Young, S. David & O'Byrne, Stephen F. - EVA and Value-Based Management

McGraw-Hill, 2001, [Finance] Grade ★★★

It's with mixed feelings I review this book almost a decade and a half after its publication. On the one hand the central insight of EVA, Economic Value Added, is as relevant as ever and unfortunately is still under-appreciated amongst corporate leaders. On the other hand the book hasn't aged well, written as it is during the days of the Technology-bubble. S. David Young is a Professor of Accounting & Control at INSEAD specializing in Value Based Management and executive compensation, while Stephen F. O'Byrne who is the President and co-founder of the consultancy Shareholder Value Advisors Inc. is an old employee of Stern Stewart & Co. Hence, both were firmly placed in the midst of the shareholder value revolution in corporate management theory during the 1990's.

The simple but still powerful basic premise of EVA is that companies' main purpose is to create shareholder value and that this is done by investing capital with a higher return than the cost of the capital. The piece of the puzzle that is missed by many is that the most expensive capital is the one that appears to have no cost - that is the equity capital. EVA is a method to measure the value creation and to present it as a monetary number. Measures that instead turn out percentages have the pedagogical disadvantage of discouraging value-enhancing investments that lower the previous overall level of return of capital. On the other hand, any measure that takes the cost of all capital into account would, if used, hinder much of the unattractive investments done simply because management teams want to peruse growth and internally generated funds seam to be cash just sloshing around without any claims on it or cost attached to it. Corporate owners beg to differ…

I very much enjoyed a short paragraph written on how financial strategy (leverage) ties to value creation. Increased leverage increases the tax shield of the company as interest payments are tax deductible and therefore the present value of the tax shield grows, as does the value of the company. This is only applicable up to a certain point where the counterbalancing risk of financial distress gives a present value of distress costs that is larger than the previous mentioned gain. I would add the strategic option value of having cash at hand at times of other companies' hardship into the equation. The chapter on Value Drivers, i.e. on the factors that increase return on capital, turns from good to excellent when it starts to discuss non-financial drivers and makes explicit ties to the Balance Scorecard Model. This bridge between corporate strategy and creation of shareholder value is an area too often neglected by both financial and management literature.

Unfortunately there is also an, in retrospect, rather petty chapter called The Metric Wars. Here the authors criticize rivaling value based measures and especially so an early version of HOLT. It feels like something out of Monty Python's Life of Brian where the People's Front of Judea ferociously fight Judean People's Front instead of fighting the Romans. I also find the chapters of management compensation long, tedious and reflecting the zeitgeist of an era when the corporate world was intoxicated with the combination of options and the ever increasing prices on a stock market that was seen as always being correct. At times it almost gets parodic, as when the authors try to justify that the market - at the time - values companies as if 99 percent of them have positive EVA when in fact only 61 percent had. This is explained with accounting adjustments, risk premia arguments and financial technicalities. The possibility of an overvalued market never really comes up!

After the two financial crashes in the first decade of the 2000's EVA has fallen from grace. Perhaps this blind faith in market prices always being right is one of the reasons that the sound parts of the shareholder value revolution are now being so out of favor? Why should there be something to learn from people proven so wrong? Well, there is.

Mats Larsson, January 2, 2014