Executive Summary

The usual approach to valuing a firm is to calculate the present value (PV) of future free cash flow. A valuable alternative is to calculate the PV of economic profits (EP). This report introduces the new HOLT Economic Profit framework and will serve as a chapter in an upcoming textbook on advances in the HOLT CFROI® framework.

Economic Profits represent the economic earnings of the firm. EP is proportional to the spread between a company’s return on capital and cost of capital. If a firm earns the cost of capital, EP is zero. Growth below the cost of capital destroys shareholder value, and these projects should be rejected. Investment into positive spread projects creates shareholder value and should be encouraged.

This report demonstrates how EP is calculated and can be used. This approach applies all the advantages of the HOLT framework to the measurement of economic profit: asset mix, project life, inflation and accounting distortions are handled identically, making HOLT EP a superior economic measure.

By splitting EP into operating and acquisition goodwill components, absolute value creation can be assessed. Insights can be gained from analyzing change in EP, which can be decomposed into three parts: change in economic spread, growth and change in goodwill. Amazon is an excellent example of a firm whose increase in EP due to growth has more than compensated the loss in EP due to decreasing CFROI. Amazon is employed as an example throughout the report. Corporate boards and investors should insist on positive change in EP. A brief case study on Danaher illustrates how EP and change in EP can be used to analyze an acquisitive company.

The introduction is rigorous. Readers that want to get straight to the point can start with the Danaher case study. Links are available in the report to jump to sections of most interest.
Introduction

The usual approach to valuing a firm is to calculate the present value of its future free cash flow to the firm’s capital providers (FCFF). A highly informative alternative is to calculate the present value of the firm’s economic profits.

Although technically correct, the FCFF method has nothing to say about the quality of the cash flow. Is a high level of free cash flow a good or bad thing? The answer depends on whether the company is forsaking value creating opportunities to report higher cash flow.

A company should invest its capital and available cash flow in projects that exceed their cost of capital. If value creating opportunities are unavailable, the firm should maximize cash flow and return it to shareholders via dividends or share buybacks.\(^1\)

As a rule of thumb, free cash flow will be negative when asset growth is greater than the return on capital.

\[
\text{Cash flow rules: if } g > \text{CFROI}^0 \text{ then FCFF} < 0
\]

Value-destroying firms often make the mistake of expanding their operations to report earnings growth. They think Wall Street wants earnings growth at all cost. This misunderstanding can lead to expensive corporate mistakes. Earnings is an accounting value and cash flow is an economic one. These profitability measures are frequently conflated. It is the quality of earnings that should inform a firm’s growth strategy.

<table>
<thead>
<tr>
<th>Cash from Operations</th>
<th>Growth Option</th>
<th>Decision</th>
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</thead>
</table>
| If CFROI > g, then FCFF > 0 | Are projects available that exceed their cost of capital?                     | Yes – invest cash flow and raise additional capital if necessary.  
No – return the cash flow to capital providers. |
| If CFROI < g, then FCFF < 0 | Are projects available that exceed their cost of capital?                     | Yes – raise additional capital  
No – don’t grow and consider downsizing if the firm is destroying value. |

The quickest way to generate cash flow is to stop growing. The decision table indicates that this is sub-optimal if a firm has projects available which exceed the cost of capital. This choke-growth turnaround rule is only warranted for value destroyers, whose return on capital isn’t meeting the cost of capital. For them, it is wise to remember humorist Will Rogers’ adage on the first law of holes: if you find yourself in a hole, stop digging.

On the flipside, potential value creation is squandered when CFOs don’t do their job of investing available cash flow and raising capital to finance projects expected to beat their cost of capital. Negative cash flow is acceptable as long as project returns are expected to exceed their cost of capital and generate positive Net Present Value (NPV) for the firm. To do otherwise is to leave money on the table. Rational shareholders prefer more value to less and the aim of the firm is to create the greatest possible NPV from its portfolio of present and future investments. Accounting earnings should never be confused with economic value.

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\(^1\) Investors prefer the most value-enhancing and tax-efficient method of cash distribution. For example, share buybacks are preferable if the company’s shares are trading at a discount to their intrinsic value. Firms loaded with dangerous levels of debt might instead use cash flow to pay down debt so that distressed investors can sleep easier at night. See Michael J. Mauboussin, and Dan Callahan. “Disbursing Cash to Shareholders: Frequently Asked Questions about Buybacks and Dividends”. Credit Suisse Global Financial Strategies. May 2014.
the greatest possible NPV from its portfolio of present and future investments.2 Accounting earnings should never be confused with economic value.

Can the concept of value creation be communicated more comprehensively? All capital providers expect compensation. There is a charge on debt which appears on the income statement as interest expense. Operating profit has to cover the interest charge and debt-equivalent charges such as operating lease expenses. If not, net income will be negative.

But what about equity? There is no charge for equity on the income statement, so it appears to have no cost to the untrained eye. Economists know that there is an opportunity cost for providing equity, which should reflect the investment’s riskiness. A residual income would subtract a charge on the equity at the opportunity cost of equity from net income. The residual income is an economic profit, which differs profoundly in concept and absolute value from accounting profit. The equity charge is simply the cost of equity multiplied by the equity. The more equity required to support earnings, the greater the economic charge and lower the residual income.

When analyzing the operating performance and value of industrial and service companies, it is beneficial to separate the firm’s operating and financing decisions, and to value the firm with respect to all capital providers. Financial structure is a secondary consideration in the capital budgeting process. Of primary concern is the intelligent allocation of capital and resources with the aim that all of the capital provided will create positive NPV. As Weingartner notes,

“Capital budgeting represents in some respects the central problem of the firm. The complexity of the problem derives from the fact that any set of actions taken today has consequences at later times, and the opportunities available at later dates are related to decisions being implemented currently.”3

The opportunity cost for the firm’s capital, which is a weighted-average of its cost of equity and debt, is the cost of capital. Value creation can be communicated by calculating economic profit (EP) and discounting future economic profits to their present value. Valuations from the FCFF and EP methods will yield equivalent results for an identical forecast.

**CFROI as a Ratio**

CFROI is a single period measure of a firm’s weighted-average IRR on its existing businesses and projects. CFROI can be expressed as a ratio using the familiar RATE4 function in Microsoft Excel.

\[
\text{CFROI} = \text{RATE} (\text{LIFE}, \text{GCF}, -\text{IAGI}, \text{NDA}) = \frac{\text{GCF} - \text{ARC}}{\text{IAGI}}
\]

The HOLT variables are well-known: LIFE is the weighted-average project life of the depreciating assets, GCF is gross cash flow, IAGI is inflation-adjusted gross investment, and NDA represents non-depreciating assets.5 CFROI as a ratio

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4 CFROI = RATE(n, pmt, -pv, fv)

requires the introduction of a depreciation variable, the Asset Recovery Charge (ARC).  

\[ ARC = PMT \ (RATE, LIFE, 0, -IADA) = \frac{RATE \times IADA}{[(1 + RATE)^{LIFE} - 1]} \]  

(2)

ARC is a depreciation annuity that represents the sinking fund charge of recovering the inflation-adjusted depreciable assets (IADA) over the project life. A lower recovery rate translates into a higher asset recovery charge.

A can of worms has now been opened. What is the rate at which the depreciable assets are recovered? In a CFROI ratio calculation, there is an implicit assumption that ARC is recovered at a rate equal to the CFROI.

Economists would argue that the sinking fund depreciation should be calculated at the firm’s cost of capital (or discount rate, DR) since by definition it represents the risk-adjusted opportunity cost of the capital provided.

\[ ARC@DR = PMT \ (DR, LIFE, 0, -IADA) = \frac{DR \times IADA}{[(1 + DR)^{LIFE} - 1]} \]  

(3)

We have maintained that a project’s NPV and the present value of its economic profits are equal. The calculation of HOLT economic profit is greatly simplified if an adjusted CFROI is defined where ARC is calculated at the firm’s discount rate. We denote the adjusted CFROI as CFROI', pronounced “CFROI prime”.

**CFROI Prime calculation**

\[ CFROI' = \frac{(GCF - ARC@DR)}{IAGI} \]  

(4)

CFROI and CFROI' are equivalent when CFROI equals the discount rate. They are always equivalent if the asset base is comprised entirely of non-depreciable assets, e.g., net working capital and land. CFROI' will be less than CFROI when CFROI is greater than the discount rate, i.e., the sinking fund depreciation decreases as CFROI increases. CFROI' will be greater than CFROI when CFROI is less than the discount rate, i.e., the sinking fund depreciation increases as CFROI decreases.

Why is CFROI' important? Because it is an economic measure aligned with the calculation of economic profit and net present value (NPV). For mutually exclusive projects, CFROI' is:

- An economic measure that takes into account risk-adjusted value
- Rank-order NPV aligned

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assumed, the NPV of Project A is 50% higher than that of Project B, making it the clear winner in a capital budgeting exercise. In fact, Project B’s cash flow would have to increase to 277 and its IRR to 12% for the NPV of the projects to be equivalent at 168. IRR is not aligned with the NPV rule in this example.

Internal rate of return is a popular and treasured metric since it does not require an external cost of capital and all the squabbling that accompanies its quantification. NPV is a superior metric for assessing value but requires an explicit risk-adjusted discount rate.

Calculation of CFROI’ is perfectly aligned with NPV in this example. Project A has a CFROI’ of 10% while Project B has a CFROI’ of 8.6%. Project A is preferable using NPV or CFROI’.

We can further illustrate differences between CFROI and CFROI’ by varying the ratio of GCF to gross investment (IAGI) and NDA% for a typical company. The straight lines represent CFROI and the dashed lines represent CFROI’ for GCF/IAGI ratios of 5%, 10% and 20% (GCF/IAGI is sometimes used as an ROA proxy, but it is a poor return on assets substitute). First of all, note how CFROI and CFROI’ equal the return GCF/IAGI when all the assets are non-depreciating. The discrepancy between CFROI and CFROI’ grows as the relative amount of depreciating assets increases. The asset replacement charge causes this discrepancy. Investors must recover the cost of the depreciating assets whereas non-depreciating assets are fully recovered at the project’s conclusion. In the CFROI calculation, when CFROI is greater than the discount rate, the replacement charge decreases as CFROI increases. This is not the case for the CFROI’, where depreciating assets are funded at the discount rate.

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discount rate, which was assumed to be 6% in this example. This example also illustrates why it is important to consider asset composition when measuring corporate profitability.

Let’s conclude this section by calculating CFROI’ for Amazon. ARC is calculated at Amazon’s 2013 average real discount rate of 4.2%, which results in a charge of $5.735bn and a CFROI’ of 11.7% versus a CFROI of 14.8%.

\[ ARC'(2013) = PMT\ (4.2\%,\ 5.3\ years,\ 0,\ -$33.283bn) = $5.735bn \]

\[
\text{CFROI}'(2013) = \frac{($10.164bn - $5.735bn)}{$37.822bn} = 11.7\%
\]

**HOLT Economic Profit**

Economic Profit (EP) is the amount of value a firm creates over a specified period, typically annual. It is proportional to the spread between a company’s return on capital and cost of capital. If a firm is meeting its cost of capital, its EP is zero. Growth into projects below the cost of capital destroys shareholder value, and these projects should be rejected. Growth at the cost of capital is value neutral. The HOLT EP is simply the economic spread multiplied by assets if CFROI’ is specified as the return on capital.

\[
EP = (\text{CFROI}' - DR) \times IAGI
\]

(5)

Use of CFROI’ leads to equivalent valuations from the FCFF and EP approaches. We demonstrate that the NPV and present value of economic profits are equivalent for the previous Project A and B example.

**Equivalence of NPV and the PV of EP**

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<tr>
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<th>0</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
<th>IRR</th>
<th>DR</th>
<th>NPV</th>
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<td>-1,000</td>
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<td>100</td>
<td>100</td>
<td>100</td>
<td>1,100</td>
<td>10.0%</td>
<td>6.0%</td>
<td>168</td>
</tr>
<tr>
<td>Project B</td>
<td>-1,000</td>
<td>264</td>
<td>264</td>
<td>264</td>
<td>264</td>
<td>264</td>
<td>10.0%</td>
<td>6.0%</td>
<td>111</td>
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</table>

**Economic Profit Analysis - Project A**

<table>
<thead>
<tr>
<th>GCF</th>
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<th>100</th>
<th>100</th>
<th>100</th>
<th>100</th>
</tr>
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<tr>
<td>- ARC\text{_DR}</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>NCF</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>/ IAGI</td>
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<td>1,000</td>
<td>1,000</td>
<td>1,000</td>
<td>1,000</td>
</tr>
<tr>
<td>= CFROI’</td>
<td>10.0%</td>
<td>10.0%</td>
<td>10.0%</td>
<td>10.0%</td>
<td>10.0%</td>
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<tr>
<td>Economic Spread (CFROI’-DR)</td>
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<td>4.0%</td>
<td>4.0%</td>
<td>4.0%</td>
<td>4.0%</td>
</tr>
<tr>
<td>Economic Profit (Spread \times IAGI)</td>
<td>-</td>
<td>40</td>
<td>40</td>
<td>40</td>
<td>40</td>
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<tr>
<td>PV</td>
<td>40</td>
<td>40</td>
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<td>40</td>
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</table>
| Economic Profit Analysis - Project B

<table>
<thead>
<tr>
<th>GCF</th>
<th>264</th>
<th>264</th>
<th>264</th>
<th>264</th>
<th>264</th>
</tr>
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<tbody>
<tr>
<td>- ARC\text{_DR}</td>
<td>177</td>
<td>177</td>
<td>177</td>
<td>177</td>
<td>177</td>
</tr>
<tr>
<td>NCF</td>
<td>86</td>
<td>86</td>
<td>86</td>
<td>86</td>
<td>86</td>
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<tr>
<td>/ IAGI</td>
<td>1,000</td>
<td>1,000</td>
<td>1,000</td>
<td>1,000</td>
<td>1,000</td>
</tr>
<tr>
<td>= CFROI’</td>
<td>8.6%</td>
<td>8.6%</td>
<td>8.6%</td>
<td>8.6%</td>
<td>8.6%</td>
</tr>
<tr>
<td>Economic Spread (CFROI’-DR)</td>
<td>2.6%</td>
<td>2.6%</td>
<td>2.6%</td>
<td>2.6%</td>
<td>2.6%</td>
</tr>
<tr>
<td>Economic Profit (Spread \times IAGI)</td>
<td>26</td>
<td>26</td>
<td>26</td>
<td>26</td>
<td>26</td>
</tr>
<tr>
<td>PV</td>
<td>26</td>
<td>26</td>
<td>26</td>
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<td>26</td>
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</table>

This simple example demonstrates a number of key points. First, the present value of future EP streams equals the NPV of each project’s cash flows. The CFROI’ for Project A is equivalent to IRR and CFROI since the assets are 100% non-depreciating. The NPV of 168 is equivalent to the present value of Project A’s
economic profit stream assuming a discount rate of 6%. The CFROI’ for Project B is lower than the IRR and CFROI, indicating that this project is not as attractive as Project A. Another key point is that CFROI’ is rank-order aligned with the lower NPV of 111, which is equivalent to the present value of Project B’s economic profits.

Another way of stating EP is after-tax operating profit (NCF) minus a capital charge (DR x IAGI).

\[ EP = GCF - ARC@DR - DR \times IAGI = NCF' - \text{Capital Charge} \quad (6) \]

The inflation-adjusted capital charge is the opportunity cost of using the assets, equal to the assets multiplied by the discount rate. This charge is analogous to the capital charge of invested capital multiplied by WACC in traditional approaches. A firm can increase its economic profit by attaining greater productivity out of its assets, e.g., improved working capital management leads to a drop in assets and the capital charge. It can improve profitability by improving NCF margin and/or asset turns.

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Using (5), Amazon’s EP in 2013 was $2.833bn, which is the amount by which NCF exceeded the capital charge.

\[ EP(2013) = (11.7\% - 4.2\%) \times 37.822bn = 2.833bn \]

What is the Connection between EP and Value?
The level of economic profit and its sustainability are integral to a company’s intrinsic value. We established that the present value of a project’s EP and its NPV are equivalent. A general demonstration is derived in the appendix. The value of a firm equals the present value of its future EP streams and its inflation-adjusted net asset value (IANA).

\[ Value = IANA_0 + \sum_{i=1}^{N} \frac{EP_i}{(1 + DR)^i} \quad (7) \]

If a firm is forecast to generate cost of capital returns, its EP will be zero, and the firm should trade at its book value. The enterprise book value is the current-dollar
net assets. Firms unable to meet their cost of capital will trade at a discount to their book value, and those able to beat their cost of capital will trade at a premium.

Growth and sustainability as value drivers are crystal clear in the EP framework. Firms able to grow EP via investment, margin expansion and/or asset productivity will increase shareholder value. Firms able to sustain value creating returns longer into the future and withstand the gravitational pull of fade will generate more shareholder value. A crucial performance measure, which we will investigate shortly, is the change in economic profit (ΔEP).

The Power of Simplicity: Spread, fade, and growth in an EP framework
The importance of economic spread and fade can be readily shown. Consider a firm whose assets are growing at a rate $g$ but whose profitability is fading at a rate $f$ towards the cost of capital $DR$. An analytical solution exists for value.

$$\text{Value} = IANA_0 \times \left(1 + \frac{(CFROI' - DR)}{(DR - g + f)}\right)$$  \hspace{1cm} (8)

The impact of profitability and fade can now be evaluated. Fade is particularly value destructive! The table below, which assumes a real discount rate of 6% and real growth of 2%, shows the multiple of intrinsic value to $IANA_0$, which is the HOLT price-to-book ratio (PBR). It is analogous to Tobin’s Q ratio. When the forward CFROI is equal to the discount rate, the PBR remains constant at 1.0. Fade doesn’t matter, growth doesn’t create value and the firm should trade at its inflation-adjusted net asset value.

The inverse of the fade rate is a measure of the expected Competitive Advantage Period (CAP). A value destroying firm with a CFROI’ of 3% should trade at a PBR of 0.67 if it expects 20 years (5% fade rate) to recover to its cost of capital, and a significantly higher PBR of 0.94 if it only expects 2 years (50% fade rate) to recover. A stellar value creating firm with a CFROI’ of 24% should trade at a PBR of 3.0 if its expected CAP is 20 years versus a significantly lower PBR of 1.3 for an expected CAP of 2 years. When fade happens, its impact can be enormous.

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8 Economist and Nobel laureate James Tobin hypothesized (1968) that the aggregate value of all firms in the stock market was equal to their replacement cost. Equivalently, aggregate market value ($V$) equals replacement cost ($C$) = $V/C$, a value-to-cost multiple. HOLT price-to-book ratio is a useful V/C proxy.
Using Economic Profit to measure the value of acquisitions

Thus far, we have focused on understanding the economics of operating assets. Economic profit analysis is also helpful in understanding the value of acquisitions.

Acquisition goodwill, which HOLT treats as a non-operating intangible asset, can be factored into the analysis of economic profit and change in economic profit. The cumulative goodwill should be used since any premium paid represents a wealth transfer from the acquiring firm to target shareholders and is an unrecoverable cost, or penalty, to the acquiring firm’s equity investors. The penalty for control, however, isn’t indefinite if change in EP becomes the focus, since ΔEP negates sunk costs such as goodwill. Let’s begin with EP.

\[
\text{Capital Charge on Goodwill} = DR \times \text{Cumulative Goodwill} \quad (9)
\]

\[
\text{Transaction EP} = \text{Operations EP} + \text{Goodwill EP} = (\text{CFROI} - DR) \times IAGI - DR \times GW \quad (10)
\]

The transaction EP includes operating EP and goodwill EP. The transaction EP for Amazon in 2013 was $2.690bn after a relatively small goodwill charge of $143m on a cumulative goodwill total of $3.384bn.

\[
\text{Transaction EP(2013)} = (11.7\% - 4.2\%) \times 37.822bn - 4.2\% \times 3.384bn = $2.690bn
\]

Amazon’s EP performance over the past decade is specified below. Operating EP swamps any charges due to goodwill. The exponential increase from $102m at the end of 2003 to $2.7bn in 2013 is extraordinary. What is the market expecting and will this trajectory continue?

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<tr>
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<tbody>
<tr>
<td>EP (Operations)</td>
<td>113</td>
<td>264</td>
<td>446</td>
<td>524</td>
<td>725</td>
<td>757</td>
<td>1,115</td>
<td>1,511</td>
<td>1,547</td>
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<td>2,833</td>
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<tr>
<td>EP (Goodwill)</td>
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<td>-9</td>
<td>-11</td>
<td>-13</td>
<td>-16</td>
<td>-36</td>
<td>-97</td>
<td>-79</td>
<td>-121</td>
<td>-165</td>
<td>-143</td>
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<tr>
<td>Total EP</td>
<td>102</td>
<td>254</td>
<td>435</td>
<td>511</td>
<td>709</td>
<td>720</td>
<td>1,018</td>
<td>1,432</td>
<td>1,425</td>
<td>1,862</td>
<td>2,690</td>
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Economic Profit

\[
\text{Estimated HOLT price-to-book}
\]

<table>
<thead>
<tr>
<th>Fade Rate %</th>
<th>0%</th>
<th>3%</th>
<th>6%</th>
<th>12%</th>
<th>24%</th>
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</thead>
<tbody>
<tr>
<td>1%</td>
<td>-0.20</td>
<td>0.40</td>
<td>1.00</td>
<td>2.20</td>
<td>4.60</td>
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<td>5%</td>
<td>0.33</td>
<td>0.67</td>
<td>1.00</td>
<td>1.67</td>
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<tr>
<td>10%</td>
<td>0.57</td>
<td>0.79</td>
<td>1.00</td>
<td>1.43</td>
<td>2.29</td>
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<td>25%</td>
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<td>0.90</td>
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<td>0.89</td>
<td>0.94</td>
<td>1.00</td>
<td>1.11</td>
<td>1.67</td>
</tr>
<tr>
<td>100%</td>
<td>0.94</td>
<td>0.97</td>
<td>1.00</td>
<td>1.06</td>
<td>1.17</td>
</tr>
</tbody>
</table>
A transaction CFROI’ which incorporates acquisition goodwill can be defined which allows another way of stating the transaction EP.

\[ \text{Transaction CFROI'} = \frac{NCF'}{IAGI + GW} \] (11)

and, rearranging (10)

\[ \text{Transaction EP} = (\text{Transaction CFROI'} - DR) \times (IAGI + GW) \] (12)

Amazon's transaction CFROI' in 2013 was 10.7% indicating that Amazon remains a value creating business if acquisition goodwill is taken into account.

\[ \text{Transaction CFROI'}(2013) = \frac{($10.164 - $5.735 \text{bn})}{($37.822 + $3.384 \text{bn})} = 10.7\% \]

The higher the premium paid for an acquisition, the greater the capital charge. Economic profit can help judge whether the charge on goodwill is being offset by growth in operating EP. This can be achieved by splitting the change in economic profit into its spread, growth and goodwill components.

**Decomposing value creation into Delta EP components**

A firm can increase its intrinsic value by generating a positive change in economic profit. ΔEP is a crucial measure of corporate performance and value creation. Annual changes in EP should be calculated and cumulative totals tallied. Bonuses of executives, division managers, project leaders and employees can be based on cumulative ΔEP over a 3 to 5 year period if shareholders want each level of the firm to be focused on value creation. Operationally, an increase in spread and growth in value creating businesses are the two major routes to achieving this goal. If acquisitions are the strategy guiding growth, then the charge on additional goodwill can be compared to the ΔEP generated from the acquired assets. If the premium paid is too high, then the economic charge on that premium will surpass the additional economic profit generated from the larger asset base.

The change in EP can be calculated for any two periods but is generally calculated on an annual basis.

\[ \Delta EP_{i+1} = (CFROI'_{i+1} - DR_{i+1}) \times IAGI_{i+1} - (CFROI'_{i} - DR_{i}) \times IAGI_{i} \] (13)

For Amazon, the operating ΔEP in 2013 was $805m.

\[ \Delta EP(2013) = (11.7\% - 4.2\%) \times $37,822m - (12.7\% - 4.9\%) \times $26,162m = $805m \]

Amazon created $805m more in economic profit in 2013 than in 2012 despite its CFROI’ dropping from 12.7% to 11.7%. Some of this increase was due to the higher risk appetite of markets, i.e., the discount rate dropped from 4.9% to 4.2%, but most of it was due to the enormous growth in assets, which was an astonishing 44.6% in nominal terms. Tremendous insight comes from decomposing the sources of value creation. Let’s see how to separate change in EP due to economic spread expansion from that due to growth.
The ΔEP equation can be rewritten as the expression:

\[
\Delta EP_{i+1} = (\Delta CFROI'_{i+1} - \Delta DR_{i+1}) \times IAGI_i + (CFROI'_{i+1} - DR_{i+1}) \times \Delta IAGI_{i+1}
\]

There are two terms that comprise the change in operating EP. The first is the improvement in EP due to economic spread expansion. The expansion comes from improvement in CFROI' and change in the discount rate. The second term is change in EP due to growth and re-investment. If growth is zero, then this term is zero. If the spread is positive, then growth creates value.

The beginning-of-year asset growth rate, \( g \), can be used to restate the equation in an explicit manner.

\[
\Delta EP_{i+1} = [(\Delta CFROI'_{i+1} - \Delta DR_{i+1}) + (CFROI'_{i+1} - DR_{i+1}) \times g] \times IAGI_i
\]

It is worthwhile dwelling on the economic spread component for a moment. The change in CFROI' is related to the operating performance of the firm. Change in CFROI' has a directly proportional impact on change in EP. Because HOLT employs a forward-looking, market-implied discount rate, the change in discount rate is related to market risk appetite and the firm’s non-diversifiable risk. The firm has some say over the latter, e.g., via its leverage and credit risk, but cannot control the former. This can prove unsettling since change in value is a function of the firm’s operating performance and market whims. Corporate managers and executive remuneration committees might find it preferable to settle on an absolute discount rate that remains constant to reduce the effect of market vagaries.

Change in EP due to CFROI' and discount rate changes (change in economic spread):

\[
\Delta EP_{spread} = (CFROI'_{1} - CFROI'_{0} - DR_{1} + DR_{0}) \times \frac{IAGI_{1}}{1 + g}
\]

The change in EP due to spread compression was -$68m in 2013 for Amazon.

\[
\Delta EP_{2013}^{spread} = (11.7\% - 12.7\% - 4.2\% + 4.9\%) \times \frac{\$37,822m}{1 + 44.6\%} = -$68m
\]

Amazon lost economic profit in 2013 due to economic spread compression. Did it compensate for the loss via growth?

Change in EP due to growth:

\[
\Delta EP_{growth} = (CFROI'_{1} - DR_{1}) \times \frac{g \times IAGI_{1}}{1 + g}
\]

Note that the measures can be normalized by dividing by IAGI, IANA or sales. Normalization by sales results in economic profit and ΔEP margins, which are particularly insightful for asset-light companies.

How much additional value did Amazon’s growth in 2013 generate?
Amazon created tremendous value by growing its business rather than maintaining a higher level of overall profitability. The operating ΔEP was $805m in 2013, i.e., -$68m + 873m. But how much of the growth came from acquiring assets? What about Goodwill?

The above analysis is based on operating returns and does not account for goodwill that may have been paid to acquire assets. Fortunately, the mathematics remain the same if we substitute Transaction CFROI’ for CFROI’ and IAGI plus Goodwill for Invested Capital in the equations.

\[
\Delta EP_{2013} (growth) = (11.7\% - 4.2\%) \times \frac{44.6\% \times $37,822}{1 + 0.446} = 873m
\]

\[
Tr EP_i = (Tr CFROI'_i - DR_i) \times (IAGI_i + GW_i)
\]

A highly insightful adjustment is to separate the effect of goodwill from operations using (18) and (9).

\[
Tr EP_i = (CFROI'_i - DR_i) \times IAGI_i - DR_i \times GW_i
\]

The contribution of operations and goodwill to EP can now be easily calculated. The change in EP can also include an acquisition component.

\[
\Delta Tr EP_{i+1} = [(\Delta CFROI'_{i+1} - \Delta DR_{i+1}) + (CFROI'_{i+1} - DR_{i+1}) \times g] \times IAGI_i - DR_{i+1} \times \Delta GW_{i+1}
\]

The goodwill term assumes that the discount rate remains constant at time i and i+1 to simplify the math. Goodwill is a sunk cost. If there is no change in the cumulative goodwill then there is no change in value due to past acquisitions. Thus we avoid penalizing future value creation for past acquisitions. This is not the case when looking at absolute EP, which has sunk costs anchored to it.

What is the change in EP due to M&A goodwill? Due to change in goodwill: \(\Delta Tr EP_i (M&A) = -DG \times \Delta GW_i\)

There was no material change in goodwill for Amazon in 2013, thus the charge due to change in goodwill is zero.

Amazon is not averse to acquisitions. The years 2009, 2011 and 2012 are noteworthy. But the charges in these years due to increases in goodwill were drowned by increases in operating EP. Despite Amazon’s CFROI’ falling since 2007, it has been generating impressive improvements in economic profit. Investors want more economic profit, even if it means lower profitability. The aim is maximizing the present value of all future economic profit streams.

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<td>Due to chg EP spread</td>
<td>84</td>
<td>135</td>
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<td>16</td>
<td>-375</td>
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<td>-16</td>
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<td>297</td>
<td>392</td>
<td>5</td>
<td>448</td>
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Change in EP (ΔEP) is the metric of choice in judging how well managers are performing as stewards of invested capital. It should be a key metric in value-based incentive programs. It has the advantage that lost value from sunk costs are negated, i.e., if the sunk cost doesn’t change then change in its capital charge is zero. Investors prefer a positive change in value creation, irrespective of whether the firm is a value destroyer or value creator. The principle of value additivity informs us that any improvement in economic profit is an improvement in the firm’s NPV and intrinsic value. Multi-year ΔEP accounts that get amortized on a rolling basis are highly suitable for incentivizing company managers.
Case Study: Danaher Corporation

Danaher is an American industrial company with a long track record of acquiring firms and successfully integrating them. Danaher has created tremendous value for its shareholders and sports an impressive CFROI.

We begin by looking at Danaher’s operating CFROI’ and its DuPont drivers. Danaher has maintained a remarkable operating return of greater than 15% for the past decade. Asset turns declined from their peak in 2006 and have been relatively steady at 1.0 for the past 5 years ($1 of sales is generated from every $1 of inflation-adjusted gross assets). The lower asset utilization has been compensated for by improving profitability, NCF’%.

The chart indicates that Danaher knows how to manage operating assets. However, nothing can be said about its ability to make value additive acquisitions. We can get a clue from the transaction CFROI’.

The transaction CFROI’, which has remained above Danaher’s cost of capital for the past decade, is about half of the operating CFROI’ due to acquisition goodwill. Danaher is creating value through its acquisition strategy, but unfortunately, we have no feel for the magnitude and timing of value creation. The next step is to calculate the absolute economic profit for each year and to split it into operating EP and goodwill EP.

Cumulative goodwill grew from $3.9bn at the end of 2003 to $22.5bn in 2013, a 476% increase! Danaher is not averse to paying a premium for control of other firms. The increasing charge on goodwill can be seen. But once it gains control, does Danaher convert its capital paid into shareholder value? Danaher was able to generate more economic profit from the operating assets than what it paid. Total EP grew from $364m at the end of 2003 to $1.5bn in 2013. Of most interest is the change in economic profit and where it is coming from.
The effects of spread, growth and goodwill are calculated. Danaher was increasing economic profit and intrinsic value until the global financial crisis of 2008/9. Significant acquisitions were made in 2006, 2007 and 2008, i.e., look at the change in EP due to goodwill line. The increase in EP due to growth more than compensated for the loss due to goodwill. It is interesting to note that the increase in EP due to growth in 2007 compensated for an increase in the goodwill charge AND a drop in spread.

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<td>270</td>
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<tr>
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<td>-316</td>
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<tr>
<td>Total Change in EP</td>
<td>161</td>
<td>140</td>
<td>328</td>
<td>95</td>
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<td>-272</td>
<td>489</td>
<td>471</td>
<td>-33</td>
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<tr>
<td>5 year total chg in EP</td>
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<td>571</td>
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</table>

CFROI dropped to 15.2% in 2009 as a result of the global slowdown. The 2009 change in EP due to spread compression was a loss of $403m.

Significant acquisitions were again made in 2011 and 2012. The change in EP due to growth in 2011 far exceeded the loss due to goodwill.

Except for 2009, the 5-year cumulative change in EP has been positive.

Danaher’s managers can take a bow for generating excellent operating returns and consistently creating value through acquisitions. Few firms are able to so effectively integrate acquisitions and expand shareholder value.
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