A Presentation on EVA

You cannot know whether your <u>business operation is creating value</u> . .

UNTIL YOU APPLY

- the **TRUE** Cost of Capital

  To

- **ALL** the Capital Employed

Most companies have no idea what either amount is

Change in investor perception

- ROE, EPS growth are not good measures / predictors of performance
- Markets are no longer fooled by changes in accounting policy which effect earnings but do not affect cash flow or value of business
- Cash flow is the real test of strength

FUNDAMENTAL DRIVERS OF SHAREHOLDER VALUE ARE :

- AN OVERRIDING FOCUS THAT ALL CAPITAL LODGED GENERATES RETURNS IN EXCESS OF THE COST OF CAPITAL

- INVEST ONLY IN VALUE CREATING PROJECTS AND STRATEGIES

[WHAT COUNTS IS PROFIT AS PERCENTAGE OF CAPITAL INVESTED]

What is Economic Value Added !

Economic Value Added (EVA) is the residual income after charging the company for the Cost of Capital provided by the Lenders and the Shareholders.

NOPAT - Cost of Capital = EVA

WHAT IS EVA

EVA = NOPAT - CAPITAL CHARGE

Where :

NOPAT = ROIC * INVESTED CAPITAL

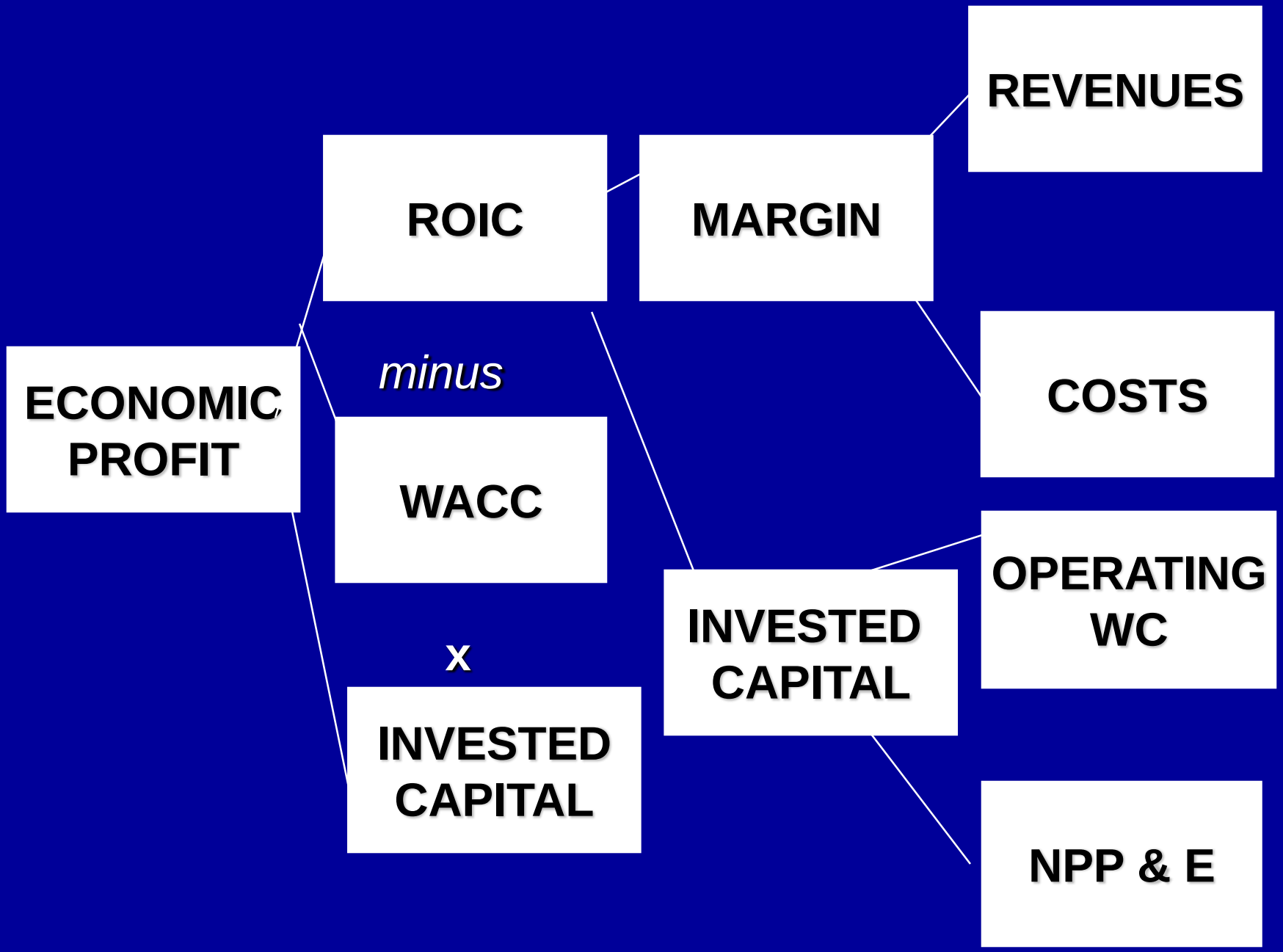
&

CAPITAL CHARGE = WACC * INVESTED CAPITAL

EVA HAS TWO DISTINCT APPLICATIONS

- MEASURE SHAREHOLDER VALUE CREATED IN THE PAST
- DETERMINE INVESTORS EXPECTATIONS AS THEY RELATE TO SHARE PRICES

[COMPETITIVE ADVANTAGE PERIOD]


ECONOMIC PROFIT
ROIC
minus
WACC
x
INVESTED CAPITAL
MARGIN
REVENUES
COSTS
INVESTED CAPITAL
OPERATING WC
NPP & E

INVESTED CAPITAL comprise of……

- ✓**Net Fixed Assets** less Capital WIP
- ✓**Net Current Assets**
- ✓**Investments**
- ✓**R & D Expenses**
- ✓**Bad Debt Reserves** added to Receivables

WHAT IS THE TRUE COST OF CAPITAL ? ….

- **COST OF BORROWED CAPITAL**

  INTEREST RATE CHARGED BY BANKS AND FINANCIAL INSTITUTIONS

- **COST OF EQUITY CAPITAL**

  RISK FREE RATE (LONG TERM GOVERNMENT SECURITIES) PLUS

  EQUITY RISK PREMIUM X BETA RISK OF EACH COMPANY

- **CAPITAL STRUCTURE IN PROPORN. OF DEBT & EQUITY**

W A C C
(WEIGHTED AVERAGE COST OF CAPITAL)

=

WEIGHTED COST OF DEBT

+

WEIGHTED COST OF EQUITY

COST OF DEBT

=

INTEREST COST

*****

(1 - TAX RATE)

BASED ON CAPITAL ASSET PRICING MODEL

COST OF EQUITY (Ke)

Ke = Rf + (Rm - Rf) *ß

RISK FREE RATE (Rf)

+

MARKET RISK PREMIUM(Rm-Rf)

*

BETA

FOR TATA STEEL

Figs. of '97-98

COST OF DEBT = INTEREST RATE * (1-TAX RATE)

= 10.7* (1- 0.105)

= 9.6 %

INTEREST RATE

I NT. RATE = INTEREST CHARGE

(GROSS) / DEBTS X 100

=Rs.465 Crs./Rs.4331Crs X 100

=10.7 %

COST OF EQUITY:

CAPITAL ASSET PRICING MODEL :

$$Ke = Rf + (Rm - Rf) * \beta$$

$$= 14 + (21 - 14) * 1.2$$

$$= 22.4\%$$

WACC i.e. THE COST OF DEBT AND COST OF EQUITY TAKEN TOGETHER

(AFTER CONSIDERING THE DEBT : EQUITY RATIO OF 1: 0.89)

FOR TATA STEEL = 15 %

STRATEGIES FOR MAXIMISING E.V.A.

EARN MORE WITHOUT INCREASING CAPITAL

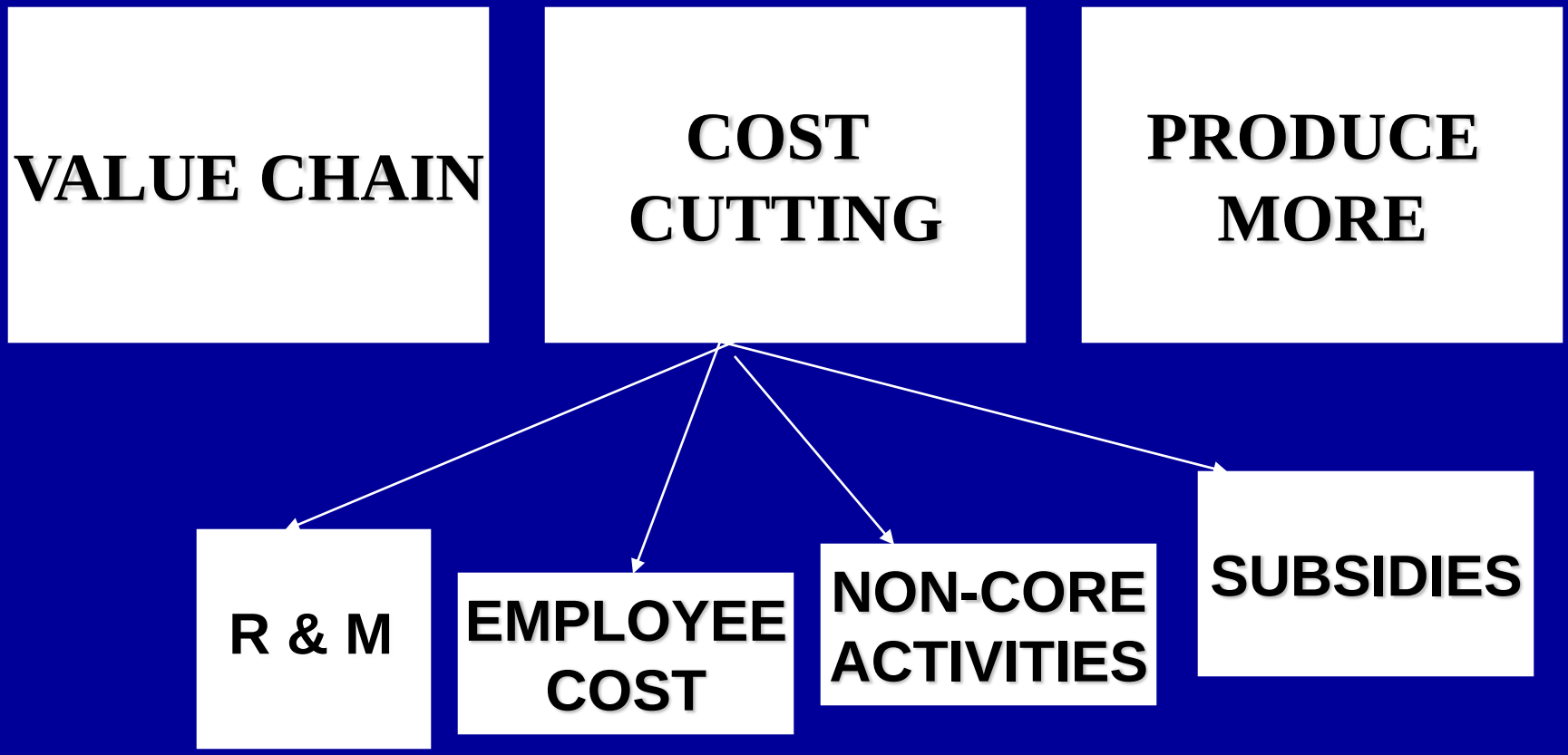
USE LESS CAPITAL

HUNT OUT LAZY CAPITAL

INVEST IN HIGH RETURN PROJECTS

REDUCE THE COST OF CAPITAL

EARN MORE WITHOUT INCREASING CAPITAL



INVEST IN HIGH RETURN PROJECTS

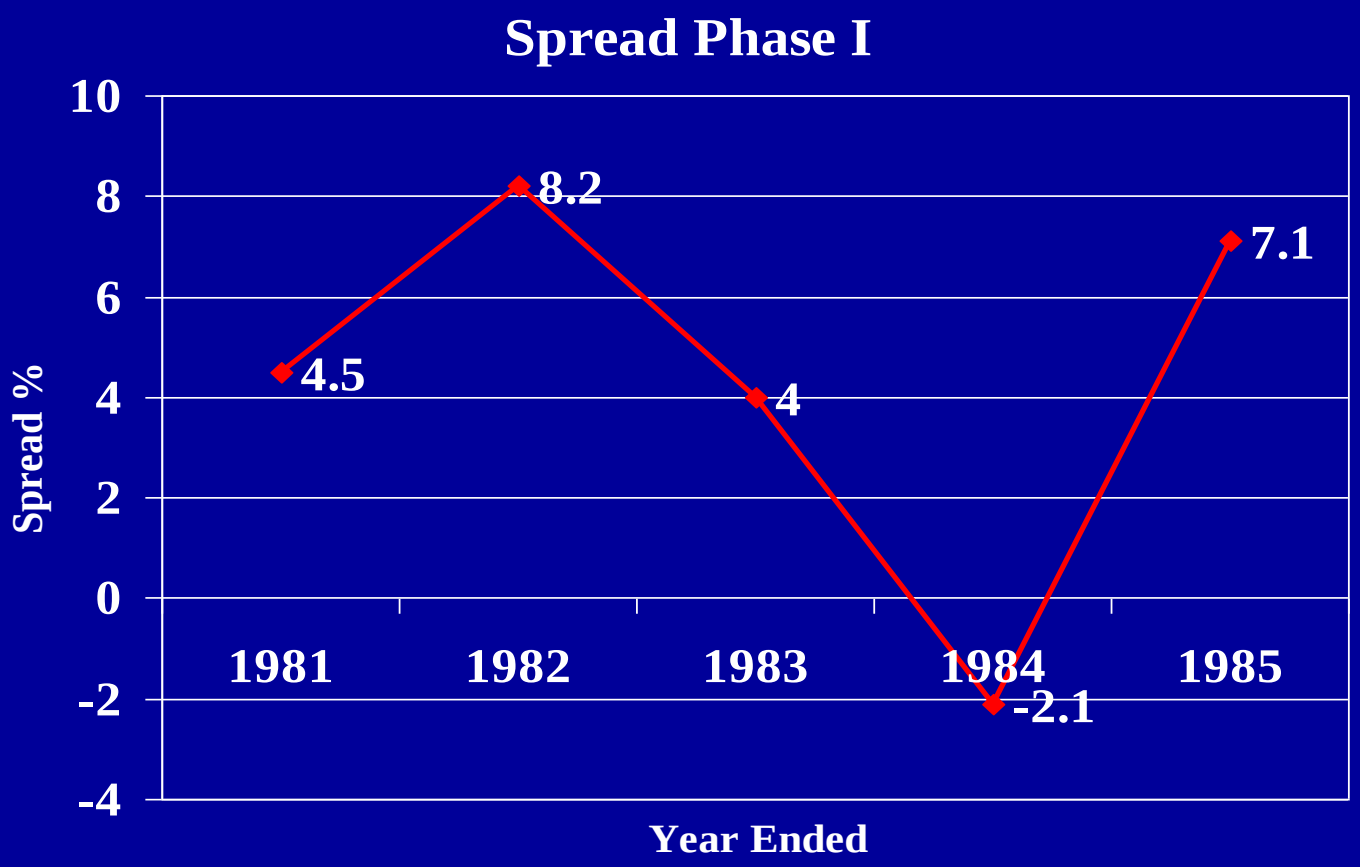
IRR > WACC

MULTIPLE HURDLE RATES

MAJOR COMPANIES

BASED ON FIGS AS ON 31ST DEC 1994

	ROIC	*WACC*	*EVA*
COCA COLA	35.5%	10.0%	25.5%
GENERAL ELEC.	14.8%	12.9%	1.9%
ORACLE SYSTEMS	37.0%	15.4%	21.6%
MICROSOFT	47.6%	14.4%	33.2%
ABBOTT LAB.	27.1%	11.1%	16%
JOHNSON & JOHNSON	19.6%	12.6%	7%
PHILIP MORRIS	16.3%	10.8%	5.5%
INTEL	28.3%	15.4%	12.9%


Spread Phase I
10
8
6
4
2
0
-2
-4
Spread %
8.2
7.1
4.5
4
-2.1
1981
1982
1983
1984
1985
Year Ended

Historical Performance of the Steel Industry

Reasons for the steel industry historical under performance include both structural factors as well as traditional management responses to these factors which have often made the situation worse.

Structural Factor	*Management Responses*	*Impact*
Market Cyclicality	Invest to meet peak demand level	Underutilized assets for much of the cycle
Dependence on critical raw materials	Vertical integration	"Hidden" inefficiencies

Structural Factor	***Management Responses***	***Impact***
Fixed asset intensity	Long depreciation cycles	Slow adoption of new technologies
Process technical complexity	Complex, tenure based management structures	Slow response to change
Wide product range	Large inventories	“Fixed” liquid assets
Overall business risk based on the above	State ownership, oligopolies and price agreements	Management laziness

EVA - A Management Approach

An integrated approach to financial management and incentive compensation.

4 M’s of EVA :

- Measurement
- Management
- Motivation
- Mindset

EVA - Measurement

- A financial performance measure. Estimate of true economic profit as opposed to accounting profit.
- It motivates managers to consider the cost of capital in every decision and to appropriately weigh the trade off between earnings and assets.

EVA - Management

- EVA is directly linked to the wealth of the shareholders.
- At project level, EVA is linked with NPV. The present value of future EVA is the NPV of the project. The companies adopting EVA framework discounts future EVA instead of cash flow.

EVA - Motivation

- The key to unlocking the power of EVA is an incentive compensation plan that makes managers to think like, act like, and be paid like owners.
- In contrast, most companies pay managers a bonus for achieving a sales target or ABP.
- Once budget becomes the basis for earning a bonus, managers have the incentive to understate and underperform the true potential of their business, and to manage the earnings and expectations of H.O. instead of maximizing value.

EVA - Mindset

- EVA strengthens corporate culture.
- It aligns people from the shop floor to the board room with a common measure, a common framework, and a common mission, facilitating empowerment, and releasing value-enhancing energies throughout the company.
- EVA managers are able to make more effective long term decisions without fearing a near term penalty.

In Conclusion ….

What counts is Profit as a Percentage of Capital Invested in the business

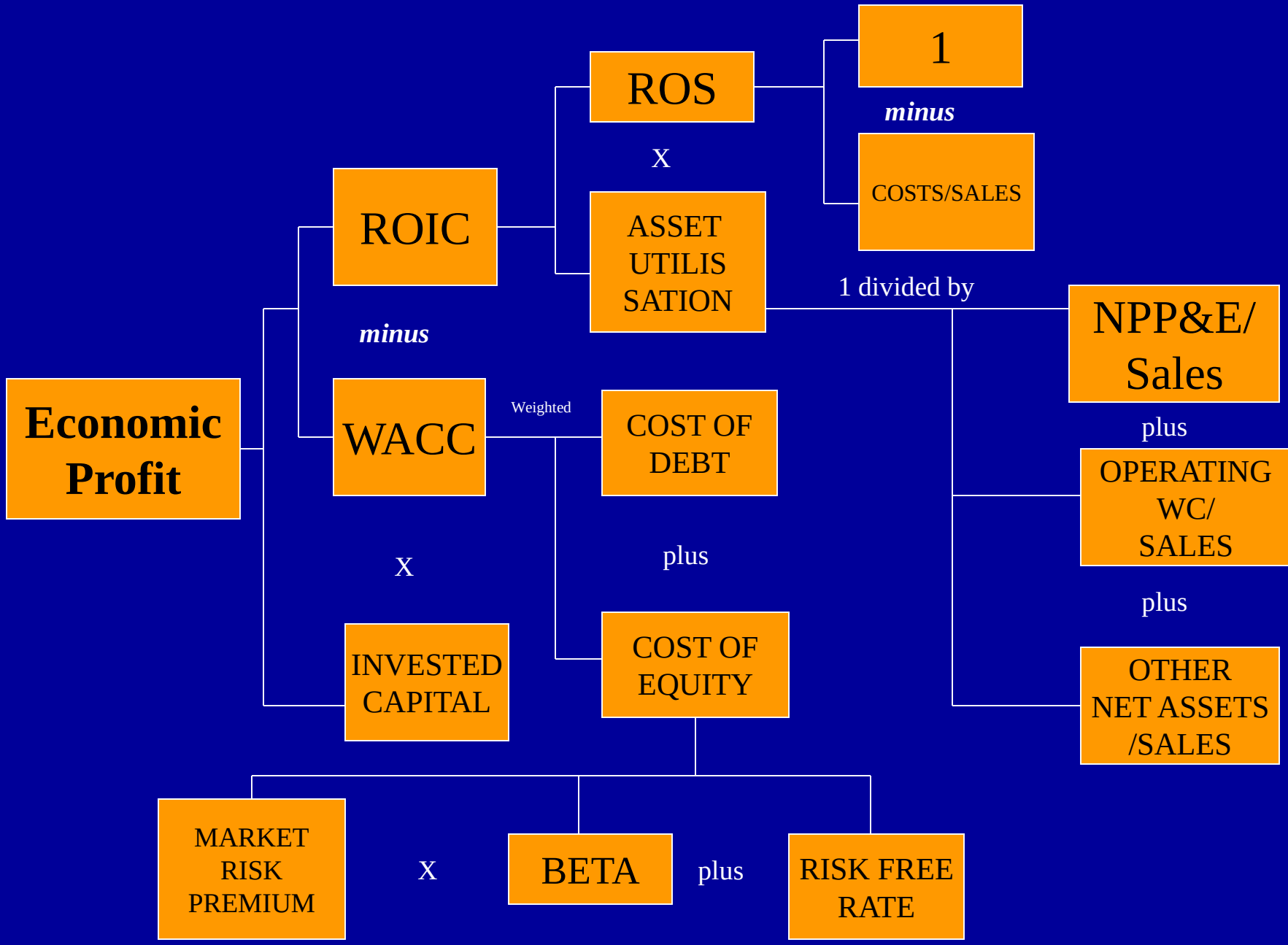
Maximize Economic Value of the business to prevent predators spotting **Value Gaps**

Link Executive Compensation to EVA Improvement (eg : PCCs)

CAVEAT !

Single minded focus on EVA ….

- Would make companies biased towards "shedding off"
- Deter companies from growing


Economic Profit
ROIC
minus
WACC
Weighted
ROS
x
ASSET UTILIS SATION
1
minus
COSTS/SALES
1 divided by
NPP&E/ Sales
plus
OPERATING WC/ SALES
plus
OTHER NET ASSETS /SALES
COST OF DEBT
plus
COST OF EQUITY
x
INVESTED CAPITAL
MARKET RISK PREMIUM
x
BETA
plus
RISK FREE RATE

THANK YOU!!!