital needs with other sources. Given the very favorable interest rate environment, the public bond and commercial paper markets have been an attractive alternative to bank debt for those companies that have the size and scale to gain access.

IT'S A BORROWER'S MARKET

In the span of just two years the tide has turned again for bankers and borrowers. It was not that long ago that a new lending opportunity could not be gold-plated enough to get a banker's pulse racing. These days, bankers are raring to go. They all seem to have significant loan growth goals that they are attempting to fill. The shift in bankers' appetite for commercial credit is clearly evident in the Federal Reserve's January 2004 Senior Loan Officer Opinion Survey on Bank Lending Practices. In the survey, 18 percent of domestic banks, on net, reported easing lending standards for large and middle-market firms. For the same period, 11 percent of domestic banks, on net, reported easing lending standards for small firms. While on its face this may not seem like much of a shift, it is in fact the largest reported net easing since 1993. Senior loan officers credited the relaxation of standards to more aggressive competition from

other lenders, as well as improvement in the economic outlook. The survey also notes that the majority of banks are experiencing improved commercial credit quality. Loan

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defaults have dropped sharply and problems that surfaced during the economic downturn have largely been cleaned up. This turn of events is having, and will have, a favorable impact on the rates and terms that borrowers can expect to see in new financings this year. It is fair to say that it is a borrowers' market for the first time in three or four years.

Loan Pricing Corp., which closely monitors corporate lending activity, confirms that middle-market loan demand was soft last year, but strengthened by 53 percent in the

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fourth quarter compared to the prior year. They expect that credit demand will pick up in 2004 as the economy strengthens further. However, the balance between credit supply and demand should continue to favor bor-

rowers, particularly in moderately leveraged financings (i.e. total debt / EBITDA < 2.75:1). As illustrated in the adjacent chart, Loan Pricing Corp. reports that the average credit spread over LIBOR slipped last year relative to 2002, except for highly leveraged deals. In transactions with total debt to EBITDA in excess of 2.75:1, borrowers paid more of a premium in order to get lenders to take the incremental risk. While borrowers are paying more at the leveraged end of the market, these are deals that would not have received much lender consideration 12 to 18 months ago.

In our view, the trend established last year is likely to continue for the balance of 2004 and probably longer. For "middle of the road" financial leverage deals (debt to EBITDA of 2:1) the average spread over LIBOR peaked in the second quarter of 2003 at 250 basis points, as shown in the accompanying chart. By the end of the year, the average credit spread had slipped about 10-percent. The current imbalance between credit supply (eager lenders) and demand (willing borrowers) suggests that pricing will soften further. Clearly there is a way to go before credit spreads drop back to the level that prevailed in 1997-1998.

We expect that the acceptable limit on financial leverage will creep up and credit spreads will slide further, even on more highly leveraged transactions. Lenders are generally eager to provide financing. Most of the bankers that we talk to regularly are not seeing the volume of opportunities that are necessary to meet their portfolio growth objectives – so they are hungry. We have always been proponents of building close relationships with bankers, but these relationships need to be broader than a single institution in order to get some competitive benefit. Now that lenders are again willing to compete for credit, prospective borrowers can expect to reap structure and pricing benefits if they cultivate competition for their business. ♦

ABOUT ZACHARY SCOTT

Zachary Scott is an investment banking and financial advisory firm founded in 1991 to serve the needs of privately held, middle-market companies. The firm offers a unique combination of in-depth knowledge of the capital markets and industry competitive dynamics, sophisticated analytical capabilities, and proven expertise in structuring and negotiating complex transactions. For more information on Zachary Scott, go to ZacharyScott.com.

Mark Working
206.224.7382
mworking@zacharyscott.com

William S. Hanneman
206.224.7381
bhanneman@zacharyscott.com

Frank S. Buhler
206.224.7383
fbuhler@zacharyscott.com

Michael T. Newsome
206.224.7387
mnewsome@zacharyscott.com

Ray D. Rezab
206.224.7386
rezab@zacharyscott.com

Doug Cooper
206.224.7388
dcooper@zacharyscott.com

500 Union Street, Suite 1000
Seattle, Washington 98101



Zachary Scott

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