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ARE INDIAN COMPANIES ADDING ECONOMIC VALUE TO THEIR OWNERS? CASES OF AUTOMOBILES, METAL, MEDIA AND TELECOM SECTORS

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ABSTRACT:

This case study aims at investigating, whether Indian companies are generating economic value to its owners, as measured by Stern-Stewart's EVA model. Three sectors - Auto, Metals and Media & Telecom - were studied by selecting 10 sample companies from each sector. It was found that all the sectors, on an average generating value add to their owners, whereas Media & Telecom sector seems to be the highest value generator. Another aim of this paper was to determine, if EVA can be used to draw inferences regarding valuation of the companies. Assuming that one of the best available valuation

ratio is P/E Ratio and it can be taken as a proxy to market valuation, we have compared the Market Value / EVA per Share Ratio to see if, EVA can actually reflect the market confidence in the companies. It was found that in case of 23 out of 30 companies, the results obtained based on P/E and MV/EVAPS reveal the same result. Thus, we conclude that Media & Telecom Sector are contributing the highest economic value add to their owners. Metals Sector is laggard in value adding activities. EVA based valuation ratios can be used as reflector of market confidence on these companies.

KEYWORDS: *investigating, generating economic value.*

INTRODUCTION

The style of value based management is permeating into corporate corridors and board-rooms in every strategic planning and performance evaluation meetings. VBM is widely accepted to be the way forward of managing businesses. *Fortune Magazine* has called the *Stern-Stewart's EVA®* as - "today's hottest financial idea and getting hotter" (Chandra, 2014). The rationale for demand for value based framework can easily be devoted to the changing

perception regarding the purpose of existence of businesses. The business world has been effusively convinced to move away from the lame *profit maximization* objective to the *shareholder wealth maximization* objective as the sole purpose of its existence. It's being further reframed as *intrinsic value maximization* of the company's ownership stakes. Such an approach of management to focus on value, delivers greater accountability and result-oriented performances, which in turn ensures the corporate governance being taken care of. As the *value maximization* objectives are being accepted

universally, the fundamental question arises, 'what is value?' In the words of the world famous investor *Warren Buffet* - "Intrinsic value is an all-important concept that offers the only logical approach to evaluating the relative attractiveness of investments and businesses. Intrinsic value can be defined simply: It is the discounted value of the cash that can be taken out of a business during its remaining life." He also highlights the two problems with determining this value - "(1) We don't really know what future free cash flow will be, nor the willingness and ability of management to use it wisely; (2)

We really don't know what the cost of capital is for a firm, particularly the cost of equity." (Buffet, 1996) The owner mindset in the shareholder community is no more interested in sheer profits that the firm is generating. Instead, it is demanding *sustainability* of the profit generating capacity of the firm and its management team. Thus, we descend that *value* is one parameter that the management team need to focus on – either creating value, adding value or nurturing those pockets of its business that enhance value.

STERN-STEWART'S EVA APPROACH

Stern Stewart & Co., is a consulting firm that proposed the concept of *Economic Value Added* as the difference between the operating profit and the costs of financing of firm's activities (O'Byrne, Spring 1996). The proposal was presented as an answer to the market's constant demand of a concrete measure of operational performance and an approach to determine the valuation multiple. *EVA* is the excess return the firm has generated through its operations over and above the cost of raising capital. *EVA* is often seen to be a measure of total factor productivity. *EVA* is given by:

$$EVA = NOPAT - (WACC \times CAPITAL)$$

where, NOPAT is the net operating profit after adjusting for taxes but before interest; WACC is the weighted average cost of capital; and CAPITAL refers to total long-term capital employed by the firm that includes shareholders' funds and long term debt. Caution needs to be exercised to adjust the accounting items considered for calculations for the distortions of GAAP. For instance, the R&D costs need to be capitalized for *EVA* computation purposes.

NOPAT can be computed as $EBIT(1 - \text{Tax Rate})$. This implies that financing decisions are separated from the investment decisions. This also implies that the value addition needs to be verified in after-tax terms. *WACC* is computed by sum totaling costs of different sources of capital with the proportion of each source in the capital structure of the company.

A comparatively higher *EVA* represents a better operational efficiency of the firm in terms of its revenue generating activities, capital allocation decisions and other strategic financing decisions. *EVA* has been adopted by a number of companies across the world, Coca-Cola, P&G and Godrej to name a few. (Chandra, 2014)

Economic Value Added (*EVA*) has gained its fame over the last two decade with more and more global corporate adapting the value-based performance measure in not just post-performance appraisal, but, also in their managerial decisions, including capital expenditure decisions, managerial compensation decisions and M&A transactions. The same is evident in the fact that a number of companies have chosen to voluntarily disclose their *EVA* history with the specifics of computations. The increased acceptance of *EVA*, as a measure of managerial performance can be dedicated to increased cognizance among the top management about the shareholder wealth maximization objective. While accounting profit is not sufficient enough to portray the financial health of the business, value-based parameters, like *EVA*, have been appreciated for their pragmatic and meaningful measurement scales.

As defined by the creators of the *EVA* concept – Stern Stewart Consulting Firm, *EVA* is a measure of economic profit. It is calculated as the excess of opportunity cost of capital over the net operating profit after adjusting for tax benefits. Thus, *EVA* becomes an integrated framework for financial management and incentive compensation and it intuitively measures the wealth the company creates or destroys each year. Stern Stewart's website also claims that *EVA* is not just an alternate way of computing profits, but, as a cultural shift that happens in the company's top management corridors. It changes the way executives view their company and manage it.

As of now *EVA* is a luxury number optionally disclosed by public companies. They may be using the same in their respective corporates or may not be, which would be unknown till there comes out a communication from the companies' side. But, based on the financial numbers and other details available in public, one can compute the *EVA*. While certain assumptions are to be made while these are

computed, when assumptions are uniformly made across companies when computing the EVA, the measure becomes comparable inter-corporate.

Automobile sector in India is experiencing dynamic times. With the growth prospects over the coming decade is promising, the challenges of fast changing consumer behaviour and technological innovations, industry players are pushed to adopt more frequently than ever in the history. Whereas, the metal sector, historically known to be non-cyclical in nature, has been experiencing a weaker demand growth in the market for longer than usual time period, high level of leverage among Indian companies in the sector offering less help. Media and telecom sector is also experiencing dynamic changes affecting their business models – internet of things, cashless transactions growth, digitalization of customer management processes, over-the top platforms that help media and entertainment companies launch, monetize and manage direct-to-consumer

OBJECTIVES:

This study is carried out to investigate the use of value-based approach to financial statement analysis. The study also aims to demonstrate application the *EVA*-based valuation ratio as an alternative traditional earnings based valuation ratios like P/E.

Another aim of this paper is to determine, if *EVA* can be used to draw inferences regarding valuation of the companies.

RESEARCH METHODOLOGY:

The research is descriptive, cross-sectional and case-analytical in nature and samples are selected using convenience sampling, mostly due to the availability of comparable data across companies. A total of 30 listed companies are selected in the order of their market capitalization. Of the 30 firms under study 10 each belong to each of the sector being studied – Auto, Metals, and Media & Telecommunications. The list of companies are presented in the Table-1 below. *EVA* and *EVA*-based valuation ratio of each companies are computed. Observations are then recorded and financial performance under VBM approach are then commented upon.

Industry	Company's Name
Auto	Apollo Tyres Ltd.
	Ashok Leyland Ltd.
	JK Tyre Ltd.
	Bosch Ltd.
	Eicher Motors Ltd.
	Hero MotoCorp Ltd.
	Mahindra & Mahindra Ltd.
	Maruti Suzuki India Ltd.
	TVS Motor Company Ltd.
	Tata Motors Ltd.
Metals	Coal India Ltd.
	Hindalco Industries Ltd.
	Hindustan Zinc Ltd.
	JSW Steel Ltd.
	Jindal Steel & Power Ltd.
	NDMC Ltd.
	National Aluminium Co. Ltd.

	Steel Authority of India Ltd.
	Tata Steel Ltd.
	Vedanta Ltd.
Media & Telecom	Idea
	Bharti Airtel
	MTNL
	Reliance Communications
	Dish TV India Ltd.
	Eros Intl Media Ltd.
	Network18 Media & Investments Ltd.
	PVR Ltd.
	TV18 Broadcast Ltd.
	Den

Data Analysis and Interpretation:

- **EBIT** – obtained from respective companies' annual reports as on 31st March 2018
- **t** – as the tax expense varies from company to company depending on their adjustments of MAT credit and deferred tax treatments, tax rate is taken as below:

$$t = \left(\frac{\text{tax expense}}{\text{profit before taxes}} \right)$$

- **NOPAT** – is computed as $EBIT(1-t)$. It may be noted that **NOPAT** determines the firm's actual operating performance after accounting for taxes (investing side), but, treating finance costs to be non-operating expenses (financing side)
- **WACC** – is computed by multiplying proportions of equity and debt with their respective costs. After-tax cost of debt (k_d) is computed by:

$$k_d = \left(\frac{\text{finance costs}}{\text{total long-term debt}} \right) X (1 - t)$$

Cost of equity (k_e) is computed using Capital Assets Pricing Model (CAPM) and is given by:

$$k_e = [r_f + \beta_e(r_m - r_f)]$$

where, r_f is the risk free rate, which is taken as on the 1st-April-2017, 5-YearGOI Bond Yield, i.e., 7.11%; β_e is the sensitivity of stock to the market, computed individually for all the companies considered; r_m is market return, taken as the 5-Year average annual return of CNX NIFTY Index preceding 1-April-2017, i.e., 7.77%. Therefore k_e would vary based on the beta value.

- **CAPITAL** – total of ordinary share capital plus reserves and surplus plus long term debt.
- The results are presented in Table-1 below:

Company's Name	NOPAT	WACC	No. of Shares	EVA (in Rs. Cr)
Apollo Tyres Ltd.	912.3452	0.071375	50.90248	65.11884
Ashok Leyland Ltd.	1752.584	0.071205	284.5877	124.7924
JK Tyre Ltd.	619.54	0.071295	22.68135	44.16986
Bosch Ltd.	1248.715	0.099632	3.13989	124.4115
Eicher Motors Ltd.	1458.195	0.102384	2.716118	149.2962
Hero MotoCorp Ltd.	3058.606	0.072563	19.96901	221.9423
Mahindra & Mahindra Ltd.	4265.182	0.072244	59.26338	308.1337
Maruti Suzuki India Ltd.	4696.351	0.076819	30.20801	360.7707
TVS Motor Company Ltd.	412.4653	0.071575	47.50871	29.52221
Tata Motors Ltd.	721.9651	0.071613	50.84767	51.70219
Coal India Ltd.	14287.95	0.07117	631.6364	1016.874
Hindalco Industries Ltd.	-22970	0.071099	206.4986	-1633.15
Hindustan Zinc Ltd.	8231.764	0.071184	422.5319	585.9716
JSW Steel Ltd.	332.4033	0.071861	48.54146	23.88685
Jindal Steel & Power Ltd.	431.7228	0.070255	91.49038	30.33061
NMDC Ltd.	3063.01	0.070982	396.47	217.4193
National Aluminium Co. Ltd.	731.8321	0.071077	257.7239	52.01665
Steel Authority of India Ltd.	-3124.99	0.071047	413.0393	-222.022
Tata Steel Ltd.	4661.283	0.070968	97.0047	330.8033
Vedanta Ltd.	0.516434	0.071017	296.5	0.036675
Idea	4306.542	0.071224	36.00509	306.7307
Bharti Airtel	9860.239	0.071192	399.74	701.9676
MTNL	-1251.85	0.071089	63	-88.9928
Reliance Communications	4704.8	0.071093	248.898	334.4796
Dish TV India Ltd. (Essel group)	1191.622	0.071325	106.59	84.99209
Eros Intl Media Ltd.	249.5603	0.07148	9.358916	17.83864
Network18 Media & Investments Ltd.	203.2362	0.071101	171.4409	14.45026
PVR Ltd.	189.4692	0.072297	4.668694	13.69814
TV18 Broadcast Ltd.	141.4357	0.071104	17.41409	10.05664
Den	-125.884	0.07114	17.7742	-8.95539

The average EVA of the three sectors are as below:

Sector	Average EVA
Auto Sector	1878.70
Metals Sector	40.22
Media & Telecom Sector	2434.65

As can be seen from the above, Telecom & Media sector has generated the highest value add to their owners compared to the other two sector. Metals Sector is the worst sector to generate value add to owners.

ValUATION RATIO Based on EVA

The multiplier models currently used most widely center around determining market price for a rupee of earnings or sales – Price-to-Earnings or Price-to-Sales

EVA per Share indicates the firm's surplus return earning capacity per share, which in turn depends on the debt-equity structure of the company. It is possible to enhance *EVA per Share* by altering the capital structure, as the capital structure alteration will have its impact on both WACC and the denominator in the ratio formula. *EVA per Share* answers the questions – “what is the *alpha* generated by the firm for each shareholder?”

$$Price/EVARatio = \left(\frac{CurrentMarketPrice}{EVAperShare} \right)$$

Price/EVA Ratio indicates the level of confidence that the market players have on the firm's capability in sustaining the current *EVA* generating capacity. In other words, *Price/EVA Ratio* answers – “what is the price that market is prepared to pay for a rupee of *EVA* that the firm generates?”

Methodology:

1. For each of the sample company under study, *EVA per Share* is computed.
2. Using the *EVA per Share* and the market price of the company, *MV/EVAperShare ratio* is computed
3. Based on the average *MV/EVAperShare ratio* of the sector companies were identified to be overvalued or undervalued. For example, *MV/EVAperShare ratio* of the companye Apollo Tyres Ltd., is 136.5214. By comparing this with the average *MV/EVAperShare ratio* of the Auto Sector (which is 300.33), we concluded that based on *EVA* based valuation ratio, Apollo Tyres Ltd., share is undervalued. The same process is applied for each of the company. The resultant table is presented below.
4. In the same way, traditional P/E Ratio based inference with regards to the valuation of the sample companies is also computed.
5. Comparing the undervaluation or overvaluation inference based on two approaches as above, conclusions were drawn:

Company's Name	EVA per share	Market Price	MV/EVAper share	Valuation	Basic EPS	P/E Ratio	Valuation	Difference valuation	Return
Apollo Tyres Ltd.	1.2793	174.65	136.5214	Undervalued	16.75	10.4269	Undervalued	Same	52.59%
Ashok Leyland Ltd.	0.4385	108.25	246.7490	Overvalued	3.76	28.7766	Overvalued	Same	1.20%
JK Tyre Ltd.	1.9474	84.49	43.3859	Overvalued	20.45	4.1315	Overvalued	Same	91.62%
Bosch Ltd.	39.6229	20671.34	521.7022	Overvalued	37	558.6849	Overvalued	Same	17.19%
Eicher Motors Ltd.	54.9667	19020.91	346.0440	Overvalued	470.9	40.3927	Undervalued	Different	58.15%
Hero MotoCorp Ltd.	11.11	2953.	265.7765	Overvalued	154.	19.06	Overvalued	Same	23.76%

	43	93		ed	93	62	ed		%
Mahindra & Mahindra Ltd.	5.1994	1212.39	233.1791	Undervalued	54.25	22.3482	Overvalued	Different	15.75%
Maruti Suzuki India Ltd.	11.9429	3707.67	310.4502	Overvalued	155.55	23.8359	Overvalued	Same	109.03%
TVS Motor Company Ltd.	0.6214	321.89	518.0025	Overvalued	7.77	41.4273	Overvalued	Same	80.84%
Tata Motors Ltd.	1.0168	387.94	381.5282	Overvalued	32.61	11.8964	Undervalued	Different	14.61%
Coal India Ltd.	1.6099	293.25	182.1538	Undervalued	22.6	12.9757	Undervalued	Same	-15.06%
Hindalco Industries Ltd.	-7.9088	87.58	-11.0738	Undervalued	0.22	398.0909	Overvalued	Different	150.80%
Hindustan Zinc Ltd.	1.3868	184.85	133.2915	Overvalued	19.33	9.5629	Overvalued	Same	53.04%
JSW Steel Ltd.	0.4921	1277.03	2595.1056	Overvalued	-32.08	-39.8077	Undervalued	Different	-82.67%
Jindal Steel & Power Ltd.	0.3315	59.31	178.9049	Undervalued	-20.79	-2.8528	Undervalued	Same	158.64%
NMDC Ltd.	0.5484	98.51	179.6356	Overvalued	7.4	13.3122	Overvalued	Same	28.67%
National Aluminium Co. Ltd.	0.2018	39.05	193.4788	Overvalued	2.84	13.7500	Undervalued	Different	78.87%
Steel Authority of India Ltd.	-0.5375	43.1	-80.1812	Undervalued	-10.69	-4.0318	Undervalued	Same	46.75%
Tata Steel Ltd.	3.4102	319.99	93.8338	Overvalued	-33.23	-9.6296	Undervalued	Different	77.22%
Vedanta Ltd.	0.0001	91.65	740939.3655	Overvalued	-31.44	-2.9151	Undervalued	Different	205.35%
Idea	8.5191	110.1	12.9239	Undervalued	8.56	12.8621	Undervalued	Same	-16.03%
Bharti Airtel	1.7561	351.93	200.4088	Overvalued	11.15	31.5632	Overvalued	Same	19.04%
MTNL	-1.4126	17.91	-12.6789	Undervalued	-31.84	-0.5625	Undervalued	Same	15.86%
Reliance Communications	1.3438	50.06	37.2514	Overvalued	2.74	18.2701	Overvalued	Same	-47.56%
Dish TV India Ltd. (Essel group)	0.7974	86.43	108.3933	Overvalued	6.5	13.2969	Overvalued	Same	-3.62%
Eros Intl Media Ltd.	1.9061	169.02	88.6751	Overvalued	22.98	7.3551	Overvalued	Same	31.29%
Network18 Media & Investments Ltd.	0.0843	44.37	526.4151	Overvalued	1.06	41.8585	Overvalued	Same	25.31%
PVR Ltd.	2.9340	732.51	249.6591	Overvalued	26.36	27.7887	Overvalued	Same	83.01%

TV18 Broadcast Ltd.	0.5775	40.5	70.1298	Overvalued	0.72	56.2500	Overvalued	Same	-
Den	-	86.88	-	Undervalued	-	-	Undervalued	Same	-
	0.5038		172.4349		14.64	5.9344			2.80%

By seeing the above table, we can notice that 3 out of 10 Auto sector companies inference differ when we apply *MV/EVAperShare ratio* instead of traditional P/E Ratio; 4 out of 10 Metal sector companies inference differ when we apply *MV/EVAperShare ratio* instead of traditional P/E Ratio; and None of the Media & Telecom sector companies results differ between the two approaches. Overall, we find that 7 out of 30 companies studied seem to be undervalued (or overvalued) under *MV/EVAperShare ratio* and overvalued (or undervalued) under traditional P/E Ratio.

CONCLUSION

This study aimed at investigating, whether Indian companies are generating economic value to its owners, as measured by Stern-Stewart's EVA model. Three sectors - Auto, Metals and Media & Telecom - were studied by selecting 10 sample companies from each sector. It was found that all the sectors, on an average generating value add to their owners, whereas Media & Telecom sector seems to be the highest value generator. Another aim of this paper was to determine, if EVA can be used to draw inferences regarding valuation of the companies. Assuming that one of the best available valuation ratio is P/E Ratio and it can be taken as a proxy to market valuation, we have compared the *Market Value / EVA per Share Ratio* to see if, EVA can actually reflect the market confidence in the companies. It was found that in case of 23 out of 30 companies, the results obtained based on P/E and MV/EVAPS reveal the same result.

Thus, we conclude that Media & Telecom Sector are contributing the highest economic value add to their owners. Metals Sector is laggard in value adding activities. EVA based valuation ratios can be used as reflector of market confidence on these companies.

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