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ISS TO INTRODUCE EVA METRICS TO PERFORMANCE MEASUREMENT

In February 2019, Institutional Shareholder Services (ISS) launched its Economic Value Added (EVA) platform as part of its online CEO Pay for Performance modeling tool, and published a white paper detailing the principles and calculations of various EVA metrics deemed to be key indicators of corporate performance. For 2019, EVA metrics will not be a factor in the quantitative CEO Pay for Performance test but will be included as informational performance measures in ISS research reports beginning in March 2019.

What is EVA?

Companies typically measure absolute and relative market and financial performance using total shareholder return (TSR) and operational metrics such as revenue, margin, profit, and/or financial returns. However, these performance indicators are subject to drawbacks because they can be influenced by factors that obscure the underlying economic results (e.g., macroeconomic factors, GAAP accounting distortions such as treatment of R&D and restructuring expenses, etc.).

EVA is designed to address these limitations by comprehensively measuring a company's sales growth, profitability, and capital efficiency, while also accounting for investors' capital costs. For most companies, EVA is defined as net operating profit after taxes (NOPAT) less a full weighted average cost of capital (WACC) charge on total capital. A modified approach applies to financial companies as described on the next page. Definitions of the components of EVA are as follows:

Input	Definition	Purpose
NOPAT	Profit after taxes, depreciation, and amortization, but before interest expense and financing charges	Profit available to cover and pay all financing costs
Capital	Total assets, net of interest-free trade funding sources like accounts payable; also equal to interest-bearing debt plus equity	Total dollars invested in the business
WACC	Estimated as yield on long-term government bonds (same for all companies in a market), plus premium ranging from 1-8% based on risk profile (same for all companies in a sector), less discount for tax deductibility of interest on debt (company-specific)	Minimum rate of return at which a company produces value for investors (i.e., exceeds the opportunity cost of investor dollars)

Input	Definition	Purpose
Capital Charge	Capital x WACC	Profit a company must earn in to pay interest on its debt, after taxes, while maintaining a minimum rate of return for investors

By combining NOPAT and a capital charge (income statement and balance sheet), ISS believes that EVA will effectively measure the three key drivers of value creation:

1. Operating Efficiency – increasing NOPAT without increasing capital.
2. Asset Management – reducing capital tied up in assets and activities that earn less than the cost of capital.
3. Profitable Growth – investing capital in positive net present value projects and strategies.

Adjustments from GAAP

To mitigate the distortion inherent in traditional GAAP accounting rules, ISS applies several adjustments to the calculation of EVA, with rules subject to the following constraints:

1. Must be standardized and formulaic so that adjustments can be broadly applied, with no individual company factors or human judgment.
2. Limited to adjustments that can be applied using Standard & Poor's Compustat financial database.
3. Must follow double-entry bookkeeping, so that any adjustment to earnings requires a corresponding adjustment to balance-sheet capital.

Summarized at the end of this letter is a list of 11 significant adjustments to GAAP accounting that ISS has identified to provide a clearer picture of a company's true growth, profitability, and capital efficiency, while also making comparisons across companies and industries more meaningful.

Differences for Financial Services Companies

Certain modifications apply to banks, financial services companies, insurance companies, and real estate investment trusts (REITs) due to the differences in their income statement and balance sheet structures. For companies in these industries, the following nuances apply:

1. Revenue = net interest income plus fee income.
2. Interest expense and financing costs are considered operating costs and are deducted from NOPAT.
3. Capital = common equity capital; excludes interest-bearing deposits and other funding sources, capital notes, and preferred stock.
4. Cost of Capital = cost of equity capital only, not WACC.

As a result, EVA for these companies is defined as net income less an equity capital charge rather than NOPAT less a WACC charge.

Primary EVA Metrics to be Used by ISS

To supplement the traditional market and operational performance measures used in its CEO Pay for Performance test, ISS identified the following four EVA metrics as strong indicators of profitable growth, operating efficiency, and asset management. These key metrics take the concept of EVA one step further and transform EVA from an absolute dollar amount to ratios and growth rates in an effort to more accurately measure long-term performance and make meaningful relative comparisons.

Metric	Calculation	Definition	Purpose	Measurement Period
EVA Margin	$\frac{\text{EVA}}{\text{Sales}}$	Percent of sales remaining after covering all operating and capital costs	Measures magnitude of value creation per unit of sales or capital	Three-year average
EVA Spread	$\frac{\text{EVA}}{\text{Capital}}$	Spread between return on capital and cost of capital		
EVA Momentum (Sales)	$\frac{\text{Change in EVA}}{\text{Prior-Period Sales}}$	Growth rate scaled to the size of the business	Quantifies EVA growth or deterioration over time, and through various market cycles and relative to peers	Three-year "trend" measured by running regression line through past four years of EVA and dividing the slope by the average of the firm's sales or capital base in the first three years
EVA Momentum (Capital)	$\frac{\text{Change in EVA}}{\text{Prior-Period Capital}}$	Growth rate scaled to the firm's capital base		

How will EVA be Used?

ISS will not use EVA metrics in the quantitative CEO Pay for Performance test in 2019 but will phase them into research reports for informational purposes beginning in March 2019. Companies that purchase the online CEO Pay for Performance modeling tool are able to access their EVA Profile on the four metrics through the Governance Analytics website.

ISS noted that the presentation of EVA metrics should not be interpreted as an endorsement or recommendation to use EVA metrics in an executive compensation program.

Speculation is that ISS will incorporate EVA metrics into the quantitative (or qualitative) CEO Pay for Performance analysis in future years, and that EVA metrics will eventually be used in lieu of, or as a supplement to, the traditional financial and market performance measures used in ISS' current analyses, with comparisons made on both an absolute and relative basis across peer groups and indices (e.g., Russell 3000, S&P 500).

Implications for Our Clients

In the near-term, we expect this development to be closely monitored by companies, but not lead to any immediate action. As ISS' new methodology gets rolled out and fine-tuned over the next couple of proxy seasons, we believe EVA will naturally seep into board-level discussions of company performance, possibly leading to consideration of including EVA or EVA-related metrics in the incentive framework of some companies, particularly those in capital intensive businesses. While this development from ISS is likely to foster increased discussions of EVA, we expect business priorities, a company's strategic direction, and other objectives (e.g., simplicity, line of sight) to continue to lead decision-making with regards to operating plans and incentive systems.

List of Significant Adjustments from GAAP

Adjustment from GAAP	Technique	ISS Noted Impact
Capitalize Investments in Intangible Assets	Do not deduct R&D and Advertising expense from profit Add these expenses to Capital, subject to a capital charge, and amortize spending over 5 years for R&D and 3 years for Advertising Pharma & Biotech companies will be amortized over 10 years for R&D and 5 years for Advertising	EVA is smoothed and more comparable Motivates managers to step up spending on promising opportunities, and to resist cuts just to make near-term earnings goals
Capitalize Impairment, Restructuring Charges, Losses on Sales, and Non-Recurring Items, net of Unusual Gains	Do not deduct these charges from profits, and instead add them to Capital, subject to an ongoing capital charge	Impairments are inconsequential Motivates managers to restructure promptly and efficiently, sell assets worth more to others, manage risks, and minimize non-recurring charges
Eliminate Impact of Excess Cash	Remove excess cash from Capital and the associated income from NOPAT	EVA is unaffected by retaining or paying out excess cash, because shareholders own the cash regardless
Treat Leased Assets as if Owned	Back the interest in rents out of NOPAT, and add the present value of rents to Capital, subject to the full Capital charge	Focus on asset management, regardless of how assets are financed Firms that lease or buy can be fairly compared
Smooth Taxes	Measure the tax on NOPAT at a set standard tax rate	Temporary shifts in the effective tax rate do not distort EVA
Recognize Value of Deferred Taxes	The cost of capital saved by deferring taxes is added to NOPAT	The value of deferring taxes is recognized

Adjustment from GAAP	Technique	ISS Noted Impact
Deduct the Net Charge Offs of Bad Debts	Add provision for bad debts to NOPAT and deduct net charge offs, and add bad debt reserve to Capital	Switches from a bookkeeping provision to actual events that managers can manage
Switch from LIFO to FIFO Inventory Costing	Add the LIFO reserve to Capital, and the change in LIFO reserve to NOPAT	Inventories closer to replacement cost FIFO cost of goods sold with LIFO tax benefit
Eliminate Retirement Cost Distortions	Add reported retirement expense to NOPAT, deduct service cost instead Deduct/add the cost/gain of capital times any net unfunded liability	EVA unaffected by the assumed return on retirement assets, and reflects true incremental cost Funding losses reduce EVA
Equity, not Entity	Deduct the provision for non-controlling interests (NCI) from NOPAT, and deduct NCI equity from Capital	Measures the value to the parent company shareholders
Cost of Capital	Reflects long-term government rates and the firm's sector risk, less the strategic tax benefit of debt	Measures the opportunity cost of the capital, provides a hurdle rate to create value, and sets target debt ratio

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The complete primer on EVA can be requested here and the supplemental white paper on using EVA to measure performance can be requested here.

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