Prepare for This Pay-for-Performance Measure

ISS is adopting a metric that may impact how investors evaluate pay practices. Companies that don't use it already should consider doing so.

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Institutional Shareholder Services (ISS) is one of the largest proxy advisory firms in the United States. Among many other services, it helps institutional investors evaluate executive pay practices. In early 2018, ISS announced the acquisition of EVA Dimensions, an equity research firm that uses the concept of economic value added (EVA) to estimate a company's intrinsic value.

According to ISS president and CEO Gary Retelny, the acquisition "will allow ISS to provide our clients a cutting-edge holistic means of assessing and defining [the] performance of their portfolio companies. Combined with our expanding suite of data and analytical portfolio tools, EVA will help investment professionals to determine the intrinsic value or risk of portfolio companies."

Most recently, ISS published its 2019 ISS Benchmark Policy Changes, in which it announced that in 2019 EVA will be featured in ISS research reports along with GAAP-based measures. In 2020, ISS will consider the inclusion of EVA-based measurements as part of the financial performance assessment methodology for its pay-for-performance model.

Some of the benefits of EVA are listed on ISS's website. They include the following: relative to traditional measures, EVA cuts through accounting distortions and charges for the use of capital, making it a superior measure of profit; EVA is "style agnostic" because it provides an unbiased view of quality, value, and growth; EVA acts as a leading indicator that could provide information on future stock prices; and EVA is a consistent, transparent framework that is comparable across companies, industries, and countries.

That is not to suggest traditional measures of performance like revenue growth, margins, asset efficiency, and rates of return aren't important, because they are. However, maximized independently, these less comprehensive measures can actually destroy value when taken to extremes.

Luckily, all of those metrics are captured in economic profit measures such as EVA, where economic profit tells you whether the traditional measures of performance are optimally balanced in a way that maximizes value. For example, a large capacity investment might drive up asset intensity, driving down rates of return. And the incremental sales growth from increased volumes may come at a lower price and, therefore, lower margins. But the growth from a large capacity expansion can be significant and offset the impact of some of the other measures.

An economic profit measure is the ideal tool to decide if growth is worth it or not. You may still convey it to investors using traditional measures and using statements like, "although margins and returns will come down slightly, the significant new growth potential is so valuable that we expect this investment to drive our share price higher over time."

For companies that have adopted this measure of performance, this will come as good news. However, for companies that have not, this measure deserves additional consideration.

Using EVA

A simple search of proxy statements for the terms “economic value added” or as it’s more commonly known, “economic profit,” yields 1,502 companies. In some cases a company will simply list “economic value added” and “economic profit” as a possible performance goal alongside other measures of performance. And although companies may have not fully adopted this measure for incentive compensation purposes, it does suggest that many companies recognize the measure as a viable metric for evaluating and rewarding executive performance.

However, the degree to which this measure is used can vary considerably and can be much more than simply listing it in a proxy. By example, over the course of 15 months one of our health-care clients has made considerable strides in weaving an economic profit performance measure into how they plan, make decisions, and incentivize management behavior. However, before adopting the measure, we needed to customize it to ensure management had the right incentives to grow profitably.

The client adopted a cash-flow based measure of economic profit called residual cash earnings (RCE), which Fortuna Advisors developed to ensure that managers make the maximizing value tradeoffs between growth and returns. The most important difference between RCE and the standard EVA measure surrounds the treatment of asset depreciation, which is an “accounting-ism” used to allocate the cost of plant and equipment against reported earnings over an asset’s useful life. Businesses recognize the non-cash cost of depreciation as a charge to earnings, and over time the accumulated depreciation is subtracted from the value of the asset.

Similar to the accounting treatment, EVA recognizes accounting depreciation as a cost while RCE does not. EVA also reduces invested capital upon which management must earn a return by the accumulated depreciation, while RCE does not. That may sound like a minor accounting nuance, but the impact to performance measurement trends and management behavior can be quite significant.

Often, new investments cause EVA to decline because management will initially be charged for depreciation plus a capital charge on a new un-depreciated asset. Then EVA often automatically rises as assets depreciate away and the capital charge declines. These depreciation impacts on EVA encourage management to milk old assets and limit new investment, which ultimately limits growth and value creation.

RCE is agnostic to whether assets are old or new, which provides both more incentive to invest in growth, since early results look better than with EVA, and at the same time there is more accountability over time, because capital charges don’t artificially decrease as assets get older.

Depreciation is not the only consideration when customizing economic profit. Other accounting items such as the treatment of R&D can also have a major impact on management behavior. For one of our clients that invests heavily in R&D, the R&D treatment that best explained market value trends over time was to capitalize rather than expense R&D for their customized RCE measure. It’s critically important to understand each company’s business model and drivers of success in order to convert GAAP into an industry’s economic reality.

There is a strong relationship between improvements in RCE and total shareholder return (TSR includes stock price appreciation plus dividends) for a company and its peers. Management can be confident that actions to grow RCE will improve the value of the company and will likely be rewarded with strong share price appreciation.

My colleagues and I applaud the commitment of ISS to embrace EVA but it is important that each company customize the measure to best encourage the right behaviors in their business and industry. Once they customize it, it should be locked down and definitive, to avoid gaming opportunities.

By embracing such a measure as the basis of planning, decision-making, performance measurement, and incentives, executives are encouraged to treat the company's capital as if it were their own money and to simultaneously manage for both the present and the long-term. In other words, it encourages managers to behave like long-term committed owners.

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