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Overview of  
Economic Value Added  
Presented by  
MPI Securities, Inc.

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MPI Securities, Inc. is pleased to present the enclosed information on Economic Value Added. Economic Value Added is an analytical framework which measures profit relative to the cost of capital employed to achieve it. It is a powerful tool for measuring corporate performance and allocating capital. We recently advised a foreign conglomerate regarding the adoption of Economic Value Added as a basis for performance measurement and capital allocation.

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# Situation Overview

# Situation Overview

- In order to maximize shareholder value, decisions must be made as to how best to allocate capital, how to evaluate investment opportunities and how to measure performance.
  - Economic Value Added provides a suitable framework to owners and executives for the allocation of capital among business units, the measurement of corporate performance, and the determination of executive incentive compensation.
  - Economic Value Added measures value creation; is based on the premise that to create value a company must earn more than its cost of capital.

# Description of Economic Value Added

# Economic Value Added

## *Definition and Calculation*

- Economic Value Added is a method of determining the extent to which a company earns profits in excess of its cost of capital, or said differently, generates returns greater than that found in a comparably risky portfolio of debt and equity. Four critical components to successful implementation of an Economic Value Added model are:
  1. Determination of the capital allocated to a subject business;
  2. Determination of the subject business' cost of capital; and
  3. Determination of the subject business' economic profit (that is, reported profit adjusted to eliminate accounting distortion).
  4. Annual measurement of changes in Economic Value Added. It is the year-over-year growth in Economic Value Added that is most important.

# Economic Value Added

## *Definition and Calculation*

- **Economic Value Added** = Adjusted Net Operating Profit After Tax (ANOPAT), less a Capital Charge
  - **ANOPAT** = Operating profit adjusted for one time charges or gains and other accounting items that distort a company's reported profitability. See sample adjustments on page 11.
  - **Capital Charge** = Total Capital x Cost of Capital
  - **Total Capital** = Total Debt + Stockholders' Equity (from the beginning of the year)
  - **Cost of Capital** = Weighted Average After-Tax Cost of a Firm's Debt and Equity (WACC). Cost of Equity is built-up using historic stock market return data (risk free rate plus equity risk premium). Cost of debt is after-tax cost of debt for subject company's borrowing costs.
- For sample calculation, refer to the next slide.

# Economic Value Added

*Definition and Calculation (cont'd)*

- EXAMPLE – Consider the following firm:

Sales	\$100,000,000
Operating Profit	\$ 9,000,000
Adjustments	\$ 1,000,000
Debt	\$ 20,000,000
Equity	\$ 40,000,000
Tax Rate	30%
WACC	10%

- Thus,
  - ANOPAT =  $\$10,000,000 \times (1 - 30\%) = \$7,000,000$
  - Total Capital =  $\$20,000,000 + \$40,000,000 = \$60,000,000$
  - Capital Charge =  $10\% \text{ WACC} \times \$60,000,000 = \$6,000,000$
  - Economic Value Added = ANOPAT less Capital Charge, =  $\$7,000,000 - \$6,000,000 = +\$1,000,000$

# Advantages of Economic Value Added

- **Transparency / Ease of Use**
  - Easy to calculate.
  - Less subject to manipulation than earnings per share.
  - Economic Value Added is less variable than accounting earnings.
- **Flexible**
  - Can easily be adapted across industries or countries.
  - Adjustments to net operating profit can be custom-tailored to reflect company/industry specific fact sets.
- **Conceptual**
  - Measures if an executive is generating company earnings greater than a comparably risky portfolio of debt and equity. If he can grow the company by investing in profitable projects and/or by minimizing the cost of capital, then the company and its owners will enjoy rising economic value.
  - Economic Value Added causes the manager to adopt the mentality of a business owner, adopt sound long-term decisions and to operate with a renewed sense of urgency.

# Economic Value Added Process

**Step 1:** Develop an Economic Value Added model.

- Determine appropriate adjustments to income statement and balance sheet.
- Determine total capital.
- Determine appropriate cost of capital.
- Develop model for future calculations.

**Step 2:** Review the determined Economic Value Added models with Company management and establish base line values. Management utilizes in performance measurement, investment analysis, and determination of an incentive compensation system based on annual or multi-year change in Economic Value Added.

**Step 3:** Determine annual Economic Value Added based on established model.

**Step 4:** Company management uses annually prepared Economic Value Added to evaluate unit performance, allocate capital and determine incentive compensation.

# Sample Adjustments

<i>Topic Area</i>	<i>Description/Examples</i>	<i>How Economic Value Added Compensates</i>
Non-Recurring Gains/Losses	<p>Uranium is discovered onsite at a company not in the mining business; a large gain on the sale of uranium results.</p> <p>The company is involved in a frivolous lawsuit, and incurs unusually high legal expenses to defend itself in a particular year.</p>	<p>Profits from this precious metal sale would be deducted from earnings (ANOPAT); executive does not get credit;</p> <p>Unusual legal expenses would be added back to earnings;</p>
Research & Development (can also be applied to a company's investment in Brand Development)	Under accounting standards, R&D is expensed, depressing profitability in the short-term.	Under Economic Value Added R&D expenses are capitalized and amortized over the period they yield benefit. This encourages long-term investment in profitable projects.

## Sample Adjustments (cont'd)



<i>Topic Area</i>	<i>Examples/Implications</i>	<i>How Economic Value Added Compensates</i>
Debt-financed growth projects	Managers could be tempted, for the sake of growth, to debt finance projects, since the cost of debt is lower than equity, and these projects will beat their low hurdle rates.	Economic Value Added uses the firm's cost of capital; which includes costlier equity capital. Marginal projects will not increase Economic Value Added.
Using bad debt reserves and other accrual accounts to manage earnings	Managers can build up large bad debt reserves in good years, and then use them to smooth earnings in bad years.	Economic Value Added does not measure expenses based on estimated bad debt expense, but by actual bad debt expense.
Off-balance sheet financing techniques	A company utilizes operating leases rather than capital leases; keeping debt off the books.	Economic Value Added captures the implied interest cost on the lease, and adjusts total capital to reflect off-balance sheet financing.
Restructuring Charges	To avoid a hit to earnings, an executive postpones a much needed restructuring that will increase the company's Economic Value Added.	Under Economic Value Added, all or a portion of these restructuring charges may be added back to ANOPAT, incentivizing managers to weed out bad businesses and enhance returns.

# MPI Securities' Role

## MPI Securities' Role

- MPI Securities will assist in evaluating Economic Value Added as a basis for performance measurement and investment allocation.
- We will advise in the implementation of Economic Value Added and ongoing annual measurement.

# Recent Assignments

<p><b>Shop-A-Snak</b>            Shop-a-Snak Food Mart, Inc.            in its sale to  <b>The Pantry.</b>            The Pantry, Inc.</p>	<p>Sale advisory for a \$180 million revenue, Florida based convenience store chain.            Pending</p>	<p>Sale advisory for a \$20 million revenue timber harvesting and sawmill equipment manufacturer.            Pending</p>	<p>Fairway Spring Co., Inc. in its sale to Fennell Spring Company, LLC.</p>
<p>Merger advisory services for an \$800 million revenue consumer products company.</p>	<p>Evaluation of strategic alternatives and shareholder liquidity options for a \$200 million revenue technology products and services business.</p>	<p>Evaluation of shareholder liquidity options for a \$600 million revenue regional pharmacy chain.</p>	<p>Strategic advisory for a \$1.6 billion revenue convenience store chain.</p>
<p>Fairness opinion for  in connection with its repurchase of 3.6 million common shares from International Truck and Engine Corporation.</p>	<p>Fairness opinion for a \$15 million revenue specialty labeling company in connection with a self tender transaction.</p>	<p>Fairness opinion for  in connection with a \$10 million PIPE transaction.</p>	<p>Sale/merger valuation for a \$20 million revenue waste recycling company.</p>
<p>Financial advisory to support implementation of a share appreciation rights plan by an \$80 million revenue specialty publishing company.</p>	<p>Advised a \$25 million revenue specialty chemical company in evaluation of an ESOP for ownership succession and employee incentive purposes.</p>	<p>Strategic advisory for a \$100 million revenue technology company in connection with an unsolicited take over offer.</p>	<p>Strategic Advisory for \$1 billion revenue civil contracting and construction materials business.</p>