

# Adding Economic Value:

## *The Complicated Case of EVA for Financial Companies*

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In 2018, shortly after its acquisition of equity research firm EVA Dimensions, Institutional Shareholder Services (ISS) announced that it will include Economic Value Added (EVA) measures in advisory reports<sup>1</sup>. ISS believes EVA measures provide a clear and more complete picture of value creation.

The challenge for financial companies is that EVA is a difficult metric to apply, since these companies have capital structures and business models that make calculation of EVA problematic. As a result, despite ISS's view to the contrary, the metric is typically not viewed as relevant for financial companies, as discussed below.

### **Economic Value Added – A Primer**

EVA is fundamentally a profitability metric. It is the best-known version of a class of financial performance measures known as economic profit models. Distinct from accounting profit, economic profit/EVA is profitability after one additional charge—the cost of the capital employed to attain those profits. The idea behind EVA is that capital is not free, and companies that earn a return on that capital in excess of its opportunity cost are the only ones actually creating value.

At its simplest, EVA (or any economic profit calculation) is defined by three building blocks:

#### ***NOPAT – (Capital × Cost of Capital)***

Where...

1. **“NOPAT”** (Net Operating Profit After-Tax) is essentially, operating income, less taxes on that income. For financial companies, ISS will define this as net income (thus deducting interest expense and treating it as an operating cost).
2. **“Capital”** is defined as total assets less non-interest bearing current liabilities (sometimes also referred to as “net assets” or “capital employed”). For financial firms, ISS is defining “capital” **solely** as equity capital (as adjusted).
3. **Cost of Capital** refers to the required or minimum return on capital an investor expects over time for investing in a company of particular risk. For financial companies, ISS will (presumably) define this as cost of equity only, to match to the definition of “capital” used. The products offered by financial companies are inextricably interwoven with their capital structures and consequently debt (deposits) and loans (assets) are central to their business model and debt is excluded from the cost of capital calculation.

ISS is providing four EVA metrics in its reports. Two metrics are “static” and are similar to net income margin and a version of return on equity (ROE). The other two metrics are “trend” measures, evaluating the growth in EVA relative to revenues and equity capital. For additional background, including detailed formulas for the four EVA metrics that ISS will use, refer to Meridian's April 2019 Client Alert.

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<sup>1</sup> In 2019, ISS included EVA data in its reports for informational purposes, but has indicated that they may include it in their quantitative pay-for-performance tests in the future

## Challenges with EVA in the Financial Services Industry

Most companies in the financial services industry already have an intimate understanding of their economic profits, measured as earnings spreads against their own definitions of economic capital. This understanding differentiates financial companies from companies in other, more capital-intensive industries, which may not focus on economic value. In other words, while the concept of cost of capital may be new for companies in other industries, in the financial services industry it *is already reflected in internal calculations (and planning efforts), in a more accurate manner.*

Financial companies use precise “bottoms-up” adjustments to internal metrics - potentially incorporating non-public data - to calculate economic value (examples include variations of ROE metrics). We think EVA is likely to be far less relevant in the financial services industry given ISS’s reliance on only public GAAP data. ISS’s attempt to customize EVA for financial companies adds complexity to the already often misunderstood metric and is likely to only add confusion for investors looking to track pay-for-performance.

Using EVA as a performance measure in the financial services industry could also have unintended consequences. Financial companies borrow funds at one interest rate and provide loans at a different, higher rate. The resulting “net revenue” takes into account both the interest earned on assets over time (“gross revenue”) as well as interest paid on deposits (i.e., a deduction from gross revenue). The spread is greatly impacted by prevailing interest rate levels in the economy. To maximize EVA, management teams could take on unplanned risks or pursue non-core activities in the name of increasing EVA. Although this may apply to any metric, to some degree the risk may be more acute with EVA because the metric incorporates many layers of assumptions, some of which are not specific to a company’s unique situation.

An additional consideration is that for financial companies invariably there is a lag between value-added growth investments and achieving a higher EVA (i.e., returns > cost of capital). While this is true for all industries, for financial companies these lags can be considerable due to the time required for new assets to reach their anticipated profit potential. Consequently, EVA (like any financial metric) is not immune to distortions and incomplete understanding, without a wider strategic view of a company’s business.

## Takeaways

Although measuring EVA can be valuable for companies in many industries, companies in the financial services industry typically gain limited insight from the metric. For financial companies, similar (and more meaningful) information can be gained through alternative and more accurate metrics. Based on our understanding to date, ISS will likely continue in its efforts to incorporate EVA into quantitative performance analyses despite its flaws. In our discussions with the proxy advisor, ISS has indicated that the metric will provide a reference or serve as a “signal” for assessing performance and does not expect companies to incorporate EVA in their incentive programs. Although incentive plans and compensation practices will not be directly affected, Boards, investors and senior management of financial companies will need to pay attention to ISS’s use of EVA and consider the implications it may have on the proxy advisor’s Say on Pay reviews and recommendations. Importantly, financial companies may consider providing feedback in ISS’s Annual Policy Survey in order to give the proxy advisor additional perspective on the use of EVA in the financial services industry.