

APPLIED FINANCE

Lecture 2

CONCEPT OF ECONOMIC VALUE ADDED

1. Traditional approaches to measuring 'Shareholders' Value Creation used parameters such as earnings capitalisation, market capitalisation and present value of estimated future cash flows.
2. Extensive equity research has now established that it is not earnings *per se*, but value which is important.
3. A new measure called "Economic Value Added" (EVA) is increasingly being applied to understand and evaluate financial performance.
4. $EVA = NOPAT - COCE$ (Net operating profit after taxes – Cost of Capital Employed)

NPOAT = Profits after depreciation and taxes but before interest costs. NOPAT thus represents the total pool of profits available on an ungeared basis to provide a return to lenders and shareholders;

COCE = Weighted average cost of capital (WACC x Average capital employed)

CONCEPT OF ECONOMIC VALUE ADDED

What does EVA show ?

EVA is residual income after charging the Company for the cost of capital provided by lenders and shareholders. It represents the value added to the shareholders by generating operating profits in excess of the cost of capital employed in the business.

When will EVA increase ?

- (a) Operating profits can be made to grow without employing more capital, i.e. greater efficiency.
- (b) Additional capital is invested in projects that return more than the cost of obtaining new capital, i.e., profitable growth.
- (c) Capital is curtailed in activities that do not cover the cost of capital, i.e., liquidate unproductive capital.

Utility of EVA

(i) EVA represents the value added to the shareholders by generating operating profits over and above the cost of capital employed in the business. Hence it is a measure of financial performance.

CONCEPT OF ECONOMIC VALUE ADDED

Utility of EVA Continued

(ii) EVA is a management tool that discloses the impact of both strategic as well as operational decision of the management. The examples of strategic decisions are: what investment to make, which business to exist, which financial structure is optimal, etc. While operational decision include, whether to make in house or out source, repair or replace equipment or, make short or long production runs, etc.

(iii) EVA can prove as an effective tool for increasing shareholders' wealth, through integrating EVA framework in four key areas, viz., to measuring business performance, guiding managerial decision-making, aligning managerial incentives with shareholder interests and improving the financial and business literacy throughout the organisation.

THE FOREIGN EXCHANGE MARKET

- ▶ The **foreign exchange market** is the market where the currency of one country is exchanged for the currency of another country. Most currency transactions are channelled through the world-wide interbank market. **Interbank market** is the wholesale market in which major banks trade with each other.
- ▶ **Participants**
 - ▶ *Speculators*
 - ▶ *Arbitrageurs*
 - ▶ *Traders*
 - ▶ *Hedgers*

FOREIGN EXCHANGE RATES

- ▶ A **foreign exchange rate** is the price of one currency quoted in terms of another currency.
- ▶ When the rate is quoted per unit of the domestic currency, it is referred to as **direct quote**. Thus, the US\$ and INR exchange rate would be written as US\$ 0.02538/INR.
- ▶ When the rate is quoted as units of domestic currency per unit of the foreign currency, it is referred to as **indirect quote**.
- ▶ A **cross rate** is an exchange rate between the currencies of two countries that are not quoted against each other, but are quoted against one common currency.
- ▶ Suppose that US\$ 0.62 DM is selling for FF 3.65 and the buying rate for the French franc (FF) is \$0.17, what is the DM/FF cross-rate? It is:

$$\frac{US\$ 0.62}{DM} \times \frac{FF 3.65}{DM} = US\$ 0.17$$

FOREIGN EXCHANGE RATES

- ▶ The **spot exchange rate** is the rate at which a currency can be bought or sold for immediate delivery which is within two business days after the day of the trade.
- ▶ **Bid-ask spread** is the difference between the bid and ask rates of a currency.
- ▶ The **forward exchange rate** is the rate that is currently paid for the delivery of a currency at some future date.
- ▶ The forward rate may be at a premium or at a discount.

- ▶ For a *direct quote*, the annualised forward discount or premium can be calculated as follows:
Forward premium (discount) =
$$\left[\frac{\text{Spot rate} - \text{Forward rate}}{\text{Spot rate}} \right] \times \frac{360}{\text{Days}}$$

INTERNATIONAL PARITY RELATIONSHIPS

- ▶ There are the following four international parity relationships:
 - ▶ Interest rate parity (IRP)
 - ▶ Purchasing power parity (PPP)
 - ▶ Forward rates and future spot rates parity
 - ▶ International Fisher effect (IFE).

CURRENCY APPRECIATION AND DEPRECIATION

“We frequently hear things like “the dollar strengthened (or weakened) in financial Markets today” or the dollar is expected to appreciate (or depreciate) relative to the Rupee.” When we say that the dollar strengthens or appreciates, we mean that the value of a dollar rises, so that it takes more foreign currency to buy a dollar.

What happens to the exchange rates as currencies fluctuate in value depends on how exchange rates are quoted. Since we are quoting them as units of foreign currency per Rupee, the exchange rate move in the same direction as the value of the Rupee: it rises as the rupee strengthens, and it falls as the rupee weakens.

Relative PPP tells that the exchange rate will rise if the India’s inflation rate is lower than the foreign country’s. This happens because the foreign currency depreciates in value and therefore weakens relative to the Rupee.

DEPRECIATION OF RUPEE AGAINST US DOLLAR

1. Rupee has depreciated a record low of Rs. 57.32 on June 22-2012 against US dollar.
2. Loss of potential European export market. Due to Euro-zone debt crises. Financial crunch and insolvency. The main countries are Greece, Ireland, Portugal, Spain and Italy and France.
3. Export leads to foreign exchange inflow.
4. Huge oil bills due to import of crude oil.
5. FII's turned bearish due to implementation of GAAR* retroactively.
6. The above mentioned reasons lead to scarcity of US dollar and depreciated partially convertible rupee to a record low.
7. Gradual strengthening of Rupee started form 4th July 2012.
8. Offloading of dollars by banks and exporters.
9. The government increased foreign investment limits in government debt by \$ 5 billion to \$ 20 billion.
10. FII's turned bullish due to announcement that application of GAAR will not be retrospectively.

**General Anti Avoidance Rule aimed at preventing deals or incomes that are structured to avoid taxes*

GAAR JARRS

1. What is GAAR? General Anti Avoidance Rule is aimed at preventing deals or incomes that are structured only to avoid paying taxes.
2. Why is GAAR Required? Isn't Tax Planning and Tax Savings Legitimate ; In India the courts have ruled that savings of taxes through permissible instruments of Tax planning is legitimate. But Tax Avoidance is illegal.
3. Why are Anti-Avoidance measures necessary? According to some expert in an environment of moderate rates of tax, it is necessary that the correct tax base be used for calculating taxes in the face of aggressive planning and use of opaque low tax jurisdictions for residents as well as for sourcing capital.
4. Whom does GAAR Affect ? Almost anybody and everybody. Corporations may be forced to re-structure salaries of employees if Taxmen conclude that these were structured only to avoid Taxes. (FII's) who invest through countries such as Mauritius to exploit bilateral Tax Treaties will be effected after GARR comes into force. It's feared that once GAAR is invoked FII's will have to pay capital gain tax for their investment in Indian equities.
5. The committee has proposed to implement GARR on P-Notes. (Participatory Notes are offshore derivative instruments issued by foreign broking houses to overseas investors who wish to invest in the Indian stock market without registering themselves with the market regulator, SEBI.

CRITICAL POLICIES AWAITING APPROVAL

1. India's is suffering from stagflation of its own version; Morgen and Stanley
2. P.M. is rated as under-achiever; Times Magazine.
3. Indian economy downgraded from stable to negative; Standard & Poors.
4. Raising FDI Limit in insurance sector from 29% to 49%.
5. Introduce the Direct Tax Code (DTC) to overhaul archaic income tax laws.
6. Banking laws (Amendment) Bill to empower RBI to supersede banks' boards; grant license to new private sector banks.
7. Introduce a uniform Goods and Services (GST).
8. Legislate the Pension Fund Regulatory and Development Authority (PFRDA) Bill to ensure social security for employees.
9. Allow FDI in multi-brand retail.

PERPLEXING FACTS

1. PM promises in G20 summit at Los Cabos, Mexico, to provide \$ 10 billion (Appx Rs 56,000 crore) under deficit economy when the people are subjected to growing economic burdens.
2. The three major rating agencies forced India to allow International Capital flows by the recent reform witnessed. There is a strong suspicions that these agencies promote agenda of international finance capital by manipulating their ratings.
3. These agencies had earlier given AAA rating to mortgage-based debt of companies like Enron.
4. In 2008, on the eve of the global financial meltdown, they had given a similar rating to Lehman Brothers and the insurance giant AIG-the main players in the Wall street collapse.
5. Reforms undertaken; opening Retail trade sector, reducing subsidy, decontrolling fuel prices, increase foreign investment ceiling in the insurance sector, allowing foreign banks to take over Indian private banks, allowing foreign investment in pension funds to go in for market investment i.e., speculation

PERPLEXING FACTS

1. The retail sector in India conservatively contributes 11% of the GDP and employs over 40 million people. According to the 4th Economic census, 38.2% of rural and 46.4% of urban employment is generated in this sector.
2. Permitting multinational giants in retail will only displace these millions into poverty and misery.
3. India to a large extent protected itself from the global financial meltdown because it did not allowed its financial sector to be open to international speculation.
4. After the proposed reforms, India may subject itself to international volatility and thus, become extremely vulnerable.
5. Allowing international speculation in pension funds and the insurance sector will ruin the lives of millions of working people.

THANK YOU