Knowledge Consortium of Gujarat
Department of Higher Education - Government of Gujarat
Journal of Commerce & Management-ISSN: 2279-025X

Continuous Issue – 15 | September –December 2015

EVA as a value based Performance Indicator – A case study with reference to Tata Steel

Abstract

Eva is a measurement tool that provide clear picture of whether a business is creating or destroying shareholders wealth. This study examines how EVA is helpful as a performance indicator of sample company and to know whether it has created or destroyed shareholders wealth over a period of time. Traditional measures like Return on Net worth (RONW), Return on Capital Employed (ROCE), Earning per share (EPS) have failed to show a clear picture of financial health of the company which has direct relation with the shareholder's value for invested money. This study examines whether EVA is an appropriate way of evaluating company's performance and also find out that this company has been able to add value in shareholder invested money since the year 2009 -10 to 2013-14.

Keywords: *Shareholder value, Net profit Margin, EVA, EPS, RONW, ROCE*

Introduction:

Originally proposed by the consulting firm Stern Stewart, a pioneer in the field, EVA is currently a very popular idea. There are so many performance measurement criteria of corporate entities. EPS, ROI, ROCE etc. are very popular and very effective measurement for profitability. But still these traditional indicators have failed to measure the true performance of the company.

EVA is the idea that company does not earn a true profit until all cost including opportunity cost and cost of capital have been covered. The amount of earning must also cover opportunity cost- the benefit foregone by using resources in a particular manner. And the last but not least earnings must cover cost of capital- the return demanded by shareholder and cost of debt.

When a company earns more than its total cost, then it has made a true profit or "economic profit". The term "economic profit" was first developed by British economist Alfred Marshall. Today the investors demand not just high return but an enhancement in the shareholder's value. Maximisation of ROI may not necessarily indicate maximisation of the value of business. People argued that the problem with ROI is that people get the "R" by starving the "I" side of the equation. These traditional methods are easily influenced by the smart and perhaps mischievous management.

They do not incorporate the risk or time value of money and also do not help investors to understand the process of value creation. Unlike accounting measures, EVA has provided financial discipline, encouraged managers to act like owners and boosted shareholders fortune. An enterprise not making profit shall turn into poor health but not adding up value may cause its termination over a period of time.

The rationale behind this research study is that shareholders have an expectation about what to get from the company at the beginning of the period. This is the minimum return that a company must give its shareholders. But EVA measures what the shareholders get above this minimum.

Literature Review:

In many studies EVA is considered as a most modern variable by the researchers and academicians of the day. Other variables are recognised as conventional or time honoured. Fortune magazine has called it "today's hottest financial idea and getting hotter". Management guru Peter Drucker refers to it as a measure of total factor productivity.

As per Ashok Benerjee(Financial Accounting-A managerial Emphasis)"EVA is just a way of measuring real profit. EVA holds a company accountable for the cost of capital, it uses to expand and operate its business and attempt to show whether a company is creating a real value for its shareholder.

Prof. H.C. Sardar and Deepak J. Thakkar (2001) has made an attempt to make comparison between EVA and other traditional indicators. They also evaluate the effect of inflation on the profitability and performance indicators viz. EVA and ROI. D.Sur (2002-03) has stated in his paper that corporate governance will be strengthened with the analysis of EVA in the decision making process.

Singh and Garg (2004) have proved in their study that there is an effective appearance of EVA in Indian corporate sectors. Suman Nayyar & Bhusan Sharma(2006) proves that EVA is the key to creating shareholders wealth and true indicator of financial performance.

Dharmesh Mistry (2011) has stated in his study that the components of EVA like NOPAT and Capital Employed have positive impact on next period's profit while traditional indicators like ROA has negative impact thereon. Vashisht and Gupta (2012) has shown in their study that EVA is an effective measures as a predictor of maximisation of shareholders wealth of public and private sector banks in comparison with other performance indicators. The result of their study indicate that EVA has a highly positive significant relation with MVA (market value added).

Meenu Gupta (2014) has shown in her study a CAMEL framework for analyzing bank's financial health. The result of the study reveal that among traditional performance measures EPS and RONW act as better predictor of financial health of banks with EVA.

Objectives:

1) To calculate and analyse traditional measurements like ROCE, RONW, EPS from the year 2009-10 to 2013-14.
2) To calculate and analyses EVA of Tata steel from the year 2009-10 to 2013-14.

Company Profile:

Born 175 years ago, in 1839, Jamsetji Nusserwanji Tata, the founder of the Tata group, was a visionary who felt the need to use the resources and capabilities at his command to the service of the people of the country and make india a self-reliant economy. Tata steel over the last century has always endeavoured to align its strategy and actions that are focused on building sustainable and long term business by placing equal emphasis on stakeholder value creation and corporate citizenship.

Establishing in 1907 as Asia's first integrated private sector steel company, Tata steel group is among the top ten global steel companies with an annual crude steel capacity of over 29 million tonnes per annum. It is now world's second most geographically diversified steel producer, with operations in 26 countries and a commercial presence in over 50 countries. The Tata steel group, with a turnover of Rs.1,48,614 crores in FY 2014, has over 80000 employees across five continents and is a fortune 500 company.

Computation of EVA:

EVA= NOPAT- (WACC×IC)

NOPAT = Net Operating Profit after Tax

Earnings Before interest and tax (1-tax rate)

OR

PAT + Interest(1-t)

WACC = Weighted Average cost of capital

IC = Invested Capital OR Capital Employed

= Net Fixed Assets + Goodwill+ Investments + Net current assets

OR

=Total Equity + Reserves + Borrowings – Fictitious Assets

WACC = (Proportion of Equity× Ke) + (Proportion of debt× Kd)

To find out cost of equity (ke), Capital Asset Pricing model (CAPM) has been used. Ke is the shareholder's expected rate of return, which can find out by using this equation:

$$Ke = Rf + \beta\,(Rm-Rf)$$

Rf= Risk free Rate of Return

For this study weighted average interest rate of term deposits is considered as Rf

Rm = Expected rate of return from market portfolio

Return of the Nifty Index was taken as the market return

β = calculated based on stock prices vis-a-vis sensex for each year separately.

By applying simple linear regression method for standard coefficient of regression

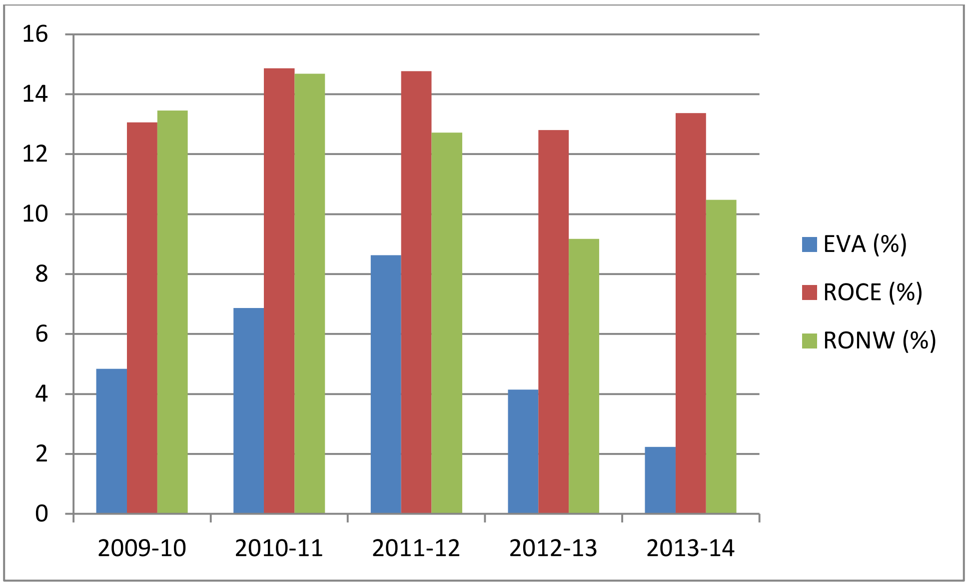
Data Interpretation: (Rs.in cr.)

Particulars	2009-10	2010-11	2011-12	2012-13	2013-14
NOPAT	6102.62	8080.68	8044.21	6376.71	7686.6
Total Equity	36961.80	48444.63	54896.36	57484.68	63422.99
Total Debt	27270.98	28011.20	24391.06	27903.60	28735.64
We	0.58	0.63	0.69	0.67	0.69
Wd	0.42	0.37	0.31	0.33	0.31
Ke (%)	5.23	3.33	-0.286	2.64	6.87
Kd (%)	3.87	4.34	5.53	4.71	4.43
WACC	4.66	3.71	1.52	3.32	6.11
C.E.	64232.78	76455.83	79287.42	85388.28	92158.63

Sources: Authors Compilation

Particulars	2009-10	2010-11	2011-12	2012-13	2013-14
EVA	3109.37	5248.99	6841.42	3539.17	2055.71
EVA (%)	4.84	6.865	8.629	4.145	2.23
ROCE (%)	13.06	14.86	14.77	12.80	13.37
RONW (%)	13.45	14.68	12.72	9.17	10.48
Net Profit Margin	19.96	22.94	19.23	12.94	15.08
EPS	60.26	75.63	67.84	50.28	64.21

Sources: Authors Compilation



Analysis:

Financial year from 2009-2010 to 2013-14 we can see there is a big divergence exist in result of traditional measures (ROCE, RONW) and percentage of EVA on capital employed. EVA is considering market return in its calculation so external factors are also important. During financial 2011-12 India has its own challenges like inflation and increasing oil prices. But in this year Tata steel is showing highest EVA by maintaining good equation between equity and debt. Company has increased its equity which has minimum cost of equity and decreased debt which has maximum cost of debt. Market is giving negative return so minimum opportunity cost is expected by investors. That is the main reason why company is creating value for shareholders at such a high level. In 2013-14 company is creating lowest value for their shareholders. Cost of equity is very high but in comparison with the cost company is not able to get that much of return to give their shareholders. Company is successfully creating value for their shareholders during this study period with certain exemptions.

Conclusion:

Any company will prefer those performance measurements which help to show value creation for their shareholders, to take strategic decisions and achieve desired result. EVA is one of the techniques which link performance measurement with the market. The study proves that EVA is the key to creating shareholder's wealth. EVA targets earn more return than its cost. That is the competitive advantage of this method. Company should train their management to accept this change and link their remuneration with the performance. Acceptance of employees is the biggest factor of successful implementation of this method. It is suggested that competent authorities should issue wide ranging guiding principles for the computation of EVA and its practice in financial reporting and accounting disclosure by the corporate world.

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