

## **THE EARNINGS PER SHARE LEVERAGE ILLUSION**

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May's failure of BankUnited FSB was the biggest thus far of 2009, and the latest in a series of bank casualties from this financial crisis. Greed, negligence on the part of rating agencies, poor regulatory oversight, government interference in the housing market, and bubble mentality have all been blamed for bank failures. Politicians have cited these factors and the current global downturn as reasons for an unprecedented degree of government involvement in the private sector.

Insufficient attention has been paid to the distorted manner in which so many bank competitors measured performance, and the ill-designed incentive systems that encouraged managers to treat their trading operations like a casino. After all, the entire sector faced the same perilous conditions, which would ultimately reveal very sharp distinctions between the strong and weak. In fact, one common theme emerging from this recession and those past has been that firms that implemented good governance practices for monitoring performance and incentivizing the right behavior tend to fare much better than those that didn't. In the case of Lehman Brothers, the crisis' most storied disaster, poor oversight contributed to the destruction of over \$45 billion of wealth.

Lehman, like Enron before it, trumpeted Earnings Per Share as a guiding metric of performance and incentives ("Enron is laser-focused on earnings per share, and we expect to continue strong earnings performance" boasted the last Annual Report before the company imploded). Lehman reported significant EPS growth through 2007, and used rewarded managers according to pre-tax income. Both firms made their executives quite wealthy, assuming they didn't invest the proceeds of the incentive payments in company stock.

Earnings Per Share has long been known to be an incomplete measure, distorting the economic performance of firms across all sectors. By not accounting for the cost of equity capital, EPS doesn't consider all of the costs of running a business in presenting its profitability. This is especially problematic for financial institutions like Lehman, which reported a leverage ratio of 30.7x (16.1x on a net basis) for 2007. Such use of debt significantly increases the cost of equity.

To illustrate, consider a bank with \$1,000 of equity, \$1,000 initial debt, and 100 shares outstanding. In order to boost their returns and EPS, they increase leverage. Notice in the table below how as the firm moves from the initial 1.00x leverage ratio to 2.00x, EPS grows by a penny- the proceeds of \$1,000 earn 0.10% above the cost of borrowing, divided across 100 shares. As more debt is taken on, EPS balloons because the spread between the incremental returns and interest expense is earned on a larger pool of capital.

Meanwhile, the opportunity cost of equity capital is rising far above what is being earned on new investments. This is because equity is a junior claim to debt- in the event of bankruptcy, lenders

must be fully paid before anything goes to shareholders. Piling more debt on a bank's balance sheet serves to make the position of an equity holder more risky. Only when a leveraging strategy delivers incremental returns that cover this "levered" cost of equity (not the new interest expense) is the firm creating value.

Leverage	EPS	Rd	Incremental Return	Cost of Equity
1.00x	\$0.80	6.00%	n/a	9.13%
2.00x	\$0.81	6.00%	6.10%	10.75%
5.00x	\$0.89	6.25%	6.50%	15.63%
10.00x	\$1.64	7.00%	8.50%	23.75%
20.00x	\$3.89	7.75%	10.00%	40.00%
30.00x	\$6.89	9.00%	12.00%	56.25%

*Rd = After-Tax Cost of Borrowing*

*Incremental Return = Interest income on new funds raised*

Tying bonus payments to EPS performance clearly creates a perverse incentive for managers to increase risk at the expense of value creation. What's more, most banks typically don't employ a clawback policy that forces managers to recover any losses that occur before earning bonuses in future periods. By limiting the downside to bad performance, the plan has the mechanics of a call option, where risk *increases* the value of potential payouts, at the expense of investors.

EVA is a much more robust measure of performance because it adjusts returns for the risk taken to earn them. If a company participates in high-risk markets, EVA forces them to justify their existence with sufficiently strong profits or prospects. This mirrors the prudent way most people look at investment opportunities- they require higher returns when outcomes are uncertain. By adopting an investor's perspective in evaluating performance, EVA maintains a close linkage to changes in market value.

Several financial institutions that use EVA to measure performance, allocate capital, and compensate managers have weathered the global recession well, and are nicely positioned to outduel their less disciplined competitors in the coming recovery. BancorpSouth's shares were *up* in 2008 and the company even *increased* its dividend, while many of its peers in the regional banking and international investment bank arenas struggled to survive. After adopting EVA earlier in the decade, the company began incorporating the measure into capital allocation decisions, and went as far as calculating EVA down to the customer account level- efforts that generate long term benefit.

The embrace of an EVA framework is a step banks can take towards survival that doesn't rely on government intervention. In this crisis, as in the many past, the well managed companies engaged in activities that create value persist and grow, while laggards occasionally fail. The rest get their act together and improve their management. **Government intervention rarely**

**produces such sensible outcomes.** This most recent crisis will encourage all who survive to adopt better governance practices.