Shareholder Value Advisors

Setting Operating Performance Targets

Our normal objective in setting operating performance targets is to determine the operating performance required for investors to earn a cost of capital return on the market value of their investment. We can show that NOPAT, with no EVA improvement, provides a cost of capital return on Current Operations Value, but no return at all on Future Growth Value (see box below for more detail). This means that a company must provide EVA improvement for investors to earn a cost of capital return on the future growth value included in the company's market value. The EVA improvement needed for investors to earn a cost of capital return on market value is called Expected EVA Improvement, or EI.

We can show that EI must satisfy:

$$c * FGV = EI + EI/c + \Delta FGV$$

If ΔFGV is zero, EI is easy to calculate: $EI = (c * c) * FGV/(1 + c)$. But we can't reasonably assume that $\Delta FGV = 0$. We need to develop a regression model, based on peer company data, to estimate ΔFGV. The regression model allows us to estimate the impact on ΔFGV of beginning FGV (a "competitive fade" effect), ΔEVA and sales growth, among other factors.

We estimate EI for a publicly traded company in the following steps:

1. Calculate EVA and future growth value.
2. Calculate the required return on future growth value.
3. Identify peer companies and develop a regression model of ΔFGV.
4. Use estimated ΔFGV to calculate EI.

To extend EI to the business unit level, we need to estimate FGV for each business unit. To do this, we develop a market value model, based on peer company data, for each business unit. The market value model uses capital and capitalized EVA to predict market value. We estimate FGV for a business unit by subtracting the business unit's current operations value from its estimated market value based on the market value model.

We estimate business unit EI in the following steps:

1. Calculate EVA for each business unit.
2. Identify peer companies for each business unit and develop a market value model for each business unit.
3. Use the market value model to estimate FGV for each business unit.
4. Allocate corporate EI to each business unit in proportion to its FGV.

Technical Note – Constant EP provides a cost of capital return on current operations value

$$EP_1 = NOPAT_1 - c * capital_0, \text{ so } NOPAT_1 = EP_1 + c * capital_0$$

$$\text{If } EP_1 = EP_0, NOPAT_1 = EP_0 + c * capital_0$$

$$\text{But } EP_0 + c * capital_0 = c * (EP_0/c + capital_0) = c * \text{current operations at the end of year 0.}$$

Thus, NOPAT, with constant EP, provides a cost of capital return on current operations, but leaves nothing left over to provide a return on future growth value.

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