Economic Value Added for Competitive Advantage:

A Case of Indian Enterprises

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Dedicated to Reverend and Sacred Guru Dev!!

Desire, Thou Dwelling So Deep Inside
Lurking on Wealth of Peaceful Mind
To Realize the Freedom, Self and ‘I’,
Discover the Happiness Within, Abide
Awareness, Intelligence, both Aligned
To Enlighten the Darkness of Mind
Let the Love and Devotion to Shine
On the Sanctuary; So Pure and Divine!!

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PREFACE

Companies are said to have a competitive advantage when they have a performance which is better than that of their industry's average performance. It has been discussed that the assessment of advantage can be either economically based or accounting based. The accounting measures for ascertaining competitive advantage include the financial ratio, while the economic measures include the ability of the firm to attract a weighted average cost of capital. Although a holistic view for the measure of competitive advantage has been a topic which has often attracted business strategy researchers and students, there is a need for further research.

The literature in the field of strategy related to competitive advantage has been focused on the source and the status of competitive advantage. What's more, the discussion of the concept of competitive advantage has given rise to various models and frameworks, as well as topics. The discussion is hugely diverse, including value chains, value linkages, cost competence, the mobility of the market, value network, alliances for competitive advantage, value resources, customer value orientation, human resources, knowledge management and learning, non-imitability of resources, and resource base advantage in the area of developing dynamic capabilities and sustainable advantage. The measure of distinct competitive advantage has often been left as matter of choice or acceptance by researchers. They have described market based advantage through either the market metrices such as customer equity, brand equity or market share of accounting, or financial measures such as current ratios, profitability ratios or shareholders' value, market capitalisation etc. Moreover, studies have been conducted with respect to companies in contexts other than India's, such as that of European nations or the United States. One of the concepts claims that an amalgamation of accounting and economic measures can be attributed to the concept of economic profit i.e. EVA®, which can be explored for defining companies' competitive advantage.

In US based companies the concept of economic value added and its adoption by some of the multinationals, has helped them achieve a competitive advantage within their respective industries. The measure and adoption of economic value added (EVA®) has helped these multinationals, such as Coca Cola, GE, Eli Lilly, Monsanto, Bestfood, Bausch & Lomb etc. not only to turn around the organisations but also to gain a competitive advantage that they could sustain. The concept of EVA® is based upon the theory of economic profit and calls for the organisations to have strong economic wealth in order to have strong and sustained growth; it was compiled with the consulting support of Stern and Stewart and Co. However, any discussion of EVA® has so far concerned only the companies in the US and European countries.

The current book is based on the project sponsored by the University Grants of India, New Delhi, who have mandated the author to explore the status of companies in India, with respect to their wealth creation i.e. EVA® and its basis for competitive advantage. The project explores the concept of EVA®, that is, based upon the definition of the companies' net profit, and how it would help them in the right utilisation of their resources and responsible strategic planning. Based on the findings of the project, which included studying the top BT 500 companies in India and their decision making based upon EVA®, the book presents a comprehensive understanding of the use of EVA® by the companies in India for their competitive advantage within respective industries. The book makes a case for the sensitisation of the concept of EVA® amongst the practitioners and promoters of Indian companies. There are cases of EVA®'s success for maintaining a sustained competitive advantage, but the concept is yet to be embraced fully due to its difficult compliance requirements.

The literature supports the benefits of the [EVA®] concept in the long-term. In the larger review it is found that the companies in India have been reluctant to use the economic value added and have dropped reporting EVA® over the last decades. It was found that, before 2008, there were 40 companies in India reporting EVA® which was reduced to just 12 companies. However, some of the companies which have been reporting EVA do use it to describe their performance. Companies such as Dr. Reddy's Lab, Godrej, Pidilite etc. have been using EVA® for their management decisions and setting up the future growth of their organisation. It has been used for defining the competitive landscape for the companies. EVA® is also being used in companies' annual reports for the financial highlight, as indicative information to stakeholders regarding the management's future, as well as current, posturing of the organisation in the contemporary business environment; post 2008, they have used it as a management decision and analysis medium. Some companies have also applied EVA® in their management practices for compensation strategies and for creating a competitive value driven environment within the organisation.

Through the analysis it was found that across the industrial sectors the EVA® experience in terms of performance has been mixed. Firms were not consistent in their performance over the period assessed. Specifically, it has been found that sectors such as the IT and pharmaceutical sector have been generating high economic value added for companies, while it is a mixed experience for the automobile industry and FMCG. It may be considered that Indian companies with consistent economic value added have been creating wealth but that it is inconsistent.

It was also found that the EVA® is linked with various other performance indicators that provide for firms' competitive advantage. It has been shown that EVA® has a relationship with market capitalisation and revenue, as well as net cash flow at the overall level of the sample of companies under observation. The empirical results based on the sample Indian companies over the period examined established that the EVA® can be potentially reflected as a measure for competitive advantage based on historical financial data.

The exploratory study in the report provides insight into the concept of EVA®; it has yet to become popular amongst managers or practitioners. The respondents of the survey do not perceive EVA® as a significant tool for competitive advantage. Due to a lack of familiarity with it, there is minimal acknowledgement that EVA® is an important tool for decision-making and that its implementation can improve business performance.

The literature supports the fact that EVA® can provide a valuable measure of wealth creation; however, claiming that EVA® alone can offer an organisation a sustainable source of competitive advantage is an overstatement. EVA® is only one piece of the performance measurement puzzle and it must be used in conjunction with a balanced set of measures that provide a complete picture. Nevertheless, the cases of Pidilite Ltd., Hero Motocorp. Ltd., Infosys, and Hindustan Unilever Ltd., discussed in this book, do provide substantial evidence of the sustenance of these organisations based on the strong wealth position and economic value added. The selected organisations have been able to create a sustainable advantage over their competitors with a strong economic profit position and a consistent adherence to EVA® reporting. The book provides a potential roadmap for establishing the EVA® as a measure for competitive advantage with the help of empirical evidence from companies in India.

Sd/-
(Saurabh)

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God bless us all

Sd/-
(Saurabh)

ABBREVIATIONS

CMIE	Centre for Monitoring Indian Economy
CAGR	Compound Annual Growth Rate
EBIT	Earnings Before Income and Tax
EBITDA	Earnings Before Interest, Tax, Depreciation, and Amortisation
EPS	Earnings Per Share
EVA	Economic Value Added
FMCG	Fast Moving Consumer Goods
IC	Invested Capital
IT	Information Technology
MVA	Market Value Added
NOPAT	Net Operating Profit After Tax
NPV	Net Present Value
ROA	Return on Assets
ROCE	Return on Capital Employed
ROI	Return on Investment
ROIC	Return on Invested Capital
WACC	Weighted Average Cost of Capital

CHAPTER I

ECONOMIC VALUE ADDED (EVA®) FOR COMPETITIVE ADVANTAGE

Introduction

Over time, the field of strategic management has been evolving through various dimensions of understanding. Amongst the evolutionary contributions of the scholars in the last 50 years, the most prominent have been Michael E. Porter's concepts of value chain analysis and the five forces model for achieving a sustainable competitive advantage. The concept of the value chain and competitive advantage have traversed a long path and are still being discussed with regard to their ability to drive organisational success and sustaining a competitive position. The theory of competitive advantage has been at the core of research for the strategic management field (Fahy, 2000; Ma, 2000, 2004; Barney 2001a; 2001b; 2007; Lin 2003; Fahy, Farrelly, and Quester 2004; Cousins, 2005; Porter and Kramer, 2006; Liao and Hu, 2007). Understanding the sources of sustained competitive advantage has been a significant area of study in strategic management (Porter, 1985, 1991; Barney, 1991; Peteraf, 1993; Ma, 1999a, 1999b, 2004; Flint and Van Fleet, 2005; King, 2007). The concept of competitive advantage provides a platform for defining a company's strategic process. Over the decades, since it was introduced by Porter (1985), the term competitive advantage has been central to the field of strategy in defining the performance parameters of organisations. The concept of competitive advantage has been used interchangeably with distinct competence or positional superiority, resulting in the achievement of superior customer value or lower cost, as well as superior returns, market share, and profitability (Day and Wensley, 1988). The discipline of strategy has been discussing the definition of competitive advantage in various contexts (Rumelt 2003).

'Competitive advantage' is described as the state of a company in which it has created more economic value than its rivals. Economic value is defined as the difference between the perceived benefits gained by the customers who purchase the products or services and the full economic cost of production of the goods and services that are being produced by a company. The size of the competitive advantage is equal to the difference of the economic value that the two companies calculate. The concept of competitive advantage provides a platform for defining the process of strategy for a company. However, over a decade of debate on the concept of competitive advantage, the literature of strategic management has shaped various perspectives. The dynamics of competitive advantage, under the contemporary scenario of intense competition, high substitutability, and shorter life cycle of the products changes rapidly. The phenomenon is particular to each industry. Therefore the perceived values also change rapidly in various industry sectors. The definition of the competitive advantage may seem simple. However, there is a difference of opinion and ideas when it comes to defining a unanimously accepted measure for competitive advantage across the industry sectors. Reaching a consensus regarding its definition is difficult, as concepts of competative advantage diverge. As per the theoretical insight from industry organisation (I/O) view, competitive advantage is based on companies' leveraging ability for sustainable performance.

It is often claimed that competitive advantages are a temporary phenomenon and do not have an influence on the long-term performance of the company given the climate of increasing uncertainty. Competitive advantage and company performance are two different constructs with a complex relationship (Ma, 2000). Internationally studies have shown a significant association between competitive advantage and performance (Ma, 2000; Fahy, 2000; Wiklund and Shepherd, 2003; Ray et al. 2004). In recent decades, the measurement of a company's performance and the competitive advantage out of the performances has been an area of research interest for scholars in the field of strategic management. Newbert (2008) has found a positive correlation between the attainment of competitive advantage by the company and better organisational performance. It is further claimed that competitive advantage can indirectly and positively influence an organisation's performance. Thus competitive advantage can act as a strong predictor of organisational performance regarding the efficiency outcome, which is described as the economic returns generated to a level that justifies the company's investment by tangible and intangible resources. Often, competitive advantage is described as a state of a company in which it has created greater economic value in comparison to its rivals. Economic value is also defined as the difference between the perceived benefits gained by the customers who purchase the products or services, and the full economic cost of production of the goods and services that are being produced by the company. The size of the competitive advantage is equal to the difference of the economic value that the companies may calculate. Due to the dynamics of industries, the task of measuring competitive advantage is challenging.

Measures of Competitive Advantage

Throughout the period, competitive advantage has been identified by the application of accounting and economic measures. But both the parameters have their disadvantages. The accounting measures are non-comparable across companies. Also, the indicators say very little about the company since many of the accounting measures take into account cost as a component. In the economic measure, we do include cost, but critics claim that this measure exaggerates the importance of the equity and debt stakeholders. Thus it becomes essential to explore the role of the combined effect of accounting and economic performance by companies in light of economic value added to complement the concept of competitive advantage. It would provide new insight for formulating a strategy for the companies. Particularly in relation to India there has been literature discussing the sources of competitive advantage for Indian companies, but due to a variety of reasons the measuring parameters of competitive advantage regarding superior performance capacity have been a quiescent area. It thus becomes germane, particularly with reference to India, where we are witnessing the new dimensions of competition frequently, to understand economic value and its role in the superior performance of companies, i.e. sustained competitive advantage. The perceived benefits are subject to change over time. Perspectives and opinions, too, keep on changing. The total cost of producing a product may not be taken into account either. Therefore it is a challenging task to identify a suitable measure for competitive advantage.

Introducing EVA® for Competitive Advantage

Economic value added (EVA®) is the concept of residual income which was refined and renamed EVA® by the Stern Stewart consulting organisation. Since then analysts have also found economic value added (EVA®) to be the most significant indicator of companies' performance. Many authors have generated a list of companies for conceiving and implementing value-creating strategies (Hitt and Ireland, 1986; Thompson and Strickland, 1987). Nationally as well as internationally, economic value added has been discussed as a measure of a company's performance (Burksaitiene 2009). EVA® has been popular amongst researchers as a measure for defining shareholder value. The concept provides insight into value creation and combines finance theory with the competitive strategy framework (Soral and Bhanawat, 2009). EVA® is a residual income value after charging the cost of capital through lenders and shareholders. It is the value added to the shareholders. EVA® is an operating profit generated in excess of the cost of capital employed. Though there have been discussions with regard to EVA® as a measure to increase shareholder value; Epstein and Young (1999) have advocated the use of the EVA® for improving capital investment decisions. It could help with external and internal decision making. Traditionally, the financial ratios have reflected the performance of companies across the competitive scenario. Prakash et al., (2003) have examined the difference between pre and post EVA® adoption of the key financial ratios and have concluded that the financial ratios, apart from a few exceptions, have a significant effect on steering towards positive change after the introduction of EVA® into companies. Ehrbar, (1998) emphasised that EVA® can be used to align the interests of agents with principals, i.e. it helps in strategically aligning the goals of managers, employees and shareholders. According to Ehrbar, EVA® represents the most '*socialising form of capitalism*'. EVA® propels a wealth building culture within organisations. The concept drives the employees at the deepest level within the organisation as it defines their contribution to a significant degree in the sustainable growth of the organisation.

Evolution of Economic Value Added (EVA®)

The evolution of economic value added (EVA®) can be traced back to the concept of economic profit, which has evolved through a classical notion of "residual income". The accounting performance measure of residual income describes it as the operating profit reduced with a capital charge. However, EVA® is a concept propagating the adjustments of how to work out the income and capital. It is attributed to the total net gain minus the interest on the invested capital at the current rate. For instance, consider the definition of economic profit made in 1890 by the famous British economist, Alfred Marshall, for the real meaning of a business owner's profit. He describes the real meaning of a business owner's profit in the following way: "What remains of his profits after deducting Interest on his capital at the current Rate may be called his earnings of undertaking or management."

Based on Alfred Marshall's statement, it is evident that economists' definition of profit, namely a residual view of income or economic profit, is radically different from the accounting measures of profit such as EBIT, EBITDA or net operating income. The difference between economic profit and accounting profit as per the classical economists is that a company is not truly profitable unless its revenues have covered the usual production and operating expenses of running a business and provided a reasonable return on the owners invested capital. The EVA® based on economic profit is fundamentally the residual view of income.

The roots of EVA® can be traced back to classical economic theory as well. In the 20th century, three leading economists defined and then refined the meaning of economic profit. Irving Fisher in the 1930s, and Nobel Laureates Franco Modigliani and Merton Miller in the late 1950s; the early 1960s brought and discussed the meaning of economic value added in the corporate valuation context. Based on the defined relationship between the net present value (NPV) and the company's discounted stream of expected cash flow, Modigliani and Miller (1958) elaborated that it is the primary driver for the company's enterprise value, and that stock price is the positive NPV rather than its capital structure and equity statistics.

The theory of 'Economic Value Added' rests on two principle assertions:

1. A company is not profitable unless it earns a return on invested capital that exceeds the opportunity cost of capital, and
2. Wealth is created when a company's manager makes positive NPV investment decisions for the shareholders

The EVA® model differs from the free cash flow model because it provides a direct measure of the value added to invested capital. The company's NPV is equal to the present value of the anticipated economic profit stream generated by its existing and anticipated future assets. NPV is a discounted stream of economic profit:

NPV = Present value of EVA®

Managers create wealth by making a discounted economic profit and from then on focus on positive NPV decisions. They destroy wealth by making discounted negative EVA® decisions. EVA® is positive when the company's EVA® spread is positive. On the other hand, economic profit is negative when corporate managers invest in assets having an after-tax return that, on balance, falls short of the cost of capital. EVA® is relatively similar to the concept of operating profits and adds one more expense, which is the charge for the cost of capital. The capital charge is a sort of rental charge on the capital used by a company, division or business unit. A reduction in the amount of capital is needed to produce a given product or service which brings a lower capital charge and higher EVA®, while any new investments will boost EVA® only if it produces a large enough increase in operating profits to cover the added capital charge. The net operating profit after tax (NOPAT) includes deductions for taxes and depreciation of equipment. Both are subtracted from NOPAT because they are genuine costs that are to be managed. EVA® or residual income is calculated by multiplying the net working capital and fixed assets used in operation by the percentage cost of capital (including the cost of capital and cost of equity (Ehrbar, 1998).

Joel Stern, the managing partner of M/s Stern and Stewart and Company, pioneered 'Economic Value Added' (EVA®) as a measure for business performance in the early 1980s. Since the introduction of the EVA® in the pursuit of shareholder value it has motivated more than 400 companies to adopt the practice, globally. Some of the companies that improved their competitive position and sustained performance were Coca-Cola, Eli Lilly, Monsanto, Best food, Bausch & Lomb, etc. (Bennett, 1991). In India too, a few companies rode on the wave of EVA®. During the 1990s Godrej, TCS, Infosys, Pidilite, etc. benefited from the adoption of EVA® into management decisions and reporting practice. One of EVA®'s most important contributions has been in bringing to light the fact that equity has a cost, albeit not as readily apparent as the cost of debt (interest expense). A company must earn for its shareholders an amount equal to the risk-adjusted return that its capital providers could earn on myriad other investments, and compete successfully for the scarce resources in the capital markets. Thus, EVA® maintains that a company has to do more than earn a positive net income. Preferably, the companies need to earn more than the cost of debt and the opportunity cost of equity to create value. Economic value added (EVA®), helps managers to understand the real drivers of business performance, which often go unnoticed. Once EVA® is embraced by corporations or companies, decisions related to the drivers for improving the performance need to be taken more consciously.

Peter Drucker (2002) sees economic value added (EVA®) as a superior performance measure. According to him,

> EVA is based on what we have known for a long time: What we generally call profits, the money left to service equity, is usually not profit at all [...] 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. It does not cover its full costs unless the reported profit exceeds the cost of capital. Until then, it does not create wealth; it destroys it.

Drucker further says,

> By measuring the value added overall costs, including the cost of capital, EVA measures, in effect, the productivity of all factors of production. It does not, by itself, tell us why a certain product or service does not add value or what to do about it. But it shows us what we need to find out and whether we need to take remedial action.

The cost of capital is the return an investor could achieve by making an alternative choice for their investment. If this return is not generated, then the investor is going to have their investments diluted or destroyed. This concept differs from the traditional definition of profit, i.e. revenue minus costs only. Practitioners adopted EVA® broadly, based on its ability to measure value from the point of view of companies. The dividend discount approach provides for wealth distribution, whereas EVA® has the capacity for continuous wealth creation.

EVA® is beyond the fundamental mechanism of measuring corporate performance. With the basics of conventional financial measures, EVA® accounts for an economic measure of benefit that can be derived out of business activities. The businesses that are able to sustain and drive leverage for their stakeholders after meeting the cost of capital compulsions are better able to manoeuvre capably against their competitors. They can reflect better responsiveness to the dynamic capabilities and hence are able to provide for value maximisation to a company. EVA® is found to be a robust measure for performance and the creation of value, as it can be well integrated or coupled with the management process, planning, portfolio management, strategic and tactical decision making targeted towards the dynamic and strategic manoeuvring for competitive advantage. The most critical mission for any business organisation is to maximise the shareholder's wealth better than its competitors. The cost of operations and value generation through productive utilisation of scarce resources defines the value based advantage of the organisation. The organisations inherently compete with each other, seeking the advantage. Thus they adopt either distinct competencies, cost advantage or differentiation to create superior value for their target market to create an above average performance which can be distinguished as a competitive advantage. The superior economic value is described in terms of economic rate of return (after risk adjustment) above the cost of capital which promotes expansion under competition. EVA® reflects its advantage over other measures as its inherent ability to be seen as integrated performance measurement, management, and an award system for an organisation directed towards above-average performance.

The Significance of the Book

Despite its distinct advantage and linkages, and the advantage of being an effective performance metric, there is not enough literature that supports the ability of EVA® to be accepted as a tool for competitive advantage, specifically in the context of companies in India. Also, based on the research available in the field of strategic management and competitive advantage in Indian companies, strategies on the basis of economic value added are yet to be defined. The lag in using economic value added in crafting strategies is probably because of general non-adoption of EVA® by all the companies in India. This book, therefore, aims at focusing on the significance of EVA® as one of the measures for competitive advantage. With the longitudinal and cross-sectional analysis of EVA® and its reporting in Indian companies over the last decade, in the following chapters, an attempt is made to establish the ability of EVA® as a significant contributor to the competitive advantage of companies in India. With empirical analysis and also the perception-based analysis in the following chapters, an attempt is made to bring out how, despite its inherent capability, EVA® has been overtly a neglected tool, due to its complexity and the lack of awareness amongst Indian companies and practitioners. Indian companies have a distinct advantage in various fields and have been able to create value for their stakeholders over time. The companies which have adopted EVA® have generally been able to sustain their advantage over the competition through the years. The literature has established that companies in India that calculate and mention their strategic decisions with reference to EVA® reflect a higher profitability as