DOI: 10.53469/jgebf.2024.06(09).13

The Perspective of Value Creation Company: Value Creation and Measurement

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Abstract: ***Value seems to be an ever - present term, major problem is there is no clear definition with respect to all business perspectives. Marketing people define it differently, finance team's definition is different and operations and HR people will define it completely different. Success of any commercial activity is driven by its strategies related to product markets and financial markets. In both the spheres the theme that drives decision making for a company would be its ability to create value. This research article aims to throw light on creation of value by a company and measuring it using various methods.***

Keywords: Value, Business Strategies, Value Creation, Measuring Value

Perspective on a value creating company

Value seems to be an ever - present term, major problem is there is no clear definition with respect to all business perspectives. Marketing people define it differently, finance team's definition is different and operations and HR people will define it completely different. Success of any commercial activity is driven by its strategies related to product markets and financial markets. In both the spheres the theme that drives decision making for a company would be its ability to create value.

From a product market strategy perspective, the concept of value is integral in decision making for a consumer– whether they are buying groceries, apparels, real estate, gold, petrol or stocks. The basic philosophy about the concept of value drives buying behaviour. Sometimes a high - priced product or service is considered more preferable than its basic version such as branded medicines against their generic versions. Sometimes the perception about value is driven by comfort or preferential treatment for instance premium lounge access at additional costs at VFS Global's US visa processing centre which apparently offers only an advantage in terms of a smaller que and better sitting arrangement but no apparent benefit in terms of visa processing procedures or timelines, but the offering is more preferable to an applicant coming to the visa processing centre. Taking advantage of this philosophy associated with value and its influence on consumer behaviour commercial enterprises create their offerings that have usefulness for its intended consumers. Like the concept of value allows a company to create successful product market strategies similar thoughts also drive a company's financial market strategy. Access to capital is easily available if the company creates value for its stakeholders. This value would get measured in terms of financial indicators like ROI, ROE or EVA and would influence behaviour of a lender or investor.

A successful company has to create a business model that finds a balance between its product market strategies that keep it competitive and financial market strategies that allow it to have access to capital to build a sustainable business and for its future growth. These strategies as stated above are driven by philosophy of "value" which seems to an ever - present term but in theory there is no clear definition of the term value. We understand the objective of business is to create value, question is how to define and measure it?

What is Value?

As per Merriam Webster dictionary meaning of value is:

Value (noun)
The monetary worth of something: MARKET PRICE
a fair return or equivalent in goods, services, or money for something exchanged
relative worth, utility, or importance
something (such as a principle or quality) intrinsically valuable or desirable
a numerical quantity that is assigned or is determined by calculation or measurement

Value (verb)
to consider or rate highly: PRIZE, ESTEEM
to estimate or assign the monetary worth of: APPRAISE
to rate or scale in usefulness, importance, or general worth: EVALUATE

Value (adjective)
of, relating to, or being a brand of inexpensive products marketed as an alternative to other, more expensive brands
e. g. consumers choosing between premium brands and value brands

In Business parlance, value is the monetary, material, or assessed worth of an asset, good, or service. "Value" is attached to a myriad of concepts including:

- shareholder value,
- the value of a firm,
- fair value, and
- market value
- Perceived value

Value can mean a quantity like production, turnover, market share, etc. which is quantifiable. In finance theory concept of value is used to determine the worth of an asset, a company

and its financial performance. At the same time, it can be expresses in terms like quality of product, loyalty of customers, brand perception, reputation, etc. The notion of value hence cannot be limited to one factor nor it can be skewed in favour of the part that is measurable. Value cannot be perceived to be only what is tangible, its intangible parts (like perception, reputation) also needs to be taken into consideration while trying to define the notion of value.

Although it can be quite confusing and challenging to create an all - pervasive definition of the term "value" there are well established parameters that allow a company to measure value creation in quantifiable terms. These parameters act as guiding lights for a company to measure effectiveness of its product market and financial market strategies and provider definitive pointers in defining a value creating company.

What is a Value Creating Company?

Borrowing thoughts from finance theory, there are two primary goals for any business:

1) Profit maximization which drives the operational decision making in a company
2) Shareholder wealth maximization which drives the strategic decision making for a company

A value creating company would be defined as the one in which management has achieved integration of the interests and actions of its key stakeholders - shareholders, managers, employees, customers, suppliers, creditors, and the community. Some of the key characteristics of such a company would be:

- Existence of sound business model
- It strategizes to have sustainable competitive advantage,
- Focusses on efficient operational execution and
- Is supported by an appropriate, balanced capital structure that supports in survival and growth.

This integration of interests of various stakeholders results in

- achieving positive cash flows as well as expectations of future cash flow patterns that exceed the cost of capital i. e. a company creates wealth.
- helps provide superior returns to shareholders, superior rewards for managers and employees, excellence in customer satisfaction, first rate performance and loyalty from suppliers, and superior credit relations.

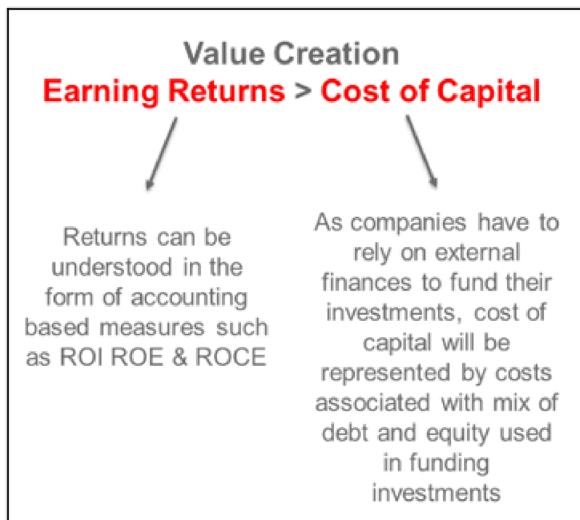
In this context, modern finance theory regards capital investments as the springboard for wealth creation and creating a sustainable business. To achieve the two primary goals of a company it will have to identify sound investment opportunities in creating new products or offerings, setting up production facilities, distribution, technical support or after sale support, etc. The pricing decisions will influence its profitability goals while long term value creation would depend on identifying funding sources whether debt or equity or a combination thereof that have a financing cost that is less than achievable ROI from such investment. If the profit margins are less and the achievable ROI from investment is less that cost of capital it will discourage the company from making such an investment as lenders or investors will not be ethicistic to fund such an investment. This in turn will force the company to rework its product market strategies and identify offerings that have a much better profit margin and a higher potential ROI so that lenders and investors find value in contributing their capital. While working out its strategies a company will also need to assess the type of business and execution risks it has to assume in such investment projects. Higher risks will diminish interests of lenders/investors as they may not find the risk - return ratios favorable to them or increase the cost of capital as lenders/inventors will ask for a higher return for assuming higher risks. This behaviour of lenders/investors driven by perception of "value" forces a company to work of creating a sound business model, strategies to have competitive advantage in its product markets, and focus on efficient execution of investment projects. These in turn then become the characteristics of a "value creating company".

Measuring Value using financial parameters:

A company generally employees various performance indicators in measuring its performance of tracing value creation from its activities. We can divide these performance indicators in three groups:

Earnings based Measures	Cash Flow based Measures	Value based Measures
These are basic accounting measures of profitability. Here are the traditional earnings - based measures used: • Earnings per Share • Return on Assets (ROA) • Return on Equity (ROE) • Return on Capital Employed (ROCE) • Return on Investments	These emphasize on removing short comings in profitability measure arising from accounting adjustments and non - cash items. Here are the traditional cash flow - based measures used: • EBITDA • Free Cash Flow • Operating Cash Flow	These measures are used to evaluate whether a company has been able to generate returns in excess of its cost of capital invested. • Economic Value Added (EVA) • Market Value Added (MVA)
Individually they are not an indicator of economic performance and thus insufficient to measure value.	As value depends on comparison of returns against costs of investments these used in isolation are not useful in measuring value.	

To define a value creating company one needs to deploy value - based measures such as EVA and MVA to identify if the company is creating value or destroying value in its operations. A company would be considered as value creating if it delivers return in excess of its cost of capital. To identify returns we can use accounting measures like ROI, ROE or ROCE and estimate its cost of capital using the weighted average cost of capital methodology which is quite well defined in finance theory. A Company's capacity to generate value will be driven by its ability to generate value creating growth in its profits measured by EVA. While to find out whether management through its decision making has created or destroyed value as of a particular point in time, a Company's MVA is useful.



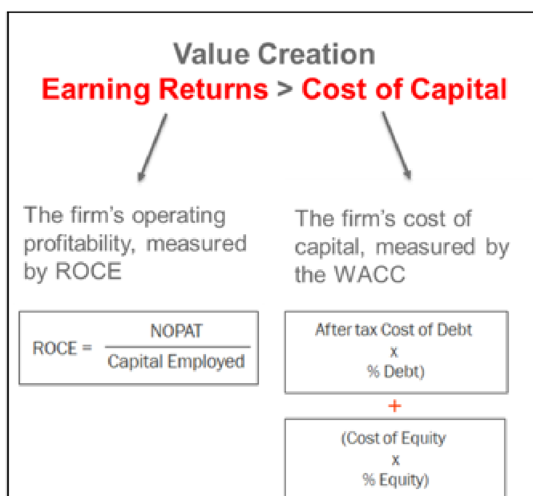
Market Value Added:

MVA represents the difference between the total market value of a company and the total amount of investor - supplied capital. If the market values of debt and preferred stock equal their values as reported on the financial statements, then MVA is the difference between the market value of a firm's stock and the amount of equity its shareholders have supplied. MVA is an external looking measure, that takes into account performance of a company's listed stock as well. The shortcoming of using MVA to understand value created by a company is that It can only be used for companies that are larger and publicly - traded. MVA is derived as follows:

MVA = (Market Value of Stock + Market Value of Debt) – Total Capital

Market Value of Stock	Market Value of Debt	Total Capital
No of Shares X Market Price	Short Term + Long Term	Capital Employed

The goal of a company to maximize MVA will be consistent with maximizing shareholder value. As a company performs well over time, it will retain earnings. This will improve the book value of the company's shares, and investors will likely bid up to the prices of those shares in expectation of future earnings, causing the company's market value to rise. As this occurs, the difference between the company's market value and the capital contributed by investors (its MVA) represents the excess price tag the market assigns to the company as a result of its past operating successes. For achieving this a company will have to undertake investment projects that have positive net present values. This will provide clarity to the Management in terms of decision making. A company can bring about clarity to its investment philosophy and not undertake fancy projects. However, one must also note that MVA is also sensitive to variables that cannot be attributed to the performance of managers. Bull and bear trending phases in stock markets can distort the reading from this measure. Thus, solely maximizing the market value of the firm's capital will not necessarily imply value creation by a company.



To identify a much better driver to define value creation by Company one needs to focus on what will drive value creation. Here is we come back to focussing on delivering excessive returns over cost of capital. Lets first look at the returns part and what measure to use for measuring it. In modern Finance Theory it is quite well established that Return on Capital Employed calculated using the base of NOPAT i. e. Net Operating Profit after Tax in numerator and capital employed consisting of overall debt and equity capital in denominator is a much comprehensive measure compared to ROI and ROE. The advantage of ROCE against ROE is that ROCE takes into consideration profitability against total capital employed (debt + equity). ROE only considers profitability based on capital employed by shareholders. It leaves the debt part out. While comparing ROCE against ROI, one must remember ROI will be calculated suing Net Profit which can be distorted by accounting practices employed by a Company and hence ROCE with its base of EBIT or Operating Profit is a much better choice to measure returns delivered by a company from its operations.

While on the other hand when we consider cost of capital, it will be influenced by weightage of debt and equity component in capital as per the preference of Company Management as well as inherent risk associated with the company's operations. The higher the inherent risk, higher would be the cost of capital.

Economic Value Added:

EVA represents a yardstick for measuring whether a business is generating returns above the cost of capital of the resources (capital base) it employs. Economic value added represents a company's periodic "real" income measured by the difference between its NOPAT and monetary value of its overall cost of capital.

It is derived as follows:

The calculation is a straightforward subtraction of the cost of capital from net operating profit after tax.

EVA = NOPAT – Cost of Capital

NOPAT = Net Operating Profit after Tax

A rather simpler and equally effective formula to calculate EVA is as follows:

EVA = ROCE – WACC

ROCE = Return on Capital Employed
WACC = Weighted Average Cost of Capital

The balancing between two elements i. e. generating returns and identifying cheaper sources of capital so as to deliver value forces a Company to focus on its product market and financial market strategies. Any imbalance in any part would impact the spread between returns generated and cost of capital and indicate success of failure of strategy for a company.

EVA also makes it possible to clearly identify important drivers of value for a company. If we try to bifurcate the ROCE formula the realization is - To deliver superior returns:

1) A company will have to increase profit margins which can be achieved either by increasing prices or cutting costs or finding a better balance between volumes, selling prices and costs.
2) A company can achieve better efficiency in delivery of profits by choosing the right technology so that it has productive assets i. e. it can offer higher turnover on lower asset base.
3) Employ tax management strategies so as to improve NOPAT.

It is quite evident that management can increase the Company’s ROCE through a combination of the following actions:

- An improvement of operating profit margin
- An increase in capital turnover
- A reduction of the effective tax rate

Conclusion

Value remains an elusive term in common parlance. In business parlance value is quantified using financial indicators. Although this focus on only quantifiable portion of value may not allow us to define or capture actual value created by a company but it will allow us to see the link between decisions executed and its impact on business. It allows us to identify characteristics exhibited by a value creating company too and establish a well defined standard methodology to measure and report such value created by a company.