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Optimum Capital Structure Strategies and Usage of Economic Value Added For Share Holders' Value Creation with Special Reference to Infosys

KEYWORDS: EVA, DEBT-EQUITY, FIRMS VALUE, WACC, CAPITAL STRUCTURE ABOUT THE COMPANY

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ABSTRACT *The concept of capital structure is extremely important because it can influence not only the return a company earns for its shareholders, but whether or not a firm survives in a recession. Maximizing shareholder's wealth has become the new corporate paradigm. The thrust area for today's management is to find means to create value for the owners. Many traditional models are present which may not measure the actual value created for its share holders. Thus, it is necessary for the usage of modern tool EVA to determine whether the wealth had been made use of or been destroyed. The firms can even plan optimum capital structure to increase their value.*

ABOUT THE COMPANY

Infosys (formerly Infosys Technologies) is an Indian multinational corporation that provides business consulting, information technology, software engineering and outsourcing services. It is headquartered in Bangalore, Karnataka. Infosys is the third-largest India-based IT services company by 2014 revenues. Infosys was co-founded in 1981 by N. R. Narayana Murthy, Nandan Nilekani, N. S. Raghavan, S. Gopalakrishnan, S. D. Shibulal, K. Dinesh, Venugopal and Ashok Arora after they resigned from Patni Computer Systems.

REVIEW OF LITERATURE

Jain, P. K (1955) examined the factors affecting the capital structure. He found that larger number of factors have a bearing on the design of the capital structure of the firm. These factors differ in intensity from one industry to another industry and even from one firm to another firm in another industry. Solomon (1963) argued that the cost of debt does not always remain constant. When the leverage level exceeds the accepted level, the probability of default in interest payments increases, thus, raising the cost of debt. Stieglitz (1969, 1974) proved the validity of the M-M model under relaxed assumptions whereas Smith (1972), Krause and Lichtenberger (1973), Baron (1974, 1975), and Scott (1976, 1977), supported the M-M model, but only under the conditions of risk free debt and costless bankruptcy. Blair (1997) observed that the EVA has generated much interest in the business community. This financial tool advocates debt finance as evidenced by its basic formula, which uses the weighted cost as the cost of capital, thus becomes cheaper than equity, partly due to the tax deductible interest.

OBJECTIVES OF THE STUDY

- To study the capital structure of Infosys
- To analyze the impact of capital structure on the value of the firm
- To make suggestions and recommendations regarding the use of EVA as a measure of financial performance

NEED AND IMPORTANCE OF THE STUDY

The effect of leverage on the cost of capital is not very clear. Conflicting opinions have been expressed on this issue. In fact, this issue is one of the most continuous areas in the theory of finance, and perhaps more theoretical and empirical work has been done on this subject than any other. If leverage affects the cost of capital and the value of the firm, an optimum capital structure would be obtained at that combination of debt and equity that maximizes the total value of the firm or minimizes the weighted average cost of capital.

SCOPE OF THE STUDY

Financial decisions are long-term decisions. They reflect the long-term strategies of the companies. Therefore the financial statement of five years is taken into consideration for studying the capital structure and economic value added.

LIMITATIONS OF THE STUDY

The study is based on the information presented in the annual reports, which is typically secondary data.

Limitations applicable in the financial statements would apply to the study also

RESEARCH METHODOLOGY

Research is a common parlance which refers to a search for knowledge. Research methodology is a way of systematically solving the research problem. It may be understood as a science of studying how research is done scientifically.

RESEARCH DESIGN

In this study, past and existing data are used to analyze the present state of affairs and therefore, the research design is descriptive and analytical in nature.

SOURCE OF DATA

The data collected for the study is secondary data in nature. Here, secondary data is collected from the balance sheets of the firm and online internet sources.

TOOLS USED

The tools used for the analyses and interpretation of financial statement in this study is

Economic Value Added

CAPITAL STRUCTURE

Capital Structure, according to Campbell B. Harvey, is "the

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makeup of the liabilities and stockholders' equity side of the balance sheet, especially the ratio of debt to equity and the mixture of short and long maturities".

ECONOMIC VALUE ADDED

EVA is the amount of economic value added for the owners by management. The thrust area for today's management is to find means to create value for the owners. It is now established that the accounting profit in no cases represents the real value created for the owners. But, it may originate the calculation.

RELATIONSHIP BETWEEN CAPITAL STRUCTURE AND ECONOMIC VALUE ADDED

Anvari Rostami, Ali Asghar Tehrani, Reza, Seraji, Hassan (2004) believed that capital structure affects the Economic Value Added and thereby shareholders' wealth. The change in the capital structure causes increase or decrease in cost of capital and so on the Economic Value Added of the firm. Therefore, finding out the correlation between these factors backed by facts and observations would benefit the decision-making process.

DATA ANALYSIS AND INTERPRETATION

Economic Value-Added (EVA) Statement:

Economic Value-Added is the surplus generated by an entity after meeting an equitable charge towards providers of capital. It is the post-tax return on capital employed (adjusted for the tax shield on debt) less the cost of capital employed. Companies which earn higher returns than cost of capital create value, and companies which earn lower returns than cost of capital are deemed harmful for shareholder value.

Table: Economic Value Added Statement in₹ crore, except as otherwise stated

	2011	2010	2009	2008	2007
Cost of capital					
Return on risk-free investment (%)	7.66	7.20	7.00	8.00	8.00
Market premium (%)	5.00	5.00	7.00	7.00	7.00
Beta variant	0.71	0.68	0.74	0.76	0.99
Cost of equity (%)	11.21	10.60	12.18	13.32	14.97
Average debt / total capital (%)	–	–	–	–	–
Cost of debt – net of tax (%)	NA	NA	NA	NA	NA
Weighted Average Cost of Capital (WACC) (%)	11.21	10.60	12.18	13.32	14.97
Average capital employed	25,688	21,634	17,431	12,527	9,147
Economic Value-Added (EVA)					
Operating profits	8,102	6,910	6,421	4,640	3,877
Less : Tax	2,490	1,681	919	685	386
Cost of capital	2,880	2,293	2,123	1,669	1,369
Economic Value-Added	2,732	2,936	3,379	2,286	2,122
Enterprise value					
Market value of equity	1,86,100	1,50,110	75,837	82,362	1,15,307
Add : Debt	–	–	–	–	–
Less : Cash and cash equivalents	16,810	15,819	10,993	8,307	6,033
Enterprise value	1,69,290	1,34,291	64,844	74,055	1,09,274
Return ratios					
PAT / average capital employed (%)	26.6	28.7	34.3	37.2	42.2
EVA® / average capital employed (%)	10.6	13.6	19.4	18.2	23.2
Enterprise value / average capital employed (x)	6.6	6.2	3.7	5.9	11.9
Growth (%)					
Operating profits	17.3	7.6	38.4	19.7	46.1
Average capital employed	18.7	24.1	39.1	37.0	48.1
EVA	(6.9)	(13.1)	47.8	7.7	37.8
Market value of equity	24.0	97.9	(7.9)	(28.6)	40.4
Enterprise value	26.1	107.1	(12.4)	(32.2)	41.1

Notes: Cost of equity = return on risk-free investment + expected risk premium on equity investment adjusted for beta variant in India. Figures above are based on IFRS financial statements. The data for year 2008 and 2007 is consolidated as per consolidated Indian GAAP. Cash and cash equivalents include investments i liquid mutual funds and certificate of deposits.

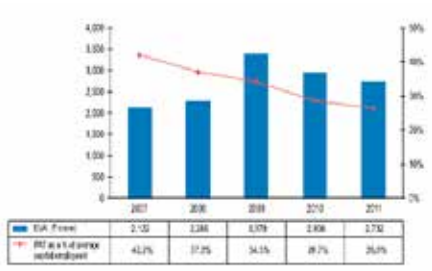

Fig. ECONOMIC VALUE ADDED-DIGRAMATIC REPRESENTATION

FINDINGS AND SUGGESTIONS

It is clear from the above table that EVA has decreased to a lower level and has shown a negative sign. The debt-equity ratio has also shown a mere fluctuating range during the five years. The firm has to take corrective actions to increase the debt content so that the WACC decreases and creates more value for the firm. Thus, by a constant value creation the investors will be attracted towards investing and increase the firm's value. Too much of debt content will lead to liquidity position. Thus, it is important for the firm to form optimum capital structure strategies to manage risk levels.

CONCLUSION

The company has used more equity capital than the debt capital. Instead, the firm may increase the debt content which may reduce the weighted average cost of capital

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and increase the value of the firm. The profitability of the company is satisfactory. The company can make use of EVA to measure the firm's value. The firm can utilize the funds by investing in government bonds and expansion of new business venture to earn a safe profit and create value for share holders and avoid insolvency in near future.

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