MEASURING SHAREHOLDERS' WEALTH BY ECONOMIC VALUE ADDED : AN ANALYSIS

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This article critically analyses the technique of EVA employed by the companies to measure their shareholders' wealth. The paper highlights the shortcomings, if any, in the working of the case study units and suggests the required corrective measures so as to improve shareholders' wealth.

I.   INTRODUCTION

The main objective of financial management is shareholders' wealth maximization. That is, the finance manager should try to maximize the value of the enterprise for its shareholders. Value is represented by market price of company common stock. Basically, the market value (MV) of share is a function of two factors : (a) earning per share of the company; and (b) the capitalization rate.

The MV of firm's share is the way through which shareholders evaluate firm's efficiency in employing their capital. Value will be created if MV of share is greater than BV (Book Value) of shares. Traditional approaches to measuring shareholder value creation have used parameters such as earning capitalization, market capitalization, etc. However, extensive equity research has now established that it is not earning

per se but value which is important. A new measure called *Economic Value Added* (EVA) is applied to understand and evaluate financial performance.

II.   EVA : THE CONCEPT

EVA examines three fundamental principles of value creation : Risk, Cash Flow and Sustainability of Returns. In, EVA, comparison is done between ROCE and COCE. ROCE is the ratio of Net Operating Profit After Tax to Capital Employed where

Net Operating Profit After Tax (NOPAT) = Profit Before Interest and Tax-Tax (PBIT)

Return On Capital Employed (ROCE)

$$= \frac{NOPAT}{Capital\ Employed}$$

Cost of Capital Employed (COCE) is the weighted average Cost of Debt and

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Cost of Equity.

It is calculated as follows :

Weighted Average Cost of Capital

$$(WACC) = K_e\ (E/V) + K_d\ (D/V)\ (1\text{-}T)$$

Where V is sum total of debt and equity.
If ROCE>WACC, EV is added; if ROCE = WACC, there is no change; and If ROCE<WACC, EV is destroyed. Thus, EVA = EBIT-Tax-Cost of fund employed.

III. EVA : CRITICAL EMPIRICAL ANALYSIS

As discussed above, EVA represents the value added to the shareholders by generating operating profit in excess of the cost of capital employed in the business. The empirical analysis of the companies selected viz., HLL, NIIT Ltd. and Rolta Ltd., is presented in Table 1.

Table 1 : EVA : Comparative Analysis of Selected Listed Public Ltd Companies, 1999 – 2001

Particular	HLL* (as on 31 Dec.)			NIIT Ltd. (as on 30 Sept.)		Rolta Ltd. (as on 31 Dec.)		
Year	1999	2000	1999	2000	2001	1999	2000	2001
NOPAT	1084	1318	1494	2241	1050	847	1036	1186
CE	2070	2389	3859	5164	7550	2894	3642	4663
EVA	694	858	723	1054	-	453	550	624
EVA as % of CE	33.52%	35.91%	18.73%	20.41%	-	15.64%	15.09%	13.38%
EVA as % of NOPAT	64.02%	65.06%	48.40%	47.03%	-	53.46%	53.06%	52.61%

Source : Annual Report of HLL., NIIT Ltd., and Rolta Ltd.
Note : *Data not available for 2001.

It is clearly evident that EVA of Rolta Ltd. has been showing an increasing trend which shows the company concern for its shareholders whereas in NIIT Ltd. EVA has increased till 2000 but due to slump in capital market, consequent upon stock market scam and recession in the economy, no value was added. Like in the case of Rolta Ltd., in HLL, EVA has also shown an increasing trend.

In case of Rolta Ltd., EVA has increased by 37.7 per cent during the period under study. However, EVA as a percentage of capital employed has shown a decreasing trend mainly because of the increase in capital employed by 61.12 per cent which is more than increase in EVA and the main reason for increase in capital employed is that the amount of loan and share capital have increased due

to expansion policy implemented by the company and profit generated during the period under study.

In case of HLL, the EVA has increased by 23.63% per cent because of increase in NOPAT by 21.5% per cent during the period under study. In HLL, EVA as a percentage of capital employed and NOPAT respectively has shown a marginal improvement mainly due to the fact that the increase in EVA by 23.63 percent is more than the increase in both the capital employed (i.e. 15.4 percent) and increase in NOPAT (i.e. 21.5 per cent).

However, in the case of NIIT Ltd. EVA has shown improvement but only till 2000 but due to loss suffered by the company in the year 2001, nothing was added to shareholders wealth. The main reason for loss suffered was slump in the global capital market due to Ketan Parekh Scam and recession in the economy and due to this its share prices tumbled down by almost 90 per cent.

Table 2. Coefficient of Correlation Analysis

Particular	Simple Coefficient of Correlation between EVA & CE	Simple Coefficient of Correlation between EVA & NOPAT
HLL	1	1
NIIT Ltd.	0.20	0.62
Rolta Ltd.	0.98	1

Source : Annual Reports of HLL, NIIT Ltd. & ROLTA Ltd.

From Table 2 it is evident that value of 'r' in HLL is 1 in both cases, i.e. between EVA & CE and EVA & NOPAT, which shows that these variables are perfectly positively correlated which implies that any change in NOPAT or CE will cause change in EVA also. Even coefficient of determination, i.e. 'r^2' implies that 100 per cent variation in EVA is due to variation in CE and NOPAT respectively.

Similarly, in case of Rolta Ltd., both EVA and NOPAT and EVA and CE are prefectly positively correlated. Coefficient of Determination, i.e. r^2 implies that 96 per cent variation in EVA is due to CE and only 4 per cent can be attributed to external factors which we have assumed constant in our study. Thus, in both HLL and NIIT Ltd., CE and NOPAT are important factors in increasing shareholders' wealth.

However, in case of NIIT Ltd., value of coefficient of correlmation between EVA and CE is quite small and therefore coefficient of determination in NIIT Ltd., when applied in case of EVA and CE, shows that 4 per cent variation in EVA is due to CE and 98 per cent is due to external factors which we have assumed constant in our study and similarly value of coelfficient of correlation between EVA and NOPAT is moderately positive and coefficient of determination in NIIT Ltd. in this case shows that 39 per cent variation in EVA is due to NOPAT and 61 per cent variation is due to external factors

which we have assumed constant in our study. Thus NIIT Ltd. is mostly affected by external factors.

IV. CONCLUDING REMARKS

From the above analysis it can be observed that EVA in case of both HLL and Rolta Ltd. has shown an increasing trend due to positive impact of NOPAT and CE. But in case of NIIT Ltd. nothing was added to shareholders' wealth in the year 2001 because of losses suffered by the company in that year.

Thus, the shareholder's value creation approach helps to strengthen the competitive position of the firm by focussing on wealth creation. It provides an objective and consistent framework to the firm for evaluation and financial performance. However, by creating shareholder's value through EVA one should keep in mind that EVA approach is biased on accounting profit which may be biased and adoption of shareholders value creation approach through EVA requires change in the mindset of Indian managers by means of education about Shareholder's Value Creation approach through EVA and benefits.

It is suggested that EVA can be increased if (a) Operating Profit grows without employing additional capital and this requires more efficient use of resources and employment of several Cost Saving Techniques; (b) additional capital is invested in projects that give higher returns than the cost of incurring new capital and for that such projects should be appraised from all angles by conducting several feasibility studies; and (c) the unproductive use of capital is curtailed.

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