CORPORATE VALUE BASED MANAGEMENT PRACTICES IN INDIA – A THEORETICAL STUDY OF SELECTED MODELS

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Abstract: *This study has been made an attempt the theoretical view of Approaches Corporate Value – based management practices in India. Value-based management can be defined as an integrated management control system that measures, encourages and supports the creation of net worth. Although VBM is more than metrics, we first focused on a non-exhaustive number of value-based metrics, divided in two segments, the listed perspective-segment and the non-listed perspective. Recent years have seen a plethora of new management approaches for improving organizational performance: total quality management, flat organizations, empowerment, continuous improvement, reengineering, kaizen, team building, and so on. Many have succeeded—but quite a few have failed. Often the cause of failure was performance targets that were unclear or not properly aligned with the ultimate goal of creating value. Value-based management (VBM) tackles this problem head on. It provides a precise and unambiguous metric – value - upon which an entire organization can be built. The thinking behind VBM is simple. The value of a company is determined by its discounted future cash flows. Value is created only when companies invest capital at returns that exceed the cost of that capital.*

Key words: *VBM, Marakon Model, Alkar Model, McKinsey Model, EVA Model, BCG Model*

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INTRODUCTION

Value Based Management (VBM) is the management philosophy and approaches that enables and supports maximum value creation in organizations, typically the maximization of shareholder value. VBM encompasses the processes for creating, managing, and measuring value. The value creation process requires an understanding of the attractiveness of the market or industry where one competes, coupled with one's competitive position relative to other players. Once this understanding is established and is linked with key value chain drivers for cash flow and profitability, competitive strategy can be established or modified to maximize future returns. Nowadays firms perform their activities in a business environment which requires them to implement such a system of indicators that illustrates value and profitability in a better way. Accounting systems, as we have known them so far, are inadequate and do not respond to a growing demand for efficient capital markets and the demand of owners. Constantly increasing efficiency in capital markets requires a more efficient allocation of capital within firms. Therefore, a new system of indicators, such as Value Based Management (VBM) - management on the basis of value, and management to increase (market) value (Dimc, 2005), which reflects the opportunities and threats much better is urgent and necessary. Value based management includes the following indicators: Economic Value Added (EVA)1 , cash value added (CVA), cash flow return on investment (CFROI) and those indicators that are relevant to shareholder value analysis (SVA). Firms may choose one of them to be key in determining their future scorecard. Indicators currently used by firms to follow their profitability and value creation are not consistent with the mechanism of capital markets and with what market considers being key in determining value. Therefore, we must build on management that is based on value (VBM). For internal financial management firms should use VBM instead of an accounting system. Accounting is, of course, required for fiscal reasons and to control business in terms of legislation, but it does not contribute to improving the quality of management structures and all those involved in value creation. For the sake of understanding and managing business operations it is therefore necessary to rely on VBM within firms. According to Weissenrieder (1998) a firm may be illustrated by two most important areas: the first is directed at the owners (capital market) and the other at the buyers (customers). The latter represents a business reality; these are activities that take place in a real business world.

Firms have to manage these activities as effectively as possible to maximize value for shareholders. At the same time firms have to be able to complete these activities in such a way that they satisfy market expectations. This may only be achieved on the part of a firm's management by simulating the reality with the mechanism of the capital market. By making a financial exemplification of a business reality they acquire the necessary management skills. This gives them a relevant feedback which they need to improve their business activities. Weissenrieder (1998) says that the boundary between a business reality and the mechanisms of capital markets can be quite rapidly abused, similarly as it can be abused with financial statements. With this every opportunity to prepare for effective corporate management is lost. They become completely misinformed unless they perceive and comprehend a business reality on the basis of VBM. A firm must operate on a strategic feedback loop which means a constant evaluation of strategies in which doing management carry out the evaluation by using information from the strategies in order to make necessary adjustments in their firms later. There are a lot of cases in firms where the scope of a business reality does not work as it should, but there are very rare cases where it functions efficiently. Financial simulation of a business reality, of course, has to take into account a discounted cash flow. According to Morin and Jarell (2001) value derives from three broad areas of decision-making: strategic, financial and corporate. Strategic determinants include production and marketing strategies and portfolio planning. Financial determinants include the optimization of capital structure and risk management. Corporate determinants include governance, mainly rewarding executive managers and business evaluation. VBM is a relatively simple framework for setting objectives of those business decisions that add an economic value to a firm in both short and long term. Several approaches to quantifying a corporate value exist and they all have roots in a discounted cash flow model, since this is also the method and manner used by investors and capital markets to actually value their firms and securities. The value of every firm is a function of expected future cash flows correspondingly discounted with relation to risk. This is nothing new, as the discounting method has been used for decades. However, VBM puts this discounting to good use and as an approach extends it to business operations as a whole, thus contributing to strategic decisions about the value and according to Morin and Jarrell (2001) it establishes an increase in these values as a basis for determining a corporate responsibility.

REVIEW OF LITERATURE

Seisreiner A. and Träger S. (2004) propose a multidimensional framework for Value based Management argues that this will help in assessing corporate value added in a comprehensive way. This framework divides the value chain into three independent dimensions: 1) Value Investment, 2) Value Creation and 3) Value Transfer. It also considers the value from every stakeholder (like Suppliers, Employees, Shareholders, Customers, and others) point of view. This paper sets the aforesaid framework as the basis of its objective of literature review as the said framework provides the greater insights into underlying concepts of value based management.

Capital is one of the scarce resources available to the firm, thus contributed proportionality for value addition to the firm. As a result, "[the] language of cost obscures the simple facts that value is lodged in scarce factors, not 'economic profit'" (Seisreiner A. & Träger S., 2004; Lippman S. A. & Rumelt R. P., 2003). It is very likely that real corporate value added is not reflected as other significant sources of wealth are simply ignored by relying on free cash flow or profit as major measure of firm's value added. The literature on real options Page 3 suggests that firms should not commit its resources until it is absolutely necessary or an alternative is available which will provide highest returns for allocated resource and its combination with others (Seisreiner A. & Träger S., 2004; Trigeorgis L., 1996; Copeland T. & Antikarov V., 2001).

OBJECTIVES OF THE STUDY

1. To study the conceptual framework of corporate value based management practices in India.
2. To study the various models viz., Marakon , Alkar , McKinsey, BCG and EVA to measure and practices of corporate value based management.

MODELS OF CORPORATE VBM

- **Marakon approach**

Marakon Associates" is an international management-consultancy firm that has done pioneer research in area of value-based management. James M McTaggert, Peter W Kontes, and Michel C Mankins have dealt with this approach extensively in the book titled, "The Value Imperative".

The key steps in this approach are:

1. Specify determinants of value
2. Understand the strategic drivers of value
3. Formulate higher value strategies
4. Develop superior organisational capabilities.

Specify the Financial Determinants of Value

This approach is based on the market to book ratio model, which stipulates that shareholders' wealth is measured as the difference between the market value and the book value of a firms' equity. The book value, B, is a measure of approximate capital contributed by shareholders, while market value, M, is a reflection of how productively a firm employs that capital. Hence, the management creates value if M exceeds B and vice-versa.

$$M/B = (r - g) / (k - g)$$

Where; M = market value of equity,

B = book value of equity,

r = return on equity,

g = growth rate in dividends,

k = cost of equity.

Understand the Strategic Determinants of Value

Important financial determinants of value include the spread (i.e., difference between return on equity and the cost of equity) and the growth rate in dividends. These are influenced through market economics and the competitive position of the firm.

Market Economics or Profitability depends on the following factors:

- Intensity of indirect competition
- Threat of entry
- Suppliers' pressures
- Regulatory pressures
- Intensity of direct competition
- Customers' pressures

The Competitive Position of a firm refers to its relative position in terms of equity spread and growth rate against the average competitor in its product market segment. It is dependent upon product differentiation and economic cost positioning.

Formulate Higher value Strategies

Value creation involves participating in a lucrative market and building competitive advantage by adopting efficient strategies. The Participation strategy defines the product markets, in which the firm will compete, and also new businesses that it should enter, and the ones that it should exit. Competitive strategy includes defining means to build competitive advantage and avoiding competitive disadvantages in the existing markets.

Develop Superior Organisational Capabilities

After dealing with competition, the company needs to develop superior organisational capabilities to overcome internal barriers to value creation and find a balance between the organisational objectives (Executives) and those of the shareholders.

The key organisational capabilities are: -

- A competent and energetic chief executive committed towards maximising value
- A compensation plan following "relative pay for relative performance" principle
- An efficient resource allocation system based on principles of zero based allocation and funding strategies rather than projects, no capital rationing, and zero tolerance for bad growth
- A corporate governance mechanism with high accountability for creation or destruction of wealth

The Marakon approach is a popular value-based planning model because:

- The various parameters included in the model- Return on equity, growth rate, and cost of equity are widely used as important measures of business performance and are easily assessable
- The market value of the firm is regarded as an external scorecard by the business sector.
- The approach is based on an intuitively appealing valuation theory

➢ **Alkar approach**

The Alkar Approach is one of the method available for measuring shareholders' value creation. This approach was developed by Alkar Group Inc., a management education, and software company, now it is a part of the LEK/Alkar consulting group. Alfred Rappaport, former chairman of the board of the Alkar group Inc., invented the concept shareholder value prior to 1981, when he published "selecting strategies that create shareholders

value", in HBR. But, Alkar approach is fully explained by Alfred(professor emeritus of J.L.Kellogg Graduate School of Management of North Western University) in his book "creating shareholder value: A Guide for managers and investors". Due to his contribution to "shareholder value creation literature", he is called as father of shareholder value.

Determinants of Shareholders Value

- Rate of sales growth
- Operating profit margin
- Income tax rates
- Working capital investment
- Fixed capital investment
- Cost of capital
- Value growth duration

➢ **McKinsey Approach**

The McKinsey model, developed by leading management consultants McKinsey & Company, is a comprehensive approach to value-based management. This approach is based on the discounted cash flow principle, which is a direct measure of value creation.

McKinsey Model of Value Based Management focuses on the identification of key value drivers at various levels of the organization, and places emphasis on these value drivers in all the areas, i.e. in setting up of targets, in the various management processes, in performance measurement, etc. Value based management is a model that allow managers to run a business focusing on the creation, improvement, and delivery of value. According to Copeland, Roller and Murrin, value-based management is

"an approach to management whereby the company's overall aspirations, analytical techniques, and management processes are all aligned to help the company maximize its value by focusing management decision-making on the key drivers of value".

According to McKinsey Model of Value Based Management, the key steps in maximizing the value of a firm are as follows:

1. Identification of value maximization as the supreme goal
2. Identification of the value drivers
3. Development of strategy
4. Setting of targets

5. Deciding upon the action plans
6. Setting up the performance measurement system

❖ **Value Maximization – The Supreme Goal**

A firm may have many conflicting goals like maximization of PAT, maximization of market share, achieving consumer satisfaction, etc. The first step in maximizing the value of a firm is to make it the most important goal for the organization. It is generally reflected in maximized discounted cash flows. The organisation's activities can be classified into financial and non-financial types. The former helps the senior management sustain focus, while the latter motivates the entire workforce. Non-financial activities include product development, customer satisfaction and quality improvement efforts, which are normally consistent with the financial goal of value maximization. In case of conflict between financial and non-financial goals, financial goals are given precedence.

❖ **Identification of the Value Drivers**

The important factors that affect the value of a business are referred to as key value drivers. It is necessary to identify these variables for value-based management. The value drivers need to be identified at various levels of an organization, so that the personnel at all levels can ensure that their performance is in accordance with the overall objective. The other objectives of a firm mentioned above may act as value drivers at some level of the organization. For example, degree of innovation in products may be identified as the value driver for the design department.

❖ **Development of Strategy**

The next step is to develop strategies at all levels of the organization, which are consistent with the goal of value maximization, and lead to the achievement of the same. The strategies should be aimed at and give directions for the achievement of the desired level of the key value drivers.

❖ **Setting of Targets**

Development of strategies is followed by setting up of specific short-term and long-term targets. These should be specified in terms of the desirable level of key value drivers. The short-term targets should be in tune with the long-term targets. Similarly, the targets for the various levels of the organization should be in tune. They should be set both for financial as well as non-financial variables.

❖ **Deciding upon the Action Plans**

Once the strategy is in place and the targets have been determined, there is a need to specify the particular actions that are required to be undertaken to achieve the targets in a manner that is consistent with the strategy. At this stage, the detailed action plans are laid out.

❖ **Setting up the Performance Measurement System**

The future performance of personnel is affected by the way their performance is measured, to a large extent. Hence, it is essential to set up a precise and unambiguous performance measurement system. A performance measurement system should be linked to the achievement of targets and should reflect the characteristics of each individual department.

Value based management focus on value creation, but managers can take it not only for shareholders' value but also for value creation that can benefit stakeholders. Developing communities in markets where firms compete can become an important driver of value creation to achieve superior performance.

➢ **EVA Approach**

In 1990 a new device was formulated to gauge the profitability of a concern, which is known as 'EVA'. This concept is, as a matter of fact, a reversion to the formulation of Alfred Marshal (1890) which he put forward in early nineteenth century. The EVA of the company is just a measure of the incremental return that the investment earns over the market rate of return. In simple terms, it can be stated that EVA measures the profitability net of cost of capital. As someone has aptly remarked, 'you only get richer if you invest money at a higher return than the cost of money to you'. Everybody knows this but many seem to forget it. Thus, EVA can be taken as the net operating profit minus an appropriate charge for the opportunity cost of all the capital invested in an enterprise. As such, EVA is an estimate of true economic profit or the amount by which earnings exceed or fall short of the required minimum rate of return that shareholder and lenders could get by investing in other securities of comparable risk.

Calculation of EVA

EVA is the surplus left after making an appropriate charge for the capital employed in the business. It can be calculated in the following way.

EVA = NOPAT – (TCE x WACC) ………………. (1)

Where, NOPAT = Net operating profit after tax TCE = Total capital employed WACC= Weighted average cost of capital While calculation of NOPAT, the non-operating items like dividend/interest on securities invested outside the business, non-operating expenses etc. will not be considered. The total capital employed is the sum of shareholders funds as well as loan funds. But this does not include investments outside the business. In determining the WACC, cost of debt is taken as after tax cost and cost of equity is measured on the basis of capital asset pricing method. Under capital asset pricing model, cost of equity, i. e, Ke is given by the following:

Ke = Rf + bi (Rm- Rf) …………………… (2)

Where, Rf = Risk free return Rm = Expected market rate of return bi = Risk coefficient of particular investment. The cost of capital is thus the most important aspect of EVA. Under the traditional methods most companies appear to be profitable whereas in reality, they are not. As Peter Drucker (1995) has observed, "Until a business returns a profit that is greater than its cost of capital, it operates at a loss. Never mind that it pays taxes, as if it had a genuine profit. The enterprise still returns less to the economy than it devours in resources... until then it does not create wealth; it destroys it."

- **BCG Approach**

The Boston Consulting Group (BCG) is a global management consulting firm, world's leading advisor on business strategy founded by Bruce Henderson in 1963. BCG with the acquired (1991) consulting firm "Holt Value Associates" Come up with an approach to shareholder value management.

BCG developed the key cash based metrics for managing fundamental value, includes TSR, CFROI, CVA and TBR. These metrics are now used widely in the corporate and finance world.

CONCLUSION

A customer-value based approach to management can help companies in still a fact based decision making process in the enterprise. This promotes faster growth through differentiated customer investment. It ensures that the highest return initiatives are prioritized. Enterprises using this disciplined four more step approach are well positioned to better understand value potential, creating value, delivering value, and managing their market position to maximize the value they capture. Enterprises that are attuned to the Value Creation Cycle build deep moats around their customers that competitors find

difficult to cross. Mastering the Value Cycle enables enterprises to win in both the customer markets and the financial markets. In short, it leads them to long-term profitable growth.

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8. EVA is a term coined by the consultancy firm Stern Stewart, which has done much to develop and promote the concept (Brealey, Myers and Marcus, 2001, p.503).