Economic Aspects of Value Creation from Share Holders Perspective

Dr. Santosh Kumar Tripathi
Principal
Marwar Business School, Gorakhpur

Abstract

Creating shareholder value is the key to success in today's marketplace. There is increasing pressure on corporate executives to measure, manage and report the creation of shareholder value on a regular basis. In the emerging field of shareholder value analysis, various measures have been developed that claim to quantify the creation of shareholder value and wealth. Corporate management has been placed under growing pressure to implement financial strategies that create value for its shareholders. Although maximizing shareholder wealth has become a paramount corporate mission, how this mission is to be achieved is much less certain. For many years, company executives and shareholders have relied to standard accounting measures are not reliably linked to increasing the value of a company' s shares. This occurs because earnings do not reflect changes in risk factor, nor do they take account of the cost of equity capital. So, the conclusions drawn on the basis of such measures create value is to earn sufficient economic returns to its shareholders. Two measures of financial performance that account properly for all ways in which value can be added or lost are Economic Value Added (EVA) and Market Value Added (MVA).

Keywords: *Shareholder, Corporate Management, Financial Performance etc.*

Research Methodology

The research paper based on secondary data collected.

The Objective of Study

- To study the value drivers.
- To study appropriate managerial processes.

Data Collection

Data has collected from newspaper, books, magazines, reports, and websites.

Introduction:

From the economist's viewpoint, value is created when management generates revenues over and above the economic costs to generate these revenues. Costs come from four sources: employee wages and benefits; material, supplies, and economic depreciation of physical assets; taxes; and the opportunity cost of using the capital. Under this value-based view, value is only created when revenues exceed all costs including a capital charge. This value accrues mostly to shareholders because they are the residual owners of the firm.

Shareholders expect management to generate value over and above the costs of resources consumed, including the cost of using capital. If suppliers of capital do not receive a fair return to compensate them for the risk they are taking, they will withdraw their capital in search of better returns, since value will be lost. A company that is destroying value will always struggle to attract further capital to finance expansion since it will be hamstrung by a share price that stands at a discount to the underlying value of its assets and by higher interest rates on debt or bank loans demanded by creditors.

Wealth creation refers to changes in the wealth of shareholders on a periodic (annual) basis. Applicable to exchange-listed firms, changes in shareholder wealth are inferred mostly from changes in stock prices, dividends paid, and equity raised during the period. Since stock prices reflect investor expectations about future cash flows, creating wealth for shareholders requires that the firm undertake investment decisions that have a positive net present value (NPV).

Although used interchangeably, there is a subtle difference between value creation and wealth creation. The value perspective is based on measuring value directly from accounting-based information with some adjustments, while the wealth perspective relies mainly on stock market information. For a publicly traded firm these two concepts are identical when (i) management provides all pertinent information to capital markets, and (ii) the markets believe and have confidence in management.

Marakan Associates, an international management-consulting firm founded in1978, has done pioneering work in the area of value-based management. This measure considers the difference between the ROE and required return on equity (cost of equity) as the source of value creation. This measure is a variation of the EV measures.

Instead of using capital as the entire base and the cost of capital for calculating the capital charge, this measure uses equity capital and the cost of equity to calculate the capital (equity) charge. Correspondingly, it uses economic value to equity holders (net of interest charges) rather than total firm value.

According to Marakan model shareholder wealth creation is measured as the difference between the market value3 and the book value of a firm's equity. Thee book value of a firm's equity, B, measures approximately the capital contributed by the shareholders, whereas the market value of equity, M, reflects how productively the firm has employed the capital contributed by the shareholders, as assessed by the stock market. Hence, the management creates value for shareholders if M exceeds B, decimates value if m is less than B, and maintains value is M is equal to B.

According to the Marakon model, the market-to-book values ratio is function of thee return on equity, the growth rate of dividends, and cost of equity.

For an all-equity firm, both EV and the equity-spread method will provide identical values because there are no interest charges and debt capital to consider. Even for a firm that relies on some debt, the two measures will lead to identical insights provided there are no extraordinary gains and losses, the capital structure is stable, and a proper re-estimation of the cost of equity and debt is conducted.

A market is attractive only if the equity spread and economic profit earned by the average competitor is positive. If the average competitor's equity spread and economic profit are negative, the market is unattractive.

For an all-equity firm, both EV and the equity spread method will provide identical values because there are no interest charges and debt capital to consider. Even for a firm that relies on some debt, the two measures will lead to identical insights provided there are no extraordinary gains and losses, the capital structure is stable, and a proper re-estimation of the cost of equity and debt is conducted.

A market is attractive only if the equity spread and economic profit earned by the average competitor is positive. If the average competitor's equity spread and economic profit are negative, the market is unattractive.

The Alcar group Inc. a management and software company, has developed an approach to value-based management which is based on discounted cash flow analysis. In this framework, the emphasis is not on annual performance but on valuing expected performance. The implied value measure is akin to valuing the firm based on its future cash flows and is the method most closely related to the DCF/NPV framework.

With this approach, one estimates future cash flows of the firm over a reasonable horizon, assigns a continuing (terminal) value at the end of the horizon, estimates the cost of capital, and then estimates the value of the firm by calculating the present value of these estimated cash flows. This method of valuing the firm is identical to that followed in calculating NPV in a capital-budgeting context. Since the computation arrives at the value of the firm, the implied value of the firm's equity can be determined by subtracting the value of the current debt from the estimated value of the firm. This value is the implied value of the equity of the firm.

To estimate whether the firm's management has created shareholder value, one subtracts the implied value at the beginning of the year from the value estimated at the end of the year, adjusting for any dividends paid during the year. If this difference is positive (i.e., the estimated value of the equity has increased during the year) management can be said to have created shareholder value.

The Alcar approach has been well received by financial analysts for two main reasons:

* It is conceptually sound as it employs the discounted cash flow framework
* Alcar have made available computer software to popularize their approach

However, the Alcar approach seems to suffer from two main shortcomings:

(1) In the Alcar approach, profitability is measured in terms of profit margin on sales. It is generally recognized that this is not a good index for comparative purposes.

(2) Essentially a verbal model, it is needlessly cumbersome. Hence it requires a fairly involved computer programme.

McKinsey & Company a leading international consultancy firm has developed an approach to value-based management which has been very well articulated by Tom Copeland, Tim Koller, and Jack Murrian of McKinsey & Company. According to them:

Properly executed, value based management is an approach to management whereby the company's overall aspirations, analytical techniques, and management processes are all aligned to help the company maximize its value by focusing decision making on the key drivers of value.

The key steps in the McKinsey approach to value-based maximization are as follows:

*Ensure the supremacy of value maximization
*Find the value drivers
*Establish appropriate managerial processes
*Implement value-based management philosophy

Economic Value Added

Consulting firm Stern Steward has developed the concept of Economic Value Added. Companies across a broad spectrum of industries and a wide range of companies have joined the EVA badwagon. EVA is a useful tool to measure the wealth generated by a company for its equity shareholders. In other words, it is a measure of residual income after meeting the necessary requirements for funds.

Computation of EVA:

EVA is essentially the surplus left after making an appropriate charge for capital employed in the business. It may be calculated by using following equation.

EVA= Net operating profit after tax- Cost charges for capital employed

EVA is net earnings in excess of the cost of capital supplied by lenders and shareholders. It represents the excess return (over and above the minimum required return) to shareholders; it is the net value added to shareholders.

In the above formula Net operating profit after tax [NOPAT] is calculated as follows:

NOPAT= PBIT (1-T)=PAT+INT (1-T)

Chief features of EVA Approach:

* It is a performance measure that ties directly, theoretically as well as empirically, to shareholder wealth creation.

* It converts accounting information into economic reality that is readily grasped by non-financial managers. It is a simple yet effective way of teaching business literacy to everyone.

* It serves as a guide to every decision from strategic planning to capital budgeting to acquisitions to operating decisions.

*It is an effective tool for investor communication.

- It is closest in both theory and construct to the net present value of a project in capital budgeting, as opposed to the IRR.

- The value of a firm, in DCF terms, can be written in terms of the EVA of projects in place and the present value of the EVA of future projects.

The Discount Cash Flow Approach

The true economic value of a firm or a business or a project or any strategy depends on the cash flows and the appropriate discount rate (commensurate with the risk of cash flow). There are several methods for calculating the present value of a firm or a business/division or a project. In following pages we will discuss three main methods that are mostly used under discount cash flow approach.

The **first** method uses the weighted average cost of debt and equity (WACC) to discount the net operating cash flows. When the value of a project with an estimated economic life or of a firm or business over a planning horizon is calculated, then an estimate of the terminal cash flows or value will also be made. Thus, the economic value of a project or business is:

Economic Value=Present Value of net operating cash flows+ Present value of terminal value

The **second** method of calculating the economic value explicitly incorporates the value created by financial leverage. The steps that are involved in this method of estimation of the firm's total value are as follows:

1. Estimate the firm's unlevered cash flows and terminal value
2. Determine the unlevered cost of capital
3. Discount the unlevered cash flows and terminal value by the unlevered cost of capital.
4. Calculate the present value of the interest tax shield discounting at the cost of debt.
5. Add these two values to obtain the levered firm's total value.
6. Subtract the value of debt from the total value to obtain the value of the firm's shares.

7. Divide the value of shares by the number of shares to obtain the economic value per share.

The **third** method to determine the shareholder economic value is to calculate the value of equity by discounting cash flows available to shareholders by the cost of equity. The present value of equity is given as below:

Economic value of equity= Present value of equity cash flows+ Present value of terminal investment

Conclusion:

The shareholder value creation approach helps to strengthen the competitive position of the firm by focusing on wealth creation. It provides an objective and consistent framework of evaluation and decision-making across all functions, departments and units of the firm. It can be easily implemented since cash flow data can be obtained by suitably adapting the firm's existing system of financial projection and planning. The only additional input needed is the cost of capital. The adoption of the shareholder value creation approach does require a change of the mind-set and educating managers about the shareholders value approach and its implementation.

References

Books

* Pandey I. M. "Financial Management", Vikas publishing house New Delhi
* Chandra Prasanna "Financial Management Theory and Practice, Tata McGraw-Hill, New Delhi Fifth Edition.

Website

www.Valuebasedmanagement.com

Newspaper

1) Times of India
2) Indian Express
3) Economy Times