Value Creation, Measurement and Approaches of Shareholders

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Abstract: The present day tools and techniques of shareholder value creation and Measurement. 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.

Keywords: Share Holders Value Creation, Measurement, Approach, Implementation

I. INTRODUCTION

Globalization has increased calls for corporations to use firms' resources to help alleviate a wide variety of social problems. These calls for expanded responsibilities for business are intuitively appealing to those who see existing governments as unable or unwilling to deal with such problems. Firms may indeed have resources that could be used to help with issues that are typically dealt with by governments or other nongovernmental organization. This paper aims to explain what shareholder value creation means, and how the present emphasis on shareholder value measurement as a strategic initiative developed in management practice and the present day tools and techniques of shareholder value creation and Measurement.

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.

More than ever, corporate executives are under increasing pressure to demonstrate on a regular basis that they are creating shareholder value. This pressure has led to an emergence of a variety of measures that claim to quantify value-creating performance.

Creating value for shareholders is now a widely accepted corporate objective. The interest in value creation has been stimulated by several developments.

- Capital markets are becoming increasingly global. Investors can readily shift investments to higher yielding, often foreign, opportunities.
- Institutional investors, which traditionally were passive investors, have begun exerting influence on corporate managements to create value for shareholders.
- Corporate governance is shifting, with owners now demanding accountability from corporate executives. Manifestations of the increased assertiveness of shareholders include the necessity for executives to justify their compensation levels, and well-publicized lists of under performing companies and overpaid executives.
- Business press is emphasizing shareholder value creation in performance rating exercises.
- Greater attention is being paid to link top management compensation to shareholder returns.

II. ANALYSIS AND INTERPRETATION

A. Shareholder Value Approaches

1. McKinsey Approach

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

2. Alcar Approach

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 Discounted Cash Flow (DCF)/ Net Present Value (NPV) framework.

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 Net Present Value (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:

1. It is conceptually sound as it employs the discounted cash flow framework
2. 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.

3. Marakan Approach

Marakan Associates, an international management-consulting firm founded in 1978, 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 Economic Value 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 value and the book value of a firm's equity. Thee book value of a firm's equity, A, measures approximately the capital contributed by the shareholders, whereas the market value of equity, N, 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 N exceeds A, decimates value if m is less than A, and maintains value is N is equal to A.

According to the Marakan 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 Economic Value 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.

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4. Economic Value Added

Consulting firm Stern Steward has developed the concept of Economic Value Added (EVA). Companies across a broad spectrum of industries and a wide range of companies have joined the Economic Value Added (EVA) badwagon. Economic Value Added 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**

Economic Value Added (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.

\[
\text{Economic Value Added (EVA)} = \text{Net operating profit after tax - Cost charges for capital employed}
\]

Economic Value Added (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 \( [\text{NOPAT}] \) is calculated as follows:

\[
\text{NOPAT} = \text{PBIT} (1-T) = \text{PAT} + \text{INT} (1-T)
\]

**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 Internal Rate of Return (IRR).
- The value of a firm, in Discounted Cash Flows (DCF) terms, can be written in terms of the Economic Value Added of projects in place and the present value of the Economic Value Added of future projects.

5. 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:

\[
\text{Economic Value} = \text{Present Value of Net Operating Cash Flows} + \text{Present Value of Terminal Value}
\]

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:

\[
\text{Economic Value of Equity} = \text{Present Value of Equity Cash Flows} + \text{Present Value of Terminal Investment}
\]

**B. Shareholder Value Management**

The criteria for valuation of equity shares proposed by Benjamin Graham, hailed as the father of the subject of Security Analysis.

Benjamin Graham’s Quality and Valuation Criteria for Value Stocks

**Adequate Size**

For India let us specify that it has to be Rs.100 crore in sales.

**Strong Financial Condition**

Current assets should be at least twice current liabilities.

Long-term debt should not exceed the net current assets

Or

Total Debt-equity ratio is to be less than 1:1

**Earnings Stability**

Some earnings for the common stock in each of the past ten years.

**Dividend Record**

Uninterrupted dividend payments for at least the past 20 years.

**Earnings Growth**

A minimum growth rate equal growth in national income over the last 7 years.

**Moderate Price/Earnings Ratio**

Current price should not be more than 20 times average earnings of the past seven years for the best companies. To give a more specific instruction, set the multiplier equal to the growth rate in EPS in percentage in the last 7 years subject to a maximum value of 20.

Or

Current price should not be more than 15 times average earnings of the past three years for the best companies.

**Moderate Ration of Price to Assets**

Current Price should not be more than 1.5 times the book value last reported. As a rule the product of the multiplier times the ratio of price to book value should not exceed 22.5.

Rules of Graham highlight the importance of earnings per share (EPS) as a determinant of share prices and values. Benjamin Graham taught Security Analysis at Columbia University during 1928 to 1956. Prior to Graham the book value of the company was the important benchmark for the valuation of equity shares. Despite the popularity of Graham’s classes and books the valuation principles of Graham were not embraced wholeheartedly by the stock market participants. Most of the active investors preferred P/E ratios based on single year EPS figures. Also the emphasis was much more on fluctuations. Hence there were no clear cut guidelines on the ratio to be applied. One thing became a rule, increases in EPS are generally welcome and are likely to be followed by share price increases. Decreases in EPS are followed by share price declines. In this paradigm, companies concentrated on reporting increasing EPS figures.

**C. Evaluation Shareholder Value Strategy**

“Finance theory rests on the premise that the goal of the firm should be to maximize the wealth of its current shareholders”. Corporate finance theory since from its origin was developed on the above premise. The financial managers are supposed to take decisions, which help to create additional value or wealth for current shareholders of the company. This goal probably remained as the goal of the finance management function only and rest of the organization may not be assessing its decisions on the touchstone of shareholder value or wealth building. Also, even today shareholders are given accounts of past transactions only. They do not know what the management is going to do in the future and how it is going to protect their wealth and increase it. The financial reporting profession mandated that only audited record of the past transactions are made available to capital market participants to make their decisions regarding fair prices to buy and sell equity shares in the market.

**CONCLUSION**

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. Globalization has increased calls for corporations to use firms' resources to help alleviate a wide variety of social problems. These calls for expanded responsibilities for business are intuitively appealing to those who see existing governments as unable or unwilling to deal with such problems. Firms may indeed have resources that could be used to help with issues that are typically dealt with by governments or other nongovernmental organization.

Reference and Notes


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