

Is EVA More Highly Correlated with TSR Than Other Performance Metrics?

Assessing ISS's Use of EVA in their CEO Pay-for-Performance Alignment Model

– IRA T. KAY, MARIZU MADU AND PHIL JOHNSON

Introduction

In 2017, Institutional Shareholder Services (ISS) introduced their secondary quantitative test, the Financial Performance Assessment (FPA). This was in response to criticisms that their primary pay-for-performance (P4P) tests, which measure the alignment of CEO pay and total shareholder return (TSR) relative to an ISS-developed peer group, only focused on TSR as the primary performance metric.

The FPA test (as used in 2017-2019) compared the company's financial and operational performance versus the ISS peer group, utilizing three or four GAAP metrics which were selected and weighted based on the company's industry. The GAAP metrics include return on invested capital (ROIC); return on assets (ROA); return on equity (ROE); EBITDA growth, and cash flow (from operations) growth.

For 2020, ISS has changed its policy on the FPA test. Economic Value Added (EVA) will replace the GAAP metrics for the vast majority of companies. The new FPA test will generally utilize four equally weighted EVA-based metrics as defined by ISS: EVA Margin, EVA Spread, EVA Momentum vs. Sales, and EVA Momentum vs. Capital. See Appendix for definitions.

In 2018, ISS acquired EVA Dimensions LLC, a firm founded by Bennett Stewart, one of the original creators of EVA. ISS and Mr. Stewart wrote a white paper published in April 2019, arguing that EVA is the best metric to use in assessing managers' performance in creating value, whether used in incentive plans or not. According to Mr. Stewart, "Increasing EVA is the key to creating wealth, maximizing NPV (net present value of cash flows), and generating TSR, all at the same time!"¹ Stewart attempts to prove this theory by showing that change in EVA is highly correlated with change in MVA

KEY FINDINGS

- Beginning in 2020, ISS will replace GAAP financial metrics with economic value added (EVA) as the metric for their secondary quantitative test, the Financial Performance Assessment (FPA).
- ISS believes that EVA is highly correlated with TSR, and thus is the best financial metric for evaluating company performance.
- Pay Governance research shows that other financial metrics have similar or better correlation to TSR than EVA. EBITDA growth is more highly correlated with TSR than EVA growth.
- The addition of EVA to the ISS CEO pay-for-performance (P4P) model could lead some companies to introduce or consider the use of EVA in their incentive plans.
- GAAP and/or non-GAAP financial metrics may be more relevant depending on a company's specific circumstances. These metrics could also help motivate management, as they may be more directly linked to strategic metrics and easier to understand than EVA.
- Companies will need to make the case to shareholders in their CD&A to justify the appropriateness of the company-selected metrics (which may include EVA).
- Over time for most companies, focusing on the company-specific drivers of value creation will translate into shareholder value creation and positive Say-on-Pay outcomes.

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(Market Value Added). MVA is the spread between a firm's overall market value, or enterprise value, given its current share price and the capital invested in its business assets. However, Stewart did not show/evaluate the direct correlation between EVA and TSR.

Is EVA a better performance evaluation/incentive metric than TSR, GAAP, or non-GAAP financial metrics? Will ISS's introducing EVA encourage companies to at least consider using EVA in their incentive plans? These are questions we address in this Viewpoint.

What is EVA?

EVA measures company profits in excess of the cost of capital (debt and equity). EVA is thus net operating profit after taxes (NOPAT), less a weighted average cost of capital charge applied to invested capital.

EVA as a performance metric offers certain benefits. It is a measure of shareholder value creation or destruction: positive EVA indicates value creation, while negative EVA highlights potential value-destroying investments. EVA provides an internal, management-controllable measure, whereas TSR is external and not directly controllable by management.

On the other hand, EVA has its share of criticisms. Using EVA as a performance metric could discourage growth and acquisition of new capital by managers. When an investment is made, the full cost of the investment is reflected in EVA, frequently before profits are realized from the investment, which reduces EVA. In addition, EVA may not be easily understood by management and other employees unless broken down into primary drivers (e.g., revenue, expense control, capital cost/charges, and ROIC).

Academic research by Pataky² found that using EVA as an investment strategy does not offer higher returns for an investor compared to other financial metrics. Furthermore, academic research by Griffith³ shows there is no correlation between companies adopting EVA and subsequent shareholder returns. Before companies in the sample adopted EVA as a measure of performance, they underperformed peers and the market, and they continued to underperform significantly after implementing the EVA compensation systems. Academic research by Robert Ferguson et al.⁴ shows there is insufficient evidence to conclude that poor stock performance leads firms to adopt EVA or that adopting EVA improves stock performance. However, there is limited recent academic research on EVA given its limited current usage. We anticipate that research will increase given the new ISS EVA methodology.

Pay Governance Analysis

To help determine whether EVA is a better performance metric than GAAP metrics, as ISS implies in their study,⁵ Pay Governance analyzed the correlation between EVA growth and TSR among the S&P 500 over a three-year period (2016-2018).⁶ **We test a simple theory: companies with positive or higher percentage growth in EVA should experience positive/superior levels of TSR (Exhibit 1).** This is the basic premise of the ISS P4P test using EVA.

We also analyzed the correlation of selected GAAP metrics and TSR for comparison. We used TSR as the benchmark for comparison because it is a widely accepted measure of the shareholder experience and is the ultimate score that investors and management teams keep track of.

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Our analysis shows the following:

- **Of all the metrics we reviewed, EBITDA growth has the highest correlation to TSR. EBITDA growth has a higher correlation than EVA growth and EVA Momentum (Capital) (Exhibit 1)-- correlation of 0.41 for EBITDA growth vs. 0.24 for EVA growth (see Exhibit 1 below).**
- EVA growth⁷ and EVA Momentum (Capital)⁸ have **similar but not superior** correlations to TSR as GAAP metrics such as Sales growth, EPS growth, Average Return on Assets, and Average Return on Capital (Exhibit 1).
- Furthermore, EVA growth and EVA Momentum (Capital) show very low or negative correlation to TSR for companies in the Energy sector (Oil & Gas companies) and Real Estate Investment Trust (REIT) sector. EVA has lower correlation to TSR for companies in these industries partly because these companies tend to have delayed profits from capital investments. Profits can be realized years after the investment is made.

Exhibit 1: Correlations with TSR

| Metric | All Companies | Energy | Real Estate |
|---------------------------|---------------|--------|-------------|
| EBITDA Growth | 0.41 | 0.25 | 0.49 |
| EVA Momentum (Capital) | 0.26 | -0.26 | 0.09 |
| EVA Growth | 0.24 | -0.25 | 0.08 |
| Sales Growth | 0.23 | 0.26 | 0.44 |
| EPS Growth | 0.21 | 0.05 | 0.15 |
| Average Return on Assets | 0.18 | 0.33 | 0.00 |
| Average Return on Capital | 0.18 | 0.31 | 0.03 |
| Free Cash Flow Growth | 0.04 | 0.04 | 0.24 |
| Average Return on Equity | -0.42 | 0.52 | -0.05 |

To further illustrate the correlation of EBITDA growth to TSR, and EVA growth to TSR, we separated our sample into two categories: companies with high TSR (above median TSR for all companies in the sample) and companies with low TSR (below median TSR).

Exhibit 2 below shows that the high TSR companies also have higher EVA and EBITDA growth than the low TSR companies. High TSR companies have annualized median TSR of 16% over the three-year period ending 12/31/18, corresponding with annualized EVA growth of 5%, and EBITDA growth of 10%. The low TSR companies have a lower annualized median TSR of 1%, corresponding with lower EVA growth of -4%, and EBITDA growth of 4% at the median.

We also found [not shown] that for companies with negative EVA growth, most (71%) have positive TSR. This partially explains why the correlation of EVA growth to TSR is not stronger than it is: in theory, we would expect companies with negative EVA growth to have negative TSR.

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Exhibit 2: Comparison of High and Low TSR Companies with their Associated EVA Growth and EBITDA Growth

| Category | Count | 3-Year Median CAGR Performance (2016-2018) | | |
|-------------------------|-------|--|------------|---------------|
| | | TSR | EVA Growth | EBITDA Growth |
| Companies with high TSR | 242 | 16% | 5% | 10% |
| Companies with low TSR | 243 | 1% | -4% | 4% |
| All Companies | 485 | 9% | 1% | 7% |

Conclusion

Our study has shown that EVA may not be the ideal performance evaluation/incentive metric for all companies. In fact, EBITDA proves to be a better metric based on TSR correlation. This finding is consistent with another firm's study⁹ which found that EBITDA is more highly correlated with TSR performance than EVA growth. Based upon the research of Pay Governance and others, it is possible that using EVA will yield a number of "false negatives" of companies with poor EVA values in the ISS test but positive/strong TSR. That being said, EVA may work well as a performance evaluation/incentive metric for some individual companies.

ISS has also stated that they do not believe companies should necessarily incorporate EVA as a performance metric in their incentive programs. However, ISS's incorporation of TSR as their primary P4P metric has influenced the widespread adoption of TSR in incentive plans, with almost 60% of S&P 500 companies having adopted it.¹⁰

Pay Governance advises our clients that companies should continue to select incentive plan metrics strategically and to investigate before relying on metrics selected by ISS for its P4P assessments. Preferred/appropriate metrics will vary by industry and by company specific circumstances and may include one or more GAAP or non-GAAP metrics (including EVA), strategic objectives, company stock price targets, or TSR. In addition to rigorous goal setting, companies should consider a thorough review of chosen metrics in the context of the link to shareholder value creation, strategy, business model, and motivation of management.

Over time, focusing on company-specific drivers of value creation will translate into shareholder value creation, greater clarity to incentive plan participants as to organizational priorities, and positive Say-On-Pay outcomes.

General questions about this Viewpoint can be directed to Ira Kay at ira.kay@paygovernance.com or Marizu Madu at marizu.madu@paygovernance.com.

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Appendix – ISS EVA Definitions

| Metric | Definition |
|---|---|
| EVA Margin (EVA ÷ Sales) | The percent of sales remaining after covering all operating and capital costs; a combined measure of profit and loss (P&L) efficiency and balance sheet asset management. |
| EVA Spread (EVA ÷ Capital) | The EVA yield on capital, which equals the spread between the firm's return on capital (ROC) and its cost of capital (COC). |
| EVA Momentum vs. Sales (Change in EVA ÷ Prior Sales) | The trend line annual growth rate in EVA over the past three years, scaled to Sales. |
| EVA Momentum vs. Capital (Change in EVA ÷ Prior Capital) | The trend line annual growth rate in EVA over the past three years, scaled to Capital. |

¹ Bennett Stewart. "The Link Between TSR and EVA." ISS. April 4, 2019

² Tamas Pataky. "Is economic value added (EVA) the best way to assemble a portfolio?" University of Central Florida, Fall 2012. <https://stars.library.ucf.edu/cgi/viewcontent.cgi?article=2367&context=honorstheses1990-2015>.

³ John M. Griffith. "The True Value of EVA." Journal of Applied Finance, Fall/Winter 2004. https://papers.ssrn.com/sol3/papers.cfm?abstract_id=670387.

⁴ Robert Ferguson et al. "Does Economic Value Added (EVA) Improve Stock Performance or Profitability?" Journal of Applied Finance. Fall/Winter 2005. https://papers.ssrn.com/sol3/papers.cfm?abstract_id=808425.

⁵ Bennett Stewart. "The Link Between TSR and EVA." ISS. April 4, 2019.

⁶ Our study included 485 companies from the S&P 500 as of September 2019, excluding those without three years of TSR or financial performance history.

⁷ EVA as calculated using S&P Capital IQ methodology and inputs: ((NOPAT/Invested Capital) – WACC) * Invested Capital. WACC: weighted average cost of capital.

⁸ EVA momentum (Capital) is defined as a change in EVA (2015-2018) divided by average capital over the three-year period ending 2018.

⁹ EXEQUITY, "ISS, EVA, and Economic Voodoo." August 20, 2019. https://www.exqty.com/uploads/6/9/9/0/69908991/economic_voodoo_20190820.pdf.

¹⁰ EXEQUITY. "2019 Relative TSR Prevalence and Design of S&P 500 Companies." September 25, 2019. https://www.exqty.com/uploads/6/9/9/0/69908991/rtsr_prev_and_design_of_sp500_20190925.pdf.