Economic Value Added and IT'S Drivers in Select Companies of Consumer Product Sector

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Introduction

Corporate managers now face a period where a new economic framework that better reflects value and profitability must be implemented in their companies. Accounting systems, which have been used up until today, are insufficient and will not stand the challenge from the increasingly efficient capital markets and owners. The increased efficiency at the capital markets requires that capital allocation within companies become more efficient and it is therefore not possible for companies to allocate capital indiscriminately. A new economic framework that better reflects opportunities and pitfalls is therefore necessary. Hence, EVA metric of performance measurement is identified and it is gaining contemporary importance.

The concept of Economic Value Added (EVA) is developed by Stern Stewart & Co. and is a registered trademark of it. EVA is the financial performance measure that comes closer than any other to capturing the true economic profit of an enterprise. EVA also is the performance measure most directly linked to the creation of shareholder wealth over time. EVA is an estimate of true "economic profit" or the amount by which earnings exceed or fall short of the required minimum rate of return that shareholders and lenders could get by investing in other securities of comparable risk. EVA-based financial management and incentive compensation system gives managers superior information and superior motivation to make decisions that enhance shareholder wealth in any publicly owned or private enterprise. Keeping the importance of EVA in view , this paper makes an attempt to analysis and show the relationship between drivers and EVA.

Objectives of the paper:

The following objectives have been set for this paper;

1. To determine the amount of EVA.
2. To identify the drivers and their impact on EVA, and
3. To offer recommendations to improve the EVA in the light of our findings.

Methodology:

The methodology adopted for our study is in three steps which are as follows:

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I) Firstly, EVA is ascertained by deducting cost of capital from NOPAT. Symbolically;

EVA= EBIT (1-t) – Cost of Capital

Where,

EBIT = Operating Profit Before Interest and Tax.

T= Effective tax rate.

Cost of Capital= Cost of Equity + Cost of Debt

For calculating the cost of equity, the constant Dividend Discount Model is employed to search for 'Ke' in the equation which is a proxy for cost of equity. Such equation employed is given below;

P= Do (1+g) / Ke-g

Where,

P= Average price of the stock = High price + Low price / 2

Do= Dividend per share at the end of the year

g= Sustainable growth rate of earnings = Return on Equity x Retention Ratio

For cost of Debt,

Cost of debt = Interest / Debt (1-t)

Overall cost of Capital (Ko) = Ke(S/V) +Ki (B/V)

Where,

Ke = Specific cost of equity

S = Market Value of equity

Ki = Specific cost of debt

B = Market Value of debt

V = Value of the firm consisting of market value of equity and debt.

This 'Ko' is applied to total capital to get the cost of capital in absolute form.

In the second, certain drivers have been identified to show how the EVA is driven. These are as follows;

a) Spread: It is the difference between Return on Capital Employed (ROCE) and Cost of Capital.

b) Size of Capital Employed.

c) Risk: Risk denotes the total risk consisting of operating and financial risk. For calculating operating risk , degree of operating leverage (DOL) is calculated by taking percentage change in operating profit due to percentage change in sales and for calculating financial risk, degree of financial leverage (DFL)is used , Symbolically;

DFL=EBIT/EBT

Where,

EBIT= Earnings before interest and tax

EBT = Earnings before tax.

And to get the total risk, Degree of Combined Leverage (DCL) is used which is as below:

DCL= DOL x DFL

d) Earnings growth: Growth in EPS is taken as a proxy for earnings growth.

Finally an analysis is carried to show the relationship between drivers and EVA.

Sources of Information and Coverage:

The information collection constitutes an important part of any research work. The present study has drawn its information from secondary sources of data. The sources of information used are;

a) Equity Master Stock Market Year Book 2001 and 2002;

b) From websites of respective companies ;

c) Top 500 companies in India of Capital Market Publicaitons.

In addition to the above, information was also collected from other sources like, Books, Journals, newspapers and Magazines etc.

The companies selected for the purpose of our study were Colgate Palmolive India Ltd.(CPL), Dabur India Ltd.(DIL), Nestle India Ltd.(NIL), Procter & Gamble India Ltd.(P&G), Hindustan Lever Ltd.(HLL). The study spans from 2000 through 2004.

Scope of the Study:

The knowledge of such exercise expected to yield some understanding about how the certain factors influence the EVA. Focusing on the driving factors of EVA, the management could bring in an improvement in EVA. Accordingly strategies, plans and programmes can be initiated and developed by the management to enhance the EVA consistently.

Drivers of EVA:

A brief theoretical explanation of the drivers identified is provided in the following pages.

- *Spread*
- *Capital Employed*
- *Risk, and*
- *Growth*

***Spread*:** Spread is the difference between the return on capital employed (ROCE) and the cost of capital employed (COCE). If this difference is multiplied with capital employed would indicate the amount of Economic Value Added or destroyed. For instance, return on capital employed is more than the cost; it would lead to positive spread. On the other hand, return on capital employed is less than the cost, the consequence of which will be negative spread. If spread is positive and the size of capital employed is more, the more economic value addition would result. If it is less, less value would be created. Whereas, this spread is negative, economic value destruction will be there. Hence, spread is a dominant factor in deciding the value of the company. Symbolically, it is shown as follows:

Spread = R- K_0

Where,

R = Return on Capital Employed = PBT / CE x 100

$K_{0 =}$ Overall cost of capital.

***Capital Employed*:** Another important determinant of EVA is the size of capital employed. Higher the size with positive spread lead to more EVA. Conversely, lower the size of capital employed with positive spread lead to lesser EVA. Higher size with negative spread brings higher destruction of Economic Value and lower size with a negative spread brings lesser destruction. Therefore, the size of capital employed by the respective companies would matter the EVA.

***Risk*:** The risk of a company in fact includes broadly two such as, operating risk and financial risk. The amount of total risk could create impact on EVA. In our study it has been proved in the subsequent pages, that the higher risk of a company has lower economic value addition and vice-a versa. Hence, risk is also one of the important influencing factors of EVA.

***Growth*:** Growth rate in earnings will also matter the EVA. Put differently, higher growth rate in earnings will bring enhancement in Economic Value provided return is more than the cost and lower growth rate in earnings will result into decrease in value. Therefore, growth is also a key determinant of EVA.

EVA Results and Analysis:

Table No 1: Showing EVA of Select Consumer Product Sector Companies

(Amt. in Cr)

Year	CPL	DIL	NIL	P&G	HLL
2000	39.23	40.49	116.71	8.30	864.12
2001	51.41	31.88	138.80	72.76	1010.47
2002	53.36	13.64	169.76	28.88	1051.40
2003	50.90	40.17	193.33	37.17	1637.49
2004	80.73	66.99	240.07	60.20	540.77
Total	**275.63**	**193.17**	**858.6**	**207.85**	**5104.25**

The performance of the consumer product sector companies measured in terms of EVA is encouraging. The select sample companies in our study on aggregate bases did create economic value for their shareholders. The combined EVA of respective companies in this study period had values of Rs. 275.63 Cr., Rs. 193.17 Cr., Rs. 858.6 Cr., Rs. 207.85 Cr. and Rs. 5104.25 Cr. respectively. With this absolutes measure, it is not possible for us to study the efficiency of value creation by the respective companies. Therefore, drawing conclusion about the superior performance of the companies become difficult. Therefore, an analysis is carried out further using increment in EVA as a refined measure to understand the superior performance of companies. Because, EVA is not the sole measure to conclude the performance nowadays. Therefore, it is being suggested in the expert circle that the increment in EVA would be the best criteria to measure the performance efficiency.

Increment in EVA and Spread:

Table No 2: Showing Increment in EVA (IIEVA) and Spread of Select Consumer Product Sector Companies

(in percentage)

Year	CPL		HLL		DIL		P&G		NIL	
	IIEVA	Spread	IIEVA	Spread	IIEVA	Spread	IIEVA	Spread	IIEVA	Spread
2001	31	29	17	0.25	(21)	50	776	134	19	15
2002	4	16	04	(10)	(57)	(20)	(60)	(17)	22	21
2003	(5)	5	56	20	194	63	31	01	14	29
2004	59	14	(67)	(65)	66	95	60	41	24	31
Average	22.25	16	2.5	(13.69)	45.5	47	202	39.75	19.75	24

It is clear form the Table no. 2 that, out of the list of select companies, P&G and CPL have shown better performance as for as the economic value creation is concerned in response to their respective spreads. To speak specifically, the P&G's average increment in spread by 39.75 per cent has led to increment in EVA by 202 percent which is more thane one i.e., 5.08. But in case of other companies like DIL, NIL have shown increment in EVA less than the increment in their spread. Therefore, the spread has declining impact on EVA. To improve the EVA in more manners, the responsiveness of EVA to spread must be read so that the strategies can be designed to manage the spread. Otherwise, important time and energy of the management could be diverted to other aspects of the management, not necessarily the spread management.

EVA and Capital Employed:

Table No 3:
Showing EVA on Capital Employed of Select Consumer Product Sector Companies

(in percentage)

Year	CPL	DIL	NIL	P&G	HLL
2000	12.78	33.25	6.65	4.09	34.03
2001	20.40	33.31	5.71	39.54	34.27
2002	20.76	28.28	2.22	13.25	48.23
2003	18.39	42.62	7.71	16.39	56.86
2004	32.82	15.18	21.75	24.18	73.42

Ratio of EVA on capital employed is used to measure the efficiency of capital in generating the economic value to shareholders. The higher ratio of EVA to capital employed would exhibit the higher efficiency of capital used and vice-versa. Taking the cue from this logic, if we observe the Table No. 3, it is evident that ratio of EVA on capital employed of NIL was exceedingly well than its peers. And also exhibit the increasing trend for the study period. Whereas, other companies of the list especially DIL and P&G have exhibited lower ratio of EVA to capital employed, which imply that the efficiency of the capital employed in generating value to shareholders is poor. Therefore, such companies are advised usually to improve the efficiency of capital employment. Such knowledge will help the concerned companies to focus their strategies upon capital efficiency improvement. In the real sense, efficiency is being measured in terms of Input - output ratio. Hence, capital will be a proxy for input and EVA for output.

EVA and Earnings Growth:

Table No 4:
Showing EVA and Earnings Growth of Select Consumer Product Sector Companies

(in percentage)

Year	CPL		HLL		DIL		P&G		NIL	
	EVA Growth	Earnings Growth	EVA Growth	Earnings Growth	EVA Growth	Earnings Growth	EVA Growth	Earnings Growth	EVA Growth	Earnings Growth
2001	31	8	17	39	(21)	(90)	776	(0.06)	19	53
2002	4	30	4	12	(57)	(15)	(60)	5.2	22	26
2003	(5)	28	56	(21)	194	28	31	(19)	14	18
2004	54	14	(67)	(21)	66	(15)	60	(11)	24	6
Average Growth	22.25	20	205	2.25	45.5	(23)	202.00	6.21	19.75	25.75

From the list of Select companies in the Consumer Product Sector Companies in the Table No. 4, it is clear that the average growth in earnings of P&G by 6.21 percent has led to 202 per cent average growth in EVA followed by CPL which has average growth in EVA 22.25 percent due to average growth in earnings by 20 per cent during the study period. By this, we can imply that the growth in earnings was a driving force in creating the economic value for P&G and CPL. This was not the case with other select companies of the list. Therefore, this produces the conclusion that the growth in earnings not necessarily a uniform driving factor for creating and improving economic value of a concern. Hence, concerned companies are suggested to read the elasticity of EVA due to growth. In other words companies should read the EVA driving capacity of growth . All growths can not be good growths. Some may be bad also .Therefore, good growths which we mean a growth which enhances the value must be adopted and worked for. Accordingly companies can tune their management in improving earnings either by increasing revenues or by decreasing costs or both.

EVA and Risk:

Table No 5:
Showing EVA and Risk of Select Consumer Product Sector Companies

Year	CPL		HLL		DIL		P&G		NIL	
	EVA (%)	Risk (DCL)	EVA (%)	Risk (DCL)	EVA (%)	Risk (DCL)	EVA (%)	Risk (DCL)	EVA (%)	Risk (DCL)
2000	39.23	3.9	864.12	2.9	40.49	4.1	8.3	2.4	116.71	3.5
2001	51.41	3.7	1010.46	2.3	31.88	4.6	72.76	2.0	138.80	3.4
2002	53.36	4.5	1051.40	1.4	13.64	7.6	28.88	2.0	169.76	3.1
2003	50.94	3.3	1637.49	1.9	40.17	6.4	37.71	2.8	193.83	2.7
2004	80.73	2.0	540.77	2.9	66.99	5.0	60.20	2.1	240.07	2.9

By observing the data present in the Table no.5, it was evident the fact that, the decrease in risk consisting of operating and financial risk has contributed an improvement in the EVA. Whereas, increase in risk has contributed fall in the EVA. For instance, taking the case of CPL, when the degree of risk was 3.9, its EVA was 39.23cr. , when it has gone done to 3.7 and 2.0 respectively, EVA went up to 51.41cr. and 81.73cr. form 39.23cr.and 50.94cr. respectively. This type of movement can also be found in NIL. As degree of risk decrease from 3.5 to 2.9, its EVA went up from 116.71cr. to 240.07 cr. during the study period. Therefore, in absolute view, we can conclude the fact that, the degree of risk and EV has inverse relationship which we can means higher the risk, lower will be the economic value addition and vise-versa. Therefore, from this we can recommend not only the concerned companies but also the other companies to try their best to minimize the risk of either operations or finance in improving the EVA. Therefore, EVA is inversely driven by the quantum of risk that the company has.

Findings

1. All select companies of the list were creating EVA.
2. The spread wise EVA creation was more in case of Procter & Gamble India Ltd.
3. The efficiency of capital in term of EVA to capital employed was more in case of Nestle India Ltd.
4. Risk and EVA were inversely related.

Recommendations

Specifically, the following recommen dations are made to improve the improve ment in EVA that,

1. The companies should try their best to improve the ratio of EVA to capital employed so that the efficiency of capital would increase.
2. The companies should design their strategies to reduce the risk which will enhance the EVA in substantial manner either through cost cutting or through revenue enhancement.

Limitations of the study

The present study suffers from the certain limitations. Those are as follows;

1. The present study was mainly confined to Five years only.
2. The impact of inflation on EVA and other variables of business risk were not ascertained.
3. Operating fixed costs include cash as well as non-cash but staff salary and depreciation representing one cash and another non-cash were taken as fixed operating costs only. No other fixed costs were included to find the operating risk.
4. In order to make an assessment of refined EVA, numbers of adjustments are to be done. But to calculate the EVA in our study, the information provided about EBIT and the effective tax rate in the annual reports were only used.
5. In order to ascertain the cost of equity, the Constant Dividend Discount Model was used. The cost of equity can also be found in a theoretically sound manner using Capital Asset Pricing Model (CAPM). As the data about risk and risk-free return is subjective, hence it was not used to find the cost of equity.
6. Average price of High and Low price of the stock is taken as proxy for price in finding the cost of equity.
7. Instead of using growth rate in earnings, the sustainable growth rate in earnings is used to get the cost of equity.
8. Whatever the conclusions drawn on the basis of our study may not represent the entire industry because the accounting policies and methods adopted in preparing the final accounts vary from firm to firm in the industry.

References

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