1. **Introduction**

1.1 **Background of Shareholder Value Creation**

The capitalist firm being one of the prime economic institutions of a modern economy, analysis of its performance assumes immense significance. Analysis of the determinants of firm performance is of utmost importance to all stakeholders of a firm, especially to its common equity investors.

It was the famous economist *Alfred Marshall* in 1890, who first spoke about the notion of economic profit, in terms of the real profit that a company makes when it covers, besides the various operating costs, the cost of its invested capital (*Kyriazism and Anastassis, 2007*).

It is clear that under the Shareholder Value Creation (SVC) approach performance measurement gains a new meaning in contrast with the traditional approach which is merely based on the simple notions of accounting profits and the relevant ratios derived from them, such as the Return on Equity (RoE) and the Return on Assets (RoA) (*Kyriazism and Anastassis, 2007*).

The difference is that the traditional performance measurement benchmarks do not consider the cost of invested capital (equity and debt) in order to generate the profits made by a company. Thus, under the traditional approach two companies that have the same ROE would be considered as equally successful, whereas under the SVC approach the same conclusion could not be reached if these two firms had a different cost of capital, in other words if their economic profit or residual income was different (*Kyriazism and Anastassis, 2007*).

The modern day finance experts have started stressing on the Wealth Maximisation principle for the owners of the companies i.e. the Shareholders. The measure that concentrates on maximizing wealth is *Shareholder Value Creation*. 
1.2 Meaning of Shareholder Value Creation

Shareholder Value Creation is creating value for the real owners of the company – the Shareholders. To put it simply the returns generated by the company over and above the cost of capital is Shareholder Value. Some companies can therefore, be value creators (return higher than the cost capital) and also some can be value destroyers (return lower than the cost of capital).

The concept of Shareholder Value Creation was first introduced in United State of America. This has resulted in a stronger US economy and better business environment (Tsuji, 2006).

The background of this clearer focus on the maximization of corporate value as a central goal of management in USA is:

1) Activation of buying and selling of management rights such as by M&A,
2) Popularization of stocks for individual investors, and
3) Bankruptcy in pension plans (Tsuji, 2006).

The creation of shareholder value leads not only to the more effective management of those corporations, but also to increases in labour productivity, job opportunities, and real per capita GDP (Copeland et al. 2000).

1.3 History of Shareholder Value Creation

The Joint Stock Company form of business organization brought a major change in the manner the business was carried out and conducted. There came about separation between the owners and managers of business. The people, who managed business, were the trustees of the owners - of Shareholders

Profit (means Profit after Tax) has been the method of measuring business performance for antiquity. But using this measure for cross sector and cross company
comparisons became difficult as the interpretations started going haywire. This was because Profit After Tax as a concept does not take in to account the factors such as:

1. **Nature of business**: It does not consider whether the business is seasonal or regular, in growth phase or decline, capital intensive or labour intensive, competitive or monopoly, etc. It brings all the businesses to the same level and make ruthless decisions based on the same. For example: A Profit after Tax of Tata Steel of Rs 5000 crores is compared with a after tax profit of Rs 1.5 Lakh of a distributor of appliances and make no distinction between the two different businesses.

2. **Amount of capital invested**: Profit after Tax would also not consider issues such as what is the investment made in the business by the business units. For instance PAT would relate profits of two business units of Rs 100 as same without considering that one unit has invested Rs 1 Lakh and the other has invested Rs 2 Lakhs.

_Hawley_ (1886) was the one of the first to list out methods of measuring business performance. He suggested Profit after Tax was a good method to measure corporate efficiency but can get biased due to loading of non operating Incomes and Expenses. He, thus, professed the concept of Net Operating Profit after Tax to be a better measure than the mere Profit after Tax.

The absolute figures of either Profit after Tax or Net Operating Profit Tax lacked in the cross sector or company comparisons. There was a need felt to look at comparable variables which would make comparisons across company and sectors plausible.

The ratios and percentages, thus, started getting more and more prevalent in the world of finance for instance Net Profit Margin, Debt Equity Ratio, Return on Networth, Return on Capital Employed, etc.
1.4 Present context of performance measurement

The ethnic accounting measures such as Return on Asset, Return on Networth, Return on Capital Employed, etc have two major problem in terms that:

1. They are based on the historical costs and;

2. They do not consider the cost that the company incurred on the capital like Preference & Equity Share Capital as they are considered as appropriations and not as business expense.

These measures thus, concentrated on the short term objective of Profit Maximisation. This hindered the growth of the company as the decisions were all aimed at the short term goal.

*Stern and Stewart* modified the concept of Residual Profit as professed by *Alfred Marshall* and propagated a new measure of corporate efficiency namely Economic Value Added (EVA). EVA is a registered trademark of Stern, Stewart & Co. They annually publish EVA of 1000 US based companies. EVA is defined as an excess of Operating Profit after Tax over Cost of Capital.

*Tham and Pareza* (2004) supported the use of EVA by stating that while choosing a project the managers concentrate on the Cash Flows as discounted by the cost of capital then why the same managers ignore cost of capital while running a company?

*Chong, Fountaine, Her, & Philips* (2008) found a great utility in EVA to an extent that they discovered that EVA can be used to manage portfolios as the EVA-based stock portfolios were found to be similar to the S&P500 Index, but yet produced positive alphas across subsamples, an indication that EVA contains information beneficial to increasing shareholder wealth, even in bear markets. On closer examination of the EVA-based stock portfolios, it was suggested that in times of
market upswings, one should construct a portfolio based on lower EVA-ranked stocks, while switching to higher EVA-ranked stocks during market downturns.

Many studies have investigated EVA’s correlation with excess returns, back-testing it against the underlying companies’ actual wealth creation, as evidenced by subsequent stock price increases, or comparing it to market value added (MVA). The research, thus far, has been inconclusive.

Some studies have shown EVA to be robust and a viable management incentive device, whereas others show it to be less useful than some conventional measurements of financial success (Chong, Fountaine, Her, & Philips, 2008).

Brewer, Chandra and Hock (1999) have proved that EVA is a better performance measure in comparison to Return on investment.

One major critic of the EVA method is its methodology. The researchers such as Kramer and Pushner (1997) concluded that the results do not fully support the arguments of EVA proponents that it is the best internal measure of corporate success in adding value to shareholder investments.

Horngren, et al (1997) claim that more than 160 adjustments are expected to calculate EVA, which makes the process cumbersome and tedious. However, for all practical purposes the companies manipulate the accounting results with 5 to 75 adjustments.

Major critique came from Latin American scientist Pablo Fernandez. He criticised EVA on the basis that it is a method based on the historical accounting and thus, cannot be used as a measure of value creation and thus, corporate performance (Fernandez, 2002).

Pablo Fernandez has thus, formulated and proposed a model which is bettering of Total Shareholder Return (TSR) as proposed by Rappaport, that we call as The Pablo
Fernandez Model (PFM). In the model, he tries to calculate the Shareholder Value as excess of Shareholder Return (based on the market) over the cost of Equity.

There are, therefore, various researchers who argue in favour of Shareholder Value Creation as a better measure for measuring Corporate Performance and a lot of researchers argue in favour of traditional accounting measures.

Within the researchers, who argue in favour of Shareholder Value Creation as measures for corporate performance have contradictory results for methods such as EVA.

It must also be noted that most of the research on EVA and PFM has happened in west, whose markets are more efficient than Asian markets in general and Indian Markets in particular.

The research, thus, makes an attempt to find out the utility of Shareholder Value Creation measures represented by EVA and PFM in markets such as India.