Advanced Corporate Management

Shareholder Value Creation

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A Quick Recap

- The role of the firm
- Organisational efficiency
- Transactions, co-ordination, motivation
- Risks and incentives
- Ownership and property rights
- Goals of firms
- Alignment of interests
- Performance measures
- Shareholder perspectives

Measurement of Shareholder Value

- Revenue growth/earnings/EPS
- Price earnings ratio, PE
  - Return on equity (shareholders funds)
  - Economic value added, HVA
- Share price/dividends
- Market value added, MVA

Economic Value Added

- MVA = Market value less capital invested
- MVA measures wealth created
- EVA = NOPAT less capital charge
- Capital charge = Cost of capital x total capital
- Cost of capital (WACC) = Weighted average of cost of debt and equity
- EVA measures return in excess of the overall cost of capital
- MVA is the present value of expected future EVAs

EVA Adjustments

- Goodwill recognition
- Economic taxes
- Bad debt reserve
- Operating leases/rentals
- Unusual items
- Major investments
- Simplicity versus complexity

Capital Budgeting

- Net present value, NPV
- Internal rate of return, IRR
- Cash flows
- Payback periods
- Return on capital
- Operating income

Corporate Goals

- Revenue/sales
- Market share
- Costs
- Profitability
- Intangible goals
- Share prices
- Economic profit

EVA Drivers

- EVA = NOPAT - (Capital x WACC)
- NOPAT drivers are
  - **Sales growth**
  - **Profit margins**
  - **Tax rates**
- Capital charge drivers are
  - **Cost of equity**
  - **Cost of debt**
  - **Capital structure**
  - **Working capital**
  - **Fixed asset investment**
  - **Other capital investment**

New Zealand Market

- Evidence on 500 companies
- In 1999, EVA loss $1.2b
- Over 9 years, total EVA loss $14b
- Note market cap about $50b
- 5% of companies = 60% positive EVA
- Only 34% of firms cover cost of capital
- NZ market/book value ratio much lower than
  US, UK or Australia i.e.NZ MVA performance is poor
- Over 10 years, risk free rate of return exceeded return on equity risk.

Some stand-out issues

- Relatively high dividends in New Zealand
- Almost all companies pay dividends
- Dividend cuts viewed negatively
- Loss of EVA increases proportionally as company size grows
- Explanation, eg, agency costs from separation of ownership and control increase with firm size
- Debt/equity ratios, eg, linkage between gearing ratio and equity returns
- Correlation of share prices to EVA versus earnings

Alignment of Interests

- Shareholders / board / CEO
- Objectives setting
- Incentives / sanctions
- Remuneration
  - Base remuneration
  - Short term bonuses
  - Long term incentives
- Governance (to come later)

Explanation of NZ problem

- Excessive focus on inappropriate measures
- Lack of focus on real shareholder value
- Non-alignment of incentives
- Inactive investors
- Inadequate governance
- Limited market for corporate control
- Sub optimal use of debt
- Inadequate management
- Poor commercial judgement