Maximizing Financial Returns for Shareholders – Business Analysis

Abstract:

In this article the importance of shareholder wealth and value in business and financial dealings will be discussed. Companies are dependent on shareholder investments so it is in the interest of the company to see to it that shareholders get enough profitable financial returns and this essay aims at analyzing ways of maximizing profitability for shareholders (Robbins et al, 2003/2004). The different concepts in business on returns, profits and shareholder investments such as returns on assets and equity will be examined. After an introduction on what financial returns and profitability would mean to shareholders, the different factors that affect profitability and contribute to maximizing shareholder wealth, the examples and evidence of shareholders returns and company policies and strategies will be analyzed. This essay would highlight the fact that it is a business and company’s primary responsibility to increase profits and improve shareholder financial returns and wealth maximization to maintain the trust of shareholders and investors in the market although there are many factors and controversies involved as will be discussed.
Introduction:

Profitability of a company is measured with the values of return on equity (ROE) and return on assets (ROA). Return on equity reveals the profits a company earns when compared with the total amount of shareholder equity. Shareholder equity represents assets created by retained earnings of business and the capital invested by the owners. Shareholder equity equals total liabilities subtracted from total assets and refers to what shareholders possess. High returns on equity indicates that the company can generate cash internally and higher returns on company’s equity suggests better position of the company. For example if a business had a net worth or shareholder’s equity of $200 million dollars and made a profit of $20 million dollars, the earnings from returns on equity would be 10% (see Omran et al, 2002). Higher returns are positive for the company and indicate valuable returns and profitability for shareholders as well. It is the responsibility of a company to see to it that shareholders get adequate and profitable financial returns for their investments (Robbins et al, 2003/2004). The formula for returns on equity is: Net Profit / Average Shareholder Equity for the Period.

Asset turnover is an indication of total sales for $1 of assets and return on assets or ROA gives an indication of profits generated by a company for each $1 in assets. Profitability is measured both in terms of returns on equity and returns on assets. The return on assets or ROA gives an indication of the asset intensity and the position of the company. Telecom providers, automobile manufacturers etc are companies that rely heavily on expensive machinery and equipments or in-house company assets that can generate
profits. On the other hand software companies have less assets and asset investments. Return on assets measures the earnings and profits of a company in relation to all its assets and available resources including shareholders’ capital, investments and long or short term funds borrowed. Return on assets is a test measure indicating profits or wealth and financial returns to shareholders. If a company has no debts then its return on equity and return on assets would be equal. Calculating returns on assets is done by either of the two ways: Net Profit Margin x Asset Turnover or Net income /Average Assets for the Period.

Maximizing Shareholder Returns: Management Theory and Evidence/Examples:

Shareholder wealth is defined as the present value of the expected future returns from the company to the shareholders of the firm. These returns can be by payments of dividends periodically, and is obtained by selling stocks. Shareholder wealth is determined by the market value of the company’s stocks (Robbins et al, 2003/2004). It is the responsibility of the company to return to its investors through profit and wealth maximization. Profit maximization is a static concept than wealth maximization and does not consider the major risk factors in measurement of profits. Whereas in shareholder returns and wealth maximizations theories and objectives, the risk factors such as profits and losses of the company as well as the pros and cons of investments and financing strategies are also considered.

Shareholder wealth maximization is the long-term goal and objective of any company as serving the interests of shareholders is one of the primary objectives in any business.
Shareholder wealth can be considered as the function of all future returns to the shareholders considering company profits, performance and market value of stocks. Thus in order to maximize shareholder wealth or shareholder interests all long run impact and effects on the firm have to be considered. Even if a firm increases short run earnings and dividends by doing away with departments such as research and development, this may be detrimental for the long run profits of the company and would reduce long-term profits, dividends and earnings and would have adverse effects on shareholder wealth.

Dockey et al (2000) discuss the ways of maximizing shareholder values and refers to the importance of research on not just profitability of a company but also on managerial attitudes/incentives and alignment or compatibility of the interests of directors and shareholders. A survey of 175 finance executives was taken from 7 EU countries to analyze strategies and the influences on strategy choice. Market leadership, continued profits, improving productive capacity, generating better products, are the best business strategies useful in maximizing shareholder returns and values. This paper highlights the importance of companies for developing close relationship with shareholders and investors.

Kumar et al (2000) uses arbitrate pricing theory and provide an economic interpretation of factors affecting the stock markets. The paper develops a multistage model to explain stock returns of representative US companies considered in the paper. The interpretation is done by using data both from monthly returns for individual securities and cross
sectional interdependencies between securities and returns have been found to be related to several factors such as costs and market return index. The change of market patterns and volatility or idiosyncrasy of the industry is taken into consideration before determining shareholder returns and company profitability. Factors such as risks, fraud and shareholder enrichment have been studied by Cloninger and Waller (2000).

Many researchers have highlighted shareholder value as a method for maximizing profits, creating wealth, measuring performance and rewarding executives. However some market analysts have claimed that shareholder value mis-allocate resources, revives old fallacies, and debases the reputation of economics as a useful business discipline.

Bauer et al (2005) emphasize on shareholder value analysis and how it relates to customer equity to develop a marketing based method of corporate valuation. The approach is an examination of the limitations and assumptions of the existing methods which are used to estimate customer value components and also examines the limitations of the concept of shareholder value. The link between customer equity (CE) and shareholder value (SHV) presents a formal model to calculate corporate value. For modelling profit streams, the discounted cash flow method is used. Customer equity and individual lifetime value of a customer form the basis of a model that can estimate corporate value using traditional financial metrics. This is thus a typical case in which the customer based valuation is important. The implications of this study suggests that advancement of quantitative techniques for modelling customer value components and explicit modelling of the future growth of customer base increase the applicability of the
model. The model developed should be applied more extensively using market data for input variables. This sort of model based on customer equity and shareholder value helps in making proper investments and helps avoid misallocation of resources. This also shows whether mergers and acquisitions would be profitable for the company and how much return the shareholders could expect from their investments. Financial valuation models makes it easier to assess returns on marketing investments and also delineates the position of the shareholders.

Many other factors affect shareholder returns and Guy (2000) discuss the impact of CEO pay such as salary and bonuses, and accounting profits from a case study of 99 British companies in the years 1972-89. The paper highlights the positive relationship between CEO pay and within company changes in shareholder returns although there has been no reported relationship between CEO pay and within company changes in accounting returns. Yet, long term average profitability have effects on CEO pay whereas differences in shareholder returns may not have much impact on within firm pay dynamics. CEO pay, profitability and shareholder returns are seen to be closely related in this study.

One example on shareholder returns has been given by Burt and Limmack (2001) who discuss business growth instances in the retail industry. They suggest that acquisition activity is a well established growth mechanism in the retail sector and between 1982 and 1996 alone more than thousand retail takeovers by or from British companies have been recorded. The authors use these instances of takeover to understand the impact of takeovers and mergers on shareholder returns. 227 takeovers were studied and this
accounted for $\frac{2}{3}$rd of the value of activity during 1982-1996 and in general terms retail takeover activities seems to provide shareholder returns as expected. Before the takeover bid, that is during the pre-bid stages shareholder returns are above average which falls sharply during the post-bid stages. Cash or equity seems to show negative results during the post-bid period and takeovers of previously independent firms seem to show lower negative returns than acquisition of subsidiaries of other companies.

Most public and even private companies focus on maximizing shareholder returns to earn trust of investors but promises of high returns to stockholders may not always be practical and may have to be done at the expense of employees, and communities and long term interests of the companies. Many market analysts have criticized this approach of focus on increasing shareholder returns, which invariably lead to higher CEO salaries and highlights the absolute capitalistic character of business and financial organizations. Yet maintaining shareholder interests and increasing shareholder value has been the focus of all businesses in recent times and seems to indicate a measure of profitability of the company.

As Armour and Mankins (2005) write for Marakon Associates that:

“Today, senior executives are intensely interested in managing their companies to create shareholder value. Rare indeed is the annual report or press release that does not reaffirm management’s commitment to, and focus on, managing for value. In short, the capital markets’ abrupt turn has sparked a renewed emphasis on maximizing
shareholder returns”.

However many market analysts have highlighted the fact that managing for value and maximizing shareholder returns is one of the most important yet the least known aspects in business analysis.

**Conclusion:**

In this article we discussed the renewed emphasis of companies in highlighting company responsibilities toward increasing shareholder value and maximizing shareholder returns. The controversies about shareholder value increase in management by the companies have been discussed and the advantages and disadvantages of shareholder value approach are suggested. Several studies have been examined and critically analyzed and examples from the retail industry, US and British companies have been used for the purposes of the study. The importance of shareholder value analysis, customer equity, profitability, long term investment, returns on assets and returns on equity are concepts that have been stressed and discussed in detail. Factors such as mergers and acquisitions and CEO salaries, takeover bids, assets and long term investments of the companies are all important in accounting for profits of the company and help in determining shareholder returns.

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