
EPM impact on valuation

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Statistical correlation between strong governance and shareholder value

Abstract

Our study of listed companies in the Indian IT sector indicates that companies that give earnings guidance experience lower volatility in stock prices. The implication of this is lower “beta” (systematic risk) and hence lower cost of equity capital and higher valuations. Specifically, **firms that provide annual earnings guidance on an average experience 16% lower beta, 144 basis points lower cost of equity, 9.4% higher valuation (market capitalisation).**

This confirms the hypothesis that non provision of guidance/ inaccurate guidance leads to wider range of analyst earnings estimates leading to greater volatility in stock price and reduced investor/analyst confidence.

A strong performance management governance framework will translate organisational strategy into financial and forward looking operational performance. **In addition to an improvement in ROCE (Return on capital employed), some of the key benefits of implementing robust EPM framework are predictable earnings and reduced variance** from budgets. Predictable earnings enable firms to offer more accurate forward looking earnings guidance to analysts and the investor community, leading to an improved perception of corporate governance and transparency.

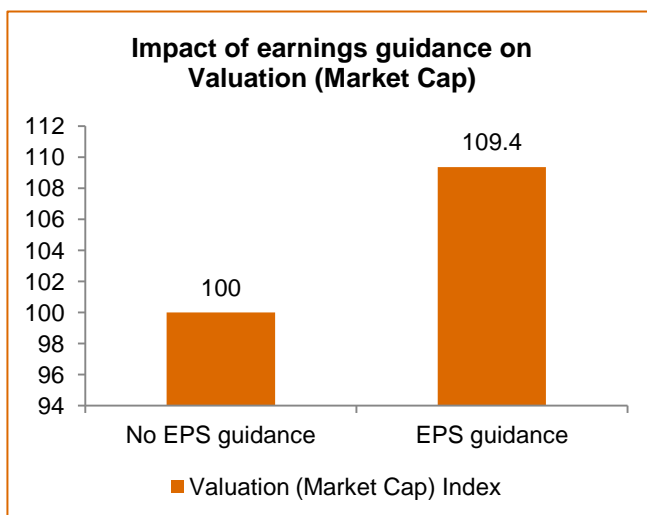
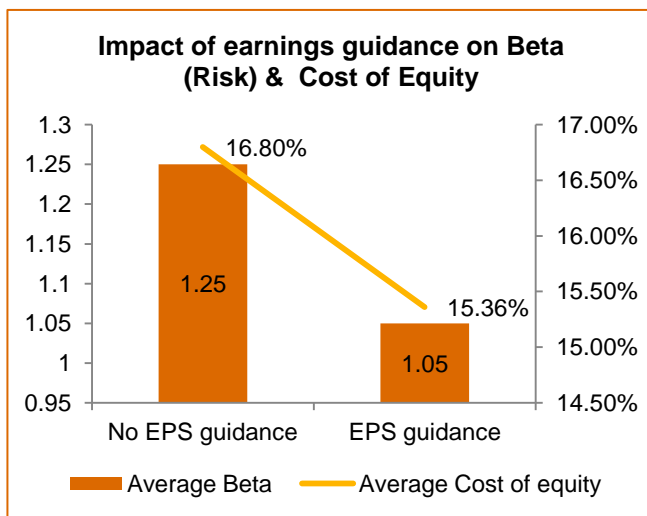
Analysis

A sample set of 30+ leading listed technology companies in India, were analysed to study impact of earnings guidance on stock prices. The firms were categorized into two buckets – namely those that give earnings guidance and those that do not. The individual beta of the firms were recorded (Source: NSE, Reuters) and a t-test for verifying the significance of difference in average beta between the two populations was conducted. The t-test rejected the null hypothesis that average beta of firms that do not issue guidance is greater than or equal to average beta of firms that issue guidance, at 95% confidence level.

For firms giving guidance: average beta = 1.05, variance = 0.04; For firms that do not give guidance: average beta = 1.25, variance = 0.06

The impact of lower beta on cost of equity was computed using the CAPM (Capital asset pricing model). This was then translated into valuation benefit using DCF (Discounted cash flow) analysis.

Findings



Summary

Based on this analysis, a firm that does not provide earnings guidance and with a current market capitalisation USD 100 million, can expect its market capitalisation to improve to USD 109.4 million, on an average, if it can provide earnings guidance (*ceteris paribus*)

Source, Assumptions and Data Set

- Source data for Analysis extracted from NSE, Reuters for 31 leading technology companies listed on National Stock Exchange, India
- Beta = values captured in Sep 2010 for the period 1-Sep-2009 to 31-Aug-2010
- Expected long term equity market return for India = 15% (based on average historical returns from NIFTY and Sensex)
- Risk free rate = 7.8% (based on average RBI 10 year bond yield in Sep 2010)
- CAPM: Cost of equity for firm = $R_f + \text{Beta for firm} (R_m - R_f)$, where R_f is the risk free rate and R_m is the expected long term market return
- DCF: Market Capitalisation of firm = Expected future free cashflow from the firm that belongs to equity holders discounted by Cost of Equity for the firm

The list of IT companies considered for the analysis:

- | | |
|-----------------|------------------------|
| • Infosys | • Oracle FS |
| • Wipro | • Tulip |
| • Mindtree | • Geometric |
| • Rolta | • NIIT Tech |
| • Mastek | • Zensar |
| • Educomp | • Tata Elxsi |
| • Patni | • Infotech Enterprises |
| • KPIT Cummins | • Sasken |
| • Hexaware | • 3i Infotech |
| • CMC | • Sonata |
| • TCS | • Financial Tech |
| • HCL | • Ramco Systems |
| • Tech Mahindra | • ICSA |
| • First Source | • Nucleus Software |
| • Hcl Infosys | • Subex Systems |
| • Mphasis | |

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