Journal of Finance and Accounting

Determinants of Share Value Creation among Listed Companies in the Frankfurt Stock Exchange, Germany: Literature and Theoretical Examination

Clop. R. Grass & Brecht Muller Orwell

ISSN: 2616-4965

Stratford Peer Reviewed Journals and Book Publishing
Journal of Finance and Accounting
Volume 5||Issue 3||Page 1-10 ||September||2021|
Email: info@stratfordjournals.org ISSN: 2616-4965

Determinants of Share Value Creation among Listed Companies in the Frankfurt Stock Exchange, Germany: Literature and Theoretical Examination

[*1]Clop. R. Grass & [2]Brecht Muller Orwell

[1,2]GISMA Business School - Hannover Campus

E-mail of the Corresponding author: grassclop.gismaac@gmail.com

How to cite this article: **Grass, C. R. & Orwell, B. M. (2021), Determinants of Share Value Creation among Listed Companies in the Frankfurt Stock Exchange, Germany: Literature and Theoretical Examination, *Journal of Finance and Accounting*. Vol5 (3) pp.1-10.** https://doi.org/10.53819/81018102t40011

Abstract

The main purpose of any firm is to enhance its shareholders' wealth. Investors, management and other stakeholders need to be aware of the company's performance to enable them make informed decisions about the future. The creation of shareholder value is becoming increasingly challenging as owners and managers are forced to make appropriate financial decisions that contribute to the management of operations that create value and also identify activities that destroy value. In addition it is necessary to implement effective instruments which are able to evaluate real value created. Value creation occurs in a company when its business is able to generate returns above the demands of investors or returns of capital invested are more than the cost of a company's capital. Most financing decisions are dictated by necessity which requires in-depth analysis of financing options, costs attracted and long-term implications. A firms' shareholder value creation is based on firms' earnings ability and firms return on its net worth. A firm financing policy may be to choose from alternative sources, which may be internal or external. Internal financing includes use of retained earnings while external financing constitutes borrowing by issuing debt instruments and issue of new shares. The skills to identify financial variables which have the greatest impact on value creation in an organization can facilitate establishment of criteria for appropriate strategies. The study found that the main measures to quantify shareholder value creation in Germany financial sector and among listed companies are earnings per share (EPS), return on equity (ROE), return on assets (ROA) and dividend per share (DPS). the determinants of value creation were found to include growth rate, operating profit margin, income tax rate, working capital investment, fixed capital investment, cost of capital and value growth duration. The study recommends that the regulatory authorities in German financial sector particular should design a policy that will motivate building materials firms to be paying dividend to their shareholders on regular basis. This will increase the shareholders' value due to the nature of relation between the variables which is positive.

Keywords: *Share, Value, Creation, Listed companies, Frankfurt, Stock, Exchange.*

1.1 Introduction

The main purpose of any firm is to enhance its shareholders' wealth. Investors, management and other stakeholders need to be aware of the company's performance to enable them make informed decisions about the future (Lashitew, 2021). Rational investors expect good long term return on their investment. Chauhan and Patel (2018) observed that maximizing shareholders' value is becoming the new co-operate standard. Managers strive to achieve this objective by making rational financing decisions regarding combination of finances which would minimize its cost of funds. Hartomo (2019) opines that, creation of shareholder value is becoming increasingly challenging as owners and managers are forced to make appropriate financial decisions that contribute to the management of operations that create value and also identify activities that destroy value. In addition it is necessary to implement effective instruments which are able to evaluate real value created. Value creation occurs in a company when its business is able to generate returns above the demands of investors or returns of capital invested are more than the cost of a company's capital (Hartomo, 2020). According to Oladele (2013), shareholder value creation occurs when a company generates more wealth for shareholders than they are able to generate for themselves. Bouncken, Fredrich, Ritala and Kraus (2020) observes that value creation involves much more than merely monitoring firms' performance; rather management team should be actively involved in the process of value creation. Högerle, Charifzadeh, Ferencz and Kostin (2020) note that, equity shareholders as the owners of the company expect high and stable return on capital supplied by them and are more concerned with utilization of funds by the company.

Most financing decisions are dictated by necessity which requires in-depth analysis of financing options, costs attracted and long-term implications. Chauhan and Patel (2018) argue that, firms' shareholder value creation is based on firms' earnings ability and firms return on its net worth. Bakhtiari, Breunig, Magnani and Zhang (2020) assert that, a firm financing policy may be to choose from alternative sources, which may be internal or external. Internal financing includes use of retained earnings while external financing constitutes borrowing by issuing debt instruments and issue of new shares. The skills to identify financial variables which have the greatest impact on value creation in an organization can facilitate establishment of criteria for appropriate strategies (Kumar, 2015). Profitability and growth are basically considered as the major determinants of firm value. Corporate strategies can be assessed on the basis of their expected effect on profitability, growth and firm value. The value based planning models suggests that management of a firm aims to create shareholder wealth by maximizing market value of the equity thereby creating excess value over the book value of the firm (Ogaili, 2020). A firm's management must focus on strategies that creates excess value attributed to market value (MV) compared to the book value (BV) of equity. A firm's management creates value for shareholders if MV>BV, destroys value if MV.

Identifying and selecting strategies that create value for shareholders is a major challenge facing management in the modern era (Feng, Morgan & Rego, 2020). The identification of financial factors which have the highest impact on value creation in a business can facilitate establishment of criteria for appropriate strategy selection in that direction. The ability of a firm to create value by distributing cash flows to its stakeholders depend on its ability for cash generation from its operating activities and access of additional funds through external financing. The two basic sources of external financing are debt and equity financing. A company's ability to borrow today

Stratford Peer Reviewed Journals and Book Publishing
Journal of Finance and Accounting
Volume 5||Issue 3||Page 1-10 ||September||2021|
Email: info@stratfordjournals.org ISSN: 2616-4965

is based on projections of its future cash flow generation. Management's investment choices and financial policy are also value drivers in the context of riskiness of cash flows for the company. Scale economies for firms in purchasing, manufacturing, distribution and research can generate value drivers in operating margin, working capital investment and fixed capital investment (Feng, Morgan & Rego, 2020). The link between value chains and value drivers as reflected by sales growth rate, operating profit margin, income tax rate, working capital investment, fixed capital investment and cost of capital are basic building blocks of shareholder value creation.

Banz (2019) advocates size effects (measured by market capitalization) as a significant determinant of average returns provided by market beta. This study finds that average returns on small size (low market capitalization) stocks are too high given their beta estimates and average returns on large size (high market capitalization) stocks are low. Bhandari (2018) documents positive relationship between leverage and average returns. Studies by (Stattman, 2020; Rosenberg et al, 2015) finds that average returns on stocks are positively related to the ratio of firm's book value of equity to market value of equity. The study by Chan et al (2021) finds that the ratio of book value to market value of equity is a significant determinant in explaining the cross section of average returns on Japanese stocks. Chen et al (2021) postulate that the earning prospects of firms are associated with a risk factor in returns. Firms with low stock prices and high ratio of book to market equity which are characterized having poor prospects by market are considered risky and have higher expected stock returns than firms with strong prospects.

Debt equity ratio (DER) is used as a variable to explain the expected common stock returns. An increase in debt equity ratio of a firm increases the risk of its common equity. Cross sectionally the common equity of a firm with higher debt equity ratio always have higher risk since the firm level risk may vary, DER is expected to be positively co related to the risks of common equity across firms (Bhandari 2018).Beta is based on a market proxy and calculated for a period. The financial leverage hypothesis suggests that increase in debt is a signal to the market that the firm's prospects have improved. The dividend payout hypothesis suggests that value creation is a function of the dividend payout of companies. Higher the dividend payout more is the value creation for the company. Ross (2017) suggests that companies that increase dividend payout signal to the market that it has the potential to generate future cash flows to meet future dividends. The value of a company is expected to increase on account of dividend payment as it signals to the market that the firm is expected to have higher cash flows. The profitability hypothesis suggests that higher the profits generated by firms, greater would be the value creation.

Board remuneration in listed companies in the (none) financial sector becomes more and more subject of public and political discussion (Karamoy & Tulung, 2020). In this context it is controversially discussed if board compensation stands in an appropriate relation to the tasks of the executive board members as well as the financial situation of a company. A direct comparison of the absolute amount of the remuneration and the personnel costs per employee, for example in the German Volkswagen AG for the business year 2018, indicates that the annual revenue of the chairman (12.7 million EUR) is 298 times higher than the average costs of an employee. The German legislature has, as a response to the criticism according the lack of transparency and too short-term orientation of the remuneration systems, introduced the Executive Board Remuneration Disclosure Act and the Act on the Appropriateness of Management Board Remuneration (Karamoy & Tulung, 2020).

A reasonable financial reward system plays, with respect to the principal agent-theory, an important role in order to influence the behavior of the management board (Hossain, 2020). Therefore the incentives for opportunistic behavior of the management (agent) at the disadvantage of the general meeting (principal), usually due to conflicts of interests and information asymmetry, should be reduced (Jensen & Meckling, 1976). Conflicts of interest also can arise between executive - and supervisory board, as both constitute agents of the general meeting (Tirole, 1986; Velte and Weber, 2011a). Correspondingly, on a theoretical basis the supervisory board ought to strive for the sustainable maximization of the shareholder value, while the executive board pursuits a short-term perspective due to the realization of individual interests (e.g. maximization of his salary and minimization of his assignment). Concerning the design of the management board remuneration system, the growing proportion of fixed salary reduces the performance of the executive board due to the fact that he accordingly lowers his work assignment in order to maximize his individual benefit.

Frankfurter Wertpapierbörse (FWB, the Frankfurt Stock Exchange) is one of the world's largest trading centres for securities. With a share in turnover of around 90 per cent, it is the largest of Germany's seven stock exchanges. Deutsche Börse AG operates the Frankfurt Stock Exchange, an entity under public law. In this capacity it ensures the functioning of exchange trading. In 1990, administration and operation of the Frankfurt Stock Exchange were transferred from the Frankfurt Chamber of Commerce and Industry to the newly founded Frankfurter Wertpapierbörse AG, which became Deutsche Börse AG shortly afterwards. The Frankfurt Stock Exchange thus formed the nucleus of today's Deutsche Börse Group. Trading at the Frankfurt Stock Exchange is governed by clear rules, which apply equally for all trading participants. Independent market surveillance is made up of the Trading Surveillance Office (HÜSt), the Exchange Supervisory Authority attached to the Hessian Ministry of Economic Affairs, Transportation, and Regional Development, and the Federal Financial Supervisory Authority.

1.2 Statement of the Problem

The primary objective of a firm is to maximize the shareholders' value. Companies are formed to benefit their owners by providing them with maximum returns and capital appreciation. A Company's shareholder value creation is a function of financing decisions and investment decisions made by the management. However, in a value driven economy some companies create value while others destroy shareholder value. A recent studies questions whether maximizing shareholder value should be the main goal for corporate managers. This is in according with what's known as 'agency theory', which starts with the premise that shareholders are the owners of the company and therefore have ultimate authority over the business and how it is managed. The theory, which was first discussed by academic economists in the 1970s, addresses problems that might arise due to differences in the goals or desires of the principal (shareholders) and the agent (corporate executives). The notion that shareholders are the company's 'highest authority' is somewhat problematic, however, given that they have limited liability for the actual business practices of the company (therefore no accountability) and often they have little familiarity with business practice and strategy. Currently, shareholder value approach reveals to a contemporary management philosophy, which suggests that an organization measures its success by inspiring its shareholders. Shareholders or stockholders are individuals or institutions that owns in a lawfully form shares of a corporation. They are considered to be a subgroup of stakeholders, which are all individuals or communities, who have a direct or indirect interest in the business entity such as suppliers, customers, government, and competitors. The idea of the shareholder approach tries to increase the organization's value by increasing firm's earnings, by increasing the market value of corporation's shares and by increasing also the frequency or amount of dividend paid. Additionally, many business analysts stated that shareholder value approach provides managers with clear mission and it enabled decision making.

With uncertainty around the world about how and when the coronavirus outbreak will decelerate, whole business sectors have been affected by lockdowns and are facing ruin. In Germany, more than 750,000 companies have put over 12 million employees on reduced working hours (Kurzarbeit), dwarfing the 3 million hit by the 2008 crisis. And in a survey of nearly 8,000 working people by the Hans-Böckler Foundation, 70 per cent of respondents said they felt financially insecure, with those in lower-income groups betraying most concern. Due to the death of Knowledge in this area, the paper sought to evaluate the determinants of share value creation among listed companies in the Frankfurt stock exchange through literature and theoretical examination.

1.3 Objective

To evaluate the determinants of share value creation among listed companies in the Frankfurt stock exchange through literature and theoretical examination.

2.1 Theoretical Review

The study was informed by Capital Asset Pricing Model (CAPM). The Capital Asset Pricing Model (CAPM) was developed by Sharpe (1964); Lintner (1965) and Mossin (1966). CAPM is based on the assumption that not all risks should affect asset price. In particular a risk that can be diversified away when held along with other investments in a portfolio is considered not risky. The CAPM gives insight about what kind of risk is related to asset return. Moreover, the theory argues that the returns both received and expected by the investor are related to the risk incurred by owing particular financial assets. The main insight of the CAPM model which is central to the shareholder view is that, there is a risk weighted discount factor which allows the investor assess the value of today’s and tomorrow’s development profits and cash flows (Mossin, 1969; Weston, 1973; Copeland& Weston, 1988). CAPM allows for investment valuation at the firm level without consideration of investor preferences and gives the expected return for any asset or portfolio as a function of a measure of risk called beta.

Numerous contributions have been devoted to verifying whether real life decision makers comply with the CAPM paradigm and it was noted that managers and practitioners often violate the stance while making capital budget decisions (Graham and Harvey 2002). The only aspect that determines the preference of risk is weight (share).A risk free rate is fixed thus; it is only the market risk that is relevant for predicting return. The risk return relation (trade-off) is linear. The model combines linear risk and return trade off with the beta to find the price of risk. The optimal risk-return trade-off is shown by Capital Market Line (CML). The CAPM formula is often graphed as the Security Market Line (SML) which shows the relationship between expected rate of return of a project and its beta. This study is based on shareholder value creation whose main focus is in appreciation of invested capital. The cost of equity, which is part of WACC, was estimated using CAPM formula.

2.2 Empirical Review

Sharma and Grover (2015) conducted a study on ‘creating and measuring shareholders’ value in Asian companies. The study examined 30 companies within a period of five years (2009- 2013).

https://doi.org/10.53819/81018102t40011

Stratford Peer Reviewed Journals and Book Publishing
Journal of Finance and Accounting
Volume 5||Issue 3||Page 1-10 ||September||2021|
Email: info@stratfordjournals.org ISSN: 2616-4965

The study took dividend and capital structure as independent variables and shareholder value creation measured by EVA as a dependant variable. The study used regression analysis technique to examine the impact of dividend and capital structure on shareholder value creation. The results show that most of the companies under review recorded a positive EVA, an indication that they created value within the study period. The current study included the working capital variable to represent short term finance and moderated the variables with GDP growth rate.

Atiyet, (2018) explored an optimal capital structure to maximize the shareholders wealth. The study also determined the most significant determinants for shareholders value creation. The researcher utilized panel data on French firms 1999-2005. The result revealed that self- financing explains positively and significantly the shareholder value creation for both (EVA and MVA). The equity issue supplies explained negatively and significantly shareholder value creation for both measures. Financial debt contributes positively to EVA and negatively to MVA. The study observed that the impact of financial factors on shareholders values depends on measure taken and the financial structure added to the model. The current study added more variables as part of financing decisions which included dividends and working capital financing.

Given the importance of growth for the firm, understanding the relationship between fast or high growth and value generation is particularly important in finance (Björkdahl, 2020). In order to bring a viable limit for the growth of the firm, several different models are developed by finance scholars (Higgins, 2017; Higgins, 2021). However, Higgins' model is the most recognized and extensively used one. The idea behind the widely known "sustainable growth rate" (SGR) model (Higgins, 2017) is that assets required for the additional sales should be financed by the retained profit and the additional debt capacity of the growth without changing the financial leverage of the firm. Studies confirmed the role played by expectations in shareholder value creation process (Kasznik and McNichols, 2020; Varaiya et al. 2017). They verified that abnormal annual returns are significantly greater for firms meeting expectations, and that, market assigns higher values to firms that meet or exceed expectations consistently. Another study (Markman and Gartner, 2020) made on 500 hyper-growth firms in United States, exhibited that growth is not related to firm profitability. Additionally, Lintner (2018) suggested that maximizing the expected value of shareholders' equity does not necessarily imply maximizing expected growth rates as generally assumed. These studies actually imply that growth and value relation may be weaker than it is generally presumed.

Lang et al. (2016) in a study found a negative relation between leverage and future growth for low Tobin's q firms. In other words, the study suggested that leverage restricts growth only for those firms whose growth opportunities are not valuable enough or recognized by the market. Leverage does not seem to reduce growth for firms which have good investment opportunities. Davidsson et al. (2019) suggested "profitability first" rather than "growth first" as the preferable strategy based on SME (small and medium sized enterprises) studies in Australian and Swedish firms. They have found no empirical evidence for the existence of profitability advantages due to the growth of sales revenues. According to their study, firms at low levels of profitability are not likely to achieve high profitability by expanding their sales volume. Their study is extended by controlling for firm type and leverage and tested on Turkey's top 1000 firms and revealed a similar result. Low growth and high profitability firms generally had greater probability of becoming a high growth firm, compared to high growth-low profitability firms (Yıldırım, 2021).

According Aghahosseini, Bogdanov and Breyer (2020), the Sustainable Growth Rate is a growth strategy based on two main assumptions. The first is that sales of a company can grow only as fast as its assets. The second assumption is that, consistent with the Trade-off Theory firm has a target debt equity ratio and that the lenders are willing to continue to extend credit at that ratio. This assumption implies that as the equity grows, debt can grow at the same rate to allow maintaining a constant debt equity ratio. Firms generally dislike issuing equity (increasing capital) because of unwillingness of shareholders, possible dilution of shares and high issuance costs. A firm can only increase financial leverage if its debt equity ratio has some margin for further leverage increase. Myers and Majluf (1984) identify this margin as 'financial slack'. The reduction of dividends will not be preferred by the shareholders and it will have negative impact on the company's stock price. Those over-growing companies are forced to retain all of the generated profit and forced to cut their dividends. Dividend cuts are often perceived negatively by the market. Besides, profit level is not expected to improve during hyper-growth periods as these firms are aggressively increasing market share or building a new market. Thus, unplanned overgrowth above the sustainable growth rate requires supplementary financing. This extra financing mostly comes from short-term debt, which increases the riskiness of the firm, and end up in value decrease.

Goedhart and Koller (2020) contend that challenges such as globalization, climate change, income inequality, and the growing power of technology titans have shaken public confidence in large corporations. In an annual Gallup poll, more than one in three of those surveyed express little or no confidence in big business seven percentage points worse than two decades ago. Politicians and commentators push for more regulation and fundamental changes in corporate governance. Some have gone so far as to argue that "capitalism is destroying the earth. Today's critique includes a call on companies to include a broader set of stakeholders in their decision making, beyond just their shareholders. It's a view that has long been influential in continental Europe, where it is frequently embedded in corporate-governance structures. The approach is gaining traction in the United States, as well, with the emergence of public-benefit corporations, which explicitly empower directors to take into account the interests of constituencies other than shareholders.

According to research, the primary reason for why investors today use ESG data is its relevance to the investment performance (Zumente & Bistrova, 2021). Other reasons, such as client requests and ethical considerations, come second, signaling that financial considerations still dominate the demand for ESG information over ethical reasons. The research thread exploring the relationship between corporate social performance (ESG) and financial. While the financial performance in terms of either higher stock returns or improved accounting records is the outcome of the relationship, directly translating into a higher firm's value, the literature has found a list of intermediating factors, which seem to moderate the ESG–firm value relationship. As summarized in an aggregated literature review by Brooks and Oikonomou in 2018, the main reasons for ESG disclosure include the firm's efforts for legitimacy and decreased regulatory burden, improved reputation, enhanced brand value, and employee motivation. Next, corporate social performance and ESG disclosure may affect its value via its risk metrics. Based on the risk–return trade-off, a lower risk profile shall theoretically be associated with a higher value.

3.0 Methods

The study conducted a desk top review of relevant theories and literature to develop study themes on determinants of share value creation among listed companies in the Frankfurt stock exchange.

4.0 Findings and Conclusions

Companies that conflate short-termism with value creation often put both shareholder value and stakeholder interests at risk. Banks that confused the two in the first decade of this century precipitated a financial crisis that ultimately destroyed billions of dollars of shareholder value. Companies whose short-term focus leads to environmental disasters also destroy shareholder value, not just directly through cleanup costs and fines but via lingering reputational damage. The best managers don't skimp on safety, don't make value-destroying decisions just because their peers are doing so, and don't use accounting or financial gimmicks to boost short-term profits. Such actions undermine the interests of shareholders and all stakeholders and are the antithesis of value creation.

For companies anywhere in the world, creating long-term shareholder value requires satisfying other stakeholders as well. You can't create long-term value by ignoring the needs of your customers, suppliers, and employees. Investing for sustainable growth should and often does result in stronger economies, higher living standards, and more opportunities for individuals. It should not be surprising, then, that value-creating capitalism has served to catalyze progress, whether by lifting millions of people out of poverty, contributing to higher literacy rates, or fostering innovations that improve quality of life and lengthen life expectancy. Shareholder value maximization has become the primary business goal and performance target for most companies. Although managers and practitioners have traditionally criticized the notion that the objective in decision-making should be to maximize firm value, in the last decade, they have recognized that shareholder-value maximization is at least an important priority for firms. It is possible to answer the first question by concluding that `shareholder value' is an area of research well-defined, robust and interesting for academics, regulators and practitioners.

While sustainability is a broad, multifaceted, and hardly measurable concept, ESG serves as a specific quantitative measure of a company's sustainability and corporate social performance, thus allowing one to better understand the impact of social responsibility efforts on quantifiable outcomes of the company's financial and operational performance. Integration of ESG factors in the investment selection process as a method for choosing sustainable investments has been trending in the current business and academic literature. One of the main reasons for this is the significant power attributed to the ESG disclosures and endeavors to affect companies' values and financial performances.

REFERENCES

Aghahosseini, A., Bogdanov, D., & Breyer, C. (2020). Towards sustainable development in the MENA region: Analysing the feasibility of a 100% renewable electricity system in 2030. *Energy Strategy Reviews*, *28*, 100466.

Bakhtiari, S., Breunig, R., Magnani, L., & Zhang, J. (2020). Financial constraints and small and medium enterprises: A review. *Economic Record*, *96*(315), 506-523.

Björkdahl, J. (2020). Strategies for digitalization in manufacturing firms. *California Management Review*, *62*(4), 17-36.

Bouncken, R. B., Fredrich, V., Ritala, P., & Kraus, S. (2020). Value-creation-capture-equilibrium in new product development alliances: a matter of coopetition, expert power, and alliance importance. *Industrial Marketing Management*, *90*, 648-662.

Feng, H., Morgan, N. A., & Rego, L. L. (2020). The impact of unprofitable customer management strategies on shareholder value. *Journal of the Academy of Marketing Science*, *48*(2), 246-269.

Goedhart, M., & Koller, T. (2020). The value of value creation. *McKinsey Quarterly*, *16*.

Högerle, B., Charifzadeh, M., Ferencz, M., & Kostin, K. B. (2020). The development of working capital management and its impact on profitability and shareholder value: evidence from Germany. *Strategic Management*, *25*(2), 27-39.

Hossain, B. (2020). Directors' remuneration and performance: Evidence from the textile sector of Bangladesh. *Journal of Asian Finance, Economics and Business*, *7*(6), 265-275.

Karamoy, H., & Tulung, J. E. (2020). The effect of financial performance and corporate governance to stock price in non-bank financial industry. *Corporate Ownership & Control*, *17*(2).

Lashitew, A. A. (2021). Corporate uptake of the Sustainable Development Goals: Mere greenwashing or an advent of institutional change?. *Journal of International Business Policy*, *4*(1), 184-200.

Ogaili, S. H. (2020). The Effect of the Relationship of Growth Return and Market Value on the Relationship of Liquidity and Company Value Growth. *Journal of Advanced Research in Law and Economics (JARLE)*, *11*(48), 503-523.

Sharma, P., & Grover, A. (2015). Creating and measuring shareholders' value in Indian companies. *IJABER*, *13*(1), 53-66.

Sharpe, W. F. (1964). Capital asset prices: A theory of market equilibrium under conditions of risk. *The journal of finance*, *19*(3), 425-442.

Zumente, I., & Bistrova, J. (2021). ESG Importance for Long-Term Shareholder Value Creation: Literature vs. Practice. *Journal of Open Innovation: Technology, Market, and Complexity*, *7*(2), 127.