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## VALUE CREATION IN INDIAN ENTERPRISES: AN EMPIRICAL ANALYSIS WITH SPECIAL REFERENCE TO IT, TELECOM AND FMCG SECTOR

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### ABSTRACT

*According to the principle of value management, firm must generate adequate returns for its owners, in line with the relative opportunity cost of investment. Companies whose returns exceed the opportunity cost to its owners create corporate value and hence shareholder's value. Traditionally, the yardsticks used to measure the efficiency and profitability of a business organization were accounting based measures like ROI, ROE, ROCE, EPS, RONW and financial ratios. But, now a day's value added measures have emerged as a replacement of the traditional accounting based measures. The reason behind this is that the financial performance of a business organization is measured from the shareholders' value point of view. Value added represents the wealth created by an enterprise during a specified period. No companies can survive and grow, if it fails to generate value to its shareholders. Hence, value added is a basic measure which is used for measuring the financial performance of an enterprise. This study is to analyze the relationship between non-market value performance indicators and market value, with a view to understand the value creation process in the Indian Enterprises. Analysis will be done for total of 36 companies from 3 sectors i.e. IT, Telecommunication and FMCG. The various details will be taken from [www.moneycontrol.com](http://www.moneycontrol.com). For the purposes of this study the market value creation measure utilized was shareholder return. Each company's shareholder return will be estimated using stock price and dividend information. Three different dimensions of non-market value creation measures will be utilized. These three dimensions will be accounting profitability, cash flow performance, and growth.*

### KEYWORDS

Value creation, EVA, ROI, ROCE, EPS.

### INTRODUCTION

Today managing to create a sustained and sustainable Shareholders' Value is currently recognized by everyone as the most important objective of any enterprise. According to the principle of value management, firm must generate adequate returns for its owners, in line with the relative opportunity cost of investment. Companies whose returns exceed the opportunity cost to its owners create corporate value and hence shareholder's value. This means that an analysis of value and performance of a firm or one of its business units centers around two main indicators: Value and Returns. Value is created in the real market by earning a return on investment greater than the opportunity cost of capital. Thus, the more you invest at a return above the cost of capital, the more value you create. That means that growth creates more value as long as the return on the capital exceeds the cost of capital. They go on to mention that one should select the strategies that maximize the present value of expected cash flows or economic profits. The returns that shareholders earn depend primarily on changes in the expectations more than actual performance of the company.

Measuring the value created by publicly traded businesses, depending on the assumptions made, is relatively straightforward. If public markets are at least semi-strong form efficient (i.e., equity prices reflect all publicly available information regarding a business's true underlying value), then the closing price on a large, publicly-traded company should accurately reflect that enterprise's value. In other words, public markets take individual investors' beliefs of the magnitude, timing and riskiness of the business's expected future cash flows and incorporate them into the actual equity value reported at closing. Therefore the managers of the companies are required to think to maximize the shareholders, value, rather than just accounting profits, when making economic decisions.

### LITERATURE REVIEW

Most of the studies relating to shareholders' value creation have investigated the information content of innovative performance measures (especially EVA) over the traditional measures (i.e., ROI, ROE, ROA, etc). There are many studies which investigate that which performance measure is most suitable to maximize the shareholders' value.

It was revealed that EVA, REVA (Refined Economic Value Added) and MVA are better measures of business performance than NOPAT and EPS in terms of shareholders' value creation and competitive advantage of a firm (Anand, et.al., 1999). Since conventional management compensation systems emphasize sales / asset growth at expense of profitability and shareholders' value. Thus, EVA is a measure that shifts focus on an organizational culture of concern for value. On examining the relationship between shareholder wealth and certain financial variables like EPS, RNOW and ROCE, it was found that there was positive and high correlation between EVA and RONW, ROCE. (Madhu Malik, 2004). There was a positive but low correlation between EVA and EPS. EVA was compared with Traditional performance measures and it was found that not a single traditional performance measure explains to the fullest extent variation in shareholder wealth. Indian companies are gradually recognizing the importance of EVA due to the superiority of EVA over ROI (Banerjee 1997). EVA is a superior performance measure both for corporate reporting and for internal governance (Bhattacharyya K Asish and Phani B.V). EVA does not provide additional information to investors, but it can be adapted as a corporate philosophy for motivating and educating employees to differentiate between value creating and value destructing activities. This would lead to direct all efforts in creating shareholder value. EVA is also highly correlated with MVA (Kramer and Pushner 1997). But there is no clear evidence to support the contention that EVA is the best internal measure of corporate success in adding value to shareholder investments. On the contrary, the market seems more focused on 'Profit' than EVA. Also there is no clear advantage to shareholders in looking at EVA, as the accounting return on their investment is NOPAT. For small entrepreneurial types of business relationship exists between certain non-market measures of value creation (Spivey F. Michael and McMillan J. Jeffery 2000). Also significant positive correlations were found between shareholder return and the earnings profitability measures of return on equity, return on assets and return on invested capital. These relationships were found to exist only for companies that reported positive earnings. Stronger relationships were found to exist between shareholder return and the cash flow performance measures of earnings growth and sales growth. Furthermore, the sales growth measure was found to be correlated for companies that had positive earnings and companies that reported negative earnings. The probability of creating future values is positively and significantly correlated with dividend policy and profitability factor (Naccur Ben Samy and Goaid Mohamed). Also the value creation is neither affected by industry patterns, nor by size. In case of banks it was found that cost and profit efficiency have a positive influence on shareholder value creation (Fiordelisi Franco and Molyneux Phil 2007). Leverage was also found to be inversely related to shareholder value creation. Other factors that were found to impact positively on value creation include deposit and loan growth rates, market concentration and employee costs. To be able to develop an effective strategy for increasing shareholder value, there is a need to first understand the factors that determine shareholder value, then assess by what means managers may create an environment where increased shareholder value is made possible (Michael et al., 2000).

### RESEARCH METHODOLOGY AND PROCEDURE

#### RESEARCH OBJECTIVES

The objectives of the study are:

- To identify the relationship between the value of the firms and performance measures.

- To measure the dependence of the value of the firms with the non-market value creation measures.
- To understand the shareholder's value creation process in the selected industry groups.

#### POPULATION, SAMPLE SIZE AND SAMPLING DESIGN

The project is mainly a study of the analysis of the relationship between the market value and the non-market value performance indicators, with a view to understand the value creation process in the Indian enterprises. Hence, the population would comprise of the companies from different industries.

Three industries will be selected and from that 12 companies under each industry will be selected. So there will be total 36 companies, 12 under each industry.

The sampling design which will be used for the study is judgemental sampling.

#### INSTRUMENTS USED AND VARIABLE DEFINITION

Our investigation focused on the relationship between total shareholder return and various non-market accounting and economic performance measures. Shareholder return and all our non-market variables were computed as an average of three years i.e., from 2008-09 to 2010-11. For statistical analysis these variables were defined as follows:

##### DEPENDENT VARIABLE DEFINITION

STOCK RETURN = shareholder return measured as the total percentage return over the last year including price appreciation (depreciation) and any payment of dividends.

##### INDEPENDENT VARIABLE DEFINITION

###### Profitability Measures

- EPS = earnings per share measured as adjusted income available to common shareholders divided by diluted weighted average shares outstanding.
- ROE = return on equity measured as income available to common shareholders divided by average common equity, expressed as a percentage.
- ROIC = return on invested capital measured as income after taxes divided by the average total long term debt, other long term liabilities and shareholders' equity, expressed as a percentage.
- ROA = return on assets defined as income after taxes divided by the average total assets, expressed as a percentage.
- AU = asset utilization computed as revenues divided by total assets
- NPM = net profit margin (or return on sales) computed as the income after taxes divided by total revenues, expressed as a percentage.
- EVA = Economic value added for shareholders computed as the [Net Operating profit after tax – (cost of capital x capital employed)]. The Cost of Capital is calculated utilizing the WACC method.

###### Cash Flow Measures

- CFPS = cash flow per share defined as after-tax income available to common shareholder + depreciation, depletion and amortization.
- CFROS = cash flow return on sales defined as cash flow per share divided by sales per share.

###### Growth Measures

- CE GROWTH RATE = capital expenditure growth rate expressed as a percentage
- EPS GROWTH RATE = earnings per share growth rate expressed as a percentage
- SALES GROWTH RATE = sales growth rate expressed as a percentage.

#### DATA COLLECTION PROCEDURE

The data for analysis has been taken from the financial reports of the companies for the past 3 years. Companies selected for the study are listed either in the BSE or NSE, and all the companies are profit-making and included in the sector specific indices of these exchanges. The firms selected are widely held and the securities of these firms are frequently traded. Analysis is done for a total of 36 firms, and is drawn from three sectors viz., i) FMCG Sector, ii) Telecom Sector iii) Information Technology.

#### TOOLS USED FOR DATA ANALYSIS

The analysis of the data collected shall be performed appropriately and inferences shall be drawn. The data collected shall be presented in forms of summarized tables and thus the trend arising there from would be analyzed. Also regression models for each industry shall be developed.

- Descriptive statistical values (To understand the relative deviation in the data)
- Pearson's Correlation (To identify the relationship between value of the firms and the performance measures)
- Regression Analysis (To measure the dependence of the value of the firms with the non-market value creation measures)

#### THE SEPARATE REGRESSION MODEL

A regression model will be calculated separately for each industry, to detect which factors affect the Market value parameter i.e. Stock Return within each business in the industry. The expected regression model shall be:

$$MV (\text{Stock Return}) = \alpha + \beta_1EPS + \beta_2ROE + \beta_3ROS + \beta_4ROIC + \beta_5ROA + \beta_6CFPS + \beta_7CFROS + \beta_8CEGR + \beta_9SALES\_GROWTH + \beta_{10}EVA + \epsilon$$

Where  $\alpha$  is regression constant,  $\beta_i$  is regression coefficients and  $\epsilon$  is random error term

## ANALYSIS

### DESCRIPTIVE STATISTICS

To understand the relative deviations in the data, all the possible descriptive statistical values are calculated. From the comparative analysis it was seen that the EPS, ROS, ROA, CFROS and EVA are highest in IT industry whereas the ROE, ROIC, CFPS and stock return are highest for FMCG industry. Most of the variables are lowest for the Telecom industry. It is seen that the sales growth rate and capital expenditure growth rate is also highest for the FMCG sector.

### UNIVARIATE ANALYSIS (PEARSON'S CORRELATION)

The correlation coefficients between the Market return and various non-market value creation measures of the sectors were found out. It is found that Earning per share (EPS) plays an important role in the Market Return (Stock Return) of any firm. It is seen that across all the three sectors under study. However, there are other parameters which have strong correlation with the market return in a particular sector.

In case of IT sector Earnings per Share (EPS), Return on Asset (ROA), Return on Equity (ROE) and EVA (Economic Value Added) have positive correlation with market return but are not too high. So it can be inferred that these parameters have some impact on the market return.

In case of Telecom sector Earnings per Share (EPS), Return on Equity (ROE), Return on Asset (ROA) and Cash Flow Per Share (CFPS) have high values of positive correlation with the market return. So it can be inferred that these parameters have a noticeable impact on market return.

In case of FMCG sector Earnings per Share (EPS) and Cash Flow per Share (CFPS) have significant relation with market return.

It is inferred that different sectors have different level of correlations for different parameters with the market return. In some sector one parameter is having a significant positive impact on market return whereas the same parameter might have a negative impact on another sector, for e.g. CFPS has a significant impact on the Telecom and FMCG sector whereas it has a negative correlation in the IT sector.

### MULTIVARIATE REGRESSION ANALYSIS

Separate industry regression equation is applied to every business industry.

#### IT Sector

The R value is calculated and it is inferred by seeing the R value that there is a good correlation between the 10 non market value variables and the dependent variable i.e. Market return ( $R = .997$ ). The R-square value indicates that 99% of the variance in Stock return or market return is explained by the 10 non-market value parameters. From the value of  $\beta$  it is seen that ROA has the greatest influence on Stock return ( $\beta = 5.595$ ), then Sales growth rate ( $\beta = 3.24$ ) followed by CEGR and ROE.

The regression model obtained for IT sector is:



**MV (Stock Return) = -153.50 + (-1.197) EPS + 2.938 ROE + (-2.472) ROS + (-.856) ROIC + .676 ROA + (-.240) CFPS + 110.880 CFROS + 1.187 CEGR + 1.394 SALES\_GROWTH + (-.002) EVA**

#### **Telecommunication Sector**

It is inferred by seeing the calculated R value that there is a good correlation between the 10 non market value variables and the dependent variable i.e. Market return (R= .993). The R-square value indicates that 98% of the variance in Stock return or market return is explained by the 10 non- market value parameters. From the value of  $\beta$  it is seen that ROA ( $\beta=.59$ ) has the greatest influence on Stock return then EPS ( $\beta=.527$ ) followed by ROS and Sales Growth rate.

The regression model obtained for Telecommunication sector is:

**MV (Stock Return) = 8.929+ .033 EPS + .057 ROE + .1 ROS + (-.107) ROIC + .012 ROA + .001 CFPS + (-11.693) CFROS + (-.008) CEGR + .022 SALES\_GROWTH + 0 EVA**

#### **FMCG Sector**

It is inferred by seeing the calculated R value that there is a good correlation between the 10 non market value variables and the dependent variable i.e. Market return (R= .97). The R-square value indicates that 95% of the variance in Stock return or market return is explained by the 10 non- market value parameters. From the value of  $\beta$  it is seen that EPS has the greatest influence on Stock return ( $\beta= 1.229$ ), then CEGR ( $\beta= .725$ ) followed by CFPS ( $\beta= .611$ ) and ROS ( $\beta= .310$ ).

The regression model obtained for FMCG sector is:

**MV (Stock Return) = 635.78 + .742 EPS + .067 ROE + .564 ROS + (-.237) ROIC + (-.126) ROA + .030 CFPS + (-655.77) CFROS + .153 CEGR + (-.083) SALES\_GROWTH + 0 EVA**

## **CONCLUSION**

This paper investigated the relationship between the non market performance measures and true market value of selected firms in India. It is found that Earning per share (EPS) plays an important role in the Market Return (Stock Return) of any firm. It can be seen across all the three sectors under study. However, there are other parameters which have strong correlation with the market return in a particular sector. It can be inferred that different sectors have different level of correlations for different parameters with the market return. In some sector one parameter is having a significant positive impact on market return whereas the same parameter might have a negative impact on another sector, for e.g. CFPS has a significant impact on the Telecom and FMCG sector whereas it has a negative correlation in the IT sector. In case of IT sector Earnings per Share (EPS), Return on Asset (ROA), Return on Equity (ROE) and EVA (Economic Value Added) have positive correlation with market return but are not too high. In case of Telecom sector Earnings per Share (EPS), Return on Equity (ROE), Return on Asset (ROA) and Cash Flow per Share (CFPS) has significant relationship with the market return. In case of FMCG sector Earnings per Share (EPS) and Cash Flow per Share (CFPS) have significant relation with market return. The multivariate analysis indicates that ROA and EPS contribute significantly to the market value. EPS and CEGR plays significant role in FMCG sector where as ROA, EPS and CFPS plays a significant role. In case of IT sector ROA, CEGR, ROE and Sales Growth plays a significant role.

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