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VALUE BASED MANAGEMENT
AND SHAREHOLDERS' VALUE CREATION
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VALUE BASED MANAGEMENT AND SHAREHOLDERS' VALUE CREATION

1.1 INTRODUCTION

Corporate world has been playing a vital role in job creation and wealth creation since industrial revolution. Not with standing only this but companies are having always a helping hand for sustainable growth of nation by a very good margin in contribution to GDP (Gross Domestic Product) of country. But before a decade, some corporate units damaged the overall impression of business world due to corporate scandal and financial fraud. This happens not only in developing country such as India but, it also threaten to advanced country of the world like U.S.A. The biggest example is collapse of ENRON is enough to understand for this. In India also, the financial fraud made in Satyam Company is the only example enough for understanding these kinds of non-ethical practice in business.

But now at the beginning of the 21st century, gone these days. The new development of modern management approach is a demand of the time. These are improving organisational performance, adopting Total Quality Management (TQM), empowerment and continuous improvement. Throughout reengineering and team building is must and most for management to create value for shareholders. Value Based Management is generally accepted by most of management in corporate world. Good corporate governance may be important perquisite to lead super performance of company which ultimately gives better return to investors and shareholders. Providing long- term value is best understood. This view is also endorsed by the International corporate Governance Network.

1.2 THE CONCEPT OF VALUE BASED MANAGEMENT

The basic concept of value base management is very simple. The company must create value for their shareholder and also for stakeholders. Value is created only when companies return on invested capital is higher than its cost of Capital. The properly execution and implementation of VBM (Value Based Management) in
company, should be an approach to management. Overall aspirations, analytical technique and management process for decision making are key drivers of values. When VBM (Value Based Management) is working well, it is easy to maximise wealth for shareholders, stakeholders and ultimately company’s value also added. These are the foundation of value based management. The management require a value creation mind-set that senior managers are fully aware about their ultimate financial goal of maximizing value. Other objectives are imperative. The managers must know whether value is created by increasing revenue growth or by improving margins. Adopting VBM and finding of value drivers are getting half-way success. Basically value of a company is determined by its discounted future cash flows but VBM extend this concept. VBM become popular in 1980, when Rappaport published a book “Crating Shareholders Value : The new standards for business work”. When the accounting profit calculated as per the norms of GAAP (Generally Accepted Accounting Principles) such as EPS (Earning per share) do not give real financial position of company thereafter Value Based Management started to measure financial performance of business ,whether a company generating wealth for shareholders or destroying wealth of their shareholders.

1.3 SHAREHOLDERS VALUE AND THE COST OF CAPITAL

The main feature of managing shareholders value is the cost of equity capital. Company should accept that shareholder capital has also cost at all. While calculating value creation, cost of capital should also be considered. Computation of cost of Preference share capital is simple and easy also because return or dividend paid to preference shareholders is fixed and amount of return is predetermined also. But computing cost of equity share capital is laborious and some difficult also. The main reason is that there is no fix rate of dividend for equity shareholders of a company. The rate of return for equity capital is uncertain. Cost of equity share capital is also known as an opportunity cost. That means if equity shareholders invest their amount rather than in company’s share, at least expected rate of return can easily be earned. So company must pay return as equal to opportunity cost.

There are many methods developed for computation of cost equity capital. Among all methods, CAPM (Capital Asset Pricing Method) method is mostly used for calculations of cost of capital purpose. Under the CAPM (Capital Asset Pricing
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Method), cost of capital is evaluated by weighted average cost of capital. The capital is written in decimal point which used in mathematics. The heart of WACC (weighted average cost of capital) is that at least a company should earn such NOPAT (Net Operating Profit after Tax) which can meet its cost of capital. When NOPAT is exceed than cost of capital , it means company is creating value for their shareholders and Vis-a-versa, if cost of capital exceeds NOPAT, shareholders wealth is destroyed by the company.

Computing the cost of capital is relates with the return on new investment than actually happened in past period. It is determined by the risk to which equity shareholders are exposed. Company should be more vigil and exact while computing cost of capital.

1.4 SHAREHOLDERS’ VALUE CREATION

After introduction of LPG (Liberalisation, Privatization and Globalization) in corporate world, the vision and mission of company changed. India also saw large scale changes in the market and the economy as a whole since 1990. Any business enterprise, how focus on interest and benefit and betterment for their owner (shareholders). Each and every kinds of company’s main objective should be to maximise wealth or value of their shareholders and stakeholders. The approach of modern management focus to develop long–term and sustainable perspectives of business and business promoters means investors of company. Globalization has brought threshold for company and management.

The main aim of any corporate unit must be the protection of shareholders interest and create shareholders’ value through professional management.

For Implementation of value based management, corporate governance framework should be adopted in business, which ensure value and accountability. Corporate governance is known as a philosophy and mechanism that involves process, system and structure which, used to direct, control and manage the business of the company. It also works toward prosperity and corporate accountability and ethics of business with ultimate goal of long-term shareholders’ value and interest of other stakeholders.
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Creating value is not a ready–reckoner or ready to use formula but competitive economic profit and long-term sustainable growth rate is heart of success of business. The VBM focus on strategic planning. Knight (1998) said that “Managing for value begins with strategy and ends with financial effect”.2 “Successful strategy” is a result of well planned and disciplined decision making method of company. The decision making process should be transparent that help companies to understand whether value is created or destroyed. Understanding value drivers and their interactions is hardest part of developing strategy. For demonstrate empirical cause-and-effect relationships between the different categories of value drivers and value creation and future financial results.

A company should attempt to achieve with its investment, financing and dividend policy. The Vision, Value and Mission of corporate in broad term are concerned about technology, management, productivity, market, image, profitability, financial resources, employees etc. Some illustration of mission and value of highly reputed Corporate units of India are narrated as below:

❖ Ranbaxy’s Mission and Values.

<table>
<thead>
<tr>
<th>Mission</th>
</tr>
</thead>
<tbody>
<tr>
<td>To become research based international pharmaceutical company</td>
</tr>
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</table>

<table>
<thead>
<tr>
<th>Values</th>
</tr>
</thead>
<tbody>
<tr>
<td>➢ Achieving customers satisfaction</td>
</tr>
<tr>
<td>➢ Provide product and services of the highest quality</td>
</tr>
<tr>
<td>➢ Practice dignity and equity and relationship</td>
</tr>
<tr>
<td>➢ Provide opportunities for our people to realize their full potential.</td>
</tr>
<tr>
<td>➢ Ensure profitable growth and enhance wealth of the shareholders.</td>
</tr>
<tr>
<td>➢ Be a responsible corporate citizen.</td>
</tr>
</tbody>
</table>

(Source : www.ranbaxy.com)
Hindustan Lever Limited’s Corporate Purpose

- Our purpose in Unilever is to meet the everyday needs of people every time to anticipate the aspiration of our customers and to respond creatively and competitively with branded product and services which raise the quality of life.
- Our deep roots in local cultures and more around the world are our unparalleled and inheritance and the foundation for our future growth.
- Our long term success requires a total commitment to exceptional standards of performance and productivity, to working to gather effectively and to Willingness to accept new ideas and learn continuously.
- We believe that to succeed requires the highest standards of corporate behaviours toward our employee, customers and the societies and world in which we live.
- This Unilever’s road to sustainable profitable growth for our business and long term value creation for our shareholders and employees.

(Sources: www.hul.com)

The investors and shareholders of company don’t want to know the past performance or past life of company but keenly interested about future of company and wants to know how the company likely to perform in future day.

1.5 SHAREHOLDERS’ VALUE MEASUREMENT

After recognizing a critical limitation of traditional accounting for measuring performance of company, a number of financial consultant such as Alfred Rappaport (1986) and Stern Stewart (1991), developed latest one methods for measuring financial performance of company. It resulted into the concept of shareholders’ value and creation of wealth for shareholders. Some most popular and widely used shareholders value measurement (metrics) are as bellows:
1.5.1 Shareholders’ Value Analysis (SVA)

1.5.2 Market Value Added (MVA)

1.5.3 Economic Profit (EP)

1.5.4 Economic Value Added (EVA)

1.5.5 Total Business Return (TBR)

1.5.6 Cash Flow Return on Investment (CFROI)

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In many companies in United Kingdom and in other countries, above metrics has been used. Some reputed companies in India like Hindustan Lever, Reliance Industries Ltd., Infosys Technologies etc. accepted value creation a central place in their corporate planning and serve as a role-model for others. Greater attention is being paid now to link up management compensation to shareholders’ value returns.

1.5.1 Shareholders’ Value Analysis (SVA)

In 1980, Alfred Rappaport developed Shareholders’ Value Analysis. The value of operation of a company is determined by discounting expected future operation. “Free Cash Flow” at an appropriate cost of capital. To find shareholders’ value, value of marketable securities should be added and value of debt be deducted from business valuation. Free cash flow is a cash flow from business operation. Free cash flow can be obtained as shown in the below table:

<table>
<thead>
<tr>
<th>Table of Showing Generation of Free Cash Flow</th>
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</thead>
<tbody>
<tr>
<td>Sales</td>
</tr>
<tr>
<td>Less: Operating Cost</td>
</tr>
<tr>
<td>Operating Profit</td>
</tr>
<tr>
<td>Add: Depreciation</td>
</tr>
<tr>
<td>Less: Cash tax on Profit</td>
</tr>
<tr>
<td>Operating Profit after Tax</td>
</tr>
<tr>
<td>Less: Investment in fixed capital</td>
</tr>
<tr>
<td>Less: Investment in working capital</td>
</tr>
<tr>
<td>Free Cash Flow From Operations</td>
</tr>
</tbody>
</table>
Free Cash Flow for all future years should be estimated for this purpose. On a year by year, future value of each component of free cash flow should be estimated separately for better and exact result.

There are mainly seven value driver for determination of free cash flow, these are as below:

- Annual sales growth rate in percentage
- Operating profit margin (before interest and tax)
- Rate of Corporate Income-tax
- Incremental fixed capital investment rate
- Rate of Investment in working capital
- Planning horizon
- Cost of capital

For this, the basic assumption is that, business will earn an average of its cost of capital. Assumption often made that the cash flow which come out in final year of the planning will continue to rise in future also.

**Critics of Shareholders’ Value Analysis:**

Only seven drivers for cash flow is not enough, more division and sub-division of these may give a better result and more perfection can be achieved to measure the performance. Though it is a sensitive analysis with changes in assumption of value of business. It is a helpful way of identifying the critical changes which effect to shareholders value.

**1.5.2 Market Value Added (MVA)**

Market value added is known as a difference between market price of shares and book price of shares.

\[
\text{MVA} = \text{Market value of shares} – \text{Book value of shares}
\]

\[
\text{MVA} = \text{Market capitalization shares} – \text{Net worth}
\]
Generally when market capitalization is higher than net worth of a company that means company creates wealth or value for their shareholder. But when, market capitalization is lesser than net worth, in such case wealth of shareholders’ destroyed by a company.

Shareholders value added = Market Value Added + Equity Dividend

MVA measures financial health and wealth of a company’s performance, it is an external tool for financial performance measurement.

1.5.3 Economics Profit (EP)

Shareholders value also can be determined by using economic profit. Residual income is known as economic profit which measures divisional performance of business. Economic profit is most popular and used in economics. In 1890, well known Economist Alfred Marshal, introduced such kind of theories. Economic profit mean that opportunity cost be deducted from the revenue. Opportunity cost that is alternative return. Economic profit is a surplus of earning, by deducting all expenses including cost of capital. It also describe as a difference between return on capital and cost of capital.

Calculation of Economic Profit:

(1) Economic Profit = Invested Capital \times (\text{Return on Investment} - \text{WACC})

(2) Economic Profit = \text{Operating Profit after tax} - \text{Capital charges}

Generally, it can be said that if economic profit is earn by a company, than it creates shareholders’ wealth, but when economic profit is not earned or it is negative, the company exactly destroyed wealth of their shareholders. For the betterment of shareholders’ value creation, operating profit after tax must be higher than its capital charges. Alternatively, capital charges should be lesser than its operating profit. Arriving to the heart point is that , a company should and must earn its operating profit after tax which can sufficient to meet their cost of capital.
Advantages of Economic Profit:

- Business valuation can be done through economic profit.
- It can be used to measure financial performance of a company.
- It is relatively straightforward.
- Its significant is that amount of tax and capital charges deducted from reported net profit of a company.

Limitations of Economic Profit:

- Its major drawback is that the data and figures obtained from traditional accounting.
- It ignores inflation and depreciation.

Though economic profit approach is helpful and useful for computation of cost of capital and return on capital.

1.5.4 Economic Value Added (EVA)

In 1991, Stern Stewart introduced the concept of Economic Value Added. EVA is a surplus amount of Net Operating Profit over its Cost of capital. The heart of EVA is that, a company’s NOPAT (Net Operating Profit after Tax) must be so sufficient that can easily meet its cost of capital. If net operating profit is higher than cost of capital, that means company creates value for their shareholders. But in case, if cost of capital is higher than NOPAT, company destroyed their shareholders’ wealth.

Formula:

\[ EVA = NOPAT - COCE \]

\[ EVA = NOPAT – \text{Capital charges} \]
Where,

\[
EVA = \text{Economic value added} \\
\text{NOPAT} = \text{Net operating profit after tax} \\
\text{COCE} = \text{Cost of capital employed (Capital} \times \text{WACC)} \\
\text{WACC} = \text{Weighted average cost of capital}
\]

**Advantages of EVA:**

- It measures business performance.
- Help to take managerial decisions.
- Improve financial literacy.
- Incentives for management with shareholders interest.
- For calculation cost of equity, CAPM. (Capital asset pricing method) is used.
- Some market factors like beta, risk free rate, rate of return etc. used in EVA calculation.

The calculation of EVA is much complicated and time consumption. The factors of adjustment also affect the result of EVA. Although EVA is very popular. The fortune magazine quote that “To-day’s hottest financial ideas and getting hotter”. Various companies from different types of industries in India adopted EVA. Management Guru, Peter Drucker also support to EVA. That is the real value of EVA.

1.5.5 Total Business Return (TBR)

Boston consulting Group (BCG) developed Total Business Return and Total shareholders Return approach to shareholders value management. Total business return is an internal counterpart of total shareholders return.

1. Total Shareholders Return (TSR)

TSR is a rate of return which earn by shareholders from stock or shares of a company. It is computed as below:

\[
\text{TSR} = \frac{\text{Dividend}}{\text{Opening market value}} + \frac{\text{(Closing market value} - \text{opening market value})}{\text{Opening market value}}
\]
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Total Shareholders’ Return is computed by using the internal rate of return. It is a comprehensive method which considered amount of dividend. TSR is popular one method which also used by many business units.

2. Total Business Return (TBR)

Total Business Return is an internal counter part of Total Shareholders’ Return, the link between TSR, TBR and value drivers is shown as under:

\[
TBR = \frac{\text{Free case flow}}{\text{opening value}} + \frac{(\text{Closing value} - \text{Opening value})}{\text{Opening value}}
\]
Total Business Return is calculated by using internal rate of return. The opening and closing value estimates market values of business. They are estimated by using the following

\[
\text{Value} = \text{Earnings} \times \text{P/E multiple}
\]

\[
\text{Value} = \text{Book value} \times \text{M/B multiple}
\]

\[
\text{Value} = \text{Free cash flow} \div \text{cost of capital}
\]

\[
\text{Value} = \text{Net Present value of expected Cash Flow}
\]

1.5.6 Cash Flow Return on Investment (CFROI)

The cash flow return on investment measures a company’s cash return on invested assets. It is determined by twelve dozen cash flow of company by its gross investment.

Definition of CFROI

“The sustainable cash flow generate by business in a particular time period as a percentage of cash invested in the assets of a company”.

Sustainable cash flow = Gross cash flow – Economic depreciation

\[
\text{CFROI} = \frac{(\text{Cash flow} - \text{Economic depreciation})}{\text{Cash invested}}
\]

Economic depreciation is the amount of annual sinking fund payment earning, cost of capital required to replace assets. CFROI include the principle of inner-rate of return, which is related with appraisal of capital investment opportunities. It also represents ‘discount rate’ which discount the future annual cash flow.

Calculation of CFROI:

- Convert account profit into real cash flow.
- Adjust non-cash and non-operating item from P/L account.
- Value of capital invested convert into inflation adjusted investment.
- Gross assets treat as current cost.
- Exclude goodwill from current asset.
Ultimately cash performance is converted into a measure of economic performance. Average life of assets of a company to be known and value of non-depreciating assets such as working capital be estimated.

\[
\text{Gross operating assets} = \frac{CF_1}{(1 + r)} + \frac{CF_2}{(1 + r)^2} + \cdots + \frac{CF_t}{(1 + r)^t} + \frac{NDA}{(1 + r)^t}
\]

CF= real cash flow

NDA= non depreciating assets

CFROI can be compared as a real cost of capital of a company, to identify the increase performance of CFROI. Investing at a Positive performance will create shareholders’ value.

1.5.7 Cash Value Added (CVA)

Boston Consulting Group (BCG) also developed cash value added (CVA) for measuring financial performance of a company. CVA is measured as operating cash flow less economic depreciation less capital charges on gross investment.

\[
\text{CVA} = \text{Cash flow} - \text{Economic depreciation} - \text{Capital charges on Gross investment}
\]

Cash value added concept removes the accounting distortion. BCG claims that CVA is better than EVA.

1.6 MANAGING SHAREHOLDERS’ VALUE

It is very clear that for a long-term succeed and sustainable growth of a company, should walk with the changing world and have to keep changing. For the betterment of individual corporate unit and creating value for their shareholders new tools and techniques such as VBM (Value Based Management) be adopted warmly. For managing shareholders value creation in a company, following steps should be taken:
1.6.1 (Good) Corporate Governance

Good governance is the key to success in long run. It is important to have effective governance system to protect shareholders value. Ethics is the foundation for sustainable growth of business. Management should undergo the process of ethics audit of the business of company and interest of their stakeholders. All the strategic decision should be taken on the basis of pragmatism and through proper way of channel. Top management of company must support to the VBM programme.

1.6.2 Employee’s Education

Employees, now perfectly termed as human resource, should be well trained about value based management. Actually they are the carriers of fruit of success of a company. For this, employee’s performance should be admired and incentives be given to them. Management should focus on better two-way communication and better work culture to bring harmony in a company. The incentive bonus system and no cap for bonus amount should be practiced. Some welfare scheme like pension, gratuity, cash bonus, paid leave for maternity, transportation, accommodation etc. be provided to employees. These facilities will create a dynamic result.

1.6.3 Changing the Culture

Creating value is a continuous cycle, supported by the sum of strategic and operational decision made throughout in the company. Effective communication and information system, be introduced and implemented into company culture. A financial expertise required for such concept like “discount cash flow” and “cost of capital”. Core values as bellows should be included:

- Pursuit of excellence.
- Faith in people.
- Customer orientation.
- Effective communication.
- Control over the cost.

In successful companies VBM explicitly associated with a few key senior individuals. They have delegated authority to make necessary change.
1.6.4 Structure and Loyalty

Value Based Management (VBM) has an impact on most aspects of organizational life including structure. It is something typical to map the current decision process to create value of shareholders. But implementing corporate governance and accountability in business structure, is having all and everything for a company. In business, must tend to demonstrate greater sense of loyalty to each other. For success, passion, and commitment for the business which resulted into value creation of shareholders. Healthy and amicable relationship and belongingness develop loyalty. To know the performance, adoption of the balanced score card is considered a unique step for a business. The company can developed its operational efficiency at global level.

1.5.6 Stakeholders

VBM work and emphasise greatly for shareholders value creation but it can not ignore stakeholders’ value. Environmental and social value also be considered. A company can only increase wealth for their shareholders, when its product meets the need of society. There is a direct link between value maximization and stakeholder value. Those companies, who fails to add value to their shareholders, definitely also not able to satisfy their stakeholders.

1.6.6 Innovation

When the world, become a global village, customer’s preference smoothly transfers from one existing product to another one. There are multinational companies to compete in the market. For development and sustainable growth of a company, must introduce novelty and varieties of products for their customers. Diversification of a business, should also a matter for better future. Using with latest technologies and professionalism in business, overall shareholders’ value and wealth would be created.

1.7 LIMITATIONS OF VALUE BASED MANAGEMENT

- In India financial literacy of employees is not remarkable, so limitation of such skilled human resource made hurdles on the road of VBM.
- Equity shareholders in India are yet not much aware for their fundamental rights in the company.
Ethical value and accountability in business in Indian culture, is yet to be a big size matters for a corporate company.

In real practice VBM and calculation of VBM is lethargic, laborious and typical.

Computation of cost of capital, some components such as expected rate of return, beta, risk free rate etc. have their own limitation which minimize power of VBM.

Structured value maximising programme and lack of the resources also effect VBM approach.

1.8. CONCLUSION

Value Based Management programme and Creating Value for Shareholders’ is now accepted globally as a corporate objective. It is a powerful tool to measure a financial performance of a company. It also set a benchmark of performance. By adopting VBM, Positive effect is made to reduce the cost of capital. However value added statement and market value added purely relate with external performance, while economic value added relate with internal measure of financial performance.

In the era of globalization, introduction of value based management, definitely help to create shareholders’ wealth.
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