'SHARE REPURCHASE - A REVOLUTION IN INDIAN DISINVESTMENT': A CASE OF NHPC

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ABSTRACT

Share Repurchase was introduced as a new mode of disinvestment by the Government of India in 2013, with NHPC. Share repurchase undertaken by a company sends out positive signals to the market and improves the valuation of the company. NHPC being a Public Sector Enterprise engaged in the generation of ***Power****, has been impacted by seasonal changes, reflected in its performance. Dilution of Government stake in the company was encouraged, to infuse better discipline and efficiency in the company's performance. There was a lot of opposition to this, with the claim that Government influence is mandatory in the company as it comes under the category of a Public Utility.*

The consistent decline in the company's financial performance, prompted the Government to introduce the route of share buyback to disinvest in the company, impacting the company's financial performance, positively. The impact though, was short lived, as several external forces destroyed many of the company's projects, forcing them to incur huge losses. Share buyback as a method of disinvestment does yield positive results and its impact depends on several factors, ranging from the nature of business that the company is involved in, to the extent of disinvestment undertaken.

Key Words: Share Repurchase, Public Utility, Disinvestment

Introduction:

Economic reforms were introduced in India, in 1991 to bring in structural reforms & accelerate the growth in the country. Indian Public Sector Enterprises were acknowledged as engines of growth, after 1947, with the Government reserving many of the companies for public sector control & governance. However, the efficiency in production & functioning of the public sector units was short lived. Consistently incurring losses became a common phenomenon among these Government controlled Units. There was a heavy burden on the Government exchequer to bail these units out and re - invest sufficiently in them to transform them into profit making ones.

A heavy fiscal deficit & near bankruptcy, that India was reeling under, in 1990, forced the Indian government to take a 'Conditional Loan' from the IMF prescribing the dilution of Government stake in state run enterprises to benefit the state as also the enterprise. Disinvestment is the process that advocates a paradigm shift in management from public authorities to private players without any change in ownership. Disinvestment results in an improvement in corporate governance, operational efficiency of the company, better market discipline, increases competition & fiscal prudence, in addition to releasing the blocked up cash resources, to be put to more productive use by the Government.

Disinvestment in India: An Overview:

Although the powerful policy of disinvestment was executed in India to improve the functioning and performance of public sector units, it has seen limited success owing to many factors - lack of transparency in valuation methodologies and execution, preference of the government to sell a minority stake only, uncertainty with regard to the labour job security, causing a low public confidence in the policy. The Government introduced cross holding of shares as a novel method, to hasten the process of disinvestment, with the cash rich public sector units buying shares in each other's companies off the government. However, the receipts from disinvestment have been negligible, prompting the government to initiate share repurchase as a mechanism to facilitate disinvestment in 2013.

Equity Repurchase:

The theory of Payment Policy was first established by Miller and Modigliani[1]. They opined that dividends & share repurchase were perfect substitutes in a perfect market, perceived to be the two most popular modes that cash - rich companies chose to give payouts to shareholders increasing Total Shareholder Value. Companies normally fund dividend payments from their Cash from Operations Flow (CFO). If a Company declares a higher dividend payment that exceeds the CFO, it pays this excess through free cash reserves, non - recurring income and may resort to debt financing.

Stock Repurchase or share buyback is a form of corporate restructuring and has been adopted across the globe to reduce public holding of equity & ensure greater control over the company by the management. Both dividends and share repurchase have an impact on the share earnings of the company. While dividends attract DDT - Dividend Distribution Tax that the company declaring the dividend has to pay, share repurchases have no such binding on the company[2]. Only investors are liable to capital gains tax on the income they receive from share repurchase. In India, unlisted companies were found to have resorted more to the route of share repurchase, to avoid paying dividend distribution tax on dividend payments. This was assessed as tax evasion, to a certain extent by authorities and hence, a 'Withholding Tax' of 20% has been levied in 2013, on the profits distributed by unlisted companies through the route of share buyback.[3]

Under share repurchase, the shares of the company are sold at a premium to the Market price to encourage shareholders to sell their stock. Share repurchase can be expedited through the open market purchase or the self tender route. The modalities involved in implementation differ such that -

In the open market purchase route -

- The company is unaware of who the purchasing shareholders are,

[1] Mertin Miller & Franco Modigliani(1961) 'Substitution Hypothesis'
[2] Applicable only to listed companies.
[3] Finance Bill 2013

- It is implemented through the stock exchange &
- The most significant aspect is that the Promoters of a company cannot participate in the open market purchase through stock exchanges,

However, in the self tender route -

- The company gets the shareholder's consent for repurchase by individually writing to each one of them;
- The stock exchange is not involved in the transaction.
- The promoters of a company are permitted to participate and tender their shares in the self tender route.

Introduction Of Share Repurchase As An Option For Central Public Sector Enterprises In India:

Although share buyback was proposed in the Disinvestment Manual, as a method to reduce government equity, the Indian Central Public Sector Enterprises did not have the provision for share repurchase, as part of their Articles of Association. Private companies however, have resorted to share buyback, primarily for one or all of the following reasons -

- their shares were undervalued,
- they had excess cash reserves in compliance with the 'signaling hypothesis',[4]
- provide better returns to existing shareholders and
- reduce the chances of hostile takeover of the company,
- encourage stock options

After a lot of discussions and deliberations, the Government permitted the Public sector companies to incorporate share repurchase in their Articles of Association from the financial year 2013 to bring them on par with the private companies, This paved the way for the government to consider this route for disinvestment with the National Hydro electric Power Corporation Limited, a Miniratna company set up in 1976, being the first Public Sector Enterprise to be disinvested.

[4] The signal that the company expects positive future returns.

The Case of NHPC:

Engaged in the generation of Hydro electricity & being the largest one in India, NHPC has a huge capex with several projects that are set up in many states across the country with a potential for major growth. It was set up as a 100% government owned company. NHPC was listed on the stock exchange[5] in September 2009 and was disinvested for the first time through its IPO in 2009, for ☐ 36 a share. Listing gave the Company the option for Corporate Restructuring. The Company's cash holding was on the rise for a fairly large period of time due to increasing internal accruals, such that new investment in upcoming projects was not available.[6] This had amounted roughly to one - fifth of the company's net worth that was being kept as cash, lessening the value of the shareholder.

Although the company performed very well in the initial years, several bottlenecks began to appear. arresting NHPC's pace of growth, such as procedural delays, delays in execution of projects, geological surprises, disputes between states and resistance from local population.[7] Increased capital work-in-progress resulting in very little of it getting converted into Operating Assets led to lower valuations of the Company.

Increased power tariffs quoted by the CERC[8] became a major component contributing to increased expenditures and lower profits for the company. The solution of **share repurchase** was devised to improve NHPC valuations, shareholder value, and add value to the company by reducing the company's equity capital.

The economic conditions, market conditions, investor sentiments caused the share prices to decline by around 30% from its initial price of ☐ 36 a share. The conditions were thus, not conducive for disinvestment in NHPC, in early 2013, when the Government proposed to offload its shares in the company through an IPO. NHPC, however proved to be cash - rich in

[5] NHPC is currently placed 15th in the order of CPSEs that are listed with the Bombay Stock Exchange with a Market Capitalisation of 22,860.93 Crores.

[6] Mr. A.B.L. Srivastava - Director (Finance) NHPC - KALEIDOSCOPE FEB 2014 issue.
[7] www.livemint.com - Disinvestment of NHPC stake hits the skids - Utpal Bhaskar, July 6th 2013
[8] Central Electricity Regulatory Commission

October 2013, with cash & reserves amounting to around ☐ 5,000/-, after having raised more capital selling tax - free bonds. This prompted the Government, on the advice of Merchant Bankers, to disinvest via the route of share repurchase in Nov/ Dec 2013.

According to the latest SEBI guidelines on share repurchase, a company is permitted to reduce equity through share buyback only to the extent of up to 25% of their paid up capital, while reserving 15% of the offer size for small shareholders (market holding ≤ ☐ 2 lakhs on the record date). NHPC divided its shareholders into 2 categories - small & general.

Category of Investor		Equity Shares reserved in Buyback	No. of Valid Applications	Total Equity Shares Tendered	Actual Acceptance
Reserved Category for Small Shareholders		18,45,11,142	3374	65,43,931	65,43,931
General Category of Other Shareholders	Promoter	104,55,63,135	1	123,00,74,277	110,71,59,036
	Other than Promoter		411	18,96,07,615	11,63,71,310
		123,00,74,277	3786	142,62,25,823	123,00,74,277

Table 1: The NHPC Share Buyback

Source: Kaleidoscope February 2014

The Government of India had planned to disinvest 11.36% of its stake in NHPC through the Offer for sale route in August 2013. However uncertainty in the economic conditions and tremendous volatility in the stock markets forced the Government to defer the decision to a later period. Hence, the route of Buyback suggested for disinvestment proved useful to both the Government & the Company. NHPC had decided to buyback 10% of its fully paid up shares of ☐ 10/- each amounting to 123,00,74,277 shares from all the shareholders. The buyback was undertaken through the self tender route.

Significance Of The Study:

The focus of the Economic Reforms initiated in 1991 was to bring about a paradigm shift in the functioning of the economy through the policy of Liberalisation, Privatisation and Globalisation. The efficient and successful implementation of the programme of Disinvestment was of paramount importance. Several models of disinvestment have been executed successfully in several countries across the world - the UK, Australia, the U.S.A., China etc.

The Indian Government has executed various models of disinvestment to encourage better and more efficient ways of production and usage of resources in the country. The programme of Disinvestment advocates dilution of Government stake in companies, with an aim to improve their efficiency and performance through Corporate Restructuring. Unfortunately the effect of disinvestment has not been experienced to the full extent by companies in India, the reasons for which are many. Primarily, it has been proven that minority shareholding as the model adopted hasn't yielded good results due to the minimal dilution of government control . With the intention of reversing this trend, the Government chose to introduce the mode of share buyback in disinvestment.

The impact of stock repurchase has been favourable on the Indian private companies that have implemented the programme. With the objective of restructuring NHPC, the Government disinvested in NHPC through the mode of share repurchase in December 2013. The existing modes of disinvestment in India - Offer for Sale, Cross Holding of shares, Minority shareholding, have a negligible effect on the immediate financial returns obtained by the company. These modes merely facilitate a change in the shareholding pattern, without impacting the number of outstanding shares in the market.

Repurchase of shares, however, has the added advantage, in that it causes a change in the shareholding pattern, as well as reduces the number of shares of the company outstanding in the market. This impacts the company positively in terms of the financial ratios of the company - primarily the earning per share and the book value of shares.

Although the earlier modes of disinvestment followed in India have been successful, the mode of Share Repurchase has greater benefits and hence is bound to have longer lasting positive effects on the disinvested company with regard to functional efficiency, profit margins, shareholder value, long term value of the company as also the stability of the company.

Review Of Literature:

Several studies done on share buyback have revealed myriad results.

1. Charu Sarin (2013) in her paper titled ***'Motives of Buyback: An empirical study of select Indian Companies'*** has studied the impact of share repurchase announcements and the method of repurchase adopted on the shareholder's value. Her empirical study showed that with buyback being a new form of corporate restructuring, its effect has been increasing - the share prices have risen from the time of announcement of buyback, for about 90% of the companies, while the earning per share of about 70% of the companies has also shown an escalated value, with buyback.

2. **Francis Thomas and Dr. R.R. Patil** (2012) in their paper titled ***'Is buyback of shares a double edged sword'*** assess if buyback of shares benefits both the shareholder and the company. With share buyback permitted in India, from very recently, their study focused on the impact of share buyback announcements of 82 listed companies on returns to the investors. Their findings indicate that price sensitivity of share prices due to buyback encourages insider trading, while it affected the takeover of some companies that required a management change.

3. **Professor Rajlaxmi**, in her paper titled '***Share Buybacks: An Analytical Study of Announcement Effect on stock prices in India'*** analyses the signalling effect of share buyback announcements of 6 companies on stock prices. The findings of the study

revealed that while some of the companies witnessed abnormal positive returns because of the announcements, several other companies received a negative reaction from the market. proving that market information plays a significant role in the reaction to a buyback announcement, characteristic of the 'Efficient Market Hypothesis' put forth by Eugene Fama.

4. **Bunny Singh Bhatia** (December 2013) in his paper titled ***'Share Repurchases: Short term effect in India'*** found that for the period 2011 - 12, the undervaluation of shares resulted in negative returns to the companies, when the share repurchase announcement was made, while, after the buyback, the market reaction was positive, proving that the buyback signals play a very important role in the returns obtained by the firm. The results of the study also showed that market information being asymmetrical caused larger variations in prices for the smaller companies.

Objectives of the study:

1. To analyse the impact of share repurchase on the growth rate of the earning per share and the PEG rate of the disinvested company with reference to NHPC.
2. To assess the change in shareholder value using the performance metric - Economic Value Added.
3. To study the Substitution Hypothesis - the effect of substituting higher dividend with share repurchase, as cash payouts.

Hypothesis:

1. **H_1:** The financial ratios and growth rates of the company are enhanced with a share buyback.
2. **H_2:** The Disinvestment route of share repurchase improves the long run shareholder value.

Methodology -

A case study is undertaken of NHPC Limited, **the only Central Public Sector Enterprise** in which the Government disinvested its stake via the method of Repurchase of shares. The impact on the earnings of the disinvested company along with changes in the long run value of the firm is assessed using the EVA. Secondary data is obtained from the annual reports, balance sheets, income statements of NHPC, financial periodicals like the Economic Times & The Mint, the magazines of the Standing Committee on Public Enterprises India, financial websites like yahoo finance, morning star, money control & reports of ICICI research.

Data Analysis and Findings:

The success of disinvestment through the route of share buyback would depend on how many of the shares were surrendered by the public. The tender route was adopted so that all shareholders were entitled to participate in the buyback. However, with a major plummet in NHPC's share price, since its IPO price of □ 39/- per share in 2009 compared to the buyback price of □ 19.25/- per unit, the small investors were not willing to tender their shares for buyback as it was a loss for them. Thus, the government got the opportunity to sell all its proposed shares and get a sum of □ 2130/- crores through the share buyback route, making disinvestment successful. NHPC saw a 100% buyback of 123,00,74,277 shares for an estimated value of □2367,89,29,832/- paid out of the cash reserves of the company and their fixed deposits with the banks.

The offer was oversubscribed and NHPC bought back the shares on a proportionate basis. Of the total 123,00,74,277 shares that were bought back (10% of the total paid up capital of NHPC), only 5.31% (65,43,931 shares) were tendered and accepted from the small shareholders, 90% (110,71,59,036 shares) were accepted from the Promoters - the Indian Government & 9.46% (11,63,71,310 shares) was accepted from the other shareholders.

Findings:

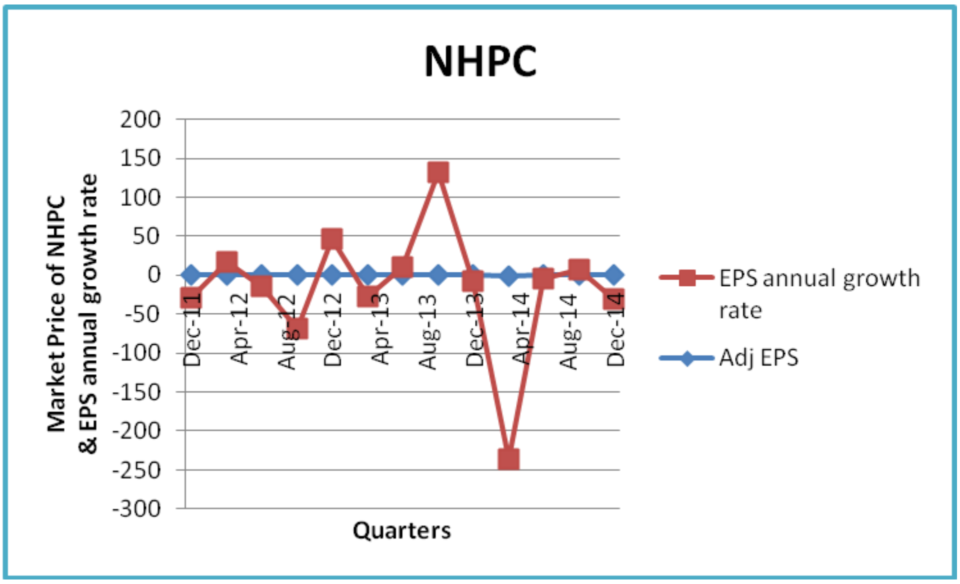
NHPC is a company whose performance is seasonal and hence, the performance of one quarter cannot be compared with that of the previous quarter. A study of the company's quarterly financials reveals this seasonal pattern in its performance.

TABLE 1a.: Growth Rate of Earning Per Share of NHPC

	Dec-11	Mar-12	Jun-12	Sep-12	Dec-12	Mar-13	Jun-13	Sep-13	Dec-13	Mar-14	Jun-14	Sep-14	Dec-14
Adj EPS	0.17	0.65	0.54	0.25	0.25	0.47	0.59	0.58	0.23	-0.64	0.56	0.62	0.16
EPS annual growth rate	-29.167	16.07	-15.625	-68.35	47.0588	-27.692	9.25926	132	-8	-236.17	-5.0847	6.89655	-30.435

Source: EPS data - Quarterly financials of the company. EPS growth rate calculated

GRAPH 1a: Growth Rate of Earning Per Share of NHPC



Earnings Per Share is a financial metric that indicates how much of the company's profit is being allotted to each outstanding share of the company. The data and the graph reveal that the EPS of the company has been consistently falling in the quarter ending December for every year from 2011 - 2014. In June 2013, the cloud burst and floods in Uttarakhand, due to which the Dhauliganga Power Station was submerged in water. The losses incurred by the company caused the overall profitability to be affected. Although the buyback in December resulted in an immediate increase in the EPS by 11% from 1.91 to 2.12[9], the quarter ending December 2013 recorded a decline of 8% in the EPS.

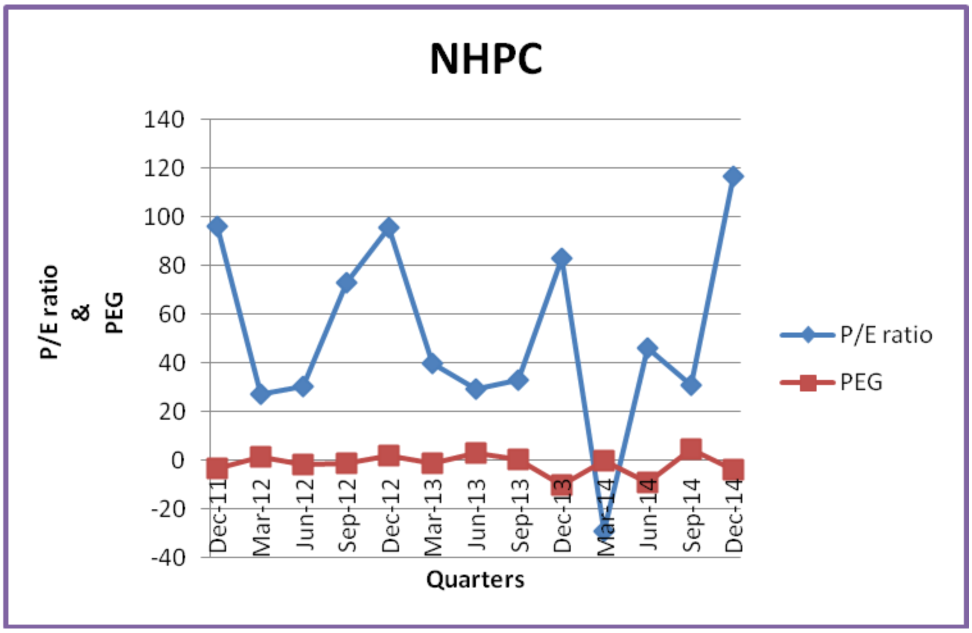
[9] Based on the company's Annual Report of FY 2012 - 13

TABLE 2: The P/E ratio & PEG

	Dec-11	Mar-12	Jun-12	Sep-12	Dec-12	Mar-13	Jun-13	Sep-13	Dec-13	Mar-14	Jun-14	Sep-14	Dec-14
P/E ratio	96.11	27.3692	30.5926	72.84	95.8	39.8511	29.3559	32.8448	82.8261	-29.156	45.96	31.1452	116.625
PEG	-3.29	1.70297	-1.9579	-1.0656	2.035	-1.4391	3.17044	0.24882	-10.353	0.12345	-9.03	4.51605	-3.8319

Source: Based on Data analysis

GRAPH 2: The P/E ratio & PEG



The price to earnings ratio (P/E ratio) is a measure that compares a company's share price to its earnings per share at a particular time, to assess the company's value. A high P/E ratio would indicate that higher growth prospects are anticipated by investors. The data reveals again, the seasonal nature of the company's business, where, the quarters ending December, from 2011 to 2014, have witnessed an increase in the P/E ratio. However, the price/earnings to growth ratio, which determines the value of the stock, has shown a fall in the ratio, for most of the quarters ending December. when compared with the same quarter of the previous year.

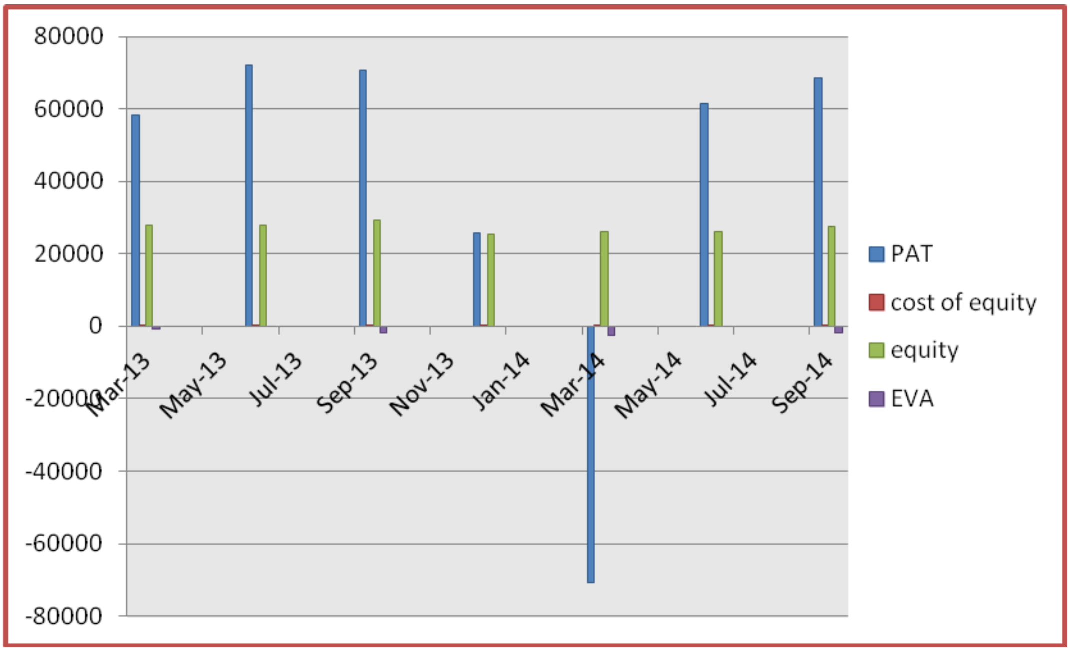
Economic Value Added is an estimate of a company's true economic profit for the year. it refers to the residual income that is left over in the firm after the cost of all capital, including equity, has been deducted. Accounting profit, however, differs from economic profit, as it is determined without including the cost of equity capital. Equity is associated with a cost, as investors lose the opportunity of investing their money elsewhere, when they buy equity. The return from other investments that carry the same risk as equity is foregone, representing 'Opportunity Cost'. EVA reflects the extent of change in Shareholder Value - a positive EVA indicates an increase & a negative EVA reflects a fall in shareholder value.

TABLE 3: Economic Value Added

	Mar-13	Jun-13	Sep-13	Dec-13	Mar-14	Jun-14	Sep-14
PAT	58326	71926	70758	25935	-70740	61603	68410
cost of equity	4.59732	7.0959	8.0566	8.57922	7.24447	12.011	8.8794
equity	27840.5	27840.5	29273.34	25472	26067.65	26067.65	27377.74
EVA	-696.656		-1650.85		-2595.86		-1746.89

Source; Based on data analysis

GRAPH 3: Economic Value Added



In trying to assess the nexus between share repurchase and shareholder value for NHPC, the impact of the share buyback reduced the net worth of the company, lessening the negative value of **EVA** and thus improving shareholder value immediately. However, the positive impact of buyback was limited to a very short time and the excessive losses negated the positive impact of share buyback for NHPC.

The Substitution Hypothesis gathered more importance, with share repurchase being adopted widely by companies. The hypothesis analyses the impact of substituting higher dividends with share repurchase. If the Government had not disinvested its shares in NHPC in December 2013, it would have owned 10,62,33,68,758 shares, though, with disinvestment through share buyback, the Government currently owns 9,516,209,722 shares.

NHPC declared a dividend of 3% for the year 2013 - 14. The Government would have received a dividend return of ☐ **31,87,01,063/-** , against a sum of ☐ **21,30,00,00,000/-** that they got through disinvestment. Thus the Government has gained an amount of ☐ **20,98,12,98,937/-,** for having disinvested their stake in NHPC in December 2013. Thus, the Substitution Hypothesis is positive in this case, proving that share repurchase has yielded a return of ☐ **2098 cr** against a probable dividend return of only ☐ **31 cr.**

CONCLUSION:

Some of the power sector companies in the public sector, like PGCIL, GAIL, NTPC have registered a positive EVA for the last few years. Their cost of capital has been fairly less, resulting in greater economic profit 'EVA'.

Dilution of Government stake in a company's equity impacts the company positively. However, the impact of share buyback was limited on the company's performance, as many powerful external factors negated the positive effects of share buyback. Greater percentage of dilution of Government stake in the company will foster growth, with all the company financial ratios increasing and improving the EVA for the company.

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