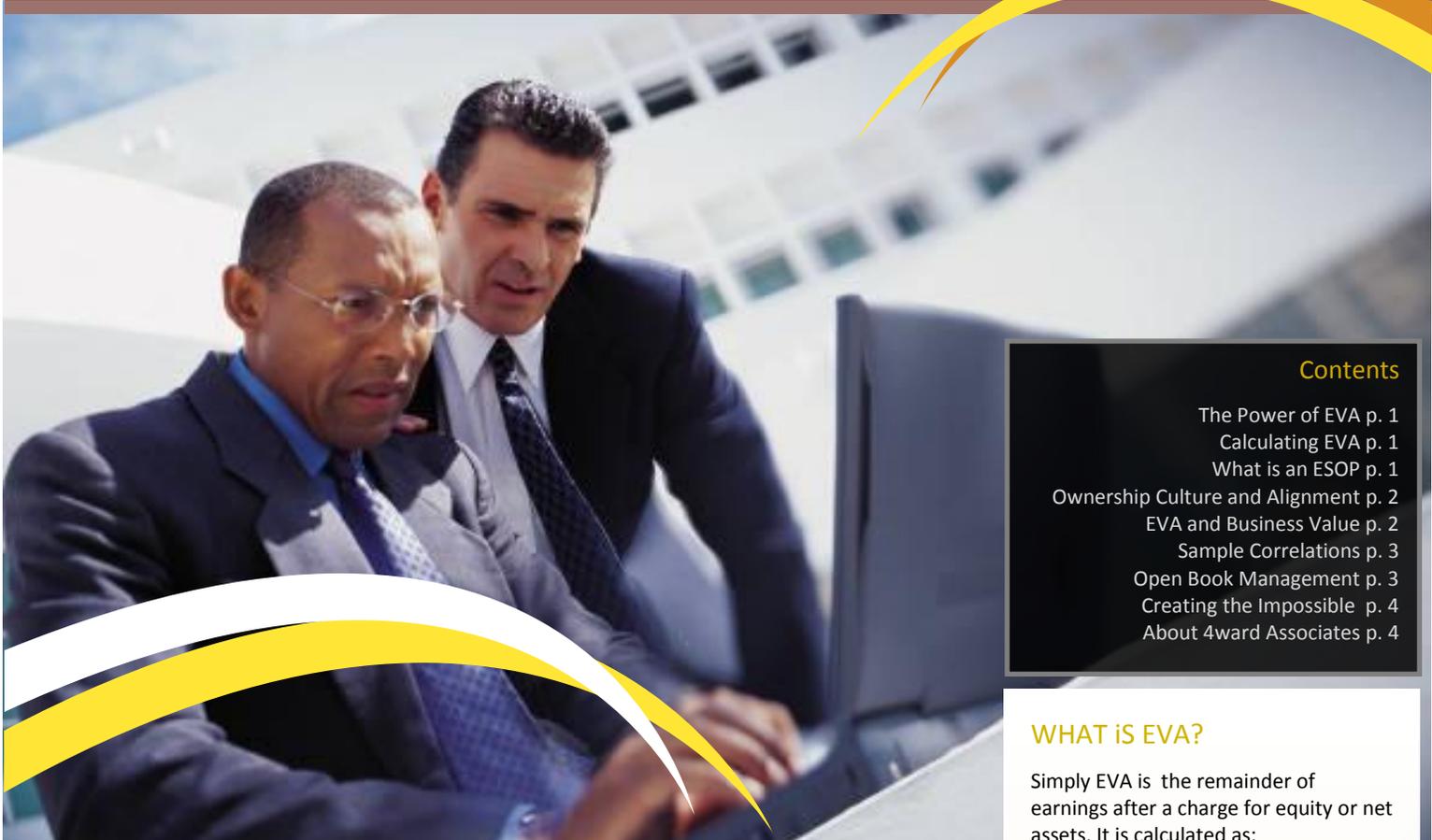


# EVA and ESOPs

A Tool to Accelerate Wild Growth in Small Business Earnings

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## EVA's Power to Maximize ESOP's Profitability

Every ESOP determines the small business' value once per year. Engaged employee-owners wait impatiently for several months as the financials are finished and the business valuations do their analysis, finally reviewed by the Plan's trustee. Momentum can be lost as the excitement over a strong year is replaced with the opportunities *du jour* in the new year. A person's ESOP account is a (very) long-term benefit and that also makes it hard to remain engaged.

We know employee and management engagement creates success. Engagement grows as people know how their actions contribute to the organization's and their own success. EVA can show them. It is a single, financial metric that combines the balance sheet and the income statement. It is a metric that can be reported monthly. It is a metric of which everyone has influence in some small or great way. Therefore, it's easy to communicate how today's efforts influence tomorrow's success and the growth of their benefits.

If EVA is tied to a quarterly or annual bonus, you can bridge the compensation gap between the short-term paycheck and the long-term ESOP payout. A bonus provides that mid-term monetary feedback on the organization's efforts..

## WHAT IS EVA?

Simply EVA is the remainder of earnings after a charge for equity or net assets. It is calculated as:

$$EVA = NOPAT - c(\text{Assets} - \text{Liabilities})$$

Where NOPAT is the Net Operating Profit after Taxes, and "c" is the cost of capital for the enterprise (a combination of the cost of debt and the cost of equity).

## WHAT IS AN ESOP?

An ESOP is a trust plan that holds a portion or all of the company's stock. An Employee Stock Ownership Plan (ESOP) will be documented and administered. The participants, eligible company employees, will receive annual statements of their accounts. They don't actually hold or own any company stock. The Trust holds the stock for their benefit and keeps record of what portion of the shares is allocated to their accounts. The trustee(s) votes the shares of stock in governance matters.

# Ownership Culture and Alignment through EVA

Engagement, ownership culture and organizational alignment take time to develop but EVA provides the focal point for building your company

Still, after several meetings explaining basic business finances to the employee-owners, a manager can hear that someone thinks revenues equals profits. It can be frustrating, but persistence pays off. They may not completely understand how EVA is calculated. They do understand how their daily efforts influence whether the number (dollars) increase or decrease. Because EVA combines the balance sheet with the income statement, everyone can influence the metric is some way.

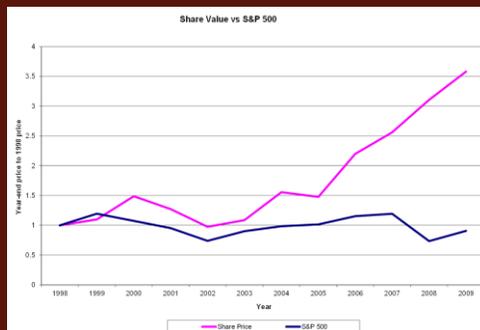
We teach them how an increase in expenses and other costs make EVA drop. We show them that increased revenue, like being able to raise prices for quality products and services, increases EVA. We show them that accuracy in order entry and billing speeds customer payments, decreasing Accounts Receivables and increasing EVA. We show them that controlling inventory and WIP, in manufacturing operations, improves EVA. Managers learn whether it's better to borrow for a capital investment or pay cash. They also learn whether an investment in equipment or personnel is good in the long-term. They have a quick easy to understand method of making the decision.

On a *pro forma* basis, you can also evaluate your segments of business with EVA—customers, market segments, product lines, etc.—and know which ones need some support to improve or perhaps aren't returning enough for the investment needed.

By showing this number (EVA), and explaining how it's influenced, you will start to get really good questions from everyone. "Why is our inventory increasing?" "Was it

worth it to expedite that product in?" "Should I offer a discount to this customer to generate more sales?" "Should we accept the customer's request to lengthen the payment terms to 120 days? With or without a price increase?" "Should we buy this service on 90 day terms and a 1% price increase?" For the most frequently asked questions, you can provide guidelines so that they're empowered to make some decisions based on criteria that improves the value of the company. Knowledge and Empowerment improves Engagement. Engagement increases the Ownership Culture. A growing ownership culture necessitates Collaboration and organizational Alignment

. When you've got a team pulling together and heading in the same direction, you've got a winner. It's a team that will thrive even in economic downturns. Competition will fold in the face of your onslaught of innovative market offers. See the chart below how one ESOP company grew in value even during the Great Recession of a few years ago.



## How EVA Relates to Small Business Value

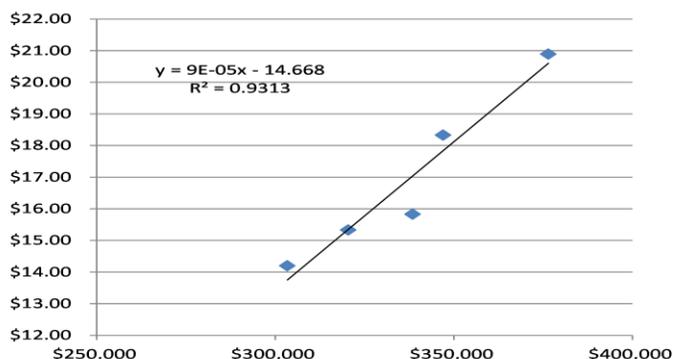
Stern Stewart researched the link between Economic Value Added (EVA)<sup>™</sup> and Market Value for public companies in the 1990's. The correlation continues today as shown by many companies, including Bennett Stewart III's EVA Dimensions ([www.evadimensions.com](http://www.evadimensions.com)). EVA Dimensions provides software that can calculate the EVA of your company and many public companies you want to keep tabs on. However, for most small businesses, a simple spreadsheet can be used to calculate EVA. With a few business valuations, an EVA model can be constructed that will create a correlation between EVA and the enterprise value.

There are many business valuation methods: 1) benchmarking with peer public companies and their stock's price/earnings ratio; 2) utilizing an earnings ratio; 3) factoring a revenue multiplier; 4) evaluating book value of the assets; 5) looking at future earnings and a discounted cash flow; 5) combining assets and earnings in an excess earnings method. EVA mimics this latter method. **See the charts that show the strong correlation.**

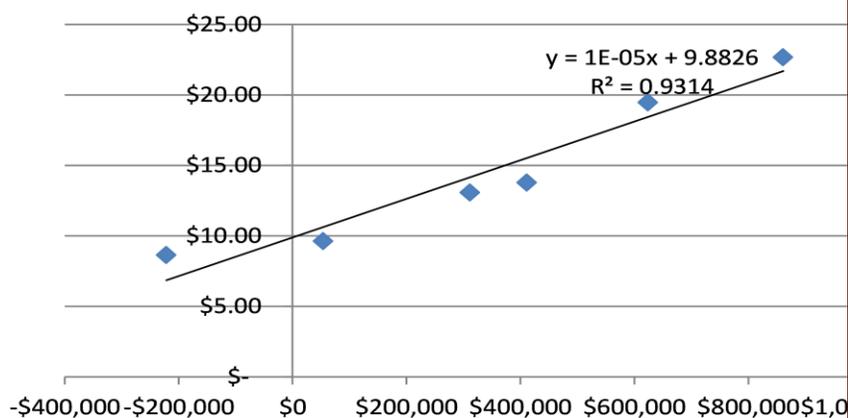
EVA can be calculated on a monthly basis (see "What is EVA?"). Market value for small businesses, at best, is calculated annually

## Sample Correlations from Actual ESOP Companies

Generally, a correlation measure (r-squared) greater than 0.90 is desired.



### Stock Value



## How Much Financial Information is Shared?

Our recommendation is that EVA, measured in dollars, is shared. Most organizations already share gross or net revenues. (Remember that you may have to continuously teach that revenues are different from profits.) You could share gross margin, inventory numbers, accounts receivable. Frankly, you can share as much as your team has the capacity to absorb.

## Open Book Management

We are big believers in open book management, coined 20 or so years ago. We do not advocate sharing wage information. However, discussions around product or service segments are important. People need to understand what influences prices and costs. They should understand what's included in overhead. What are considered fixed expenses and what are variable expenses? Everyone should understand these concepts and know how your company accounts for these.

Similarly, they should know how to read the company's balance sheet, especially if the company has debt. Everyone should be exposed to how the company is valued, and how the balance sheet and income statements are used in those valuations. If they are employee-owners (some prefer the term, beneficial owners), they will begin to understand how they contribute to their long-term benefit of a larger payout from the ESOP.

## Correlation and Valuation

**Q: If we start using EVA, can we discontinue contracting for a business valuation?**

A business valuation is an estimate using several methods that provide a group of ranges in enterprise value. A number is selected that seems to fit the primary methods and fall within the other methods' ranges. Valuations are imperfect but good approximations of the real value for the company. Legally, an ESOP needs to have a third-party valuator.

EVA gives a dollar value for how much "value" is added to the company during a given year. It too is an approximation based on the balance sheet, on a particular day at period end. It is not looking at any past or future earnings, like the valuation methods use.

Surprisingly, EVA can correlate strongly with the business valuation, but it's never exact. The best that we've seen is a correlation that predicted stock value within 5%.



### About 4ward Associates

With over 30 years of turning around organizations from disaster or helping them accelerate success, we are a proven team in building an aligned, focused organization. We can help with team dynamics, key metrics, corporate culture, and uncovering the obstacles that prevent your team from succeeding. We have experience directly inside ESOP's, manufacturing, service and non-profit organizations. We here to partner with you so that you're not going it alone. We'll help you find the fun that you had in the beginning when you started in this business.

[www.4wardassociates.com](http://www.4wardassociates.com)

## How We Can Help You Achieve the Impossible

### Build Your EVA Model to Correlate with Your Business Value

Understanding what drives your business is important to developing the model

### Education Modules to Build Ownership Culture

Using terms you use inside your company, we will create education modules about your ESOP, your culture and how each employee-owner can contribute to mutual success. Different people are motivated by different goals therefore the message will be varied to appeal to your whole group.

### Create Bonus Plan(s) that Reward Success

Bridging that gap between the paycheck, which is immediate compensation, and the ESOP distribution, when they retire or leave the company, is important to continue the daily drive to improve.

### Management Team Coaching on Using EVA in Decision-Making

In any decision, there are many options to explore. EVA provides a straight-forward framework for driving long-term value. The management team needs to understand more of the intricacies in the EVA model.



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