

EVA as A Value-Based Management Tool – A Case Study of Selected Indian It Companies

*** Sunil Kumar Reddy**

**** Kiran Kumar K V**

* Student – PGDM, International School of Management Excellence (ISME),
88, Chembanahalli, Near Dommasandra Circle, Sarjapur Road, Bangalore – 562125

** Associate Professor - Finance and Research Scholar,
International School of Management Excellence (ISME), 88, Chembanahalli,
Near Dommasandra Circle, Sarjapur Road, Bangalore – 562125

Abstract

Of late business objectives are being measured in terms of value generated to investors, over and above their investment. Such transition from profit perspective to value perspective is largely benefitted by Economic Value Added (EVA) that, in a simple fashion,, gives the true performance of the firm in generating operating profit over and above the investors' required rate of return. The objective of our study was to measure the EVA generated by selected top IT companies of India and conduct a peer-to-peer comparison. The study revealed that TCS, Infosys and Wipro have generated the highest EVA. Incidentally, these were also the top three firms in the industry in terms of their market capitalisation. To nullify the size factor and determine the real performance of the said companies, we computed the EVA to capital employed ratio and found that TCS, Tata Elxsi and Oracle have generated the highest value add per rupee of capital employed.

Keywords: EVA, Indian IT Sector

JEL Code: G30, G31

Introduction

Economic value added is a concept to measure the performance of a firm's management in creating value for the shareholders. Economic value added (EVA) is a theory developed by Stern Steward and Co. According to the model of EVA, a companies should also deduct the cost of equity capital from the accounting profit to arrive at a value which is the actual wealth created for the investors.

It can be defined as a measure of performance of a company which focus more on wealth creation for the shareholders rather than just the accounting profit. For finding real profit which a firm has earned, all the cost are deducted from the revenue made and similarly the cost of using capital should also be deducted whether it is a debt or equity. An accountant explicitly deducts the cost of debt i.e. interest from the revenue but does not consider cost of equity. So, positive accounting profit does not mean wealth / value creation but positive EVA would mean that the management of the company has done well and has created wealth for their shareholders.

In comparison to the net profit calculated in normal accounting, EVA figure are more meaningful. An investor can easily understand by looking at the EVA whether he has earned more than his opportunity cost of capital or not and conclude about his investment decision. A positive EVA means that the management has worked towards maximizing the shareholder's wealth.

EVA is computed using the below formula:

$$EVA = NOPAT - (CAPITAL * WACC)$$

• Net operating profit after tax (NOPAT) is profits derived from a company's operations after cash taxes but before financing cost and computed as $NOPAT = EBIT (1 - t)$

- t refers to effective tax rate which is computed as $t = (\text{tax expense} / \text{EBT})$
- CAPITAL refers to total long-term capital employed by the firm that includes long term debt and shareholders' funds.
- WACC is computed by multiplying proportions of equity and debt with their respective costs. After-tax cost of debt (k_d) is computed by: $k_d = (\text{Finance cost} / \text{Long term debt}) (1 - t)$; Cost of equity (K_e) is computed using Capital Assets Pricing Model (CAPM) and is given by $k_e = r_f + \beta (r_m - r_f)$, where, r_f is the risk free rate, which is taken as on the 20th January 2016, 364 days T – bills i.e. 7.27%; β is the sensitivity of stock to the market with respect to the company; r_m is market return, taken as the 5-Year average annual return of CNX NIFTY Index preceding 20th January 2016, i.e., 5.49%.

Literature Review

Vijayakumar (Vijayakumar, 2011) attempted to test if EVA could be used as a predictive tool of the performance of Indian Automobile companies and found that sales and EAT were strongly related to EVA. Kiran Kumar (Kumar, 2015) computed different ratios using EVA as a variable and attempted to study the performance of Indian FMCG companies. He found that companies like UBL, Tata Global Beverages and Godrej Industries have eroded value in the study period. Raiyani and Joshi (Raiyani & Joshi, 2011) studied the correlation between the investment in stakeholder relationships and corporate performance using EVA. They found that Indian banks have destroyed wealth of shareholders over the years excluding a few.

Objectives

The broad objective of this study is to analyse the effectiveness of using EVA as a measure of shareholder wealth. In this context specific objectives of study are as below:

- ✓ To determine the EVA generated by selected Indian IT companies.
- ✓ To appraise the financial performance of selected Indian IT companies on a value based framework.
- ✓ To evaluate superiority of absolute-EVA numbers for comparing firms, over EVA based ratios

Research Methodology

To achieve above objectives the following methodology of research is followed:

Research Type - This will be descriptive study and as it uses financial data extensively, this also can categorise as analytical study.

Sample - The sample size is 10 Indian IT companies selected based on the market capitalisation. Hence sample is selected using judgemental sampling. The sample data is collected through official sources (www.nseindia.in, www.rbi.org, published annual report of selected companies). The list of companies selected is given in the below table (Table-1):

Table-1		
Sl.No	Company	Market Capitalisation
1	TCS	449543.28
2	Infosys	254800.07
3	Wipro	132430.33
4	HCL	114458.37
5	Tech Mahindra	45522.37
6	Oracle	30656.45
7	Mindtree	12811.73
8	Mphasis	9319
9	Hexaware	7397.34
10	Tata Elxsi	6582.93

Data Analysis - For the purpose of computation EVA below data are collected:

- | | |
|--------------------------|-----------------------|
| ✓ Historical share price | ✓ EBT |
| ✓ Risk free rate | ✓ Long term debt |
| ✓ EBIT | ✓ Financial cost |
| ✓ Tax expenses | ✓ Shareholders' funds |

Using above data we computed

- ✓ Capital employed
- ✓ Interest rate(K_d) computed as (Financial cost / Long term debt)
- ✓ Effective tax rate (t) computed as (Tax expense/ EAT)
- ✓ NOPAT computed as EBIT (1 - t)
- ✓ Cost of equity using CAPM computed as $r_m + \beta (r_f - r_m)$

Period of Study - This study is cross-sectional in nature, hence all financial data used for this purpose pertain to financial year end 31st March 2015, across selected Indian IT companies.

Data Analysis, Results and Interpretation

The data collected for respective companies are presented in table presented below (Table-2):

Table-2						
Company	EBIT	Tax Expenses	EBT	Long-Term Debt	Financial Cost	Shareholders' Funds
TCS	26402.68	6238.79	26298	939.29	104.19	50634.76
Infosys	16798	4911	16798	0	0	48068
Wipro	11520.9	2510.1	11171	1645.3	349.9	37,092
HCL	9208.29	1815.11	9117.1	993.1	91.23	24,224.4
Tech Mahindra	3,648	959.5	3,618	500.1	29.9	12248.6
Oracle	1830.8	638.5	1830.8	0	0	3444.1
Mindtree	690.9	154.5	690.8	0	0.1	2012.4
Mphasis	962.4	263.04	934.5	420.1	27.9	5479.7
Hexaware	418.12	97.97	418.12	418.12	0	1209.5
Tata Elxsi	155.1225	53.1	155.12	0	0	283.43

The computation of tax rate, interest rate, capital employed and NOPAT are presented in below table (Table-3):

Table-3				
Company	Capital Employed	Interest Rate	Effective Tax Rate	NOPAT
TCS	51574.05	11.09%	23.72%	20139.17
Infosys	50736	0.00%	29.24%	11887.00
Wipro	38737.30	21.27%	22.47%	8932.18
HCL	25217.49	9.19%	19.91%	7375.02
Tech Mahindra	12748.70	5.98%	26.52%	2680.57
Oracle	3444.07	0	34.88%	1192.30
Mindtree	2012.40	0	22.37%	536.38
Mphasis	5899.80	6.64%	28.15%	691.51
Hexaware	1627.62	0	23.43%	320.15
Tata Elxsi	283.43	0	34.23%	102.02

The computation of cost of capital is presented the below table (Table-4):

Table-4	
Company	Cost of capital
TCS	6.9%
Infosys	5.7%
Wipro	7.1%
HCL	6.2%
Tech Mahindra	5.2%
Oracle	7.8%
Mindtree	7.2%
Mphasis	7.1%
Hexaware	7.2%
Tata Elxsi	8.5%

The computation of EVA is presented in table below (Table-5):

Table-5	
Company	EVA
TCS	16580.56
Infosys	8995.05
Wipro	6181.62
HCL	5811.53
Tech Mahindra	2017.64
Oracle	923.66
Mindtree	391.48
Mphasis	272.62
Hexaware	202.96
Tata Elxsi	77.93

As we can observe from above table all the selected IT companies in India have generated positive EVA to its owners. Going by absolute numbers we can say that TCS has added the highest Economic value followed by Infosys and Wipro. These are mainly concentric because of their higher operating efficiency (As represented by their EBIT). All these three companies have low debt which may also have contributed to higher EVA. It must be noted here that as per MM2 proposition the unlevered capital structure of firm will bring down the perceived risk of investing by the equity shareholders. Therefore, cost of equity which is a function of β (As per CAPM approach) will also come down. Hence, cost of capital will also come down.

EVA to Capital Employed Ratio Analysis

Even though EVA is a convincing approach to analyse the company performance, while comparing among peers it become challenge as EVA give absolute rupee value added. This in turn is ignoring parameters like size of company. To overcome this limitation, we have computed EVA to Capital Employed Ratio by dividing the EVA by the capital employed by the firm. Such ratio will create common size parameter enabling us to compare firms of different size. For our sample companies the same is computed and presented in the below table (Table-6):

Table-6	
Company	EVA to Capital Employed Ratio
TCS	32%
Infosys	18%
Wipro	16%
HCL Tech	23%
Tech Mahindra	16%
Oracle	27%
Mindtree	20%
Mphasis	5%
Hexaware Tech	12%
Tata Elxsi	27%

As we can see from above table TCS is still the best performing company in the terms of EVA addition followed by Tata Elxsi and Oracle. What this means is for instance, Tata Elxsi has generated 27% of capital invested by the shareholders as the value addition. Thus, we can conclude that instead of using pure EVA as performance measure may be useful to develop ratios based on EVA. This also gives as clear cut picture than traditional profit based ratios like ROCE as demonstrated in the below table (Table-7) including the rankings:

Company	EVA/Capital	ROCE	Rank based on EVA/Capital	Rank based on ROCE
TCS	32%	38%	1	1
Infosys	18%	24%	6	6
Wipro	16%	22%	7	7
HCL Tech	23%	29%	4	4
Tech Mahindra	16%	21%	8	8
Oracle	27%	35%	3	3
Mindtree	19%	27%	5	5
Mphasis	5%	11%	10	10
Hexaware	12%	20%	9	9
Tata Elxsi	27%	36%	2	2

Conclusion

Companies like Infosys ensure to report EVA in their annual report consistently, that shows that EVA is not just a theoretical framework; rather, it's a structure which can be practically adopted. The crux of the same lies in the company's belief in value-based management. Our study shown that EVA is a constructive tool that can be used as a target-setting, strategy-formulating and performance evaluating instrument, which in its entirety delivers an enhancement in the firm's intrinsic worth.

Our study showed that IT companies overall have been successful in generating positive EVA, especially, TCS, Infosys, Wipro and HCL have been generating higher EVAs in absolute numbers. As we also wanted to test a comparative EVA performance, we analysed the selected companies using EVA to Capital Employed Ratio and found that TCS, Tata Elxsi and Oracle are the top 3 firms returning maximum value per rupee of investment.

Works Cited

1. Chandra, P. (2014). Strategic Financial Management. McGraw Hill.
2. Kumar, K. K. (2015). Are Indian FMCG Companies adding Economic Value to its Owners? A Case Study using EVA-based Ratios. The Management Accountant.
3. Raiyani, J. R., & Joshi, N. K. (2011). EVA Based Performance Measurement: A Case Study of SBI and HDFC Bank. Management Insight: SMS Varanasi.
4. Vijayakumar, A. (2011). Economic Value Added (EVA) and Shareholders Wealth Creation: A Factor Analytic Approach. Research Journal of Finance and Accounting.