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# Shareholder Value Analysis: A Review

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**Abstract:** ***The main objective of every business is to increase its Shareholder Value. There are many factors affect the shareholder value, each and every decision taken by the management effect the net present value of the cash. This article is a study about conceptual and behavioral aspects of the Shareholder Value Analysis, which suggests the actionable points about Shareholder Value Analysis on the basis of previous studies and cases. The inter relationship of different decisions with shareholder value which is considered as Shareholder Value Network.***

**Keywords**: Shareholder Value, Net Present Value**,** Shareholder Value Network, Behavioral aspects, Decisions

## 1. Introduction

**Shareholder Value Analysis** (SVA) is the process of analyzing how decisions affect the net present value of cash to shareholders. The analysis measures a company's ability to earn more than its total cost of capital. This tool is used at two levels within a company: within an operating business unit and for the corporation as a whole. Within business units, SVA measures the value the unit has created by analyzing cash flows over time. At the corporate level, SVA provides a framework for evaluating options for improving shareholder value by determining the trade-offs between reinvesting in existing businesses, investing in new businesses and returning cash to stockholders.

The root of the fixation with shareholder value lies in the presentation that the main objective of any company is to maximize the shareholder's return on their equity. This is not new idea but the formalization was developed in the 1980's by Rappaport and various firms of consultants. In essence we are dealing with DCF just as we were with brand valuation and customer life time value. The technical adjustments for debt, risk and costs of capital are important but not relevant here. The dangers, and perhaps fallacies are once again both Conceptual and behavioral. Shareholder value analysis has been over-promoted from a useful tool for resources allocation to a universal framework for decision making. The first sets of problems below are conceptual.

### 1.1. Concept

- In theory. Shareholder value gives a long term view by forecasting the future. But look more closely and you will find the future look remarkably like today. By projecting the present into the future, without adequate allowance for external changes, management is condemned to relive Groundhog Day; a movie where the hero is awakened by his alarm clock every morning to discover it is the same day over again. The long term is an illusion; we are just looking at today repeated with minor variation.
- The focus is internal and on concepts than can be expressed in money term. More important, but non-financial, drivers are excluded.
- Excessive emphasis on shareholder value leads to seeing customers and employees as merely means to the achievement of what the CEO really cares about : profits and share prices .it will not take long for customers and employees t get the feeling they are being used.
- The allocation of costs may give top management a false picture. Applying shareholder value analysis to business units, for example, requires central costs to be spread on some arbitrary basis that is probably false to the extent that the units do not directly give rise to these costs.

### 1.2. Behavior

- Value analysis means to compare existing alternatives. In practice, the eyes-down nature of this analysis prevents managers looking for better alternatives; they just battle for the one they want against whatever alternative has been put up by their counterparts.
- Similarly, the complications enable marketers, who soon developed the technical skills, to apply their creativity to manipulating the numbers as distinct from implementing the best marketing program.
- Conversely, marketing investments with outcomes that are hard to express in financial terms are more likely to be put on the back burner. Radical innovation leads to performance well nigh impossible to forecast; yet may firm owe their continuing existence to these leaps of faith. Using a higher discount rate to allow for increased risk is no solution-subtracting an arbitrary number from a wrong number can only make it right by chance. So the things that might transform the business are abandoning in favor of more cuts to the status quo.

## 2. Implementation

SVA consists of three primary analyses:
- Determining the actual costs of all investments in a given business, discounted to the present, using the appropriate cost of capital for that business
- Estimating the economic value of a business by discounting the expected cash flows to the present
- Determining the economic value of each business by calculating the difference between the above analyses.

This tool requires a thorough understanding of each business in order to accurately determine the amount of investments and the expected cash flows that these investments will yield.

### 2.1. Purpose

SVA is used either as a tool to aid in one-time major decisions (such as acquisitions, large capital investments or division breakup values) or as a methodology to guide everyday decision making throughout the organization. When used as an everyday tool by line managers, SVA can be applied in many ways to:

- Assessment of performance of the business or portfolio of businesses: Since SVA accounts for the cost of capital used to invest in businesses and the cash flows generated by the businesses, it provides the user with a clear understanding of the value creation or degradation over time within each business unit.
- Analyze the hypotheses behind business plans, by understanding and interpreting the fundamental drivers of value in each business, management can test assumptions used in the business plans. This provides a common framework to discuss the soundness of each plan.
- Determine priorities to meet each business full potential: This analysis illustrates which options have the greatest impact on value creation, relative to the investments and risks associated with each option. With these options clearly understood and priorities set, management has a foundation for developing an implementation plan.

## 3. Literature Review

Barclay, Holderness & Sheehan (2008) studied that Corporations uniquely have a tax preference for cash dividends. Nevertheless dividends do not increase following trades of large-percentage blocks of stock from individuals to corporations. These findings are not driven by the investing firms' tax rates or by agency problems. Instead, operating companies expand the target firms and pursue joint ventures. Dividends are lower with these investors. Financial investors are not attracted to dividend-paying firms and tend to be passive.

Mekonnen (2002) studied the issues of value driver measurement and ranking. The research revealed that, value drivers have similar pattern across industries. Furthermore, it was found that the effect of operating cost and interest expenses, on free cash flow, is much more important than sales(revenue).

Lange (2000) examined the concept that, Shareholder value has gained increasing acceptance as a measure of a company's performance in competitive global capital markets. Risk management has also raised its profile in the wake of significant corporate disasters. Value-based management aligns the organization's objectives with those of shareholders, and hence the financial markets. Risk management has an important role in this process through the identification of internal and external threats to an organization's objectives.

Booth (1998) discovered that the values of the stock market values are driven by real performance of the corporates, as compared to market index. The key relationship is, if the money entrusted to corporate management earns comparatively higher return than the owners can get in other avenues. Focusing on this relationship differentiates the value manager from other managerial styles. Implementing a "value managerial" system can be accomplished by two main metrics: sales, operating margin, turnover metric and a more traditional return on investment, reinvestment rate metric. Both metrics are simply ways of expressing the underlying determinants of market value. The most critical decision facing a firm is whether to adopt a value based managerial system rather than a particular set of decision tools.

Vishwanandham and Luthara (2005) used strategic profit model (SPM) and the economic value-added (EVA to measure shareholder value). SPM measures the Return on Net Worth (RONW) which is defined as the return on assets (ROA) multiplied by the financial leverage. EVA is defined as the firm's net operating profit after taxes (NOPAT) minus the capital charge. Both, RONW and EVA provide an indication of how much shareholder value a firm creates for its shareholders, year on year. With the increasing focus on creation of shareholder value and core competencies, many companies are outsourcing their information technology (IT) related activities to third party software companies. Indian software companies have become leaders in providing these services. Companies from several other countries are also competing for the top slot.

**Action checklist-**

**1) Understand and Calculate the Organization's Shareholder Value**

It is important when planning to adopt shareholder value as a significant financial objective that you understand the implications and best approach for your business. This can be achieved by planning the approach first with professional advisers, such as accountants or consultants who specialize in this area. A company's shareholder value can be calculated as follows:

**Shareholder value = Total business value--Debt**

In other words, the value given to shareholders is found by subtracting the market value of any debts owed to the company from the total value of the company.

The 'total business value' has three main components:

- Present value of future cash flows during a planned period
- Residual value of future cash flows from a period beyond the planned period
- Weighted average cost of capital.

This is represented in the following equation:

**Total business value = Present value of future cash flows + Residual value of future cash flows**

**Weighted average cost of capital**

If the result of this equation is greater than one, then the company is worth more than the invested capital and value is being created.

*** Future Cash Flows:**

Future cash flows are affected by growth, returns and risk, and these aspects can be explained by seven key value drivers, as described by Alfred Rappaport, that must be managed in order to maximize shareholder value: sales growth rate; operating profit margin; income tax rate; working capital investment; fixed capital investment; cost of capital and value growth duration.

*** Residual Value:**
The residual value- the price at which a fixed asset is expected to be sold at the end of its useful life- is an important figure, which represents cash flows arising after the normal planning period. It has been estimated that as much as two thirds of the value of a business can be attributed to cash flows arising after the normal planning period (usually five to ten years). In another way, only one third of the value of a business results from cash flows arising during the normal planning period.

*** Weighted Average Cost of Capital**:
(WACC) WACC consists of the cost of equity added to the cost of debt, and its purpose is to express the return that a company must earn if it is to justify the financial resources that it uses. The WACC therefore expresses the opportunity cost of the assets in use. WACC is also entirely market-driven--if the assets cannot earn the required return then investors will withdraw their funds from the business.

**2) Gain top management Commitment-**
SVA is based on the belief that creation and maximization of shareholder value is the most important measure by which to assess business performance. This overriding objective must be accepted by top managers for it to be achieved and take root in the organization. There should also be an acceptance that traditional measures and approaches may fall short of achieving this objective.

**3) Identify the Company's Key Value Drivers and Set Targets**
Unlocking shareholder value is about maximizing cash flows, and to achieve this the key value drivers of the business need to be identified (the seven value drivers are listed in point 1 above). To take one example, improvements in the operating profit margin will be affected by sales and expenses; each of these in turn will be driven by a number of other factors (e.g. distribution or selling), which are themselves subject to other influences. This analysis of value drivers links financial and operational objectives and provides a frame work for:

- Setting performance targets
- Assigning responsibility to individual managers
- Reviewing the company's financial performance (and benchmarking against competitors)
- Developing strategic plans----in using SVA, it is possible to measure the incremental change in shareholder value arising from each strategy, by calculating the difference between the present value of future cash flows before and after implementation of the strategy. Identifying the key factors influencing each value driver is invariably a process of trial and error. However, this process is fundamental to managing, controlling and making improvements in the business which will lead to improved cash flows.

**4) Communicate the Approach and Train Staff**
Managers need to understand the broad nature of creating shareholder value, particularly when appraising potential projects, but the technical aspects of SVA are unlikely to be of concern. Managers need to understand the importance of identifying, controlling and improving the performance of the value drivers, and the key factors influencing them. Adoption of SVA and setting of new targets will probably challenge managers' existing habits and approaches, and as a result may cause resistance. Previous approaches will need to be re-evaluated and possibly discarded in favour of new targets. Unlocking shareholder value is essentially a change process, and it requires line managers (who are invariably the people making the key operational decisions) to be fully trained. It is also important when implementing an SVA approach to achieve early, high profile successes. As with any change process, early successes will demonstrate the value of the new approach, highlighting the benefits and winning over sceptics.

**5) Change the Company's Information Systems to Monitor and Measure Progress**
The organization's financial reporting systems and information systems in general, will probably need to be revised when SVA is implemented. Conventional reporting systems are unlikely to provide all of the information required, or to provide it in the most effective format. In order to implement SVA and unlock shareholder value, managers must be able to regularly measure and monitor information concerning the key value drivers and targets that have been set.

**6) Change Managers' Financial Incentive Schemes**
Review your incentive schemes for managers and revise them to reward performance that adds shareholder value. For senior managers incentives should reflect the need to increase shareholder value over realistic time periods, rather than focusing simply on short-term profit growth or earnings per share. Incentives and bonuses for line managers should reflect their success in exerting a positive influence over the value drivers that they control.

**7) Monitor & Review Progress**
Creation of sustained value will require permanent monitoring. Appraisals, performance reviews, management meetings and key decisions will all need to focus on the progress that has been achieved, and the action that is required to continue building shareholder value. Failure to emphasis value creation can result in managers focusing on targets which are no longer relevant, or which are actually harmful to the long-term value of the business.

## 4. Do's and Don't For Shareholder Value Analysis

**Do**

- Take time to understand what will increase shareholder value in your company--what the value drivers are and what factors influence them.
- Communicate with and train line managers so that they know where the priorities are and are able to make the right decisions at key moments.

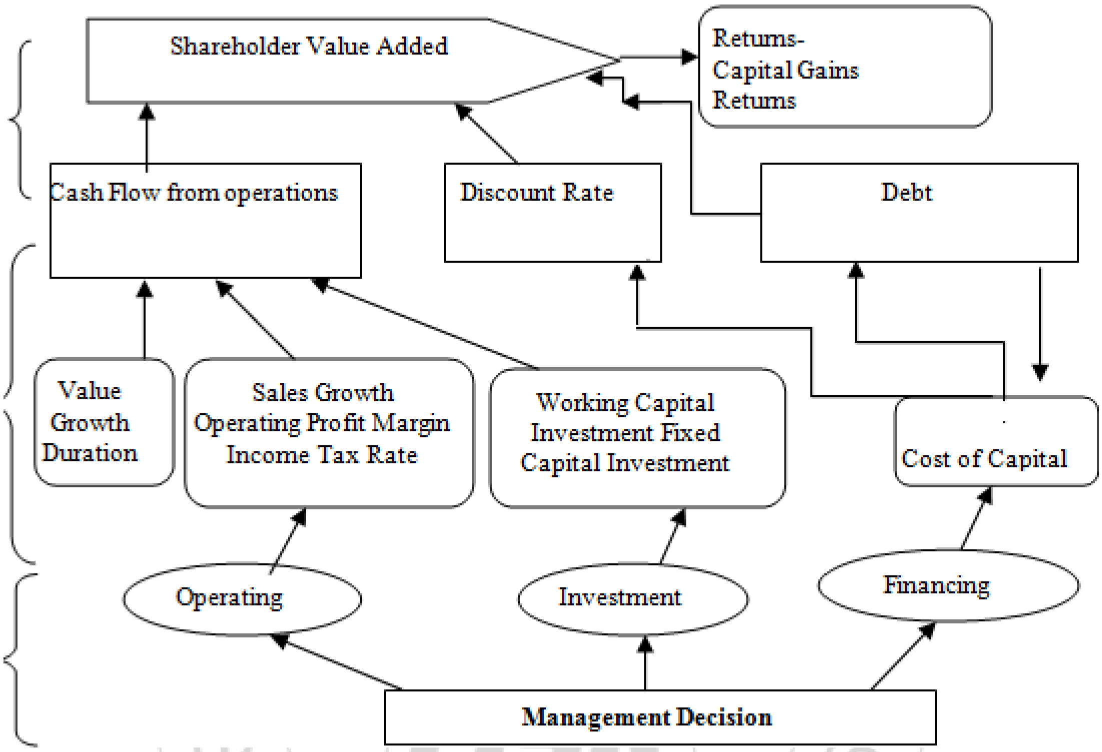
- Review internal systems and make sure that they adequately and routinely provide the information needed to measure shareholder value.

**DON'Ts**

- Be impatient--unlocking shareholder value is likely to take time, and some estimates claim that two years is the norm.
- Cut corners--adoption of SVA will take time, energy and commitment. It may require a complete overhaul of the way the business is run.
- Be half-hearted or hesitant--make sure that you know what improvements you are looking for and what needs to be done to achieve them, and then take action.

## 5. Shareholder Value Network

In the next figure the Shareholder Value Network shows the relationship between Management Decision and Shareholder Value. All decisions have their contribution in Shareholder Value Added

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