

EVALUATION OF FINANCIAL PERFORMANCE USING VALUE ADDITION METRICS – A SELECT STUDY OF 'IT' COMPANIES IN INDIA

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Abstract

In today's competitive world, value and wealth creation for shareholders are among the most important goals of businesses. For the sake of achieving his goals, the investor needs some instruments in order to measure the potential value of each investment opportunity. It is clear that these instruments are not capable of predicting the exact future, they just provide some piece of information and advice that help the investor in the decisions he makes. Among these criteria, the most common types are Return on Investment (ROI) and Earnings per Share (EPS). Despite the numerous applications of these instruments, theoretically, they are not related with shareholders' value or wealth creation. In recent years, the modern evaluation techniques based on economic theories such as Economic Value Added (EVA), Market Value Added (MVA) and Shareholder Value Added (SVA) replace the accounting data-based criteria and have widely drawn the attentions. These criteria follow the performance assessment with regard to the changes in the value and alongside maximizing the long term shareholder returns. In this research paper, one of the most important criteria; i.e. Shareholder Value Added (SVA), is investigated from several viewpoints.

Keyword: Performance Evaluation; Value Creation; Shareholder Value



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INTRODUCTION

There are certain tools to measure the financial performance such as comparative statements, common size statements, trend analysis, ratios and CVP analysis which gives analytical results. Although financial ratios analysis is often used by several companies in order to measure their performance, it does not mean that the financial ratio analysis is the best measurement to determine the performance of a company, because of the weakness of the concept of financial ratios. They are:

1. Ratios are only estimations.
2. The differentiation of implementing accounting standards within companies can influence the results in measuring the financial ratio analysis.

3. Financial ratio analysis can give guidance of the financial condition of the company only.
4. Companies experience fluctuation is in general and their financial condition is in particular, so the balance will differ along with the year where the report is prepared.

It is clearly observed that due to limitations in measuring the financial performance using financial ratios experts in management tried to find the new method in ascertaining the financial performance; finally, they found the exact method known as the Economic Value Added [EVA].

Economic Value Addition (EVA)

EVA is defined as “Excess profit of a firm after charging cost of capital”. In other words, EVA means any profit caused over and above the cost of capital. Maximization of shareholders wealth is linked with the surplus profit. EVA which is regarded as a comprehensive measure of performance and is an indication value creation and calculated by deducting the cost of capital from Net Operating Profit After Tax (NOPAT). Thus, EVA is considered as the true measure of corporate surplus or effectiveness, which should be shared by the shareholders, management and employees.

Shareholder Value Added (SVA)

Shareholder Value Added is also one of the emerging metric of financial performance. SVA is the difference between the Return on Equity and Cost of Equity is multiplied by Equity Capital Invested.

Market Value Added (MVA)

Market Value Added is the difference between the Market Value and Book Value of the equity. In modern approach MVA is the present value of the future stream of EVA.

REVIEW OF LITERATURE

Bardia (2002)¹ wrangled that the concept of EVA is better than the concept of accounting profit as a tool, as value creation because it considers the overall cost of capital. In this paper, an attempt has been made to analyze the financial performance of Infosys Technologies Ltd, on the basis of traditional parameters like ROCE, ROE, EPS, etc. and the new performance measure EVA.

Mangala, Deepa and Simpy (2002)² discussed that maximizing shareholder value had become the new corporate paradigm. Although shareholder’s wealth maximization has been recognized by managers and researchers, is the ultimate corporate goal, the maxim has gained a new dimension only in the recent years, due to the introduction of the concept of EVA.

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EVA was coined and registered by Stern Stewart & Co. The present paper attempts to study the relationship between EVA and Market Value among various companies in India. The EVA of 15 companies among five industries i.e. Fast Moving Consumer Goods, Information Technology, Pharma, Automobile and textile has been computed. The results of the analysis confirm Stern's hypothesis and conclude that the company's Current Operational Value is more significant in contributing to a change in market value of shares in Indian context.

Sparling and Turvey (2003)³ revisit the relationship between EVA and shareholder return and re-examine the evidence and issues surrounding the use of EVA as a tool for valuing investments. Using the Stern Stewart Fortune 1000 data, they examine two potential relationships for 33 food companies listed in the database. The correlations found were extremely weak in all instances tested.

Mandeep Kaur, Sweety Narang (2009)⁴ explained 'Managing for shareholder value' and 'shareholder value creation' has become the widely accepted corporate objectives since the last decade. Most of the companies in India are still in the dark about what exactly they are supposed to do for managing shareholder value, though virtually they all say that they are doing it. For the real key to create wealth, a business enterprise has to earn economic returns to its owners for its economic survival. In a market-driven economy, there are a number of firms that create wealth, whereas others certainly destroy it. Economic Value Added (EVA), being a value-based measure, assists investors with wealth discovery and company-selection processes. In the present study an attempt has been made to explain the application of EVA principles for the evaluation of companies and industries. It highlights and explains all the elements that find place in EVA computations like calculations of Return on Invested Capital (ROIC), Weighted Average Cost of Capital (WACC), cost of debt, cost of equity as per Capital Asset Pricing Model (CAPM), cost of preference capital, and finally of EVA. Taking a sample from India's most valuable companies that the study shows that on an average about 48% of the companies are actually wealth destroyers. It is quite shocking that of the 12 year study period, from 1996-2007, the sample registered negative EVA for eight years consecutively (1996-2002).

STATEMENT OF THE PROBLEM

In order to dig the research gap some of the important studies have been reviewed and it is found that the existing literature on financial performance measurement of companies in India is not plethora in nature. And in-depth studies into the performance evaluation of IT

companies have revealed that Economic Value Added, Market Value Added and Shareholder Value added metrics are not found.

NEED FOR THE STUDY

The Indian industrial performance has been getting higher day by day and making the country to move from creeping state to walking stage towards the development state. In this scenario, the financial performance of any sectors or any industry is very essential and significant for the better future of Indian economy. Hence, there is a need to study the financial performance of the Services sector in a fervent manner; particularly the IT sector should give utmost importance to their financial performance analysis as they contribute a lot in exports of the country.

OBJECTIVES OF THE STUDY

1. To study the performance of IT industry in India.
2. To analyze the Shareholders Value Addition (SVA) of select IT companies.
3. To study the impact of EVA on SVA of select IT Companies.

HYPOTHESES

1. Ho: The impact of EVA is not significant on SVA of select IT Companies.

SAMPLE DESIGN

The present study is based on highest market capitalization of the listed companies in National Stock Exchange (NSE) from which five top corporate entities have been chosen out of ten top most companies according to Alpingi Search Engine on 20th November 2016. These mentioned five top companies even exist in the 30 percent of total market capitalization. The market capitalizations of these top five companies are as follows:

Name of the company	Market Capitalization (Rupees in Crores)
Tata Consultancy Service	4,78,265
Infosys	2,73,381
Wipro	1,35,058
HCL Technologies	1,16,133
Tech Mahindra	47,670

Source: Alpingi Search Engine

SOURCES OF THE DATA

As the study largely depends on secondary data, the required data was collected from Stock Exchange Official Directories to find out the market return and Beta values to compute the cost of equity by CAPM method, daily closing values of industry and concerned IT

companies. Besides, the data was collected from journals, books, theses works and dissertations for the purpose of literature review and references.

Similarly, the data was also collected from websites and Annuals Reports of the select companies for the financial years of 2007-2008 to 2016-2017 to compute the Value Addition Metrics such as EVA, SVA and MVA.

DATA ANALYSIS

Information technology in India is an industry consisting of two major components: IT and Business Process Outsourcing (BPO). The sector has increased its contribution to India's GDP from 1.2% in 1998 to 7.5% in 2012. According to NASSCOM, the sector aggregated revenues of US\$160 billion in 2017, with export revenue standing at US\$99 billion and domestic revenue at US\$48 billion, growing by over 13%. USA accounts for more than 60 per cent of Indian IT exports.

The Indian Information Technology / Information Technology Enabled Services (IT/ITES) industry is a global powerhouse today, and its impact on India has been incomparable. In the last decade, the industry has grown six fold in revenue terms, and relative share to India's GDP has increased to more than 9.3 percent in Financial Year 2016-2017. India is the topmost off-shoring destination for IT companies across the world. Having proven its capabilities in delivering both on-shore and off-shore services to global clients, emerging technologies now offer an entire new gamut of opportunities for top IT firms in India. The country's cost competitiveness in providing IT services, which is approximately 3 to 4 times cheaper than the US, continues to be its Unique Selling Proposition (USP) in the global sourcing market. Indian IT-ITES industry offers cost-effectiveness, great quality, high reliability, speedy deliveries and, above all, the use of state-of-the-art technologies globally.

Indian global sourcing market growth continues to outperform IT-BPM industry growth. During 2016-2017, the global IT-ITeS market grew to US \$ 1.2 trillion (excl. hardware) and global sourcing grew 1.7 times to reach US \$ 173-178 billion. India continued as the world's Number one sourcing destination with a healthy and significant share of 55 per cent. Indian IT-ITeS industry has set up 1000 global centers in over 200 cities across 80 countries.

HYPOTHESIS RESULT

HYPOTHESIS RESULT OF EVA TO SVA OF IT COMPANIES

HYPOTHESES	Co-efficient of Correlation	Regression	t-Test	P-value	Decision
Ho : There is no significant relationship between EVA and SVA of IT companies	0.51	0.26	1.02	0.38	Accepted

Source: SPSS calculations

Ho: states that there is a medium positive correlation between Average EVA to Average SVA. As SVA moves by one, EVA moves by 0.51 in the same direction. 0.26 % change in EVA is due to change in SVA. The t-statistics of this is found at 1.02. The p-value in this case is 0.38, which is higher than 0.05. Therefore, Null hypothesis is accepted.

Conclusion

As such there is no significant relationship between EVA and SVA. Hence, it is concluded that Shareholder Value does not shows impact on Economic Value Addition.

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