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Explaining Necessary Conditions of Value Creation Using Shareholder Value Creation Process

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ABSTRACT

Shareholders value creation is the most important goal of a company. Recent studies illustrated that just one seventh of companies are able to create long term shareholder value. In this paper, the sources of value creation has been analyzed, 11 main sources has been discovered. These sources have been analyzed by their sustained shareholders and the process of value creation has been offered. Finally, the required conditions in creation of economical value have been extracted. It is shown that for creating value and making economical profit, at least, one of the value creation factors should be enforced in such a way that do not disturb other factors. If these conditions do not exist, then shareholder value growth would not happen.
KEYWORDS: Shareholder Value creation process, long term shareholder value creation, economic value, corporation objective

INTRODUCTION

Shareholder value creation and main sources of value

Several articles analyses the main goal of companies (Jensen, 2001) expressed the shareholder value creation are the fundamental goal of companies. Although there are various debates in this area that are against as (Freeman, Wicks, & Parmar, 2004) say that the goal of each company is the stakeholder value, but it is obvious that they are saying one thing in common, value creation. The difference and their debate are about value distribution. (Ameels, Bruggeman, & Scheipers, 2002) On the other side, argued that if the stakeholder theory be considered as the goal of corporation, it can concluded that among all stakeholders, shareholders are the most prominent one and they have first priority between all. (Bender & Ward, 2009) concluded that considering value creation of shareholders in both theories is acceptable but with different emphasis and they can be graded differently.

Corporation objective and shareholder value:

(Zook & Allen, 1999)reported that only one seventh of companies can gain sustained shareholder value. In this report it would be considered 10 years period as a long term. Also, (Slywotzky, Morrison, & Quella, 1998)showed that among a list including 15 companies with highest level of income throughout the world, just 2 companies are among them create value for shareholders. Also among 15 companies with highest level of profit, only 7 small companies do so. (Fernández & Bermejo, 2009) in 2008 showed that among the list of DOW JONES just two companies have created shareholders value. (Kennedy, 2002) notified that two third of the excellence scholars (Peters & Robert H. Waterman, 1982) faced with problems after 5 years. This case is true for half of companies noted in (Collins & Porras, 1994) after 10 years. (Slywotzky, 1996) expressed that being large is not necessarily important and companies should try to create value. The most recent research of this area (Fernandez, Aguirreamalloa, & Corres, 2011) showed that among 30 highest market price companies in 1999 that were listed in S&P500, only 6 companies were creating positive values between 1993 to 2010 and the others has been losing their value.

Because of the importance of this issue, it is clear that researches analyses it from different view point. Several researches, consider different sources to create long term value creation.

Main Source of Shareholder Value Creation:

In following table the most important sources of value creation is presented:

1- Sustained competitive advantage appears in most researches and would be considered as the most important factor of shareholder value creation.
2- Long term investment is another factor that several resources pointed out.

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3- (Zook & Allen, 2004)showed that 3 factors; size of company, growth of industry and growth of company will not have any effect on long term value shareholder value creation .

4- Shareholders value creation in many aspects and several debates occurred among scientists. These debates especially in economical crisis period will be intensified. The most challenging debate has been done in (Sundaram & Inkpen, 2004)and(Jensen, 2001). These papers that are followers of shareholders values creation, believe that several goals is not useful for the company and make managers confuse. Maximizing long term value of shareholders makes them much more advantages and values that is much better for stakeholders. Instead, (Freeman, Wicks, & Parmar, 2004) believes that paying attention to stakeholders is fundamental for reaching long term shareholder value and having several goals for managers is not hard for managers at all and it is not avoidable in this complicated world. (Kaplan & Norton, 2004) in line with several and some time contradiction goals. (Martin, 2010) use customers value as a solution instead of shareholders value and stakeholder value and show that organizations benefit from this method could gain long term value of shareholders.

Table 1. Shareholder Value Sources

References / Shareholder Value Sources	Freeman, Wicks, & Parmar,) (2004	(Martin, 2010)	(Bowman & Ambrosini, 2000)	Ameels, Bruggeman, &) (Scheipers, 2002	(Brealey, Myers, & Allen, 2008)	(Pindyck & Rubinfeld, 2009)	(Slywotzky, 1996)	(Zook & Allen, 2001)	(Kaplan & Norton, 2004)	(Rapparport, 2000)	(Rappaport, 2006)
Competitive Advantage			*	*	*	*	*	*	*	*	*
sale growth rate									*	*	
Profit margin and Productivity									*	*	
Targeted investment				*	*					*	*
Making strategic decisions				*							*
Keeping valuable sources			*			*					*
Human resource management system	*		*	*							*
Dividend to shareholder				*							*
Other Stakeholders	*										
Customers	*	*	*			*	*				
Business model							*				
Related diversification									*		

5- For gaining long term value of shareholders, lots of researches focuses on stakeholders .In other words, they consider long term value of shareholders as the goal and attention to stakeholders as a tool. For example (Bowman & Ambrosini, 2000) argued human resource and keeping valuable resources as driver of shareholder value creation. (Rappaport, 2006) emphasis on the attention to managers and employees. Also, it expressed whenever the opportunities in the market are not attractive; more shares' profit should be distributed among shareholders for increasing the attractiveness of the organization for investment. (Slywotzky, 1996) expressed that value decrease is because the business models get old fashioned. (Ameels, Bruggeman, & Scheipers, 2002) introduces several systems for awarding.

6- (Rappaport, 1983) argued that strategic planning should be financially evaluated. (Rapparport, 2000) invented the word of shareholder value And presented main factors on shareholder value for the first time and made strategies based on them. His final list is (Rappaport, 2006).

RESEARCH METHODOLOGY

(Priem & Butler, 2001)&(Godfrey & Hill, 1995)says that most conceptual research in management are based on logical positivism for their research method . In this way, propositions are extracted based on searching right inputs and developed on the basis of research goals. So, the accuracy of research results is valid based on the literature(Colquitt & Zapata-Phelan, 2007). These researches are known as conceptual researches and their goal is to develop the concept based on the literature, logics and mathematics(Godfrey & Hill, 1995). The researches that are based on logical positivism can be divided into two parts: theory building, and theory testing (Colquitt & Zapata-Phelan, 2007).

Theory building

In these researches, building managerial theories is the goal. These researches based on the literature and using valid laws and theorem, there would be more valuable conclusions that their accuracy will be confirmed according to the literature (Whetten, 1989)and (Corley & Gioia, 2011).

Theory testing

In these researches, findings of theory building researchers are testes in real world and the results will be reported. Then, reported results and theories will be corrected. These researches will be investigated, most of the time separated from theory building research(Colquitt & Zapata-Phelan, 2007).

In this article, the goal is to explain the value creation according to different stakeholders. So, logical positivism is used to extract the process of shareholder value creation. In this way, three different aspects of literatures merged together to coherent investigation of value creation and, necessary conditions get extracted based on this basis. The aim of this research is developing logical propositions. Theory building is to present necessary conditions for value creation. Testing these conditions in different industries is considered to be further researches.

The process of value creation:

Value creation is a process which begins from investor with specialization of financial sources. Managers accumulate financial resources and use them in several projects (Bender & Ward, 2009)The final result of all personnel and human resources change into goods. Goods have use value and utility for customers will pay the exchange value in a price form. (Besanko, Dranove, Shanley, & Schaefer, 2009) (Lepak, Smith, & Taylor, 2007) and (Bowman & Ambrosini, 2000).

So depend on the view point and according to the literature this process can be divided into three parts.

Value creation from investors view point

Value creation form managers view point

Value creation from business view point

Value creation from investors' view point

Investor is going to increase the profit of his stocks. So, he makes some investments that have more output and less risk.

Long term investors:

(Graham & Dodd, 1934) present a way to know when the best time for selling and buying stocks is. It was named value investment and was based on knowing intrinsic value of stock. That was based on the intrinsic value whenever the stock price was more than this value, It should be sold and whenever it was less than this value it should be bought (Graham & Dodd, 1949)

$$\begin{aligned} P \succ IV \rightarrow \text{Sell} \\ P \prec IV \rightarrow \text{Buy} \end{aligned} \tag{1}$$

Where:

P- Share price

IV- intrinsic value of stocks

In fact, it said that the price is willingness to pay of stock buying that is different from intrinsic value. In the long run, stocks will reach to intrinsic and fundamental value. So, whenever you hear that intrinsic value is less than stocks' price, this equation will not last and price decrease to reach the intrinsic value level. So, now it is time of selling. Conversely, whenever the price was less than intrinsic value, since the price increase through long time to reach to intrinsic value, it is time to buy. Obviously, this method for selling and buying stock is applicable in the long run (Bender & Ward, 2009).

Long run investor is going to make more profit with less risk in the long run. He invests in companies which have high intrinsic value. It will gain at the time company can keep his competitive advantage and created value with more possibility (Bender & Ward, 2009) So consistency of competitive advantage can create value for long term investors (Brealey, Myers, & Allen, 2008).

Short term investors:

Against long term investor, short term investor will merely work based on the fluctuation of stocks' price whether it create value or not. Methods as offering unexpectedly high level of profit, more than what is common in market make stocks to be more attractive and investors tend to buy more, their price becomes permanently high and make inconsistent value (Fernandez, 2002) illustrated this by a mathematical evaluation. So paying efficient stock profit is a source for creating value for short term investors. On the other hand, (Rappaport, 2006) express that regarding this case that a company may not be at top for a while and it may not create value, whenever there was not any good chance to create a value, making investing attractiveness by paying the profit of stocks can be an effective way for sustaining value.

Value creation form manager's view point:

Top management involves in making strategic decisions and is looking for creating and sustaining competitive advantage where the company has monopoly power and can have more profit. It can be saved in two ways:

1- Making limitation in market entrance (Porter, 1997)
2- Sustaining valuable resource (Barney, 1991)

Also top management works with update business model along with environmental uncertainty (Slywotzky, 1996).

So, the sources of value creation from top management are: competitive advantage, saving valuable resources and business model.

Value creation from financial manager's view point:

Top management invests money in several projects by collecting money from shareholders. In fact, project includes several strategies that management can choose and have special financial aspects as entering new market, buying another company, and so on.

Top management is going to choose a set of projects that have more NPV. Although most references as (Brealey, Myers, & Allen, 2008) look into competitive effects evaluations but this process deal merely with evaluating strategic choices and cannot create and formulate strategic choices. So first strategic formulation delivered and then best strategy will be selected.

So, the source of shareholder value creation in this respect is a good investment.

Value creation from other managers' view point:

Other managers most of the times think about improving productivity, cost decrease, rise of profit margin and focus on optimization of resources especially human resources. So, value creation resources in this area are productivity improvement, raising profit margin and human resources.

Economical profit, value calculation index from manager's view point

Economical view:

Business is looking for gaining profit using its resources. This profit should be more than the opportunity cost that is spent for using sources. In general, business is deal with two profit; accounting and economical. Accounting profit contrary to economic profit is that type of profit in which no opportunity cost is included. (Mankiw, 2011).

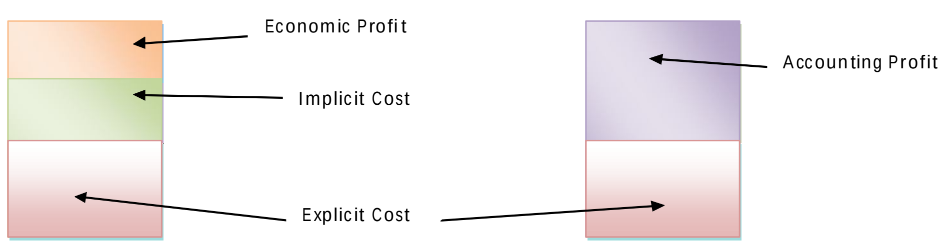

Fig. 1 Economical and accounting profit (Mankiw, 2011)

So following equations exists:

$$\begin{aligned} EP &= AP - OC \\ AP &= RV - C \qquad (2) \\ EP &= RV - OC - C \end{aligned}$$

Where EP, AP, OC, RV, C means economical profit, accounting profit, opportunity cost ,income, explicit cost respectively.

Investment view

In investment view, it is supposed that shareholders invest in this organization and whenever they want can get their money out. Keeping stocks and not selling shares requires the organization to make them reach to the least expected profit that is the expense of a chance that total stock will have and should be deducted from annual profit. So, in recent years generally management board will receive awards from share holders according to the formula of value creation (Ameels, Bruggeman, & Scheipers, 2002) EVA is used for analyzing awards.

$$EVA = IC \times (ROIC - WACC) \qquad (3)$$

Where, EVA, IC, ROIC, WACC means economical value added, invested capital, return on invested capital, Weighted average cost of capital, respectively.

In fact, a business will create value whenever it can gain more profit than cost of capital.

Value creations from customer's view point

Customer buy goods or services because consuming their goods make surplus grow(Pindyck & Rubinfeld, 2009). Producers sell goods to increase their own welfare (Mankiw, 2011).

Value creation is the summation of consumer and producer welfare (Jelassi & Enders, 2005) In fact, customers and producers divide value created among them and each use their surplus of producer and customer (Besanko, Dranove, Shanley, & Schaefer, 2009).

In other words, organizations will make goods using their own resources. This goods have use value (Bowman & Ambrosini, 2000).Use value is defined as the value that customer feel (Lepak, Smith, & Taylor, 2007) Whenever the expense of used sources is paid by producers what is remained is value created (Besanko, Dranove, Shanley, & Schaefer, 2009)that will be divided between seller and buyer according to the rate of bargaining (Brandenburger & Stuart, 1996).

It is clear that whenever a customer is going to buy goods, he should pay money that is the price of it. That is exchange value that customer should pay to use its advantage. In fact, exchange value determines a part of value created that will be done for customer and producer. In fig. 2, this issue is analyzed.

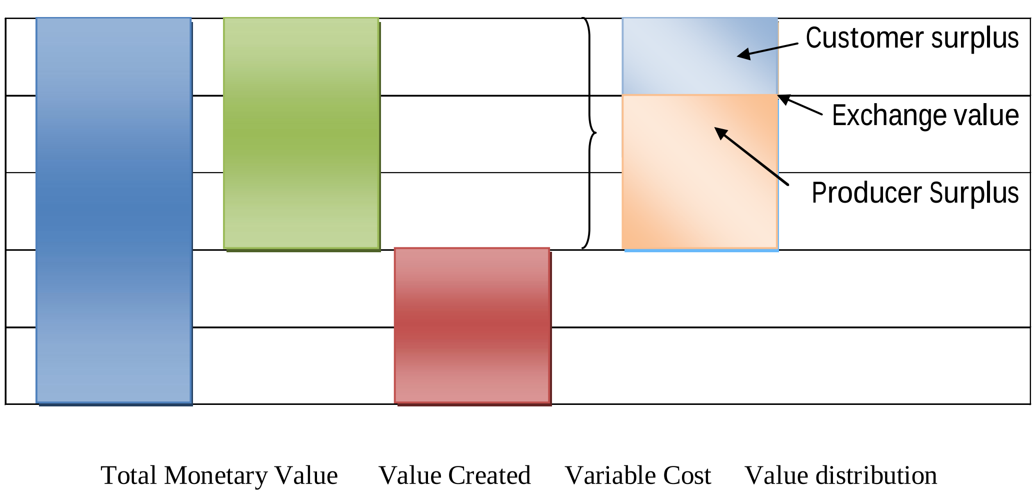

Fig. 2 value creation from customers view point

Accordingly, following equations can be concluded:
Total Monetary Value=Value Created+ Variable Cost
Value Created=Consumer Surplus Producer Surplus (4)
Total Monetary Value- Price=Consumer Surplus
Price-Variable Cost=Producer Surplus

Also, in literature following terms are equal:

Total Monetary Value=Consumer Benefit (5)
Exchange Value=Price

So, we will have:

Total Monetary Value- Exchange Value =Consumer Surplus
Exchange Value – Variable Cost=Producer Surplus (6)

It is clear that customers buy goods that make higher welfare. The reverse is also true. Businesses are interested in those markets that are able to make higher welfare. Thus, each one is going to increase their bargaining power by exchange value.

Notice:
In mentioned equations, by expense we mean variable cost and not total cost of production and not average cost (Pindyck & Rubinfeld, 2009) .The reason is that whenever the equilibrium of demand and supply occur, the only thing that will increase is variable cost that are for production of each goods and fixed cost that are used at the beginning have not changed and they will not enter into value and price equation and they should be deducted. In next section this will be done in order to calculate economic profit.
Excessive welfare of producer and economical profit:
Current calculations were done to calculate producer surplus and economic profit

$$\begin{aligned}
&\text{Total Producer Surplus} = (P - VC) \times Q = R - TVC \\
&\text{Economic Profit} = \text{Total Producer Surplus} - FC = R - TVC - FC \qquad (7) \\
&\text{Economic Profit} = R - TVC - FC = P \times Q - TC = (P - AC) \times Q \\
&\rightarrow \text{Economic Profit} = (P - AC) \times Q
\end{aligned}$$

Where,
EP, P, AC, VC, TVC, Q, FC, R, TC, refer to economic profit, Price, Average Cost, Variable Cost, Total Variable Cost, Quantity, Fixed Cost, Revenue, and Total Cost, respectively.

Three conditions must be analyzed for finding when economic profit happen:

a) $P - AC \succ \circ$

In this situation, the business will start creating value.
So, economic profit is different created value and producer surplus. As it is mentioned, created value refers to customer and producer surplus. It is that part of created value that is based on exchange value and is given to producers. Economic profit means deduction of fixed expenses from total amount of producer surplus. In monopoly markets, this might happen most of the time and the organizations are interested in making economic profit.

b) $P - AC = \circ$

Whenever this equation becomes zero, it shows that business has accounting profit and not economical profit but it is not going to exclude from the industry in the long run. That is because accounting profit equals with opportunity cost. In competitive markets this happens.

c) $P - AC \prec \circ$

In this way, the organization will go out of the industry in the long run, although accounting profit may still be available. That is because created accounting profit is less than opportunity cost and profit would not cover costs (Pindyck & Rubinfeld, 2009).

RESULTS

The relationship between value creation process from investors and managers view point:

It can be shown that whenever economic profit decreases, it will become equal with intrinsic value of the stocks (Koller, Goedhart, & Wessels, 2010).So this criteria is not a type of short term index and whenever a company in each period makes economic profit, intrinsic value of stocks will increase in the long run and investors will tend to invest more. It is clear that whenever a company invest in a period of time that will be utilized in future, economic profit can become negative in some periods but the intrinsic value will stay high(Bender & Ward, 2009). So, this notification should be considered by managing directors at the time of investment.

The relationship between value creation process from managers and customers view point:

$$\text{Economic Profit} = R - TVC - FC$$

$$\text{Economic Profit} = (P - VC) \times Q - FC \tag{8}$$

$$\rightarrow \text{Average Economic Profit} = \text{Producer Surplus} - \text{Average Fixed Cost}$$

From relation 8, following results can be concluded:

1- Producer surplus is a necessary condition for creating economic profit. So it is possible that a company be unsuccessful in creating shareholders value although it create producer surplus.
2- In order to reach to average economic profit of each goods, average fixed cost should be deducted from producer surplus.

The result of all three processes with each other and extracting value creating conditions:

The intrinsic value of stocks of an investor will increase and he will be more interested in investment whenever the managers create value. On the other hand, managers create value when situation that they produce goods whose producer surplus that is more than its fixed expenses. Then, it can be concluded that long term value creation of shareholders depends on the situation that producers surplus be more than fixed costs of goods. Now, the question is that when producer surplus is more than average fixed expenses?

Fig. 3 will show this much more clearly:

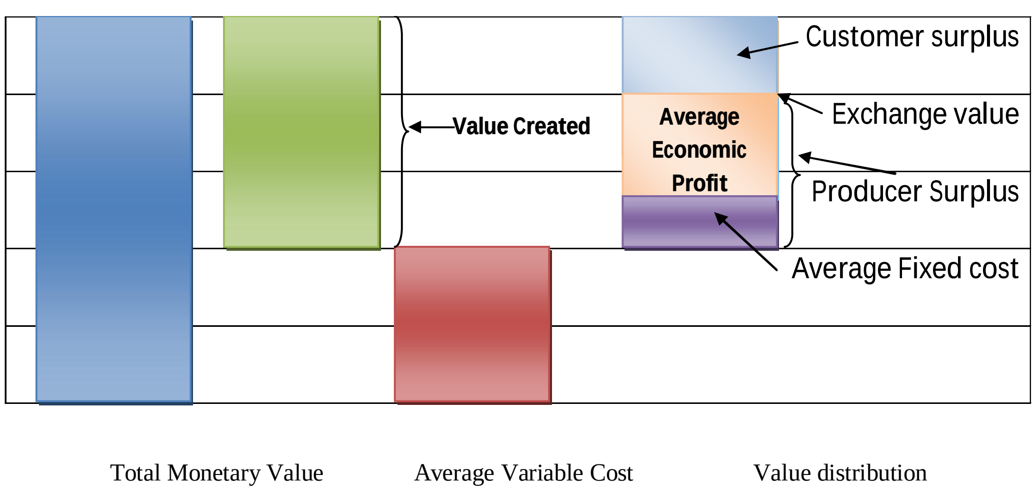

Fig. 3 Average economic profit

The average economic profit can be increased as follows:

a) Decreasing of average fixed cost
b) Decreasing consumer surplus
c) Increasing use value

As you have seen in table 1, literature refers into 11 sources. These sources can simply be related to three above method of economic profit. This relation will be evaluated as follows:

a) Decreasing of average fixed cost
Actually means increasing productivity. For example, using production in scale and increasing sale growth can help productivity promotion and increase average economic value.

b) Decreasing consumer surplus
Benefit from competitive advantage and making strategic decisions make the increase the ability of bargaining power in front of customers. This make customers have less customer surplus .Protecting valuable sources and entering market with low competitor rivalry make have less consumer surplus.

c) Increasing use value
Generally, profitable investment, especially related diversification that is makes better production and cause customers to benefit from value. On the other hand, dividing profit share is a good mean for attracting investment and developing suitable products. This case is also true for award of human resource since people make more attempts for creating more valuable product and the interest for value creation will increase. Suitable business model results in supporting customers' needs.

Necessary condition of shareholder value creation:

(Coff, 1999) argued that competitive advantage and value creation may not lead to performance and shareholder value creation. This happen when stakeholder's bargaining power absorbs those values that have been created. Thus these conditions that argued in this paper only necessary conditions of shareholder value creation and not sufficient.

CONCLUSION

At the beginning of this article it was expressed that the main goal of business is sustainable value creation. As it is mentioned, only one seventh of companies were able to gain this goal. It is illustrated that there are 11 sources of value creation. These resources were more investigated by value creation process and it becomes clear that value creation can be expressed by different viewpoints. It is showed that different process is absolutely related to each other. According to mathematical relations, the definition of average economical profit is extracted and necessary conditions for long term shareholder value creation are extracted.

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