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To Barbara and Our Family
## Contents

<table>
<thead>
<tr>
<th>Chapter</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>Foreword by James A. Abate</td>
<td>vii</td>
</tr>
<tr>
<td>Preface</td>
<td>ix</td>
</tr>
<tr>
<td>About the Author</td>
<td>xi</td>
</tr>
<tr>
<td>CHAPTER 1 The EVA Revolution</td>
<td>1</td>
</tr>
<tr>
<td>CHAPTER 2 EVA in the Theory of Finance I: Investment Decisions</td>
<td>19</td>
</tr>
<tr>
<td>CHAPTER 3 EVA in the Theory of Finance II: Financing Decisions</td>
<td>41</td>
</tr>
<tr>
<td>CHAPTER 4 Basic Economic Profit</td>
<td>61</td>
</tr>
<tr>
<td>CHAPTER 5 Financial Characteristics of Wealth Creators (and Destroyers)</td>
<td>81</td>
</tr>
<tr>
<td>CHAPTER 6 Enterprise Valuation I: Free Cash Flow Model</td>
<td>105</td>
</tr>
<tr>
<td>CHAPTER 7 Enterprise Valuation II: Economic Profit Model</td>
<td>129</td>
</tr>
<tr>
<td>CHAPTER 8 Traditional Measures of Profitability and Success</td>
<td>145</td>
</tr>
<tr>
<td>CHAPTER 9 EVA Accounting Adjustments</td>
<td>169</td>
</tr>
</tbody>
</table>
CHAPTER 10
Role of Economic Depreciation 207

CHAPTER 11
Estimating the Cost of Capital 217

CHAPTER 12
Estimating MVA with Published Financial Reports 233

CHAPTER 13
Company Analysis Using EVA 255

CHAPTER 14
Industry Analysis Using EVA 275

CHAPTER 15
Macroanalysis Using EVA 297

INDEX 317
The pendulum swing of investors and corporate decision makers’ focus over the past few years has probably not been this extreme for at least a generation. Growth for the sake of growth has been replaced with intense scrutiny of capital usage and payback. Risk has changed from loss of opportunity to loss of capital. Most importantly, valuation and all of its individual components has highlighted the need to reconcile what market expectations already reflect at today’s stock price in terms of actual company fundamentals and outlook.

The concept of economic profit now more popularly known as economic value added has been constant during this dramatic change in market and economic environment. In a perverse way, though, it has taken a bear market, recession, corporate scandals and change in the systemic risk environment to bring increased attention to advanced financial statement analysis.

In 1997, I was working at Credit Suisse Asset Management, responsible for the firm’s active large-capitalization portfolio management, Select Equity. The product was unique in that it was managed using economic profit-based analyses as its foundation. Although some product literature describing the process existed, there was market demand for a more comprehensive white paper to establish the validity of economic profit ingrained into this so-called new style of investing. Despite a successful history of implementing this concept on real world assets under management, a suspicion arose because the economic profit “style” emphasized cash flow returns on capital rather than earnings-per-share. It also emphasized substituting the company’s cash flow volatility to measure risk rather than beta, a unique approach at the time.

Several books had been written principally for the corporate user dealing with economic profit and other value-based metrics but none were available dealing substantially with the linkage to stock price and investment performance. The broad acceptance into the commonplace of Wall Street was still in the future. This to me represented an irony in that corporations seemed to be more fluent in the knowledge and understanding of the principles behind economic profit than Wall Street analysts, the primary user of financial statements and influential in interpreting and valuing businesses. In searching for an academic to assist me in crafting a white
paper, I came across the first edition of *Foundations of Economic Value Added* authored by Dr. James Grant. The book was groundbreaking because it was the first to create a bridge between these constituents. Dr. Grant and I have collaborated on many projects over the years since then including coauthoring a book, *Focus on Value*, further explaining economic profit as a practical tool for corporate and investor decision making.

In between the time of the first and second editions of *Foundations of Economic Value Added*, much progress has been made in advancing many of the tenets that were part of the original edition. However, like most business endeavors and even portfolio management, gains tend to be uneven and compressed. It is perhaps unfortunate that the increased acceptance and rapid adoption of economic profit based analyses in research has occurred after investors have lost confidence in management, financial statements, and Wall Street research. Though the concepts are intact, it is refreshing to see continued refinement in the application and implementation of economic profit principles.

The second edition of *Foundations of Economic Value Added* is a book to be read, underlined, written in, and reread. It offers readers the opportunity to not only learn the basic elements of value-based financial statement analysis but also illustrates the linkage between corporate decision making regarding capital allocation and stock price in a powerful and common sense way.

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Foundations of Economic Value Added, Second Edition is a greatly expanded version of the first edition. In this context, the second edition provides a much broader and sharper focus on the role of economic profit in the theory of finance, the empirical relevance of EVA as a measure of corporate financial success, and how to apply EVA principles when evaluating companies, industries, and even market economies. In this expanded work, there are several new chapters on economic profit including how to estimate EVA with standard accounting adjustments, enterprise and stock price valuation using free cash flow and economic profit models, the EVA role of positive and negative economic depreciation, and the development of an EVA-based factor model approach to estimating the cost of capital.

Having said that, it is important to emphasize that Foundations of Economic Value Added, Second Edition holds to the founding tenets of the first edition. To repeat, graduates of corporate finance (some of whom are perhaps now CFOs) will recall that in a well functioning capital market, the firm’s operating and investment decisions can be made independently of shareholder “tastes” (or utilities) for present and expected future consumption. In this rational setting, the favorable NPV—equivalently, the discounted positive average EVA—announcements by corporate managers are wealth enhancing for all of the firm’s existing shareholders, while the investor-perceived negative NPV announcements unfortunately destroy shareholder value. Whether corporate managers realize it or not, this efficient market condition is why they can make investment decisions according to the classic net present value rule.

Likewise, the modern principles of corporate finance reveal that if the capital market is indeed efficient, then these discounted positive average-EVA growth decisions can largely be made without regard to the particular method (debt versus equity) of corporate financing. In effect, the EVA-enhancing decisions by managers in a levered firm (a company with long-term debt) have the same wealth impact as if the firm were totally unlevered (that is, debt free). However, with market imperfections, corporate managers need to consider the discounted EVA impact of the firm’s effective debt-tax subsidy and/or potential agency benefits arising from debt financing due to the presumably lower weighted average cost of capital.

As with corporate finance, EVA has many investment applications. For instance, if the firm’s market capitalization (debt plus equity value) falls short
of the EVA-based intrinsic value, then its outstanding bonds and stocks would be undervalued in the marketplace. By purchasing the mispriced securities of firms having, for example, relatively low NPV-to-EVA multiples, the active investor may reap windfall capital gains on the firm’s outstanding debt and equity securities. Stock price rises in this active investing scenario because the discounted positive EVA announcements increase the true earnings pie for investors, while bond investors may reap windfall capital gains due to credit upgrades on the firm’s risky debt. Hence, securities analysts and investment managers can also see that EVA has joint pricing implications for the valuation of the firm’s outstanding debt and equity securities.

In the development of the first and now second edition of *Foundations of Economic Value Added*, I have benefited from many insights from professional associates. John Stahr, Wayne Archambo, and Paul Price were duly acknowledged in the first edition, and I am still grateful for their early comments in shaping my understanding of the practical significance of economic profit principles when evaluating companies, industries, and market economies. In this second edition, I am most grateful for comments and insights received from my professional colleague, James Abate of Global Asset Management in New York, who contacted me shortly after the publication of the first edition of this book. It has been a great pleasure to develop and see EVA principles in action from the dual perspectives of stock selection and portfolio risk control. Jim and I also coauthored *Focus on Value: A Corporate and Investor Guide to Wealth Creation* (John Wiley & Sons, 2001) from which advanced EVA insights in that book—such as the EVA-based factor model approach to estimating the cost of capital—are also included herewith.

On the research side, I am most grateful to Al Ehrbar and Bennett Stewart of Stern Stewart & Co. for their “no questions” asked policy in supplying MVA and EVA data on the Performance 1000 Universe. For the record, my enthusiasm about EVA (and its discounted MVA equivalent) as an innovative tool in measuring true corporate profit has in no way been influenced by anyone at Stern-Stewart. I would also like to thank Meredith Grant Anderson (Ph.D. candidate in physics at Carnegie Mellon University), and Ganesh Jois (MBA candidate in the Honors Program at Baruch College) for their quantitative research assistance in constructing the numerous exhibits in this book. Last, but hardly least, an enduring word of thanks goes to Frank J. Fabozzi of the Yale School of Management. His encouragement and flexibility over the years has made it a real pleasure to write both editions of *Foundations of Economic Value Added*. As mentioned before, it was Frank, not I, who had the initial insight to expand upon my EVA study in the Fall 1996 issue of the *Journal of Portfolio Management*.

James L. Grant
About the Author

James L. Grant is President of JLG Research, a company specializing in economic profit research, and a member of the finance faculty at Baruch College of the City University of New York. Dr. Grant serves as a Special Adviser to Global Asset Management in New York. He holds a Ph.D. in Business from the University of Chicago’s Graduate School of Business and has been a featured speaker at industry conferences on value-based metrics. Dr. Grant serves on the Editorial Advisory Board of the Journal of Portfolio Management. He has published several articles in investment journals, including JPM and the Journal of Investing. Dr. Grant is the coauthor of Focus on Value: A Corporate and Investor Guide to Wealth Creation (with James A. Abate) and coauthor and coeditor (with Frank J. Fabozzi) respectively of Equity Portfolio Management and Value-Based Metrics: Foundations and Practice.
The EVA Revolution

In a market-driven economy many companies will create wealth. Other firms however will undoubtedly destroy it. Discovering those economic factors that lead to wealth creation and destruction among companies is important to many constituencies, not the least of which is corporate officials and investment managers. For corporate managers, wealth creation is fundamental to the economic survival of the firm. Managers that fail (or refuse) to see the importance of this imperative in an open economy do so at the peril of the organization and their own careers.1

Finding the “best” companies and industries in the marketplace is of primary importance to investment managers. With the proper financial tools, portfolio managers may be able to enhance their active performance over-and-above the returns available on similar risk indexed-passive strategies. A new analytical tool called EVA is now assisting this wealth-discovery and company-selection process. The innovative changes that this financial metric have spawned in the twin areas of corporate finance and investment management is the driving force behind what can be formerly called the “EVA revolution.”

EVA IN PRACTICE

The analytical tool called EVA, for Economic Value Added, was commercially developed in 1982 by the corporate advisory team of Joel Stern

1 It goes without saying that, in principle, a nonmarket economic system will create less wealth than a market-oriented system.
2 It should be noted that the commercial development of EVA did not just happen overnight. It was the outgrowth of early economic profit innovators like Joel Stern who recognized the practical limitation of accounting earnings. For example, see Joel M. Stern, “Earnings Per Share Don't Count,” Financial Analyst Journal (July/August 1974).