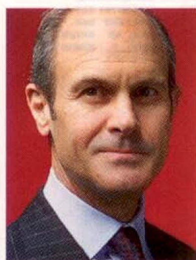
# FIRST

## VALUE DRIVEN

# "Many performance ratios lie about a company's health. A new metric has emerged that can't easily be gamed—and savvy investors and managers will check it out."

*by* GEOFF COLVIN



IN BUSINESS AS IN LIFE, BE CAREFUL what you wish for. I know a company that wished for a better return on equity. What could be wrong with that? It paid its executives according to that measure, and man, did they deliver. In some years the firm had the best ROE in its industry. It was winning bigtime.

The firm was Lehman Brothers, now dead because managing for ROE caused executives to overborrow; after all, debt is capital that earns a return (in good times). Yet it isn't equity, so extreme leverage simply juices ROE until bad times arrive. Wishing for the wrong thing—managing for the wrong ratio—killed the company.

The larger, chilling reality is that every other ratio out there can lead to the same disaster. Gross margin? Earnings per share? It's easy to make any of them look better while damaging the business. Which is why a new ratio that you've never heard of, EVA momentum, is so intriguing. It has been developed by consultant Bennett Stewart, one of the creators (with Joel Stern) of the measure called economic value added, or EVA. Now used by myriad firms, including Siemens, Best Buy, and Herman Miller, EVA is essentially profit after deducting an appropriate charge for all the capital in the business. Because it accounts for all capital costs, its proponents say, EVA is the best measure of value creation. Now Stewart is making a bold claim about his latest idea: EVA momentum, he says, is the one ratio that can't be manipulated. "It's the only percent metric where more is always better than less," he says. "It always increases when managers do things that make economic sense." If he's right, it is worth knowing about—for managers at every level and for investors.

➔ **EVA MOMENTUM IS A SIMPLE CONCEPT.** It's the change in a business's EVA divided by the prior period's sales. So if a company increases its EVA by $10 million and the prior period's sales were $1 billion, then its EVA momentum is 1%. That's not bad, considering that for most companies this figure is zero or negative, and the average for many companies is generally around zero. Stewart's firm, EVA Dimensions, has crunched the five-year data for firms with revenues of at least $1 billion. The three top performers by EVA momentum: Gilead Sciences (with an average annual EVA momentum of 24.3%), Google (22.7%), and Apple (12.1%).

It's no surprise to see those names identified as excellent performers; what's interesting is the way they did it. The key insight is that achieving high EVA momentum requires a business to do two difficult things at once. It must grow while at the same time maintaining healthy EVA profit margins or improving poor ones. Apple and Gilead, a biopharmaceutical company, grew spectacularly while also increasing their EVA profit margins impressively; Google simply maintained an excellent EVA profit margin while growing sales 760% during the five years. That combination of increasing sales and an excellent or improving EVA is the extremely rare basis of great financial performance.

➔ **CAN THIS RATIO BE GAMED?** It's hard to see how. A popular gambit of conniving managers is to shrink a ratio's denominator recklessly, which is what Lehman executives did when they cut the E in ROE dangerously low. But the denominator in EVA momentum is the last period's sales, so it's fixed going in. Relentlessly jacking up EVA—the numerator—is difficult; a proper calculation of EVA values spending on R&D and employee training, the kinds of long-term investments that help companies over time.

EVA momentum is brand-new—*Fortune* is the first to write about it—and while Stewart has measured it in hundreds of companies, real businesses have yet to apply it. So we don't know what will happen when this ratio confronts actual managers trying to make actual profits. But when a big new idea comes along, adopting it first creates a major advantage. This could be one of those times. ■

FEEDBACK *gcolvin@fortunemail.com*

## EVA MOMENTUM: HOW TO GET IT RIGHT

**1. DON'T OBSESS ABOUT SALES.** Managers fixate on how to increase their company's revenues, but if it doesn't boost EVA, it does nothing to create value.

**2. BAIL OUT OF EVA-NEGATIVE BUSINESSES.** Ford's sale of capital-intensive, EVA-sapping Jaguar and Land Rover shrank the company, but in the end increased its value.

**3. ANNIHILATE WASTED CAPITAL.** Cutting working capital, as Wal-Mart did in 2009, and offloading unproductive assets are great opportunities to build EVA when growth is slow.

WESLEY MANN



➲ **Colvin on business** To read more of Geoff's columns, go to **fortune.com/valuedriven.**