



USER'S GUIDE

EVA® METHODOLOGY
EVA® SCORECARD

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Introduction to Inoventor

The Economic Value Added (EVA) is a measure of corporate financial performance that hundreds of companies around the world have implemented as part of their executive incentive program. Many corporations now use an economic value-added (EVA) approach to promote, measure and reward the creation of shareholder wealth. Up until recently, the focus of economic evaluation had been directed toward the internal financial management of companies. Inoventor now brings this same technology to financial professionals and serious investors. The EVA framework allows investors to more systematically quantify the economics of a business, bringing new discipline to support their judgment. Inoventor's research database supports EVA's use in security analysis for investors, equity research analysts, investment advisors, and portfolio managers. The following pages illustrate how EVA can be used to improve fundamental security analysis, therefore enhancing the stock picking process.

Introduction to EVA

Economic Value Added (EVA) is a measure of true economic profit created by a company. The higher the Economic Value Added is, the more value a company is generating for its investors. While the accounting profit, as reported in the North American corporation's financial statements, considers solely the cost of the debt in calculating the cost of capital of a company, the economic profit as provided by the EVA approach considers also the cost of the equity which in fact is the return that is anticipated by the providers of this equity (the investors), for other investment with comparable risk. It is therefore calculated by analyzing the delta between the Return on Capital generated by a company and its real Cost of Capital including the cost of its equity.

EVA Indicators

-Performance Spread: The difference between return on capital (ROC) and cost of capital (COC). A positive performance spread is desired.

-Performance Index: Ratio of ROC to COC. It is a more meaningful indicator when comparing companies of different sizes and in different industries. A performance index of greater than 1 is desired, indicating that for every dollar of costs incurred by the company, the company is generating more than \$1 in returns.

Measuring Return on capital

Return on Capital (ROC) measures a company's management's success at effectively using shareholders invested money. It is defined as NOPAT (Net Operating Profit After Tax) divided by Invested Capital. Higher ROC is better and it needs to exceed the Cost of

Capital (COC) for the company to be considered a generator of positive EVA and therefore a wealth creator for the shareholders.

Measuring Cost of capital

Shareholders require a rate of return on their capital that is equivalent to the risk taken given the investment. Equity capital coming from public stock holders might require 7% to 15% return on their capital depending on the risk of the business. On the other hand, in the current market, debt holders tend to require much less, ranging from 2% to 5%. Cost of Capital (COC) for a company is the weighted average cost of capital combining the cost of equity (as estimated using the Capital Asset Pricing Model (CAPM)), cost of preferred stock, and cost of debt.

The EVA® ScoreCard

The EVA® ScoreCard produced by Inoventor for over 13,000 North-American companies is a complete document focusing on the main factors necessary for effective analysis. It is used to measure the economic performance as well as the economic risk of North American companies. The scorecard is divided into six sections:

1. General Information
2. The SPscore from Inoventor
3. The Historical Basic Evaluation
4. The key EVA Performance Indicators
5. The key EVA Risk Indicators
6. The EVA graphs

SECTION 1 - GENERAL INFORMATION

This section contains general information about the company: the sector in which it operates, the current stock price, fiscal year end, etc. A direct link to the company website is also included.

SECTION 2 - THE SPSCORE FROM STOCKPINTER

Inoventor uses a multi-criterion approach in establishing an SP rating for Economic Performance as well as an SP rating for Economic Risk for the North American companies (including ADRs) tracked in its database. For example, an Economic Performance score of 80% means that the company is in the top 20% best performing companies, amongst the universe of companies covered; moreover, an Economic Risk score of 20% means that the company's Economic Risk is in the top 20% of the least risky companies. The investor will therefore be looking for companies showing a high performance-score and a low risk-score. The overall SPscore rating is obtained by combining the performance and the risk scores. This section provides the current SPscore and the previous quarter's score to identify if the company's standing improved or weakened.

SECTION 3 - THE HISTORICAL BASIC EVALUATION

This section contains the basic indicators regarding the accounting performance of the company. This data is from company's financial statements and covers a 5-year horizon

- **Annual Sales**, provided in the same currency as the one used in the rest of the EVA ScoreCard
- **Market Value**: Total market value of capital including the equity and debt outstanding
- **Invested Capital**, as of the beginning of the 12-month period covered by the EVA ScoreCard
- **Stock Price**
- **Sales / Assets Ratio**
- **Debt / Assets Ratio**
- **Operating Profit / Sales Ratio**

- **Net Profit After Tax (NOPAT) / Sales:** calculated and adjusted according to the EVA rules
- **Net Income / Sales**
- **Return on Equity:** Net income divided by common equity, as published in the company's financial statements
- **Dividend Yield:** calculated based solely on the past 12-months paid dividend, not adjusted to the expected dividend for the next 12-month period
- **Dividend:** calculated solely from the past 12-mo paid dividend
- **Earnings per Share (EPS):** Net profit divided by the number of share outstanding; this is not the diluted EPS
- Price / Earnings Ratio (P/E Ratio), often used to establish a target price for the company's stock
- **PEG Ratio** which is the P/E Ratio weighted by the EPS growth over the last 12 months

SECTION 4 - THE KEY EVA PERFORMANCE INDICATORS

This section presents the main indicators that Inoventor uses to calculate the economic performance (SP Performance score) of the company. Let's review these indicators:

- **Return on Capital (ROC):** This return is obtained by dividing the NOPAT presented in the preceding section by the invested capital.
- **Cost of Capital (COC):** Normally, the cost of capital found in standard financial statements considers only the cost of debt. On the other hand, EVA considers both the cost of debt and the cost of equity. This cost is obtained by using the Capital Asset Pricing Model (CAPM) algorithm which considers the beta of the company in calculating the cost of the equity.
- **Performance Spread:** The performance spread is one way to present a company's EVA. It is the difference between the return on capital (ROC) and the cost of capital (COC). A performance spread that is positive shows a positive EVA.
- **Performance Index (EPI):** A better way of presenting the EVA. Instead of taking the difference between the ROC and the COC, the performance index is the ratio ROC to COC. The EPI is the preferred EVA indicator since it makes it easier to compare companies of different sizes and industries. A performance index above 1 shows a positive EVA.
- **Weighted EVA Change:** The EVA change over the last couple of years is as important as the EVA itself in measuring the economic performance of a company. A positive but decreasing EVA is less attractive than a negative but increasing EVA over the past years. To have a valid measure of the EVA change, it is normally weighted by the invested capital.
- **Market Value Added (MVA):** The market value added is the difference between the market value of a company and the capital that was invested in it by its shareholders. Normally, this number should be positive for an investment to be considered.

- **Free Cashflow:** The free cashflow measures the amount of cash available after all expenses have been accounted for. The higher the better as this allows the company to pursue investment opportunities that can maximize shareholder value.

SECTION 5 - THE KEY EVA RISK INDICATORS

This section presents the main indicators that StockPointer uses to calculate the economic risk (SP Risk score) of the company.

- **Price / Intrinsic Value Ratio (P/IV):** This ratio is used to establish where the stock price lies as compared to its target price. Based on EVA, Inoventor calculates an intrinsic value for a company's stock. If the P/IV ratio is less than 1, this means that the stock price is lower than its intrinsic value, therefore, is undervalued. On the other hand, a P/IV greater than 1 indicates an over-priced stock. An ideal P/IV ratio lies between 0.25 and 2.0.
- **Future Growth Value (FGV):** This indicator is another approach to identify whether the stock is priced fairly. The FGV is the portion of the company's market value that is based on the expected growth. A negative FGV (the ideal situation for investors) shows a discounted stock price while a positive FGV shows a stock trading at a premium (optimistic growth expectation). The FGV is a good way to represent the growth that the market expects from a company and therefore it is an excellent measure of volatility if that growth is not met.
- **Business Model Stability:** This indicator measures the stability of the return on capital (ROC) over the past few years. An ROC that fluctuates a lot shows a company that has some difficulties in generating a stable and consistent ROC that investors desire. It is also a good indication of the company's management qualities.
- **Price Variation:** This indicator shows the price variation over the 12-month period preceding the publication of the last financial statements.
- **Debt Ratio:** This ratio shows the significance of the long-term debt compared to the capital invested in the company.

SECTION 6 - THE EVA GRAPHS

The EVA ScoreCard shows three graphs that are important in any economic valuation.

1. The **Peer List:** This graph is a performance/risk analysis of comparable peers. It shows the SP performance and risk scores of 10 companies listed as the closest peers of the analyzed company, from a sector or a sales-volume view. The performance score is shown along the x-axis and the risk score is along the y-axis. Companies with the best SPscores from Inoventor will appear at the top right-hand side of the chart. It makes it easy to establish where the company stands compared to its peers and if another investment opportunity is more attractive. To access the EVA ScoreCard of any of the peers, simply click on its ticker found on the graph.

2. The **Price / Intrinsic Value Analysis**: This graph is important because it shows how the stock price compares to its intrinsic value. It lets us quickly recognize if the stock is undervalued or overvalued.

3. The **Future Growth Value**: This graph shows the FGV quarterly values presented in Section 5 over the last 3 years. As previously mentioned, the investor should be looking for companies that demonstrate a negative FGV or an FGV that is at an acceptable level from a risk standpoint.

The Main Indicators to Focus On

Amongst all the information that can be retrieved from the EVA ScoreCard, here are 7 most significant indicators when evaluating the economic performance and risk of a company.

UNDER THE “MOST COMMON INDICATORS” UNDER BASIC FINANCIAL INDICATORS:

1 – Does the company distribute dividends?

Is the dividend-yield positive?

Have dividends been growing over past 2-5 years? Ideally, dividends should grow over the years.

Are dividends lower than earnings per share? Be cautious with companies who distribute more than their EPS.

UNDER THE “PERFORMANCE INDICATORS”:

2 - Does the company generate a positive EVA? Does it create wealth for its shareholders?

Within the performance indicators, is the Return on Capital positive? Ideally, it should be over 10%

Is the Performance Spread positive? It needs to be positive for the company to generate a positive EVA; we must remember that EVA is the difference between the Return on Capital and the Cost of Capital. The greater the Performance Spread is, the better.

Has the Performance Spread been positive over the past 2-3 years? Ideally, it should have been positive and growing; be cautious with companies for which it has been decreasing.

3 – Is the Invested Capital being utilized efficiently? Does it create added value?

Back within the performance indicators, is the Market Value Added (MVA) positive? Ideally, it should also have been growing over the years.

Is the MVA at a level where we are satisfied as investors?

UNDER THE “RISK INDICATORS”:

4 – Is the stock price under or over-valued? Is the stock too over-priced compared to its intrinsic value?

In the risk indicator section, is the price/intrinsic-value ratio under or over 1? A ratio that is under 1 shows an under-evaluated stock while a value above 1 shows an over-evaluated stock, compared to its real value.

As investors, we are looking for stocks that carry a P/IV that is lower than 1.

5 – Is the stock price artificially inflated by the market due to an over-optimistic forecast of future growth?

Within the risk indicators, is the Future Growth Value (FGV) at an acceptable value? We suggest a value between -70% and +25%?

Is the FGV growing, meaning that the market price has increased? Or is it falling, meaning that the market price has decreased? Be cautious with companies with an FGV lower than -70%. It may indicate a company that the market does not appreciate to its full value.

THE GRAPHS:

6 – How does the company's Economic Performance compare to its Peers'?

Where is the company located on the Peer List? Ideally, the higher the SPscore, the better; however, we consider a score around 65% to be a buy.

7 – Is the stock price too high?

Using the intrinsic value, has the stock price historically been at a comparable level or has it been too high (or too low)? In addition, it is important to notice if the price and intrinsic value are moving in the same direction or if they are diverging. A positive signal for investors is when the price and intrinsic value are both increasing.

As for the FGV, this conveys if the stock is trading at a discount or premium, concluded by the difference between the real profits of the company vs. the market's expectations of future growth.

In combining these two graphs, someone can easily evaluate if a stock is expensive or if it is a bargain.