



ADVOCATING EVA FOR CAPITAL BUDGETING

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FUZZY FINANCE



FOCUSED FINANCE



Source: Unknown

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WHAT IS REQUIRED TO HAVE A FOCUSED FINANCE?

- One measure that integrates all – Value creation
- Linking periodic performance analysis to capital budgeting techniques and shareholder value analysis:
 - Economic value added (EVA) Linked to NPV
 - Market value added (MVA)
- A measure that gauge management's performance
 - Focus on decisions that create value in the future.

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STRATEGIES TO CREATE VALUE

$$EVA = \left[\frac{NOPAT}{Capital} - \text{Cost of capital} \right] * Capital$$

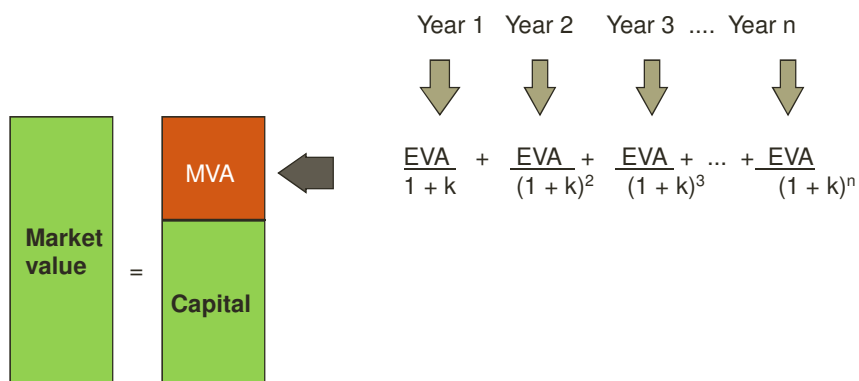
Operate: Improve the return on existing operating capital

Decrease: WACC

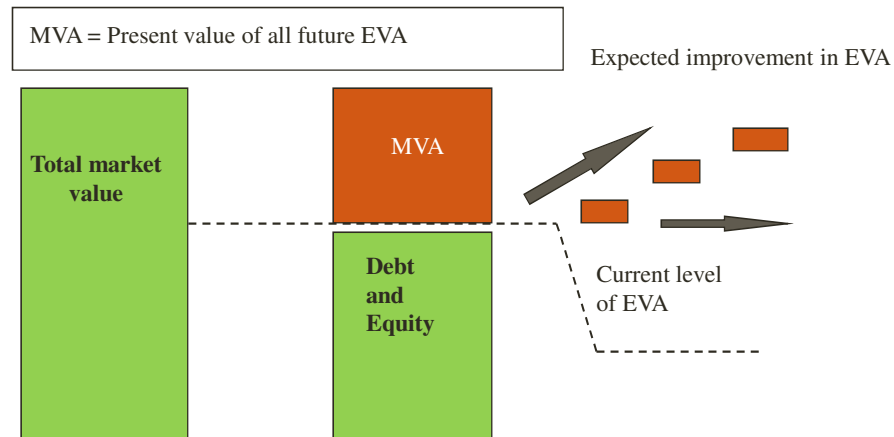
Build: Invest as long as returns exceed the cost of capital

Harvest: Re-deploy capital when returns fail to achieve the cost of capital.

EVA IS THE SOURCE OF MVA II



EVA IS THE SOURCE OF MARKET VALUE ADDED



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EVA IS THE SOURCE OF MVA III

Companies that consistently earn profits in excess of their required return ...

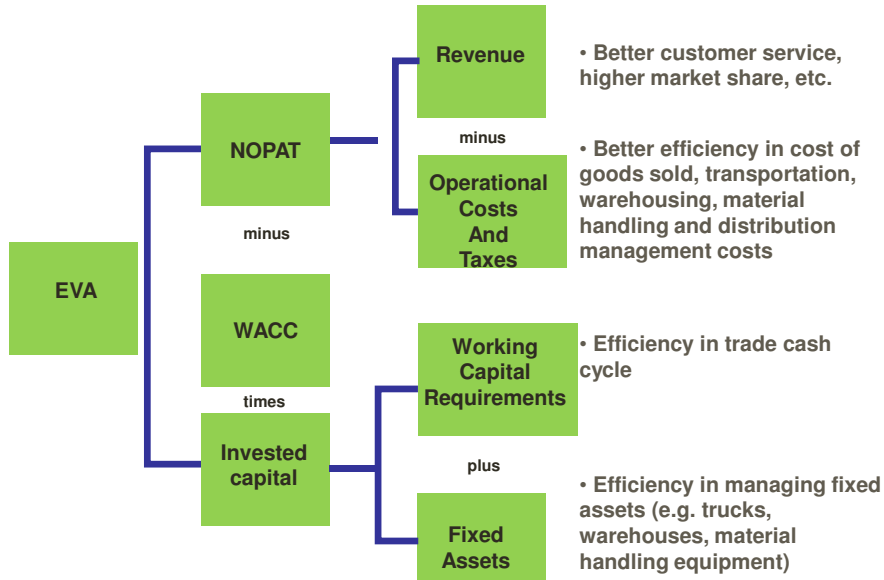


... are typically valued at premiums to book value.



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SIMPLE TO CALCULATE



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SIMPLE EXAMPLE OF NPV VS EVA

Suppose a certain project costs \$1,000,000 up front, but after that it will generate net cash inflows each year (in perpetuity) of \$120,000. If the firm's cost of capital is 10%, then the project's NPV and EVA are:

$$\text{NPV} = -\$1,000,000 + (\$120,000 \div 0.10) = \$200,000$$

$$\text{EVA} = \$120,000 - \$100,000 = \$20,000$$

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WHY USE EVA IN CAPITAL BUDGETING INSTEAD OF NPV?

- Present value of EVA = Net Present Value of cash flows
- Provides insight into each period
- Is a direct link to performance
- More useful for future project audits.