HAVE CASH, WILL HOARD

It's not just Infosys, a clutch of heavyweights, too, are sitting on a huge cash pile. Investors want payouts but the companies have different plans

ILLUSTRATION: KISHORE DAS

Jitendra Kumar Gupta

The irony is stark. Warren Buffet is a vocal advocate of investing in companies that pay dividends. Be it IBM, Coca-Cola, American Express or Wells Fargo, Procter & Gamble, Walmart or ExxonMobil, Berkshire Hathaway's favourite investments all pay dividends regularly. But Berkshire itself hasn't paid out a cent in dividend since 1967. That year, it paid 10 cents a share and the Oracle of Omaha insists, even now, that he must have been in the bathroom when that decision was approved. Investors aren't all that pleased with Buffett's stand — in March this year, shareholder David Witt proposed that Berkshire use some of its $48.2 billion cash towards giving dividends. "Whereas the corporation has more money than it needs and since the owners, unlike Warren, are not multi-billionaires, the board shall consider paying a meaningful annual dividend on the shares," Witt's proposal states. Incidentally, referring to shareholders as owners is classic Buffett terminology.

The proposal was defeated in the May 3 Berkshire shareholders' annual meeting — not surprising, really, given that Berkshire holds a third of voting rights and Buffett has explained his standpoint on dividends quite clearly in the past. In his 2012 letter to shareholders, Buffett addressed the issue of cash utilisation and dividend; he explained that what seems to be the best strategy — paying money back to shareholders in the form of dividends — may not be the best one for investors, considering the other ways of creating value for shareholders. "A profitable company can allocate its earnings in various ways (which are not mutually exclusive). A company's management should first examine reinvestment possibilities offered by its current business — projects to become more efficient, expand territorially, extend and improve product lines or to otherwise widen the economic moat separating the company from its competitors." The second step, he said, "is to search for acquisitions unrelated to our current businesses. Here, our test is simple: Do Charlie [Munger] and I think we can effect a transaction that is likely to leave our shareholders wealthier on a per-share basis than they were prior to the acquisition? The third use of funds — repurchases — is sensible for a company when its shares sell at a meaningful discount to conservatively calculated intrinsic value."

It's a debate that resonates back home in India as well. In end-July, former Infosys CFOs V Balakrishnan and TV Mohandas Pai wrote a letter to the new management at the IT giant, urging it to use some of its ₹30,000 crore war chest to buy back shares worth ₹11,200 crore. The argument: Infosys has never been a generous dividend distributor, nor has it made any aggressive acquisitions. In which case, the money is just lying idle, even as the company's shares are languishing compared with other IT majors. This, then, can be an efficient way of returning shareholders some of their wealth.

THIRTEEN LARGE COMPANIES ARE SITTING ON ₹189,307 CRORE CASH, THIS WORKS OUT TO 68% OF THEIR COLLECTIVE NET WORTH

MEET THE HOARDERS

Infosys isn't the only company sitting on piles of cash. Research by *Outlook Business* shows that as on date, 13 such large companies are collectively sitting on ₹189,307 crore of cash and cash equivalent (adjusted for debt) in their books, which works out to about 68% of their collective net worth. A large part of the equity is deployed in cash and liquid assets, which, one can argue, is hardly the purpose of these businesses. The impact of carrying such large sums of cash is showing up in the return ratios as well. (*see: A problem of plenty*) Strikingly, a collective return or annual yield on these funds (that is, other income divided by cash and cash equiva-

A problem of plenty

Of the list, state-owned enterprises continue to hold a high amount of cash

COMPANY	ADJUSTED CASH AS % OF MARKET CAP	ADJUSTED CASH AS % OF NET WORTH	REPORTED RoE (%)	ADJUSTED RoE (%)
Coal India	24	129	33	NA
Engineers India	31	100	20	NA
Bharat Electronics	37	80	15	29
NMDC	30	76	24	75
Oracle Financial	22	76	17	43
Hindustan Zinc	36	68	20	43
Infosys	14	65	26	56
Max India	23	64	32	74
Oil India	33	62	19	35
Bayer CropScience	10	50	85	116
Ambuja Cements	12	42	14	17
Concor	10	39	15	16
Cairn India	30	32	24	28

Note: Since the adjusted equity is negative in the case of Coal India and Engineers India, the return on equity is not applicable. Source: Ace Equity

lent) that are parked in banks and other instruments is about 10.4%, compared with the companies' core return on equity (RoE), which is in excess of 45%. This is also a reason why the reported average RoE (or the diluted RoE) of these companies stood at a mere 25%. No wonder, then, that lower return ratios are hammering their valuations. "Accumulated cash is impacting their RoE and, thus, valuations. A company with higher RoE will get higher PE and shareholders will get rewarded accordingly," agrees Sunil Singhania, CIO, equity investments, Reliance Mutual Fund.

Take a look at how some of the companies on the list have been affected: NMDC reported an RoE of just 24% against the adjusted RoE of 75%. Adjusted RoE takes into account only those profits that are generated by the core business (excluding other income), divided by the equity or net worth (excluding cash and cash equivalent) that is actually employed in the business, assuming that the excess funds are kept in the bank or other instruments and are not deployed in the business. Similarly, state-run coal mining company Coal India is losing big time as it continues to sit on ₹55,000 crore of cash, which is 129% of its net worth. Though it reported RoE of 33%, if one adjusts the cash, the company is practically equity-free. Similarly, Engineers India, which undertakes engineering work in the hydrocarbons space, recorded a RoE of 20%, but if that figure is adjusted for cash, the company is not using any equity. There is a huge difference in the reported and adjusted RoE of companies such as Bharat Electronics and Max India as well.

"Return shareholder money instead of destroying wealth by parking funds in banks
—SUNIL SINGHANIA
CIO, Reliance Mutual Fund

But, quite obviously, cash kept in banks yields only about 8%, hurting the overall return to shareholders. Consider Infosys, which has cash and cash equivalent of ₹29,000 crore (equal to 67% of its net worth). Thanks to the low yield on the cash on its books, it has reported an RoE of 26%, which is less than half its adjusted RoE of 56%. Similarly, in 2009, about 20% of Ambuja Cement's shareholders' funds were deployed in cash and cash equivalent, which currently stands at about 42% of net worth. With a large part of equity parked in bank deposits, RoE has dropped by 600 basis points from about 20% in 2009 to 14% currently.

Compare these companies with TCS, which has paid back a large part of its cash to shareholders, benefiting both its RoE and valuations. In FY14, TCS paid 47% of its available cash in the form of dividends, where Infosys forked out just 12.24%. Accordingly, TCS has an RoE of 44% and an adjusted RoE of 53%.

What happens with cash-rich companies, then, is that despite good core RoE, their valuations have been impacted. Typically, markets tend to ascribe higher valuations to companies that earn better return on shareholder funds. For instance, many FMCG companies, such as Nestlé, HUL and Colgate, return a large chunk of cash generated to shareholders as dividends. That is also a reason why many of these companies have very low equity deployed in the business, and thus generate very high RoE and command very high multiples or trade at higher valuations.

The difference is visible. TCS is currently valued at 25 times its trailing earnings, against 19 times for Infosys. Even if part of the valuation gap is explained by higher growth and stable management at the Tata group company, there's no denying that Infosys has been los-

> *Only when a company has run out of ideas will it give back money to shareholders*
> —**ANIL SINGHVI**
> **Chairman, Ican Investment Advisors**

ing valuation premium because of the humongous amount of cash in its books.

ARE CFOs STUPID?

If the point is so crystal clear, why are companies stockpiling cash? Many companies — especially those in cyclical or less-predictable businesses — are firm believers in saving for a rainy day. Certainly, in a downturn or an extended bad phase, companies without sufficient reserves can be wiped out. Companies such as Arshiya International, Opto Circuit and Educomp have faced this situation in the past, where this cash crunch led to a big liquidity crisis and they were left unable to even pay salaries. Keeping some cash on hand to cover basic fixed expenses such as interest, salaries and operating expenses can prove a sensible strategy, even if it earns less return.

There's another reason behind this hoarding. Nirmal Gangwal, MD, Brescon Corporate Advisors, explains, "When the business environment is unstable thanks to government policies or other such issues, many companies end up hoarding cash. Also, many of these companies are looking for opportunities to grow through both organic and inorganic routes and are waiting forthe right opportunities to knock on their doors." That's certainly true for companies such as NMDC, Coal India and Bharat Electronics where NMDC wants to invest in steel capacity as a part of its forward integration, Coal India is looking for overseas mines. Infosys, too, has been scouting for suitable acquisition targets, while Bharat Electronics is planning to expand operations.

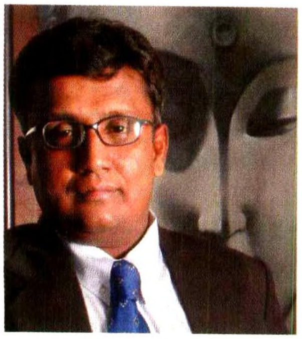
Anil Singhvi, chairman, Ican Investment Advisors, insists there is nothingwrong with companies hoarding cash, "I do not fully subscribe to the idea of giving money back to shareholders — it would look like the company has run out of ideas. Companies cannot set targets like 'I have to have an acquisition in the next one year'. It doesn't work that way, which is why evenif the funds are kept in a bank at 8-9% and you believe that the company is good, you should not bother about the cash." Singhvi himself is a corporate finance veteran who served as CEO of Gujarat Ambuja Cement, the most efficient cement manufacturer in the country before Holcim took it over.

But, ask investors, do acquisitions and expansions really require such huge sums to be kept aside, indefinitely? "Even though many of these companies can argue that this cash could be utilised over a period of time for capex and other business-related activities, the accumulated cash in some of the cases is far greater than what could actually be utilised," says Nilesh Shah, MD and CEO, Envision Capital. Investor concern over large sums of money lying unutilised or the lack of clarity on when and for what it is to be used is understandable. Coal India, Engineers India, Cairn India, Hindustan Zinc and several other PSUs are guilty of keeping money idle in banks for long periods. Coal India's cash has grown from ₹39,000 crore in FY10 to ₹62,000 crore in FY13, before it was given out through special dividend (129% of face value or utilising about ₹20,000 crore) in January 2014.

MANY COMPANIES – ESPECIALLY THOSE IN CYCLICAL OR LESS-PREDICTABLE BUSINESSES – ARE FIRM BELIEVERS OF BUILDING A SURPLUS FOR A RAINY DAY

DISTRIBUTING THE SPOILS

So, how can companies create value? Going by Buffett's thinking, if the first two options — investing in the business and acquiring a company — have already been explored, the next best thing would



One needs to question whether a company is able to use the surplus cash for growth
—**IV SUBRAMANIAM**
MD and CIO, Quantum Advisors

be to buy back shares. Certainly, it's an option Berkshire itself has used in 2012, as have companies such as Apple and IBM. "If companies are not able to find avenues that can create value for their shareholders, they should return money to the shareholders rather than destroying wealth by parking funds in banks," says Singhania. That's a thought echoed by Shah of Envision Capital. "The best way to create value for shareholders in some of these cases would be to use the excessive or surplus cash for buying back shares." That's exactly what Bayer Corp did in October 2013. Selling some of its businesses and a huge land bank in Thane, Maharashtra, yielded the company close to ₹500 crore. It had also accumulated cash equivalent of about ₹974 crore, and used a large part of this — about ₹490 crore — to buy back a 7.29% stake in the company, improving its RoE and earnings for existing shareholders.

Let's illustrate this with a hypothetical case. If a company has earned ₹100 crore profit and has 100 million shareholders, its earnings per share will accordingly be ₹10 per share. Now, if the company decides to buy back 20 million shares the same year, the effective earnings per share on the remaining 80 million shares will now be ₹12.5, which is 25% higher. This way, the company can reduce its number of shares and increase its earnings per share, which will ultimately reflect in higher valuations. As a bonus, if the company is buying back shares at a lower valuation, then existing shareholders can enjoy a higher proportion of growing future earnings and dividends. A rule of thumb is that if the earnings yield (EPS divided by market price on existing shares is higher than the yield on the bank deposit, any buyback will add more value for existing shareholders. For instance in the recent past, government-owned utility NHPC, despite having a huge requirement for the fund for its ongoing projects, went on to buy back its shares when the stock was trading at 0.6 times its book value and six to seven times its earnings. At the time, the earning yield on its shares alone was close to 14-16%, against the 8-9% yield on funds deposited in the bank.

Sebi's new norm regarding minimum public holding.

KEEPING TABS

So, what should investors be looking for in companies with huge cash reserves? "One needs to question whether the company is able to use the surplus cash for growth. In the past, companies like Bajaj have used their cash for building competitive advantage, which is good. Just keep an eye on whether the company is using the surplus cash to expand in unrelated areas, which could pose an even bigger risk," says IV Subramaniam, MD and CIO, Quantum Advisors. Not many company managements are great with acquisitions, and even less have a good track record of getting into new businesses and making a roaring success of it.

Certainly, there are way too many opportunities to let slide. Recently, Vedanta group company Cairn India made headlines when it transferred cash to its

PSUs DID NOT BUY BACK SHARES WHEN THEY WERE TRADING AT ATTRACTIVE VALUATIONS A YEAR BACK, DESPITE HAVING HUGE CASH RESERVES

Does this apply to PSUs? Market pundits believe that most PSUs that are sitting on huge cash are handicapped as despite having huge cash reserves and their shares trading at low valuations (about a year back), they did not buy back shares. Also, they have suffered in the past for not being able to take active decisions about deploying funds in businesses that are far more robust and earn better RoEs. Besides, the government is the largest stakeholder in most of the PSUs and any buyback will further increase the state's holding. And that's not a desirable outcome at a time when these companies are actually looking to offload the government's stake, following parent company Sesa Sterlite as a $1.25-billion loan for two years. As the second-largest shareholder in Cairn, the Life Insurance Corporation of India (LIC) has asked for more information on the loan, even as the Street has demonstrated its apprehensions on the related-party transactions and use of surplus cash, which is supposed to be used for its own business — the company's stock tanked almost 6% during market hours once this information was made public. Whether companies use their surplus cash for share buyback or keep it as a war chest for future acquisitions or organic growth, the bottomline is that investors should keep an eye on where the cash is going.