

The Investigation and Analysis Application Factors in Financial Decision with Focused on Criteria of Shareholder Value Added and it's Effects on Market Performance Evaluation

Mahmoud Samadi Largani ; Mohammad Taleghani

Department of Management & Accounting, Tonekabon branch, Islamic Azad University, Tonekabon, Iran

ABSTRACT

In today's competitive world, value and wealth creation for shareholders are among the most important goals of businesses. For the sake of achieving his goals, the investor needs some instruments in order to measure the potential value of each investment opportunity. It is clear that these instruments are not capable of predicting the exact future, they just provide some piece of information and advice that help the investor in the decisions he makes. Among these criteria, the most common types are Return on Investment (ROI) and Earnings per Share (EPS). Despite the numerous applications of these instruments, theoretically, they are not related with shareholders' value or wealth creation. In recent years, the modern evaluation techniques based on economic theories such as Economic Value Added (EVA), Market Value Added (MVA), Refined Economic Value Added (REVA), Shareholder Value Added (SVA), Cash Value Added (CVA), and Adjusted Economic Value Added (AEVA) replace the accounting data-based criteria and have widely drawn the attentions. These criteria follow the performance assessment with regard to the changes in the value and alongside maximizing the long-term shareholder returns. In this paper, one of the most important criteria; i.e. Shareholder Value Added (SVA), is investigated from several viewpoints.

KEYWORDS: Market Performance Evaluation, Shareholder Value Added, Financial Decisions.

1. INTRODUCTION

New performance evaluation criteria are closely related to shareholder value. These criteria are reflected in the future. Investors believe that inflation and market risk at all times is impressive and worth the money.[6] while The value driver model is a comprehensive approach that canter on seven key drivers of shareholder value i.e. sales growth rate, operating profit margin, cash tax rate, fixed capital needs, working capital needs, cost of capital and planning period or value growth duration.

It can be used to estimate the value of the shareholders' stake in a company or business unit, and can also be used as the basis for formulating and evaluating strategic decisions. The value of the operations of a business is determined by discounting expected future operating "free cash flows" at an appropriate cost of capital. In order to find shareholder value, the value of "marketable securities and other investments" must be added to, and the value of debt must be subtracted from, the business valuation.

The drivers which distinguish the value approach from the traditional (the use of accounting measures such as return on assets) are as follows:

- ❖ Revenue Growth - can improve NOPAT and thus SVA
- ❖ Operating Margin - revenue and cost efficiencies to maximize shareholder value
- ❖ Working Capital - management of inventory, debtors and creditors to optimize revenue growth and decrease costs.
- ❖ Fixed Assets - disposal of surplus/non-performing assets and investment in assets which will create returns in excess of WACC.
- ❖ WACC - optimization of the debt/equity mix to reduce overall costs of capital

Therefore, measures of financial performance based on traditional values is to improve overall performance and evaluation criteria used in the calculation of the cost of capital [9,15]. While the company mainly focused on creating maximum shareholder value is also important to note that the net present value of all activities should make a positive return. Value-based measures of financial performance, as the guide management in achieving these objectives have been developed [3].

Shareholder Value Added

The measure has been described by Rappaport [11]. Who is regarded as one of the most prominent publicists in the field of shareholder value metrics[1].

SVA criteria for evaluating the performance of value-based management (VBM) is considered. This measure of shareholder value at the weighted average cost of capital investment compared with shows [11].

The SVA method has rooted from experiences connected with using the discounted cash flow model (DCF) [13].

In fact, SVA, the idea is that shareholders' money should give a higher return than could be earned by investing in other assets at the same level of risk. Value creation is virtually guaranteed when a company's return on capital exceeds its cost of capital. In sharp contrast, accounting profitability does not necessarily lead to value creation. In fact, in many cases, profitable projects actually destroy the value of the company [5].

Pablo Fernandez (2002) is of the opinion that accounting based measures (including EVA, Economic Profit, Cash Value Added), being historic in nature does not measure value creation [4].

SVA method of calculation is as follows:

$$\text{SVA} = \text{NOPAT} - (\text{WACC} \times \text{CAPITAL})$$

The first step in calculating SVA is to calculate NOPAT; the second step is to estimate capital employed; the third step is to estimate the appropriate WACC; the fourth step is to calculate the capital charge; and the fifth step is to calculate SVA.

NOPAT is an operating performance measure after taking account of taxation, but before any financing costs. Interest is totally excluded from NOPAT as it appears implicitly in the capital charge. NOPAT also requires further equity-equivalent adjustments. Capital costs include both the cost of debt finance and the cost of equity finance. The cost of these sources of finance is reflected by the return required by the funds provider, be they a lender or a shareholder. This capital cost is referred to as the Weighted Average Cost of Capital (WACC) and is determined having regard to the relative capital structure of the business. The WACC is used in SVA as the minimum hurdle rate of return the GBE needs to exceed for value to be added.

According to Rappaport, the value of a company can be broken down into three main components: the current value of cash flow from operations during the forecast period, the residual value and the market value of marketable security [8].

The SVA analysis with predictable cash flows, all courses are scheduled to begin.

- 1) **Calculate the residual value** through the end of each year cash flow before investment in new capitalizing.
- 2) **Discounted cash flow and residual value with cost of capital.**

In this view, (SVA) is defined as the difference between the present value of incremental cash flow before new investment and the present value of investment in fixed and working capital

$$\text{SVA} = (\text{PV of cash flow from operations during the forecast period} + \text{residual value}) - \text{Debt}$$

Residual value: The Residual value of company's is Free Cash Flow in year n by the discounted rate is the equal to the cost of capital.

3. The difference between the Created shareholder value (CSV) with SVA :

Created shareholder value: A company creates value for the shareholders when the shareholder return exceeds the share cost (the required return to equity).

$$\text{Created shareholder value} = \text{Equity market value} * (\text{Shareholder return} - K_e)$$

Or

$$\text{Created shareholder value} = \text{Shareholder value added} - (\text{Equity market value} \times K_e)$$

4. The difference between EMV1 With SVA

The Equity Market Value of Company's Market Value that is each share's price multiplied by the number of shares. The increase of Equity Market Value in one year is the Equity Market Value at the end of that year less the Equity Market Value at the end of the previous year. The Equity Market Value is also called as Capitalization.[7]

$$\text{EMV} = \text{Treasury securities are guaranteed a long-term interest rate} + \text{premium risk}$$

The Shareholder Value also is calculated as follows:

Shareholder Value Added	=	Increase of Equity Market Value
	+	Dividends paid during the year
	+	Other payments to shareholders (discounts on par value, share buybacks...)
	-	Outlays for capital increases, exercise of options and warrants
	-	Conversion of convertible debentures.

¹ Equity Market Value

Rappaport summarizes the main relationships within the shareholder value concept in a succinct chart (Figure 1)

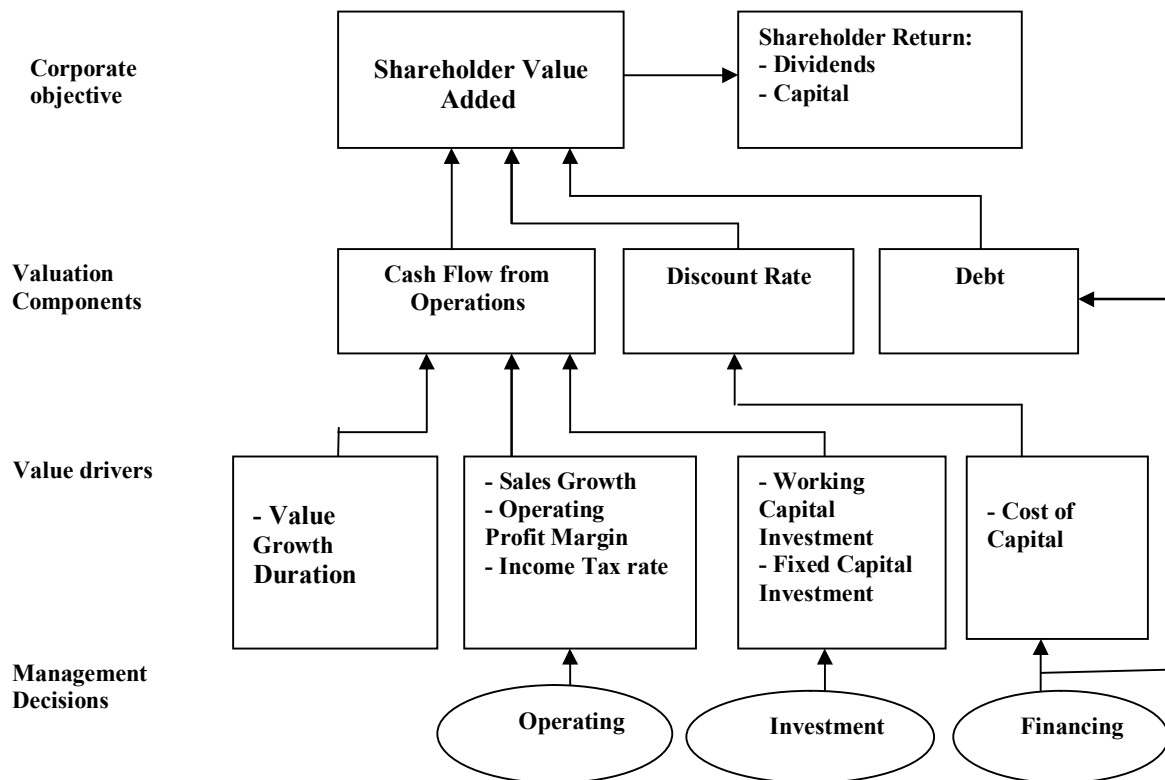


Figure 1. Rappaport's shareholder value network [8]

Shareholder returns (SR)

The Shareholder Return is the Shareholder value added in one year, divided by the Equity Market Value at the beginning of the year.

Shareholder Return = Shareholder Value Added/Equity Market Value

We saw that the company creates value if the shareholder return exceeds the required return (and it destroys value in the opposite case). However, the shareholder return is often compared with other benchmarks⁵. The most common Benchmarks are (Figure 2) [8]:

- Zero.** If the shareholder return is positive (above zero), the shareholders have more money in nominal terms than at the beginning of the year.
- The return of Treasury bonds.** If the shareholder return exceeds that of investing in Treasury bonds, the shareholders have obtained an additional return for bearing more risk.
- Required return to equity (also called cost of Equity).** If the shareholder return exceeds the expected return, the company has created value.

Required return on equity = return of long-term treasury bonds + risk premium

- Shareholder returns of companies in the same industry.** If the shareholder return exceeds the shareholder return of companies in the same industry, the company has created more value than the other companies in its industry (for an equal investment and risk).

- Return of the stock market index.** If the shareholder return exceeds the return of the stock market index, the company has outperformed the market as a whole.

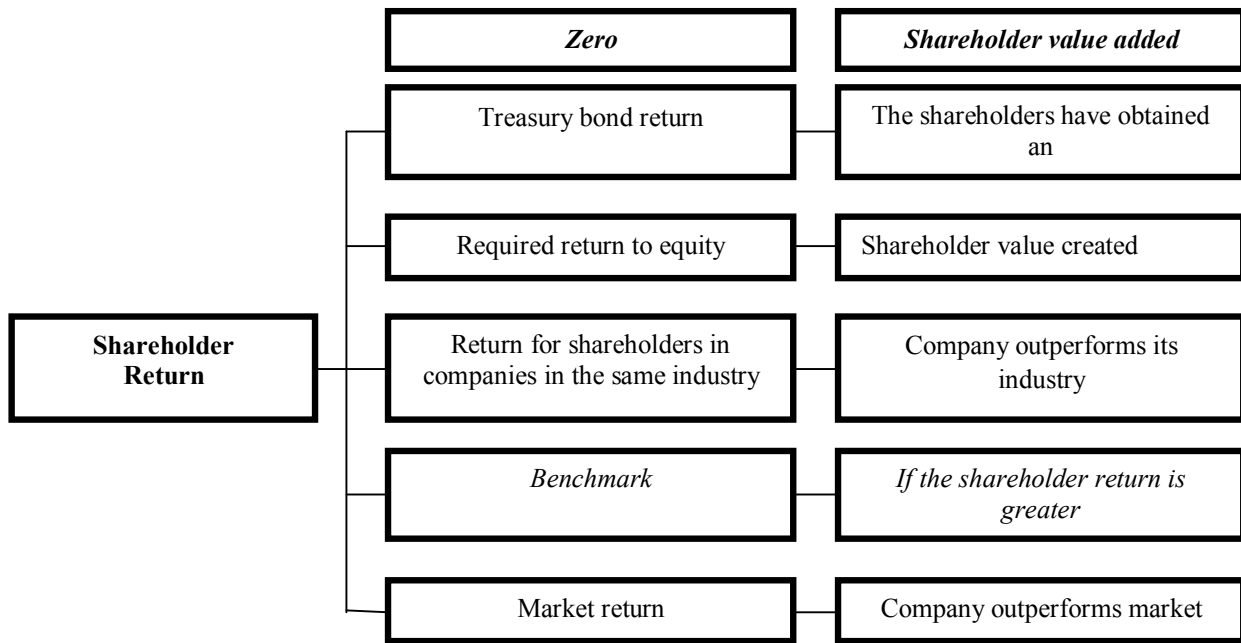


Figure 2. Comparing different benchmarks with Shareholder return [12].

Major factors which can create added value for a firm

Some of the major factors which help to create added value are the followings:

- **Cost leadership and differentiation.** Michael Porter distinguishes between two types of competitive advantage: cost leadership and differentiation. If a company decides on a cost leadership strategy, its aim will be to achieve the lowest costs in its industry for producing a given good or service. With a strategy of differentiation, a company attempts to set itself apart from its competitors by picking out features which the customers want and which cannot be copied by other companies in the same market.
- **Organization.** Constant change demands technological leadership from companies if they are to survive in the global market.
- **Strategic innovation.** Strategic innovations do more than simply help achieve a competitive advantage – they also help to undermine the position of competitors.
- **Compensation and incentives.** The division of ownership and control in major public companies produces what are known as agency costs.
- **Optimizing capital structure.** Since higher indebtedness often increases the overall costs of capital, a company can create added value for its shareholders by repaying surplus (equity) capital. In doing this, it has basically three options: dividends (e.g. super dividends or bonus dividends), share buy-backs or reducing the par value of equity securities.
- **Financial engineering.** In the financial sector, in particular, there are a number of ways in which financial engineering can increase the value of a company. For example, an acquisition might release synergies by creating an “internal capital market”. As a result, operating loans can be made from free cash flow instead of being sought externally, or different currency positions can be netted against each other.
- **Communications.** Information is a key factor in maximizing shareholder value. The more favorable investors judge the risk and return opportunities to be, the more likely they are to make their capital available to companies on favorable terms.

Advantages and disadvantages of SVA

SVA is an important variable that has important distinctive features that separate it from the traditional accounting measures. This criterion was used because the amount of capital a business is examined. SVA combination of existing data on the income statement and balance sheet in order to determine which of these data, and investors are used to display the total additional return.

The use of SVA will be of significant benefit as an additional tool used to provide insightful advice to both management and shareholders [14]. Compared with EVA, Mills and Print express their preference in favor of SVA because the driver tree model appears to be very useful in helping managers to understand the dynamics of value creation.

SVA widely as a tool to be considered in deciding the level of business communication that exists between it and business strategy (Figure 3), focuses on three areas:

At the broadest level, the link between SVA and business strategy focuses on three main areas:

- improvement in operating decisions to maintain and/or increase NOPAT;
- investment in projects which provide a positive contribution to SVA; and
- reducing capital which does not earn an economic profit. e.g. divesting loss making activities, or economizing on working capital/assets

The sole concentration on shareholder value has been widely criticized. While shareholder value benefits the owners of a corporation financially, it does not provide a clear measure of corporate social responsibility and environmental issues like employment, ethical business practices. A management decision can maximize shareholder value while lowering the welfare of the local communities, the workers employed and the environment. Additionally, short term focus on shareholder value can be harmful to long term shareholder value; the expense of tricks that briefly boost a stock's value can have negative impacts on its long term value.

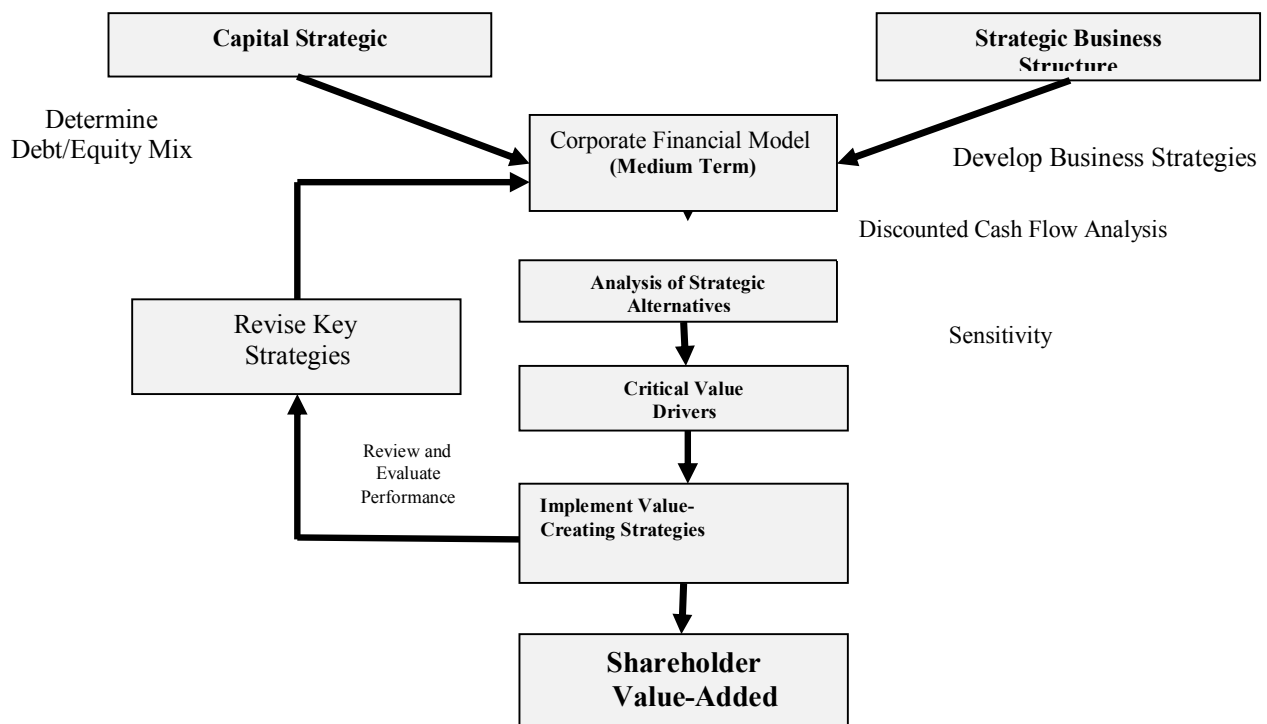


Figure 3. The Value Creation Process [14].

SVA summary a clear direction for managing grown businesses in exchange for, or reduce the efficiency of capital investment provides.

7- Conclusion

Performance assessment can be the result of both financial and non-financial nature such as the number of complaints and the time of delivery (Customer Satisfaction Index). Generally, there are various criteria for the performance assessment of companies. Implementing the inappropriate criteria for performance assessment ends in the situation where the company's value is not directed toward the real value, and, as a result, causes the loss of a group of shareholders and the abundant profit of the other group. Thus, among the different criteria of performance assessment, the economic criteria, in comparison with traditional (Accounting-based) criteria, attempt to convert the accounting information to economic information through some modifications and make it the basis of companies' performance assessment. As mentioned in this paper, SVA, as a separate criterion from other value-based criteria, is capable of describing Shareholder Return (SR); i.e., by increase in a company's SVA, SR increases. Finally, with respect to the criticisms made by the researchers of financial field, it is necessary, by realizing innovative criteria, to take a firm step in order to make accurate decisions in financing, operating and investing sections.

REFERENCES

1. COPELAND T.E. (1994), Why value? *The McKinsey Quarterly*, no. 4, pp. 97-109.
2. DECHOW P.M., HUTTON A.P. and SLOAN R.G. (1999), An empirical assessment of the
3. Erasmus, PD (2008). The relative and incremental information content of the value based financial performance measure cash value added (CVA).
4. Fernandez.P. (2002) A Definition of Shareholder Value Creation, Research Paper no. 448.
5. Froud J., Haslam C., Johal S. Williams K., Shareholder value and financialization: consultancy promises, management moves, "Economy and Society" Volume 29 Number 1, February 2000, p. 80-110
6. Iva Hovezakova, BA, (2010), The project of the Economic Value Added implementation into the management of the company XY so in order to raise its economic performance
7. Jalaja, (2010), Shareholder Value Creation in India-a sect oral analysis.
8. Laura Giurca, (2007), NEW APPROACHES ON SHAREHOLDERS VALUE OF A FIRM, Faculty of Economy and Business Administration, University of Craiova
9. Lehn, KL, & Makhija, AK (1996). EVA and MVA as performance measures and signals for strategic change. *Strategy and Leadership*, 24 (3), 34-40.
10. Nikoumram, Hashem, and Asgari, Mohammad reza (2009), the Model For Location Expected returns Exchange Papers Tehran Stock With Use Of Indices, EVA, REVA, EPS, and the EP.
11. Rappaport A., Creating shareholder value: The new standard for business performance, New York Free Press, 1986.
12. Fernandez.P. (2001) A Definition of Shareholder Value Creation, IESE business school.
13. Szymanski P., Zarządzanie Majątkiem Obrotowym w procesie kreowania wartości przedsiębiorstwa, PhD thesis, Akademia Ekonomiczna i'm. Oskara Langego we Wrocławiu, 7. July 2005
14. Tasmania Department of Treasury and Finance, Shareholder Value Added a discussion paper for government, business, enterprises and state-owned companies, July 1999.
15. Young, SD, & O, Byrne, SF (2001) EVA and value-based management: A practical guide to implementation. New York: McGraw Hill.