NHPC Limited: Buy-Back of Shares for Creating Value

TEACHING NOTE

CASE SYNOPSIS

This case highlights the considerations involved in the buy-back decisions. The buy-back of shares reduces the number of outstanding shares; the shareholders’ funds as well as the assets base of the company. It helps the company in optimizing its capital structure by increasing the financial leverage and results in higher Earnings per Share (EPS) and Return on Equity (ROE). However, the management also needs to keep in mind the cash requirement for funding future expansion plans, change in the shareholding pattern, liquidity in the stock market, impact on credit rating, and ability of the firm to raise capital in future. The regulatory framework regarding buy-back of shares does impact the buy-back decision. Additionally, there are promoters’ own agenda to increase stake in the company or generate cash by tendering their own shares in the buy back. The situation described in the case can be analysed within the framework of commercial, legal, and ethical justifications.

LEARNING OBJECTIVES

The case can be used with students of Strategic Financial Management/Corporate Finance at MBA level. The case aims to understand and analyze the buy-back decision by a profit-making and growing organization. The revenue and profits of the company were consistently growing, but due to a large capital base, the Earnings per Share (EPS) and Return on Equity (ROE) continued to remain low. As a result, the share price of the company also had underperformed the market. The company has a large cash balance lying idle but it is involved in implementing large projects in a capital-intensive business. In such a situation does it make financial sense to use the surplus cash to buy-back the shares?

In particular, the case has the following learning objectives:

- To identify the rationale for buy-back of shares.
- To understand the impact of regulatory framework on financial decisions.
- To explore various methods through which buy-back can be implemented.
- To analyze the impact of buy-back of shares on the key financial parameters of a company.
- To appreciate the ethical issues involved in decision making.

ASSIGNMENT QUESTIONS

1. What are the key reasons for the low EPS and ROE of NHPC?
2. How does the regulatory framework impact the buy-back decision?
3. Compare the various methods used for buy-back of shares.
4. Does buy-back of shares really create value for the shareholders?
5. Should NHPC go for buy-back of shares?
6. Which of the four scenarios would you recommend and why?

TEACHING PLAN

The case can be handled in a 90 minutes session. The time allocation for the case discussion is as follows:

1. Reasons for low EPS/ROE of NHPC Limited 20 Minutes
• Capital Intensive business
• High Capital Work-in-Progress due to aggressive expansion
• Surplus cash balance
• Moderate debt-equity ratio
• Large equity base

2. Legal considerations in a finance decision 10 Minutes
• Extent of buy-back
• Need to extinguish the shares
• Restriction on further issue of capital
• Need for Board approval / shareholders’ approval
• Debt to Equity ratio to be maintained

3. Compare the method of buy-back 10 Minutes
• Tender offer – buy-back from all the shareholders on a proportionate basis
• Open Market purchase – buy-back through stock exchange mechanism
• Book building – buy-back by inviting bids

4. Impact of buy-back 20 Minutes
• Reduce number of equity shares
• Reduce shareholder funds
• Reduce cash in hand
• Reduce income from surplus cash
• Increase borrowed funds if buy-back is funded by taking loans
• Lower Interest Coverage Ratio
• Improve EPS / ROE
• Change in promoters’ stake depending upon the method of buy-back
• Increase in the share price due to improvement in ratios

5. Future course of action 30 Minutes
• Preserve cash
• Use buy-back for optimizing the capital structure
  i. Without borrowings, using only excess cash available
  ii. Using borrowed funds in addition to using the excess cash

ANALYSIS

REASONS FOR LOW EPS AND ROE

The case provides an excellent opportunity to the students to analyze the financials of a profitable, dividend paying company with a large capital base and low financial leverage. Due to large capital
base the EPS and ROE remained low. The students can start with analyzing the profitability and ROE of the company as in Table 1.

Table 1  
Profitability and ROE of NHPC

(Rs. Million)

<table>
<thead>
<tr>
<th></th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
<th>2012</th>
<th>2013</th>
</tr>
</thead>
<tbody>
<tr>
<td>Profit After Tax</td>
<td>10,752</td>
<td>20,905</td>
<td>21,667</td>
<td>27,718</td>
<td>23,482</td>
</tr>
<tr>
<td>Total Income</td>
<td>32,615</td>
<td>48,120</td>
<td>49,055</td>
<td>67,219</td>
<td>62,994</td>
</tr>
<tr>
<td>Number of Equity Shares</td>
<td>11,182.5</td>
<td>12,300.7</td>
<td>12,300.7</td>
<td>12,300.7</td>
<td>12,300.7</td>
</tr>
<tr>
<td>Shareholders' Funds</td>
<td>179,783</td>
<td>232,732</td>
<td>245,806</td>
<td>263,535</td>
<td>278,405</td>
</tr>
<tr>
<td>Net Margin (%)</td>
<td>33.0%</td>
<td>43.4%</td>
<td>44.2%</td>
<td>41.2%</td>
<td>37.3%</td>
</tr>
<tr>
<td>Earnings Per Share (Rs.)</td>
<td>0.96</td>
<td>1.70</td>
<td>1.76</td>
<td>2.25</td>
<td>1.91</td>
</tr>
<tr>
<td>Return on Equity (%)</td>
<td>6.0%</td>
<td>9.0%</td>
<td>8.8%</td>
<td>10.5%</td>
<td>8.4%</td>
</tr>
</tbody>
</table>

Where

\[
\text{Net Margin} = \frac{\text{Profit After Tax}}{\text{Total Income}}
\]

\[
\text{Earnings per Share (EPS)} = \frac{\text{Profit After Tax}}{\text{Number of Shares}}
\]

\[
\text{Return on Equity} = \frac{\text{Profit After Tax}}{\text{Shareholders' Funds}}
\]

The table clearly depicts that the net margin of the company is very high (37.3 percent) but the ROE is low (8.4 percent). Both the revenue and profit after tax have grown at a healthy rate in the last 5 years. As the company is in hydropower, the material cost is zero resulting in high margins for the company.

The capital structure of NHPC can be analyzed by calculating the Debt Equity Ratio and Interest Coverage Ratio as depicted in Table 2.

Table 2  
Capital Structure of NHPC Limited

(Rs. Million)

<table>
<thead>
<tr>
<th></th>
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</tr>
</thead>
<tbody>
<tr>
<td>Borrowed Funds</td>
<td>122,340</td>
<td>138,682</td>
<td>145,693</td>
<td>176,411</td>
<td>186,273</td>
</tr>
<tr>
<td>Shareholders' Funds</td>
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<td>278,405</td>
</tr>
<tr>
<td>Earnings Before Interest and Tax (EBIT)</td>
<td>16,721</td>
<td>28,617</td>
<td>25,610</td>
<td>38,446</td>
<td>33,474</td>
</tr>
<tr>
<td>Interest</td>
<td>5,052</td>
<td>4,571</td>
<td>3,666</td>
<td>3,381</td>
<td>3,853</td>
</tr>
<tr>
<td>Debt Equity Ratio (Times)</td>
<td>0.68</td>
<td>0.60</td>
<td>0.59</td>
<td>0.67</td>
<td>0.67</td>
</tr>
<tr>
<td>Interest Coverage Ratio (Times)</td>
<td>3.31</td>
<td>6.26</td>
<td>6.99</td>
<td>11.37</td>
<td>8.69</td>
</tr>
</tbody>
</table>

Where

\[
\text{Debt Equity Ratio} = \frac{\text{Borrowed Funds}}{\text{Shareholders' Funds}}
\]
Interest Coverage Ratio = \( \frac{Earnings \, Before \, Interest \, and \, Tax}{Interest} \)

NHPC had maintained a debt equity ratio of around 0.67 times and has a high interest coverage ratio indicating strong ability to pay interest on borrowed funds. For tariff fixation, the debt to equity ratio of 70:30 was considered. NHPC funded its project with much lower debt equity ratio than what was permitted.

The ROE can be further analyzed using the Dupont Analysis (Table 3)

<table>
<thead>
<tr>
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<td>48,120</td>
<td>49,055</td>
<td>67,219</td>
<td>62,994</td>
</tr>
<tr>
<td>Net Assets</td>
<td>302,123</td>
<td>371,414</td>
<td>391,499</td>
<td>439,946</td>
<td>464,678</td>
</tr>
<tr>
<td>Shareholders' Funds</td>
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<td>232,732</td>
<td>245,806</td>
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<td>278,405</td>
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<td>8.8%</td>
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<td>8.4%</td>
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<tr>
<td>Net Margin</td>
<td>33.0%</td>
<td>43.4%</td>
<td>44.2%</td>
<td>41.2%</td>
<td>37.3%</td>
</tr>
<tr>
<td>Total Income / Net Assets</td>
<td>0.11</td>
<td>0.13</td>
<td>0.13</td>
<td>0.15</td>
<td>0.14</td>
</tr>
<tr>
<td>Net Assets / Shareholders' Funds</td>
<td>1.68</td>
<td>1.60</td>
<td>1.59</td>
<td>1.67</td>
<td>1.67</td>
</tr>
</tbody>
</table>

The ROE can be represented as:

\[
\frac{Profit \, After \, Tax}{Total \, Income} \times \frac{Total \, Income}{Net \, Assets} \times \frac{Net \, Assets}{Shareholders' \, Funds}
\]

Net Assets had been taken as the total assets minus operating liabilities i.e. liabilities other than borrowed funds. From the above break up it is clear that notwithstanding high margins, NHPC has low ROE due to following reasons:

a) Low Income to Net Assets Ratio – As the business is capital intensive, the assets base is large. The assets also include Capital Work in Progress (36 percent of the total assets) and Cash balance (10 percent of the total assets) which are not directly contributing to the profits of the company.

b) Low Net Assets to Shareholders’ Funds – Though the regulations permit the Debt Equity Ratio of 70:30, NHPC is maintaining a much lower leverage.

LEGAL CONSIDERATIONS IN A BUY-BACK DECISION

The discussion can now shift to the legal considerations in a buy-back situation and the rationale behind them. The Indian Companies Act imposes significant conditions on companies proposing to buy-back its shares. Some of the significant restrictions are:

- Buy-back is permitted only for cancellation and not as an investment. The shares bought back need to be extinguished.
- Buy-back proposal requires approval of the Board of Directors or Shareholders.
- The quantum of buy-back is restricted to 10 percent of the share capital plus free reserves with board’s approval or 25 percent with shareholders’ approval.
- The post buy-back debt equity ratio is not to exceed 2:1. High leverage firms accordingly are not permitted to go for buy-back.
• After completing buy-back, the firm is not allowed to raise capital by issue of shares within the next six months.

As buy-back results in reduction of the shareholders’ funds, it may mean dilution of security for the lenders and hence these restrictions.

**METHODS OF BUY-BACK**

Regarding the methods of buy-back permitted by the regulator (SEBI), promoters are permitted to participate in the buy-back in two of the methods – tender offer and book building. In case of buy-back through open market purchases, promoters are not permitted to offer their shares for buy-back. In situation where the intention is to buy-back only from the non-promoters, open market purchase is the only option. It would lead to increase in the promoters’ stake in the company. Such a method could be used by the companies to increase promoters’ stake in the company and as a defense mechanism against possible takeover.

If the promoters intend to participate in the buy-back, it could be done either in the tender offer method or through book-building method. In the former the buy-back price is fixed beforehand by the company before inviting the bids and the shares are bought on a proportionate basis. In the later method, the buy-back price is discovered by announcing a ceiling price and inviting bids from the shareholders. The book-building method leads to better price discovery for buy-back considering the bid received at different price levels.

The promoters’ holding in NHPC was already 86.36 percent and the government of India was looking to raise cash to meet its disinvestment targets. In such a situation the tender offer method is most suitable.

**IMPACT OF BUY-BACK – DOES IT REALLY CREATE VALUE?**

The focus now can shift to the alternatives presented. The students may be asked to identify the impact of the buy-back on the financials of the company. The attention will be drawn to the following aspects:

- Decrease in number of shares / share capital / shareholders’ funds
- Decrease in cash & bank balance / Decrease in the size of the balance sheet
- Increase in borrowings if the buy-back necessitates borrowings
- Increase in Debt Equity Ratio
- Decrease in Other Income / Profit After Tax
- Decrease in Interest Coverage Ratio
- Increase in EPS
- Increase in ROE
- Impact on Promoters’ Stake under various methods of buy-back

The buy-back of shares does create value for the shareholders by increasing the key financial ratios. In cases where the promoters’ holding is low, it also could be used to increase the same and thereby acting as a defense against hostile takeover, if the promoters do not participate in the buy-back.

<table>
<thead>
<tr>
<th></th>
<th>2013 Actual</th>
<th>Scenario I</th>
<th>Scenario II</th>
<th>Scenario III</th>
</tr>
</thead>
<tbody>
<tr>
<td>Profit After Tax (Rs Million)</td>
<td>23,482</td>
<td>21,990</td>
<td>21,441</td>
<td>19,329</td>
</tr>
<tr>
<td>Number of Shares (Million)</td>
<td>12,300.7</td>
<td>10,908.7</td>
<td>10,396.7</td>
<td>8,820.7</td>
</tr>
<tr>
<td>EPS (Rs.)</td>
<td>1.91</td>
<td>2.02</td>
<td>2.06</td>
<td>2.19</td>
</tr>
<tr>
<td>Return On Equity</td>
<td>8.4%</td>
<td>8.8%</td>
<td>8.9%</td>
<td>9.3%</td>
</tr>
<tr>
<td>Book Value Per Share (Rs.)</td>
<td>22.63</td>
<td>22.97</td>
<td>23.12</td>
<td>23.67</td>
</tr>
<tr>
<td>Debt Equity Ratio (Times)</td>
<td>0.67</td>
<td>0.74</td>
<td>0.78</td>
<td>1.04</td>
</tr>
<tr>
<td>--------------------------</td>
<td>------</td>
<td>------</td>
<td>------</td>
<td>------</td>
</tr>
<tr>
<td>Interest Coverage Ratio (Times)</td>
<td>8.69</td>
<td>8.11</td>
<td>7.90</td>
<td>4.34</td>
</tr>
</tbody>
</table>

**DECISION – TO GO FOR BUY-BACK OR NOT AND HOW MUCH?**

The followings arguments may emerge:

1. **Maintain status quo:** As NHPC is in expansion mode, it would need all the cash at its disposal to fund the investment requirements, reference can be drawn to Exhibit-I which shows that capacity is being enhanced by over 80 percent. The other argument in support for this alternative is that the buy-back is not likely to have any major improvement in EPS/ ROE. The interest coverage ratio would decline possibly impacting the credit rating of the company. Additionally, the company would not be permitted to raise further capital for the next six months.

2. **Scenario 1:** Buy-back up to 10 percent. This option would require only a board approval and could be faster. The impact on Debt Equity Ratio and Interest Coverage Ratio is only minimal. EPS and ROE increases. The floating stock in the market would not be severally affected.

3. **Scenario 2:** Buy-back to exhaust the surplus cash available without resorting to additional borrowings. This would require shareholders’ approval and therefore time consuming. The Debt Equity Ratio and Interest Coverage Ratio would increase marginally. Though the PAT would decline due to loss of interest income on surplus cash, the EPS and ROE would improve further due to smaller equity base.

4. **Scenario 3:** Buy back up to 25 percent by taking additional loan. In this option the impact on the key parameters is the greatest. The EPS and ROE increases, so do the debt equity ratio. The interest coverage ratio declines significantly. PAT also falls due to loss of interest income as well as increase in interest on borrowed funds. With increased debt equity ratio and lower interest coverage, the credit rating may also get affected adversely. It may raise questions about the ability of the company to raise money in future at a reasonable cost.

The instructor may raise the agency conflict issue here. Suppose the management decides to preserve the cash in view of the expansion plan whereas the Government of India, as the largest shareholder, wants to use the buy-back of shares to take away cash from NHPC to meet its disinvestment targets. How should the management react? Is it correct for the majority shareholders to pressurize the management to act in their interest? Buy-back often is justified as it leads to increase in promoters’ stake in the company. Is it a valid reason for buy-back of shares? The ethical issue involved in the situation would supplement the discussion on the financial and legal aspects.

**WHAT HAPPENED?**

NHPC bought back 1230.07 million equity shares equivalent to 10 percent of the equity share capital of the company. The buy-back price was kept at Rs 19.25 per share and the buy-back aggregated to Rs, 23.68 billion. The company used the tender offer method wherein all the shareholders including promoter (Government of India) participated in the buy back. The offer started on 29th November and closed on 12th December 2013. The company purchased 1107 million shares from the government thereby reducing the government’s stake in the company marginally to 85.96 per cent from 86.36 per cent.

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