

Infosys (INFY) - A Wealth Creator or Destroyer

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Abstract

Infosys an Indian multinational provider of business consulting, technology, engineering, and outsourcing services with revenue of \$7,398 million and net income of \$1,725 million in the fiscal year 2013, has been declaring Economic Value Added (EVA) in its annual reports since 1996. Why Infosys is declaring the EVA, when it's not mandatory to report such figures in annual report? What purpose does the EVA statement in the annual report serve to the investors? Most importantly, what do these EVA figures reflect for zero debt company like Infosys? The case gives an opportunity to analyze and evaluate Economic Value Added by Infosys from year 2000 to 2012 and to draw interpretations regarding the wealth creation done by Infosys over a period.

The pedagogical objective of the case is to make students understand and apply the concept of EVA for financial performance evaluation while drawing interpretations out of it. The case brings out the fundamental concept behind adopting and reporting EVA. The case also aims to compare and contrast the EVA with traditional financial accounting measure - Return on Investment (ROI).

Key Words: Economic Value Added, Corporate Value reporting policy, Infosys, Return on Investment, Shareholder Wealth Creation

The Case

Utterly confused with the numbers on Economic Value Added, Mr. Paul, an MBA 1st Semester student sighed while holding a cup of coffee in his hostel room of the LBG business School in India. Even the hot summer season was sending a chill down his spine, since 15 marks, individual case study was due for submission in less than 24 hours. The Infosys EVA appeared to be a mystery to him. Being in MBA 1st semester with B.Com background, he had some basic knowledge of accounting, but he regretted missing out the vital session on Economic Value Added. As a result, he was still struggling to solve the case on EVA analysis given by the Finance faculty. After all, analyzing the EVA of Infosys was no joke, especially when 10 year trend needed for a billion dollar company. Although the case gave the basic information, but still he found it to be a massive task to analyze and evaluate the EVA of Infosys. Did Infosys generated the wealth or was a wealth destroyer over the past years, were the questions that constantly challenged him? Paul knew that the only way to solve the case was to go back to the basics and dig out the information about the company and class notes on EVA.

About Infosys

Infosys limited (formerly Infosys Technologies Limited) is an Indian multinational provider of business consulting, technology, engineering, and outsourcing services. Headquartered in Bangalore, Karnataka, has acquired the third-largest India-based IT services company status by 2012 revenues. It started with just \$ 250 in 1981 by the seven engineers, and within few years, it had become a global leader in consulting, technology and outsourcing with revenues of US \$ 7.2 billion (Q3 FY13), while managing clients from 30 countries. The company has a

global presence with more than 155,000 employees worldwide, across 67 offices and 69 development centers in the United States, India, China, Australia, Japan, Middle East and Europe. According to the company, its huge success has been based on bringing to life great ideas and enterprise solutions that drive progress for its clients.

(<http://www.infosys.com/about/Pages/index.aspx>)

Strategy

Infosys has strengthened its position as a leading global consulting and technology company by:

- Strengthening its strategic partnership with clients;
- Increasing its relevance to clients by being able to work in the entire spectrum of their business;
- Delivering higher business value to clients through the alignment of our structure and offerings to their business objectives. (Source: Infosys's annual report)

Products and Services

- Consulting and systems integration comprising consulting, enterprise solutions, systems integration and advanced technologies;
- Business IT services comprising application development and maintenance, independent validation services, infrastructure management, engineering services comprising product engineering and life cycle solutions and business process management.
- Products, business platforms and solutions to accelerate intellectual property led innovation, including Finacle, which offers solutions to address the core banking, mobile banking and e-banking needs of retail, corporate and universal banks worldwide; and
- Newer areas such as cloud computing, enterprise mobility and sustainability. (Infosys annual report 2012-13, Form 20-F | 33)

Sources of Revenue

Infosys delivered high quality solutions through the Global Delivery Model. Using Global Delivery Model, the company divided projects into components that it executed simultaneously at client sites and at its development centers in India and around the world. It optimized its cost structure by maintaining the flexibility to execute project components, with its scalable infrastructure and ability to execute project components around the clock and across time zones, enabled to reduce project delivery times. The company's main clients are US and European companies. Although the company has been increasing its services to the Middle East, India, Japan and China. Infosys greatly benefit from the growth of these nations while the adversity directly impacted its revenue generating ability. (Annual report, Infosys annual report 2012-13, form 20-K, 33)

Financial Performance - The revenues of the company grew from \$4,663 million in fiscal 2009 to \$7,398 million in fiscal 2013 and the net income growth from \$1,281 million to \$1,725 million during the same period, representing a compound annualized growth of 7.7%. The share prices of the company had grown many folds since 2000 (Refer figure 1).

The Infosys Corporate Reporting™ framework

Infosys has always pioneered in adopting reporting policies that minimized the information asymmetry between the management and shareholders. Infosys was the first Indian company to adopt the US Generally Accepted Accounting Principles (US GAAP) and the first foreign private

issuer from India to file primary financial statements with the Securities and Exchange Commission (SEC) in accordance to International Financial Reporting Standards (IFRS), as issued by the International Accounting Standards Board. It had issued the brand valuation statement, balance sheet including intangible assets, intangible asset scorecard, risk management report, human resource accounting and value-added statement in its annual report (Refer figure 2).

Economic Value Added (EVA) and Return on Investment (ROI)

The Infosys had been disclosing the EVA statement for years, as a part of its value reporting, the Infosys had been amongst the few companies in India those have continued to disclose the EVA information in the annual reports since 1996. A statement of EVA and ROI has been given in Table - 1.

As Mr. Paul started to draw interpretations from the reported values of EVA of Infosys given in annual reports, he noticed that, although the EVA of Infosys had been positive throughout 2000-2012, but there are fluctuations in EVA generation from year to year. What does it mean? What was happening to the EVA and ROI growth rate? He kept wondering.

After hours of work and going through the information provided in faculty notes, he was sure that Infosys had been a wealth creator ever since year 2000 and not even for a year the company destroyed wealth of shareholders.

Perhaps the strategic focus of the company had been key to its wealth creation or probably something else. He also noticed that the company sales had been increasing year on year, but the ROI gave a very different trend. What parameters he should rely on? Although he had prepared and made basic evaluations, but was that sufficient? Was EVA a better performance measure than ROI? Not sure, about his analysis, Paul looked for expert guidance in EVA analysis of Infosys.

Assignment Questions

1. Critically examine EVA as a measure of financial performance and compare to ROI?
2. What are the Benefits of disclosing the EVA information in annual report? Comment on the Value reporting policy of Infosys?
3. Analyze the EVA generation of Infosys from 2000-2012, do you agree with the Paul's statement that the Infosys has been a shareholder wealth creator since 2000.
4. What benefit you think Paul would have put forward in favor of Infosys being disclosed the EVA information in its annual report.

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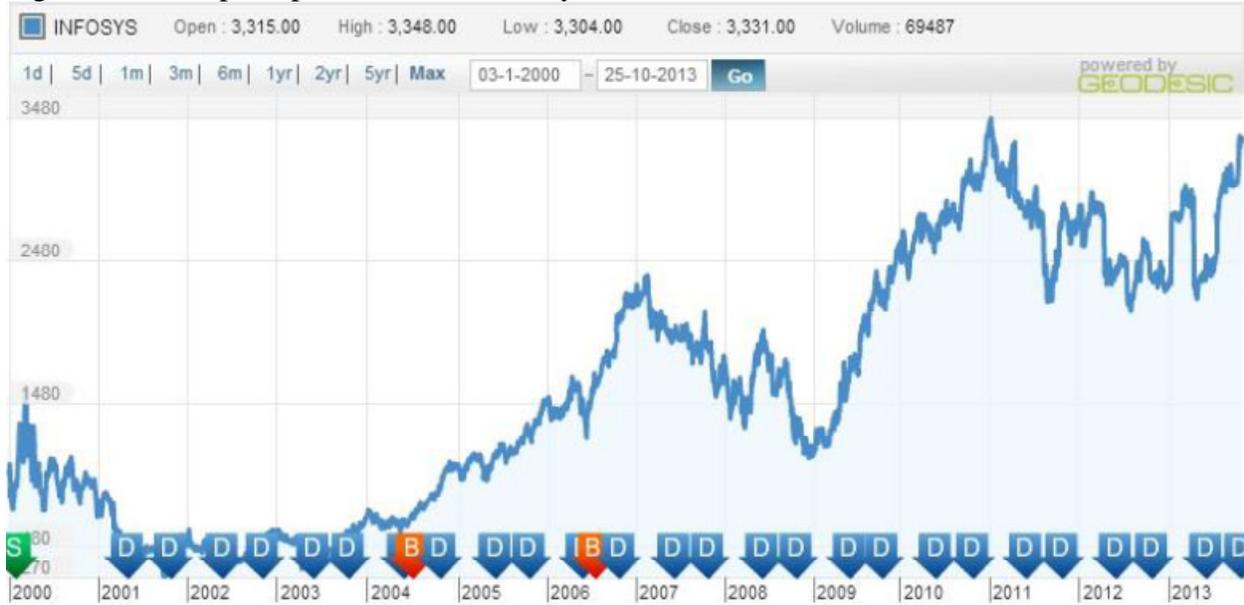
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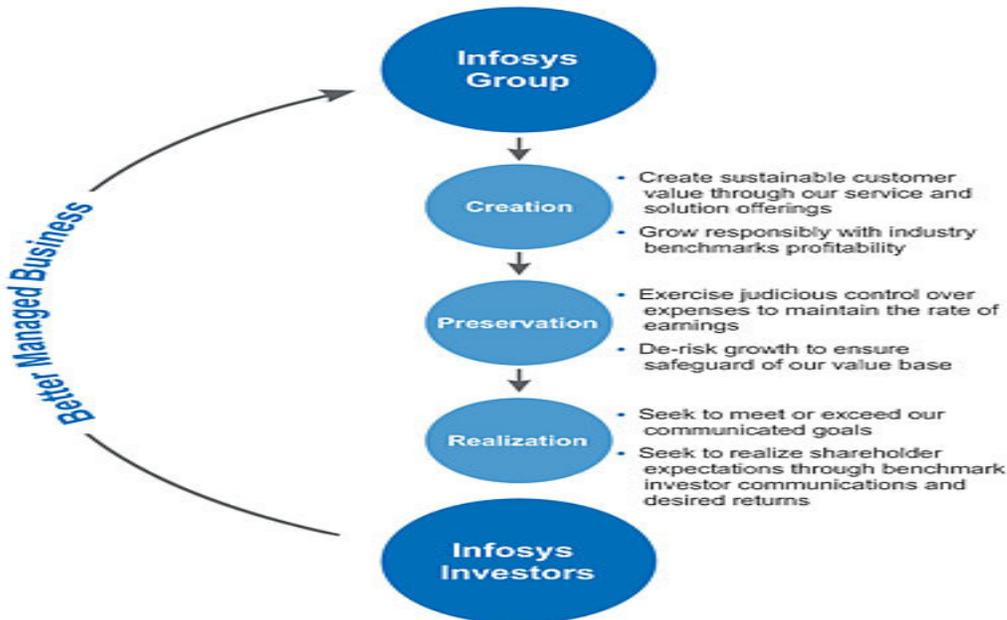
Tables and Illustrations

Figure - 1 Share price performance of Infosys



(Source-www.moneycontrol.com)

Figure – 2 The Infosys Corporate Reporting™ framework



(Source-Infosys website)

Table – 1 EVA and ROI of Infosys from year 2000 to 2012

Infosys EVA 2000-2012													
YEARS	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
In ₹ crores													
Average Capital Employed	703.87	1111.47	1734.97	2493.4	3124.82	4331	6177	9147	12527	17431	21634	25688	30382
Operatubg profit (PBT extraordin	325.65	696.03	943.39	1079.28	1357.94	2045	2654	3877	4640	6421	6910	8102	9779
Less: Tax	39.7	72.71	135.43	201	227.54	326	313	386	685	919	1681	2490	3367
Less Cost of Capital	156.89	234.3	297.9	423.63	440.29	590	801	1369	1669	2123	2293	2880	3506
Total EVA	129.06	389.02	510.06	454.65	689.63	1132	1540	2122	2286	3379	2936	2732	2906
EVA/Average Capital Employed	18%	35%	29%	18%	22%	26%	25%	23%	18%	13%	14%	11%	10%
Growth Ratios (%)													
Operating Profit Growth		114%	36%	14%	26%	51%	30%	46%	20%	38%	8%	17%	21%
Average Capital Employed Growth Rate		58%	56%	44%	25%	39%	43%	48%	37%	39%	24%	19%	18%
EVA growth rate		201%	31%	-11%	52%	64%	36%	38%	8%	48%	-13%	-7%	6%
Infosys ROI calculation													
Years	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Operating Profit	378.8	808.92	1037.63	1272.04	1583	2325	2989	4225	4963	6906	7360	8414	10061
Total Assets	833.3	1389.64	2080.31	2860.65	3253.43	5241.73	6897	11162	13490	17809	22036	24501	29757
Total Average Assets	703.87	1111.47	1734.975	2470.48	3057.04	4247.58	6069.365	9029.5	12326	15649.5	19922.5	23268.5	27129
Return on Investment	54%	73%	60%	51%	52%	55%	49%	47%	40%	44%	37%	36%	37%

1 US Dollar equals=62.51 Indian Rupee as on Dec, 2014.

(Author's analysis based on Infosys data)

Table – 2 EVA Statement declared in annual report, a snapshot

Infosys Annual Report 2011-12

Additional Information

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.

in ₹ crore, except as otherwise stated

	2012	2011	2010	2009	2008
Cost of capital					
Return on risk-free investment (%)	7.99	7.66	7.20	7.00	8.00
Market premium (%)	5.00	5.00	5.00	7.00	7.00
Beta variant	0.71	0.71	0.68	0.74	0.76
Cost of equity (%)	11.54	11.21	10.60	12.18	13.32
Average debt / total capital (%)	-	-	-	-	-
Cost of debt – net of tax (%)	NA	NA	NA	NA	NA
Weighted Average Cost of Capital (WACC) (%)	11.54	11.21	10.60	12.18	13.32
Average capital employed	30,382	25,688	21,634	17,431	12,527
Economic Value-Added (EVA®)					
Operating profits	9,779	8,102	6,910	6,421	4,640
Less: Tax	3,367	2,490	1,681	919	685
Cost of capital	3,506	2,880	2,293	2,123	1,669
Economic Value-Added	2,906	2,732	2,936	3,379	2,286
Enterprise value					
Market value of equity	1,64,592	1,86,100	1,50,110	75,837	82,362
Add: Debt	-	-	-	-	-
Less: Cash and cash equivalents	20,968	16,810	15,819	10,993	8,307
Enterprise value	1,43,624	1,69,290	1,34,291	64,844	74,055
Return ratios					
PAT / average capital employed (%)	27.4	26.6	28.7	34.3	37.2
EVA* / average capital employed (%)	9.6	10.6	13.6	19.4	18.2
Enterprise value / average capital employed (x)	4.7	6.6	6.2	3.7	5.9
Growth (%)					
Operating profits	20.7	17.3	7.6	38.4	19.7
Average capital employed	18.3	18.7	24.1	39.1	37.0
EVA*	6.4	(6.9)	(13.1)	47.8	7.7
Market value of equity	(11.6)	24.0	97.9	(7.9)	(28.6)
Enterprise value	(15.2)	26.1	107.1	(12.4)	(32.2)

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

(Source –Infosys annual report)

Table -3 Economic Value Added – Formula and Analysis

The EVA = NOPAT – (WACC x TC) or EVA = NOPAT- (Capital Charge), where

1. NOPAT (Net Operating Profit after Tax): Calculated as NOPAT = Operating Income x (1 - Tax Rate)
2. WACC (Weighted average cost of capital): The WACC is the average cost to a firm for the various types of financing that it receives or a tool through which company can assess how much they must earn on their assets at a minimum to cover the cost of financing them.
3. TC (Total Capital Employed): total shareholders fund and long term liabilities.
4. EVA can be described as post-tax return on capital employed (adjusted for the tax shield on debt) less the cost of capital employed.
5. Positive EVA denote the generation of wealth, while negative EVA indicate the extent to which the company had destroyed the wealth.

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