CHAPTER 35

SHAREHOLDER VALUE CREATION AND CORPORATE GOVERNANCE

Problem 1

Net margin	57.8%
Leverage	1.68
Retention ratio	0.3
Assets/sales	2.01
Sustainable growth	16.9%

Sustainable growth: $$\frac{\text{net margin} \times \text{retention} \times (1 + \text{D/E})}{\text{Assets/sales} - [\text{net margin} \times \text{retention} \times (1 + \text{D/E})]}$$

Problem 2

Growth	15%
ROI	16%
Interest rate	7%
Target growth	18%
Payout	60%
Retention	40%
Required D/E	3.22

The formula for target or sustainable growth is:

$g_s = b[r + (r - i)D/E]$

In this problem, r, i, b and g_s are known. Hence, to obtain target growth, the required D/E ratio will be follow:

$0.18 = 0.4\ [0.16 + (0.16 - 0.07) \times D/E]$

$0.036D/E = 0.18 - 0.064$

$D/E = 0.116/0.036 = 3.22$

Problem 3

	(Rs crore)
PAT	123
Interest	24
Tax rate	35%
Invested capital (IC)	1340
WACC	15%
EBIT (1-T) = PAT + INT(1 - T)	139
Capital charges = WACC × IC	201
EVA	-62

I. M. Pandey, Financial Management, 9th Edition, Vikas.

Problem 4

	2003	*2002*	*2001*	*2000*	*1999*
(A) Risk-free rate	6%	7.30%	10.30%	10.45%	12%
(B) Risk premium	7%	7%	7%	8%	8%
(C) Beta	1.57	1.41	1.54	1.48	1.48
(D) Cost of equity	17.0%	17.2%	21.1%	22.3%	23.8%
(E) Capital employed (Rs crore)	2,470.48	1,734.97	1,111.47	703.87	245.42
(F) Enterprise value (Rs crore)	25,208.82	23,627.37	26,348.61	58,829.80	9,256.14
(G) MVA, (E - F) (Rs crore)	22,738.34	21,892.40	25,237.14	58,125.93	9,010.72
(H) PBT	1158.93	943.39	696.03	325.65	155.86
(I) Tax	201	135.43	72.71	39.7	22.94
(J) PAT, (H - I)	957.93	807.96	623.32	285.95	132.92
(K) Capital charges, (D ×E), (Rs crore)	419.73	297.89	234.30	156.89	58.51
(L) EVA, (J - K), (Rs crore)	538.20	510.07	389.02	129.06	74.41
(M) M/B, (F/E)	10.20	13.62	23.71	83.58	37.72
(N) ROE, %, (J/E)	38.8%	46.6%	56.1%	40.6%	54.2%
(O) Economic return (L/E or N - D)	21.8%	29.4%	35.0%	18.3%	30.3%

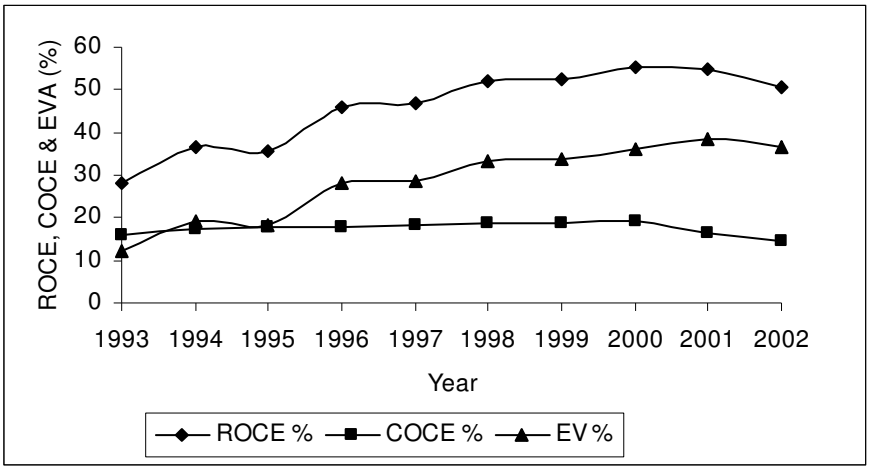
CASE

Case 35.1: Hindustan Lever Limited

The purpose of this case is to clarify the concept of economic value added (EVA) and show the methodology of calculating EVA. This case illustrates how HLL calculates its cost of equity and WACC. It also shows the methodology of calculating EVA. The instructor may like to students to explain Table 35.1 to ensure that they understand the calculation of WACC and EVA.

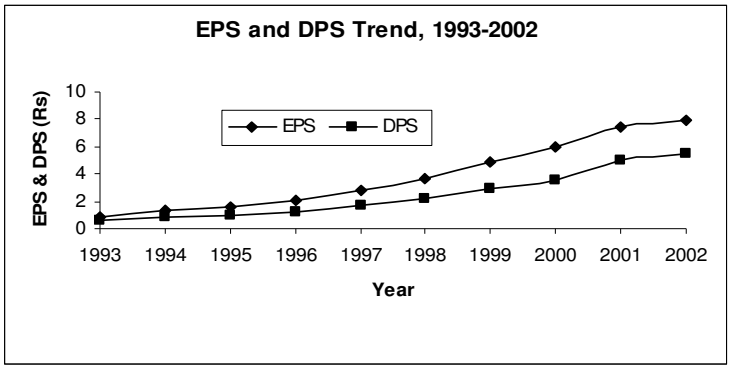
EVA is the difference between after-tax operating income and the charges (cost) for the capital employed. Thus, it is an economic surplus – an amount over and above the cost of employing capital. EVA divided by capital employed is economic rate of return. The EVA spread in percentage is the difference between the economic rate of return and the cost of capital. Table 1 in the text of the case shows that HLL's EVA has been continuously growing over years; from Rs 60 crore in 1993, it has grown to Rs 1,236 crore in 2002. As the following table shows the EVA spread in percentage has grown from 12.1% in 1993 to 36.4% in 2002 (a slight drop from 2001).

Cost of Capital	*2001*	*2002*	***Year***	***ROCE %***	***COCE %***	***EV %***
Cost of debt	12.00%	10.20%	***1993***	28.3	16.2	12.1
Post-tax Cost of debt	7.72%	6.45%	***1994***	36.7	17.6	19.1
Cost of equity	16.70%	14.40%	***1995***	35.8	17.8	18.1
Risk-free rate	7.20%	7.20%	***1996***	45.8	17.8	28.0
Risk premium	9%	9%	***1997***	46.7	18.3	28.4
Beta	0.8	0.8	***1998***	51.8	18.6	33.2
Debt ratio	1.8%	1.3%	***1999***	52.4	18.8	33.5
Equity ratio	98.2%	98.7%	***2000***	55.2	19.3	35.9
			2001	54.9	16.5	38.4
COCE	16.54%	14.29%	***2002***	50.7	14.3	36.4



The following table shows the trend in the companies EPS, DPS and share price. Both EPS and DPS have shown continuous growth. Share price has also grown except that it declined in 2002 (as compared to the previous year). The drop in the share price corresponds with the drop in the EVA spread (%).

Year	***1993***	***1994***	***1995***	***1996***	***1997***	***1998***	***1999***	***2000***	***2001***	***2002***
EPS	0.91	1.30	1.64	2.08	2.81	3.67	4.86	5.95	7.46	7.98
DPS	0.56	0.80	1.00	1.25	1.70	2.20	2.90	3.50	5.00	5.50
Share Price	57.50	59.00	62.40	80.70	138.35	166.35	225.00	206.35	223.65	181.75



Considering the annual dividend yield and capital gain/loss, the average market return on HLL's shares during the period 1993 to 2002 is 18%.

Year	***1994***	***1995***	***1996***	***1997***	***1998***	***1999***	***2000***	***2001***	***2002***
Annual market return	4.0%	7.5%	31.3%	73.5%	21.8%	37.0%	-6.7%	10.8%	-16.3%

Average 18.1%