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ECONOMIC VALUE ADDED

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Abstract
After liberalization, corporate goals have changed widely. The main aim of any enterprise whether public sector or private sector, the ultimate aim is to create value to the shareholders' investment. EVA, an acronym for Economic Value Added is a financial measurement of how much value was created or destroyed for the reporting period. There are many numbers of traditional measures of corporate performance, for example Return on Asset (ROA), Net Profit Margin, Operating Profit Margin, Return on Investment (ROI), Return on Net Worth (RONW), Return on Equity (ROE) etc., Among these, EVA is considered as a new measure that focuses on clear surplus.

Key words: EVA, Capital, Beta.

Introduction

EVA is a performance-metric that calculates the creation of shareholder-value. That means it is a measure of shareholder-value and is said to be an estimate of the true economic profit of an enterprise. But it distinguishes itself from traditional financial performance metrics such as Return on Asset (ROA), Net Profit Margin, Operating Profit Margin, Return on Investment (ROI), Return on Net Worth (RONW), Return on Equity (ROE) etc. The problem with these measures is that they lack a proper benchmark for comparison. The shareholders are expecting a minimum rate of return for the risk involved in the investment. In order to overcome these problems the concept of EVA was developed. In short EVA represents value generating power of an organization which is the main aim of financial management.

Stern Stewart & Co. is a global consulting firm, which was established in 1982. This firm pioneered the development of its proprietary EVA (Economic Value Added) framework. It has developed this tool to put an end to inefficient use of capital. EVA is based on the principle that since a company employs equity capital to earn a profit, it must pay for the use of this equity capital. As management consultant Peter Drucker once said, "Until a business returns a profit that is greater than its cost of capital, it operates at a loss. The enterprise still returns less to the economy than it devours in resources. Until then it does not create wealth; it destroys it". Including the cost for the use of equity capital it sets EVA apart from more popular measures of bank performance, such as Return on Assets (ROA), Return on Equity (ROE) and the efficiency ratio, which do not consider the cost of equity capital employed. As a result, these measures may suggest, a bank is performing well, when in fact it may be diminishing its value to its shareholders. Shareholders expect management to generate fair rate of return for the risk they are taking. The bank creates shareholders' value only if it generated returns in excess of its cost of capital. The excess return is simply termed as EVA. It focuses on clear surplus generated from operating activities over and above the cost of capital.

OBJECTIVE OF THE STUDY

- To enumerate the concept and components of EVA

COMPONENTS OF EVA

Net Operating Profit after Tax (NOPAT)

The first step in calculating EVA is NOPAT calculation. This represents adjusting earnings before interest and after tax (EBIT). This adjustment is necessary because bank's net profit is usually calculated under generally accepted accounting practice (GAAP). In other words NOPAT is the operating profits of the firm adjusting taxes to a cash basis. The NOPAT includes interest income, other incomes deducting interest on deposits, operating expenses and taxes. This gives overall prominence for operating profit. 30% Tax rate is taken. The formula for NOPAT is as follows,

NOPAT = Total income – Interest on Deposits – Operating Expenses – Tax.

INVESTED CAPITAL

Invested Capital represents the total amount of capital invested in the operations of a company over its life without considering the source of financing the capital. It does not matter whether the capital is debt or equity and the assets are working capital or fixed assets. At the end of the day, it is all cash and, as investors, one would like to know how well the company is managing cash. Invested capital can be determined either from the assets side of the balance sheet or the liabilities side.

Invested Capital = Equity + Reserves and Surplus + Borrowings

RETURN ON INVESTED CAPITAL

Companies fund their investment from equity, debt and retained earnings. The returns equity investors expect from a company are least equal to what they will achieve by investing in the market index although the actual figure depends on the risk profile of the company. The returns institutional and private lenders expect from a company are, again, at the very least, equal to the prime lending rate. Even retained earnings, contrary to what most managers believe, are not totally free. The company can, after all, expect some returns from its retained earnings if it invests them in either the equity or debt markets. The ROIC represents the total percentage return the company generated on its average invested capital.

ROIC= (NOPAT/ Invested Capital) ×100

COST OF EQUITY

Equity capital is contributed by the shareholders. The return on equity (ROE) is the annual rate of return shareholders expect to get from their investments and for the risk they are bearing. It is usually equal to the risk free rate plus the market premium. CAPM is the most recommended, simplest and widely applied method for calculating the expected return on equity

CAPM

The CAPM states that a firm's cost of equity capital is equal to the risk free rate of return on the market, plus a premium above the risk free rate, to reflect the relative riskiness of the investment.

The CAPM can be expressed as:
$Re = Rf + \beta (Rm-Rf)$
Where:
Re = Return on Equity
Rf = Risk Free Rate of Return
Rm = Market Rate of Return
β = Equity Beta measures the correlation between the asset's risk and the overall market.

RISK- FREE RATE (Rf)

The rate of return earned out of an investment in financial instruments which have no default risk is termed as risk-free rate. Practically government treasury bonds are considered as risk-free rate. 364 day Treasury bill rate for each year has been taken as risk free rate for this study.

MARKET RATE OF RETURN (Rm)

The market rate of return is the return that an investor expects from an investment in a market portfolio. The annualized rate of return of the market for each year can be calculated in several ways. The following procedure was used in this study. The daily closing price from 1st April to 31st March next of each year was taken. The average of this value provides the average daily rate of return; multiplying this with 365, yields the average yearly rate of return.

BETA (β)

Beta is a measure to know how particular stock price moves in relation to the market as a whole. It is usually described as a measure of volatility. In short it explains the relationship of the asset return with that of the market return. In this study CNX NIFTY has been taken for market return. The daily closing price of asset return and market return has been taken for beta calculation. The formula used for calculation of beta as follows.

Beta (β) = Covariance of (Stock Return, Market return) / Variance of Market Return

COST OF DEBT

Cost of debt is easy to determine because it is the fixed rate of return on the capital (borrowed capital) contributed by the investors. Cost of debt is determined by dividing total interest paid by the firm to the total borrowings. It is denoted as follows

Kd= Interest expended – Interest on Deposits / Total Borrowings

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WEIGHTED AVERAGE COST OF CAPITAL (WACC)

Weighted Average Cost of Capital is an opportunity cost that is equivalent to the rate of return that an investor could expect to earn by investing in stocks of other companies of comparable risk. A company should explore projects that provide an ROIC that is greater than WACC to add wealth to its capital position, which can be distributed to its investors. Similarly, companies should reject the projects that provide an ROIC that is less than WACC. The true cost of capital is the weighted average cost of capital of both cost of equity and cost of debt.

$WACC = we \times ke + wd \times kd$
Where
we = Proportions of Equity
ke = Cost of Equity
wd = Proportions of Debt
kd = Cost of Debt

ECONOMIC VALUE ADDED (EVA)

EVA is a performance measure to estimate the minimum level of operating profits, the bank should generate to create shareholders' value. It is derived by multiplying bank invested capital and WACC. In other words, EVA measures, how much net operating profit (NOPAT) exceeds the capital charge. Mathematically, EVA focuses management of capital and management of profits. The formula for calculating EVA is as follows,

$EVA = NOPAT – (WACC \times Invested\ Capital)$ (OR)
$EVA = ROIC – WACC$

CONCLUSION

Economic Value Added is a technique which helps to examine three basic factors viz, risk, cash flow and sustainability of return. Moreover it is a useful tool to measure bank's historical success in creating values, the performance of bank's stock in the near future and for examining the excess returns in future and its impact on the value of the bank. EVA as a performance indicator measures true surplus available to shareholders, management and employees.

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