Incremental economic value added (I-EVA)

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An economic approach to identify a key driver of valuations

"Growth benefits investors only when the business in point can invest at incremental returns that are enticing—in other words, only when each dollar used to finance the growth creates over a dollar of long-term market value. In the case of a low-return business requiring incremental funds, growth hurts the investor."

Warren Buffett

Shareholder value creation drives valuations (not earnings)

Incremental Economic Value Added (I-EVA) represents our estimate of incremental shareholder value creation at a company - the "economic" value additionally created by management. I-EVA is the central thread that runs through all our equity analysis.

The best stocks to invest in are those where management, through its strategy and capital allocation policies, look set to deliver sustained and rising incremental shareholder value creation. Stock set to enjoy strong I-EVA improvement over a long sustained are likely to see robust valuations.

The commonly used "accounting" metric such as earnings per share (EPS) can be a flawed indicator for tomorrow's winners, and an "economic" metric such as historic return on invested capital (ROIC) can be inadequate.

Employing an "accounting framework", a typical sell-side model keeps within a narrow income statement-centric framework for analysis, with an flawed emphasis on EPS. In contrast, our I-EVA calculation brings together line items from all three financial statements, offering a more complete financial analysis. It focuses not just on the outlook for the numerator (cash flow) but also the denominator (invested capital), and hence become a better metric to judge value creation.

I-EVA succeeds in explaining valuations as it is an objective measure of management's success in delivering incremental returns on each dollar invested in the business. It can do so because it asks the key question - how will the deployment of invested capital in the recent past impact future growth in cash flow?

Key insights

Which stocks are likely to show the strongest (weakest) incremental shareholder value creation trends into the future?

Which stocks appear to be on the cusp of value creation (or destruction)?

Is the management strategy to create shareholder value aggressive or is it defensive?

How does the value creation outlook compare to peers; or even stocks in another sector?

Understanding valuations

We subscribe to that conceptualisation of equity valuations as consisting of two parts - the steady state component and the future value component. Historic value creation cannot explain valuations, and indeed to understand why stocks a valued as they are, we need to consider the two outlooks as seen by Mr Market – the near-term one value creation based on I-EVA, and the longer-term sustainability outlook represented by I-CAP.

The steady state component reflects any annuity-like cash flow generation characteristics the firm may possess, due to the near-term “certainties” in I-EVA and management policies on dividends, stock buybacks and debt repayment. As an example, a company with a secure position in a mature industry, milking revenues and cash flows while it lasts, returning excess capital to shareholders or paying down debt will, in general, see the steady-state component accounting for the bulk of the valuation. Companies enjoying higher I-EVA are likely enjoy higher valuations.

The future value component of the valuation is the “option” part of a stock’s valuation and represents the strength of the competitive advantage enjoyed by the company; the duration over which a company is expected to generate above-average excess returns in its I-EVA. It reflects the long-term expectations embedded in the valuation. For example, a company that has a sustainable dominant technological edge and market share in a sector set for strong secular growth will have the future value component accounting for the bulk of its valuations.

Companies enjoying higher I-EVA and higher I-CAP values have a strong likelihood of enjoying higher valuations. More specifically, what matters in stock selection is the potential for upside (or downside) to the I-EVA and I-CAP into the future - not the absolute size. It is the outlook for these two components, that provides the definitive basis for an equity investment recommendation. Other beneficial features of I-EVA

I-EVA vs EVA: different approaches

Our I-EVA measurement and traditional EVA analyses do share a fundamental conviction that real value is created ONLY when management capital allocation decisions create “economic” value. That’s where the similarity ends.

Traditional EVA measures, such as those devised by Stern Stewart, emphasize the importance of returns generated above a hurdle rate, which can assist management to evaluate the economic value of potential projects in their quest to deliver shareholder value. Used in equity research, the results are evaluated and contrasted against an earnings-based measure such as EPS.

The methodology behind our I-EVA measure is quite different as it targets the equity investor who needs to determine whether management has delivered, and can deliver into the future. Our emphasis is not on absolute economic value creation but on the forecast rate of change - the “incremental future outlook” in value creation (as measured by I-EVA).

Traditional EVA is time consuming and impractical

It is entirely logical that traditional EVA analysis places emphasis on the spread between a return on capital and its overall cost of capital. However, this calculation, in itself, is not of great value in the stock selection process.

Traditional EVA measures delve into great detail with adjustments across financial statements to arrive at what constitutes economic value. Contentious adjustments have to be made routinely for line items including writedowns, goodwill and amortization, restructuring and other charges. Not only is this time consuming it can also be of dubious value in a stock selection process as adjustments can seem arbitrary and controversial.

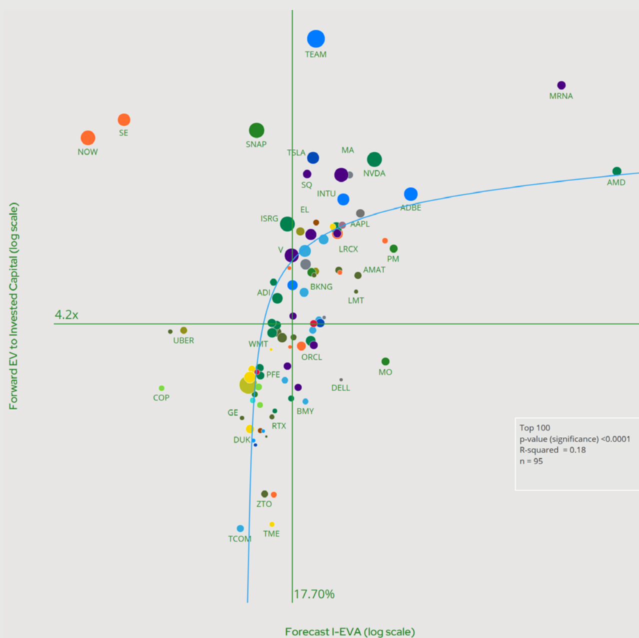
Why I-EVA is better, simpler and effective

I-EVA calculations focuses on increments, or marginal profits, and this overcomes the complexity and introduces consistency to investment evaluation. The absolute size of the invested capital base is irrrelevant and the focus is simply on future change in profits relative to the recent change in the invested capital base.

This feature also confers to the methodology a forward-looking characteristic that is so important in equity evaluation, as the calculation analyses how recent incremental capital investments (t-1) could create/destroy incremental cash flow during the future period (t+1).

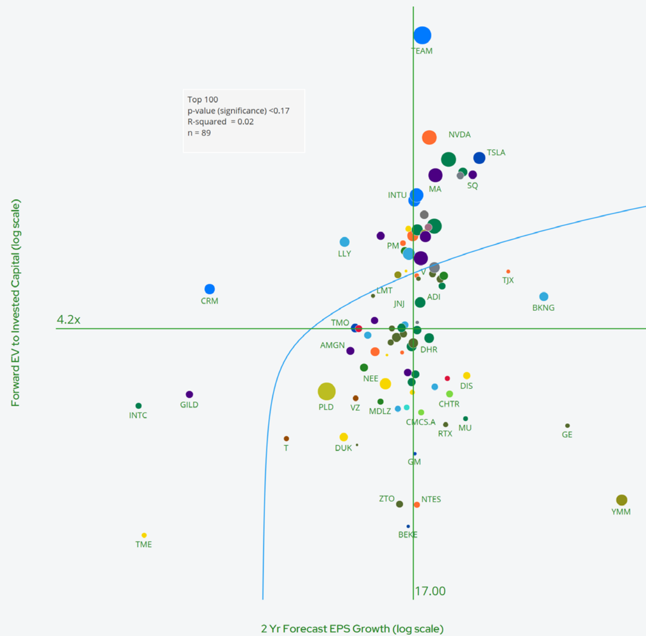
The emphasis on the "incremental" gives I-EVA a quality which makes it a universal metric. It allows comparisons and analysis of shareholder value creation prospects across multiple sectors, or even companies operating in sectors with vastly different dynamics. After all, for every company, regardless of sector, the key goal is (should be) the effective allocation of capital to create incremental value for shareholders.

Companies enjoying high returns or ROIC, often flagged by traditional EVA approaches, are not necessarily great stock ideas. In our methodology even companies with low, or even negative, returns on capital can be attractive investments if the forecast I-EVA is set to improve. For example, a company or a sector, whose forecast I-EVA is turning less negative, and is indicative of an inflection point, in momentum may be an attractive investment (and vice-versa).



Traditional EVA methodology can cause arguments. Why shouldn't, for example, acquisitions made in the past, but which no longer places a demand on capital, be ignored in the analysis if they are not pertinent to cash flow generation? An I-EVA based approach makes such a discussion are redundant due to the focus not on the absolute values of goodwill or any other asset base, but the periodic change in the invested capital base.

Finally, as in the I-EVA calculation both, the numerator and the denominator, are percentage change numbers and, hence, independent fom each other as two sets of variables, this lends itself to credible statistical analysis. *(see following sections)*



I-EVA - a credible metric for stock selection

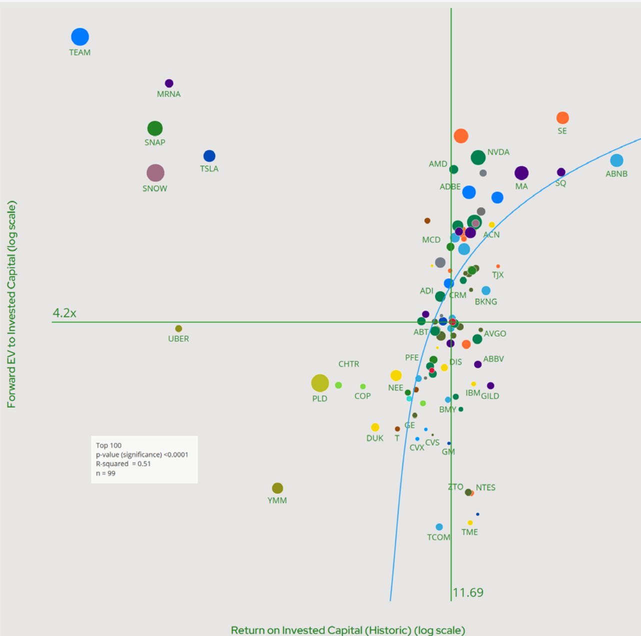
I-EVA explains much of the variations in valuation multiples. I-EVA value show high correlation to valuations, as measured by forward EV/IC, and the R^2 value does suggest a decent level of predictive component. Our analysis across multiple sectors indicates that this explanatory power of I-EVA holds strongly across most equity sectors.

This “economic” framework for equity analysis ignores earnings per share or prospective earnings growth rates in the stock selection process. The fundamental is that it is the present value of their future cash flows, and not the present value of their future earnings, which determines valuations.

The I-EVA measure, because it takes into consideration the shareholder capital expended to generate a unit of top line growth, is superior to EPS or even ROIC based metrics, as it reveals the true incremental economic value added.

EPS – hardly the valuation driver

The sell-side prefers to focus on EPS and earnings measures - the company management’s favourite metric. Unfortunately, it is easy to demonstrate, as the chart shows, that there is no relationship between forecast EPS growth and the valuations enjoyed by a stock.



Indeed, a focus on earnings-based metrics can lead to an erroneous conclusion regarding shareholder value creation. The main problem with the earnings focus of the sell side is that it reveals little about shareholder value creation, and companies will destroy shareholder value if management strategy on capital allocation is wasteful.

Employing an “accounting framework”, a typical sell-side model is income statement-centric, but an incremental economic value added (I-EVA) calculation brings together line items from all three financial statements, offering a more complete financial analysis. It focuses not just on the outlook for the numerator (cash flow) but also the denominator (invested capital), and hence become a better metric to judge value creation.

at least statistically speaking, as the numerators, NOPAT, and enterprise value, in the two axes are highly correlated, as the chart shows. Absolute ROIC measures, therefore, do not provide a helpful guide to the outlook for valuations.

How I-EVA is different to ROIC (& better)

The emphasis of I-EVA is on marginal economic returns and this, we believe, is superior to ROIC, which is an absolute economic return measure. Stocks enjoying high ROIC are not necessarily investible and, indeed, stocks on low or even negative ROIC can be compelling buy ideas.

While ROIC calculations can provide an excellent snapshot of the firm the absolute nature of this metric makes it of limited value in stock selection. ERI's I-EVA framework, on the other hand, captures management's success in delivering incremental returns on each dollar invested in the business. In other words, unlike ROIC, I-EVA analyses how effective the capital allocations of the past will be in creating incremental value in the future.

Disclaimers

Plain english

The deep desire to understand cause and effect is hard-wired into a curious investor's head. However, investing in equities is extremely complex and results can be extremely uncertain. There is no formula and there are no secrets to success in equity investing. Much of what passes in the investment media as equity research can be flawed, biased or both. However, while remaining conscious of the dangers, equity investing for the long term can be a rewarding exercise for a sceptical investor who uses the mosaic of information available in an intelligent and disciplined manner.

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