MERCER

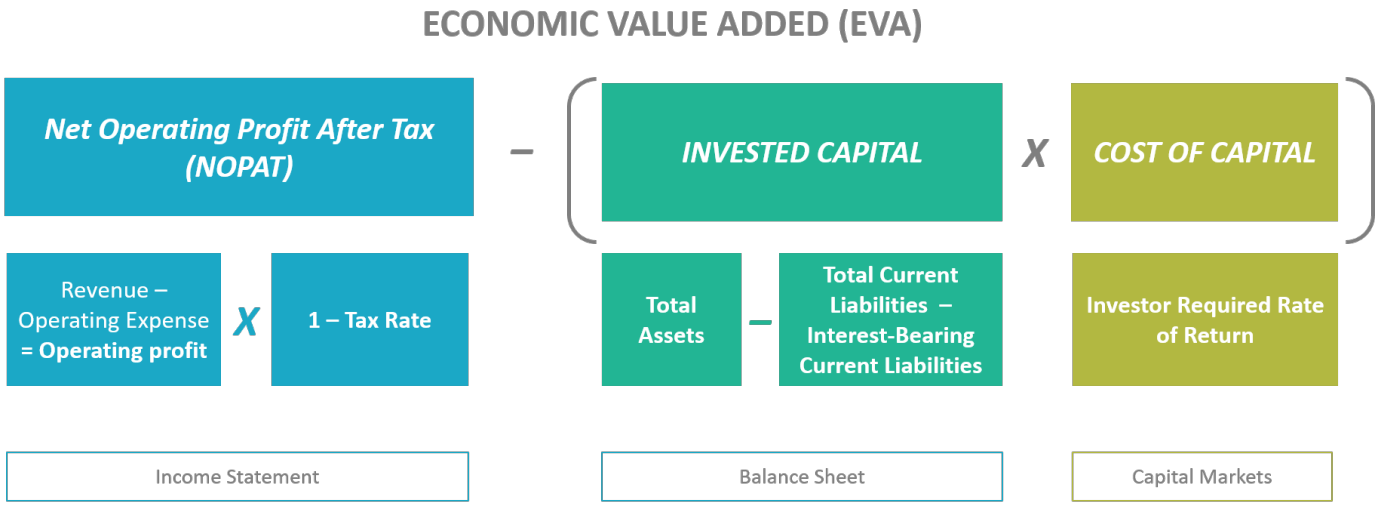
PERFORMANCE MEASUREMENT SPOTLIGHT: WHAT YOU NEED TO KNOW ABOUT ECONOMIC VALUE ADDED

Economic Value Added (EVA) has been around in various forms, and with various names, for more than 30 years. So, why is this metric back on the radar for shareholders, executives, directors, and compensation professionals? In 2018, proxy adviser Institutional Shareholder Services (ISS) announced it will incorporate EVA into its pay-for-performance assessments starting in 2020. This makes it a good time for a briefing on the potential impact of this development, and a conversation about the strengths and weaknesses of EVA as an incentive plan metric.

WHAT IS EVA?

EVA measures a company's economic profit after operating expenses and a charge allocated for capital deployed in the business are taken into account.

Companies can make many potential accounting adjustments to EVA, but it's generally defined as Net Operating Profit After Tax (NOPAT) – (Invested Capital x Cost of Capital), as shown below.



Proponents of EVA tout its simple messaging: Value is created by the company when economic profits exceed the cost of creating them (EVA > 0), while value is destroyed when the reverse is true (EVA < 0).

Looked at this way, EVA can be used to inform a wide variety of decisions and actions. Also, compared to other financial and accounting metrics, such as GAAP net income, revenue, or earnings per share (EPS), some see EVA as a more complete indicator of economic performance because it incorporates all expenses, including the opportunity cost of capital deployed. However, even in its simplest form, EVA is more complex than other metrics, since it incorporates items from the income statement, balance sheet, and capital markets.

Given the attention EVA is getting from ISS, companies should have a general understanding of:

- Whether it aligns with Total Shareholder Return (TSR)
- How ISS will use it
- Whether it might be appropriate as an incentive plan metric

DOES EVA PERFORMANCE ALIGN WITH TSR?

TSR is a more universally recognized measure of overall company performance than EVA. It's often used in incentive plans, since it clearly reflects shareholder value creation and can easily be used to compare performance across companies and industries. But TSR is affected by external elements beyond management's control, such as market and sector volatility and expectations of future performance. This makes it difficult for employees to see how their actions can influence TSR. In contrast, EVA is based primarily on company-specific financial metrics. It breaks down financial statement items into smaller, more digestible operational components that can give employees — including those below management — a better line of sight to how their actions can influence company value. But is EVA a good measure of shareholder value creation?

Mercer reviewed EVA and TSR of S&P 500 companies for three-year periods over the past 13 years and found a relatively strong relationship between the two: The highest EVA Margin performers aligned with the highest median TSR in all periods.

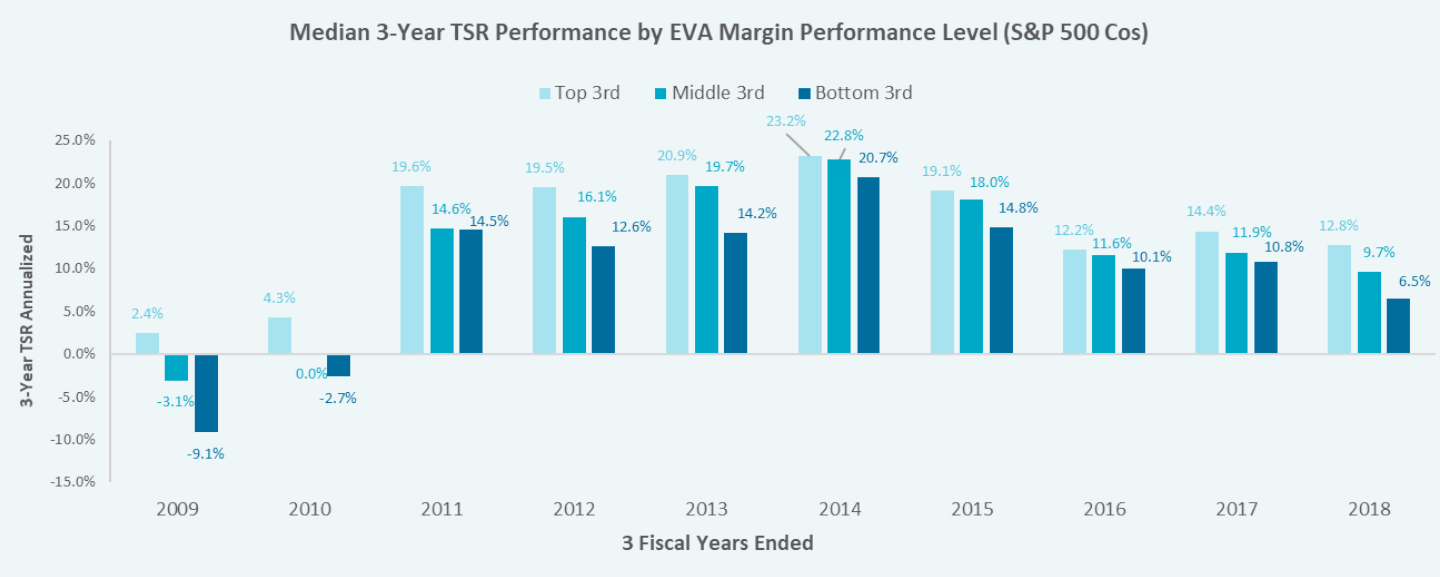
MEDIAN THREE-YEAR TSR PERFORMANCE BY EVA MARGIN PERFORMANCE LEVEL

Mercer analyzed three-year EVA Margin (i.e., EVA / Sales) and TSR of S&P 500 companies over the past 13 years (2006 to 2018). We calculated three-year EVA Margin as average annual EVA Margin for each company for each three-year period. We then grouped companies by EVA Margin into top-, middle-, and bottom-third performers for each three-year period, and calculated median three-year annualized TSR for each group.

As shown in the graph below, we found a relatively strong relationship between EVA Margin and TSR performance. The highest EVA Margin performers aligned with the highest median TSR in all periods.

For example, for the three fiscal years ending in 2018 (2016, 2017, 2018), median annualized TSR of the companies whose EVA Margin performance ranked in the top third was 12.8%. For the companies whose EVA Margin performance ranked in the bottom third, median TSR was 6.5%.

Most notably, in bearish markets such as 2009 to 2010, the lowest EVA Margin performers were likely to have negative TSR while high EVA performers maintained positive TSR.



HOW WILL ISS USE EVA?

ISS acquired EVA Dimensions LLC, a firm that measures corporate performance based on EVA, in 2018. Since then, the proxy adviser has touted the metric in a series of articles and whitepapers. In 2019, ISS included EVA metrics in companies' research reports for information purposes, but didn't use them in making proxy voting recommendations on executive compensation programs (e.g., for "say-on-pay" voting).

The proxy adviser will start using EVA metrics as a secondary screen for its CEO pay-for-performance assessments in 2020, in place of or in addition to the GAAP metrics it currently uses. (Its initial primary quantitative screen continues to be based on TSR.) ISS originally intended to use EVA in 2019, but relented after pushback from companies and investors. The secondary screen can push an initial quantitative screen "concern level" from low to medium or medium to low. The secondary screen generally affects a very limited number of companies: Last year, only around 10% of companies were impacted by the secondary screen and ISS moved only half of those to a higher concern category — and only some of those ultimately received an "against" SOP recommendation from ISS.

SHOULD COMPANIES CONSIDER EVA AS AN INCENTIVE PLAN METRIC?

Few companies currently use EVA to measure CEO performance (3% in short-term incentive plans and 1% in long-term incentive plans), according to a recent Mercer survey of S&P 500 companies. Should this change now that ISS plans to use EVA in its pay-for-performance evaluations?

The simple answer is no. ISS policies shouldn't dictate incentive plan design and ISS isn't advocating companies use EVA as an incentive plan metric. But it's a good time for companies to reassess the best metrics for driving shareholder value and rewarding executives.

Selecting performance metrics. Metrics should be selected based on a variety of factors, including:

- ***Lifecycle.*** Each stage in a company's lifecycle has its own measurement priorities. Start-ups or organizations pushing for growth in new areas have different strategic and financial goals than established firms. As a result, growth-related metrics usually play a more prominent role in measuring performance in earlier stage companies, whereas profitability or return-based metrics tend to become more important as a company matures.

- ***Business strategy.*** Performance metrics should support a company's specific business strategy. For example, a discount retailer might focus on gross margin as a measure of performance, while a mature manufacturing-based company might find a metric such as EVA a useful tool to evaluate the productivity of fixed assets.

- ***Precision vs. complexity.*** Companies should be mindful of the trade-off between precision and complexity. More complex metrics may more completely capture performance results, but they can be harder to explain to leaders and shareholders. EVA falls on the high end of the complexity spectrum for operational metrics, while metrics such as revenue growth are much easier to understand and communicate.

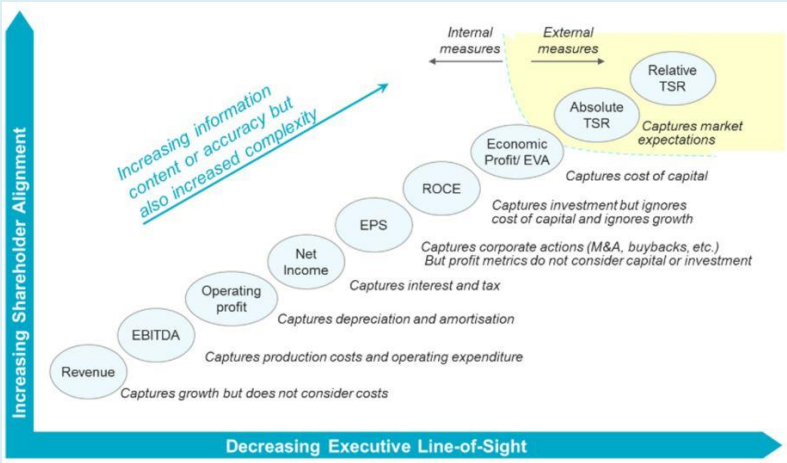
- ***Line of sight.*** For an incentive plan metric to be effective, plan participants should believe they can directly affect its outcome. Most employees can impact a variety of individual elements of EVA that contribute to profitability, but line of sight can be murky for several reasons, including the following:

  – Cost of capital may increase for market-related reasons

  – Debt/equity financing decisions are made by a small group of executives

  – Many employees can't directly impact the balance sheet (outside of working capital components such as inventory and receivables)

INCENTIVE PLAN METRICS: BALANCING SHAREHOLDER ALIGNMENT AND LINE OF SIGHT



As performance measures align more closely with shareholders, they tend to include more information. But plan participants may not see how they can directly affect complex measures.

Effective incentive plan metrics should balance shareholder value creation with participants' line of sight.

EVA's lack of transparency and complexity are the prime reasons it's not a more prevalent performance metric.

- ***Correlation with long-term value.*** Companies should use metrics that correlate with long-term value creation for shareholders. As discussed above, while there's generally a strong correlation between EVA and TSR, particularly in down markets, each company needs to evaluate and understand the specific metrics that align with long-term value creation.

For most companies, introducing EVA would require a dramatic change of culture and decision-making approaches — including substantial and recurring investment in educating leadership and employees on EVA and why it's important to the firm.

CONCLUSION

EVA can be used to inform a wide variety of decisions and actions, such as clarifying priorities, allocating resources, and measuring pay-for-performance alignment. But given its complexity, it needs to be part of a company's culture to be effective. And effectiveness as a management tool doesn't necessarily translate into effectiveness as an incentive plan metric. Companies should continue to select metrics based on their specific facts and circumstances and balance the often conflicting goals of accuracy and complexity.

ABOUT MERCER

At Mercer, we make a difference in the lives of more than 115 million people every day by advancing their health, wealth, and careers. We're in the business of creating more secure and rewarding futures for our clients and their employees — whether we're designing affordable health plans, assuring income for retirement or aligning workers with workforce needs. Using analysis and insights as catalysts for change, we anticipate and understand the individual impact of business decisions, now and in the future. We see people's current and future needs through a lens of innovation, and our holistic view, specialized expertise, and deep analytical rigour underpin each and every idea and solution we offer. For more than 70 years, we've turned our insights into actions, enabling people around the globe to live, work, and retire well.

HOW MERCER CAN HELP

Elevate your workforce with improved management, compensation, and communication strategies. Draw from rigorous analytics and data-driven insights to increase the efficacy of your workforce systems. Mercer can help you to design value propositions that appropriately recognize your talent and inspire engagement.

For further information, contact a Mercer consultant.

Join the conversation:

@MercerCanada Mercer Canada