

Share Buybacks: Value accretive or destructive?

A review of recent examples in the Indian market

C I A N S
A N A L Y T I C S



August 2014

Executive Summary

- Indian companies have been witnessing a large cash build-up — average cash reserves with the BSE Sensex constituents^[1] ^[2] increased from ~INR 325.7 Cr to ~INR 6,000 Cr, a staggering CAGR of 38.2% during 2005–2013.
- With huge piles of cash, India Inc. now faces a double dilemma — on the one hand, the global recession is a thing of the past and, on the other, domestic economic growth and activity are expected to remain benign over the medium term.
- A large cash build-up, without adequate avenues to invest the excess cash, leaves companies with two primary options to return money to shareholders: a cash dividend or a stock buyback.
- Given the long-term signaling impact of a cash dividend whereby shareholders start expecting future dividends on the basis of the current dividend, a stock buyback may be the preferred method of rewarding shareholders.
- We at Cians analyzed the empirical data for the 50 recent buybacks in India (amounting to INR 25,000 Cr) and their relative performance over a six-month period after the buyback was announced. The following were some of our observations:
 - On an average, buyback of shares was offered at a premium of ~25%
 - Mean adjusted return (mean return of the stocks over and above the SENSEX return) for the data was ~10%, while the median return was roughly -3%
 - This huge difference between the mean and the median was due to the fact that while some stocks produced returns of more than 100%, others underperformed SENSEX and lost value over time
- A closer look at some of the recent largest outperformers and underperformers reveals: DCM Shriram's and Infinite Computer Solutions' buybacks stand out as successful programs, while that of JBF Industries and Sinclairs Hotels weren't very successful.
- The single most critical factor that separated the successful vs. not so successful program was "timing". While managers at DCM Shriram and Infinite Computer Solutions managed to invest in their own stocks when the stocks (on a P/E multiple basis) seemed undervalued, their counterparts at JBF and Sinclairs Hotels misread the markets and initiated buybacks at a time when valuations were sky high, i.e., overvalued.
- In conclusion, a buyback decision may always seem like an attractive option when management has excess cash on hand. But the reality is not all buybacks are destined to be successful. Success or failure of any buyback depends largely on getting the choice of your investment "timing" right. Well, it's not an easy choice to make.

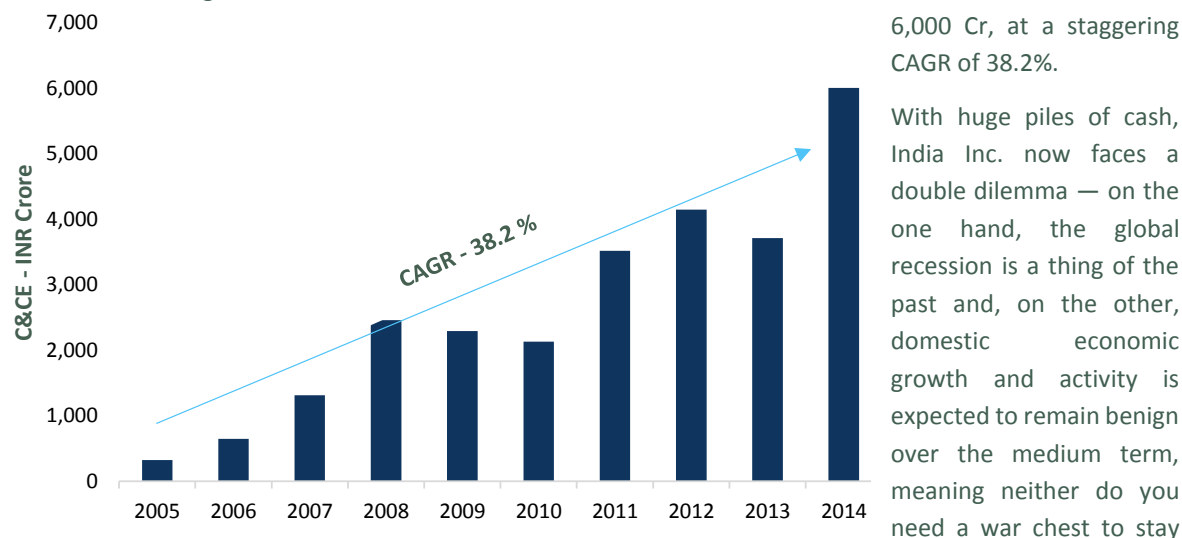
^[1] BSE Sensex as on 8th August, 2014.

^[2] We have considered BSE constituents as representative of the India Inc. and our calculations exclude any "Banking and Financial corporations" given their statutory requirements

India Inc. has large piles of cash but what to do with it?

There is an age-old proverb that says that the financial markets are driven by just two emotions: fear and greed. Although this is an oversimplification, it does hold true more often than not. While psychologists and behavioral scientists labor hard to determine how these two emotions, and in what proportion, impact the markets — it is almost as interesting to see what happens to those who weather the storm.

As they say, “what doesn’t kill you makes you stronger”. Intuitively, all participants (i.e., investors and companies alike) have a strong craving to fill up their pockets and accounts with cash and hold stronger balance sheets during periods of recession or negative growth and subdued economic activity. India Inc. displayed no contrary feeling or emotion during the period of economic turmoil. If we look at the data during 2005–2014, average cash reserves with the BSE Sensex constituents^{1 2} increased from ~ INR 325.7 Cr to ~INR



6,000 Cr, at a staggering CAGR of 38.2%.

With huge piles of cash, India Inc. now faces a double dilemma — on the one hand, the global recession is a thing of the past and, on the other, domestic economic growth and activity is expected to remain benign over the medium term, meaning neither do you need a war chest to stay

afloat nor that growth opportunities are abundant. The million dollar question is what do you do with such deep pockets then?

A large cash build-up, without adequate avenues to invest the excess cash, leaves companies with two primary options to return money to shareholders: a cash dividend or a stock buyback. Given the long-term signaling impact of a cash dividend whereby shareholders start expecting future dividends on the basis of the current dividend, it would seem that a stock buyback may be the preferred method of rewarding shareholders. Let’s review the empirical evidence.

Buyback: A win-win situation?

When managers look at a buyback, they often hypothesize that it is a win-win situation for all. Participating shareholders get their cash returns at a premium, managers are successful in increasing the company’s EV and EPS, and the remaining shareholders also get a good deal if the market price increases to at least the buyback price. They often gauge the performance of the buyback program against the performance of underlying stock returns after the program was initiated. Is it that simple? Maybe not. To understand the

Average cash reserves for BSE constituents increased at a CAGR of 38.2% during 2005-2014

Without adequate avenues to invest the excess cash, companies are likely to choose between a cash dividend or a stock buyback

¹ BSE Sensex as on 8th August, 2014.

² We have considered BSE constituents as representative of the India Inc. and our calculations exclude any “Banking and Financial corporations” given their statutory requirements

intricacies of buybacks and their performance, we take a deeper look at some of the variables and their interplay at large.

To better understand buyback performance, we analyzed empirical data for the latest ~50 buyback stocks³, amounting to 25,000 Cr and their relative performance over a six-month period after the buyback was announced. Our return calculations adjust for BSE performance to negate any noise related to the overall market performance.

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Company Name	AD*	Buyback Price (Max)	Premium	Adj. Return**
Prime Property Development	5/14/2014	19.5	15.0%	0.2%
Edelweiss Financial	4/23/2014	45.0	29.1%	65.8%
Supreme Petrochem	4/21/2014	70.0	5.7%	2.2%
Indo Borax	2/27/2014	145.0	40.9%	19.4%
DCM Shriram	2/22/2014	90.0	32.7%	176.8%
Gujarat Apollo	1/20/2014	125.0	16.4%	2.2%
Mastek	1/8/2014	250.0	36.8%	-8.4%
Claris Lifesciences	1/4/2014	250.0	25.0%	-44.3%
UPL	12/30/2013	220.0	13.6%	51.8%
VLS Finance	12/10/2013	14.5	5.1%	11.6%
Frontline Securities	12/4/2013	32.5	3.2%	87.5%
CAIRN India	11/26/2013	335.0	1.2%	-14.5%
Jagran Prakash	10/30/2013	95.0	12.8%	17.2%
Alliance Integrated	10/28/2013	162.0	-9.2%	-25.6%
NHPC	10/24/2013	19.3	-1.8%	-8.1%
Circuit Systems	10/23/2013	8.0	105.1%	139.9%
Bayer CropScience	10/23/2013	1580.0	-2.4%	-17.1%
Garware Wall Ropes	9/24/2013	60.5	34.7%	34.6%
Sinclair's Hotels & Resort	9/2/2013	390.0	12.9%	-44.8%
Jindal Steel and Power	8/30/2013	261.0	7.2%	-16.5%
JBF Industries	8/21/2013	105.0	24.5%	-32.4%
Nitin Fire	8/13/2013	66.6	23.3%	3.2%
eClerx	8/9/2013	825.0	5.0%	38.3%
The Great Eastern Shipping	8/8/2013	279.0	18.2%	-11.2%
HT Media	7/12/2013	110.0	12.0%	-22.2%
Crompton Greaves	6/28/2013	125.0	55.9%	30.3%
S Mobility	6/19/2013	75.0	122.6%	-8.5%
Infinite Computer Solutions	6/19/2013	120.0	49.3%	46.6%
Avantel	6/14/2013	75.0	23.5%	-36.7%
APTECH	5/13/2013	82.0	34.6%	16.4%
Motilal Oswal Financial	4/27/2013	90.0	4.6%	-24.9%
Maharashtra Seamless	4/8/2013	300.0	46.5%	-19.8%
Shri Dinesh	3/19/2013	91.0	25.8%	0.2%
SMS Pharmaceuticals	2/26/2013	300.0	40.3%	-22.0%
Panama Petro	2/14/2013	160.0	15.6%	-11.4%
KRBL	2/12/2013	35.0	29.2%	-20.9%
Sandesh	1/18/2013	302.0	-15.5%	-15.9%
Graviss Hospitality	1/5/2013	27.0	35.0%	-3.4%
Gradiente Infotainment	11/9/2012	16.0	95.1%	-78.4%
Rain Commodities	10/3/2012	46.0	5.3%	9.2%
Kanoria Chemicals	8/8/2012	42.0	15.4%	-3.5%
Tips Industries	7/25/2012	88.0	44.1%	23.2%
LKP Finance	5/29/2012	80.0	42.9%	-4.1%
Sasken Communication	4/27/2012	180.0	45.7%	-9.5%
Zee Entertainment	4/13/2012	140.0	12.3%	46.9%
ECE Industries	2/13/2012	125.0	1.7%	-9.3%
JK Lakshmi Cement	2/7/2012	70.0	3.2%	142.2%
Kirloskar Oil Engines	1/25/2012	170.0	21.9%	8.0%
Valiant Communications	12/21/2011	18.0	29.5%	27.5%
Mean			25.5%	10.0%
Median				-3.4%

Source: Bloomberg, SEBI; * Announcement date ** Adjusted returns = Stock returns less BSE Sensex return over the period

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On a returns only basis, the last 50 programs resulted in an average adjusted return of 10%; 10% above and beyond the benchmark index returns looks phenomenal. But wait a minute! The devil's in the details. Turn your attention to the median returns — the broader returns now look dismal at -3%. On an individual basis, the adjusted return varies quite a bit. While some stocks reported returns in excess of 100% post buyback, others seem to have lost their sheen and value. There are no clear-cut answers.

Why the difference?

The table below captures the post buyback performances of DCM Shriram and Infinite Computer Solutions. Both scrips performed exceedingly well and posted adjusted returns of 177% & 47%, respectively, in the six months immediately after the buyback.

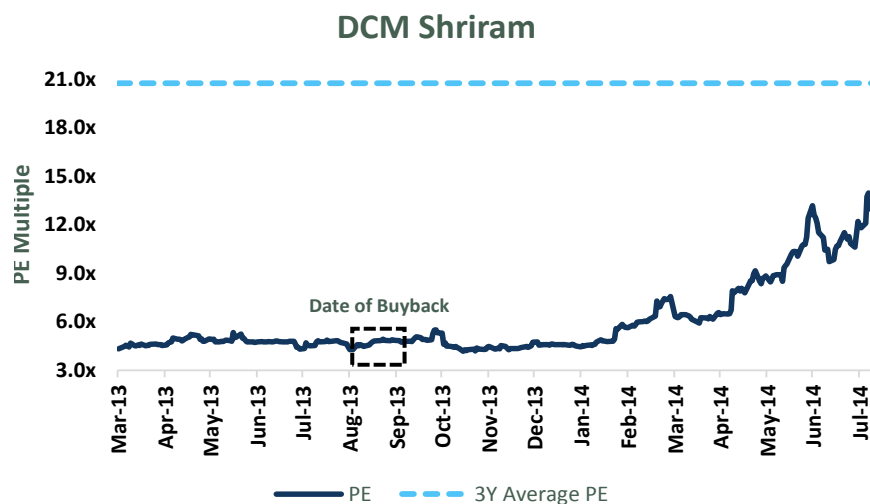
Company Name	AD*	Price on AD	Price - 6 months from AD	Adjusted Return - 6M**	EV on AD (INR MN)	EV - 6M from AD (INR MN)
DCM Shriram	2/22/2014	67.8	203.95	176.80%	20,387.80	36,410.00
Infinite Computer Solutions	6/19/2013	80.35	124.6	46.60%	2,709.90	4,295.30

*Source: Bloomberg, SEBI website; * Announcement date ** Adjusted returns = Stock return less BSE Sensex return over the peri*

DCM Shriram

Interestingly, company management offered to buy back 1.5 Cr equity shares at a premium of ~33%. The premium amount offered looked very attractive, given 20–25% is the relative norm. While the offer seemed exaggerated and an anomaly, management may have sensed and strongly believed that the company shares were truly undervalued and a buyback would make perfect sense and be a prudent investment decision. The stock price on the buyback announcement date (2/22/2014) was trading close to INR 67.8, which appreciated to INR 75 within a day and has continued its trajectory. Over the six-month period, the stock breached the INR 200 level, recording an astounding adjusted return in excess of 155%.

DCM Shriram and Infinite Computer Solutions managed to invest in their own stocks when the stock (on a P/E multiple basis) seemed undervalued



We also took a closer look at DCM Shriram's average P/E multiple in the period leading up to the buyback and later. Interestingly, when the buyback was announced the P/E multiple for DCM's stock was calculated at 5.5x, which was much lower when compared to its average P/E for the 3-year period leading up to the

buyback. For management's perfect timing, the markets seemed to reward the company and its shareholders. The company's EV also expanded from INR 2,000 Cr to INR 3,600 Cr within this period. A successful buyback program such as DCM's created value for participants, the remaining shareholders and the company alike.

Infinite Computer Solutions

Infinite Company management offered to buy back 3 Cr equity shares at a premium of ~50%. Again, a 50% premium to the then trading price seemed against the norm, but very attractive. On the day of the buyback announcement, the stock traded at INR 80.4 and reacted sharply to the buyback news, with price going up 7.2% within a month. The shares continued to perform exceedingly well and reached INR 124, reporting a 46.6% adjusted return post buyback.



After looking closer at Infinite's P/E multiple over time, there is a seemingly similar story to DCM's. Infinite offered to buy back shares at a time when its P/E multiple (2.7x) had fallen much below the previous 3-year average of 5.7x.

The common attribute in both cases seems to be the correct timing. So, are managers more adept at gauging the right time to invest? Are they better at

following the basic investment principle of buying low and selling high, even when it comes to the company's own stock? Unfortunately not. Most managers, like investors, are no better equipped to read markets and at beating the "timing". We now look at a couple of instances where buybacks didn't really follow the desired trajectory.

The table below captures the post buyback performance for JBF Industries and Sinclairs Hotels. While these buybacks were also proposed at a premium and management may have thought that a trajectory similar to that of DCM and Infinite would take hold, the exact opposite happened. Adjusted returns for both scrips were anything but stellar.

The common attribute in both cases seems to be the correct timing. For management's perfect timing, the markets seemed to reward the company and its shareholders

Company Name	AD*	Price on AD	Price - 6 months from AD	Adjusted Return - 6M**	EV on AD (INR MN)	EV - 6M from AD (INR MN)
JBF Industries	8/21/2013	84.35	67.65	-32.40%	41,683.10	39,916.30
Sinclairs Hotels & Resort	9/2/2013	345.45	237.2	-44.80%	2,285.40	1,345.5***

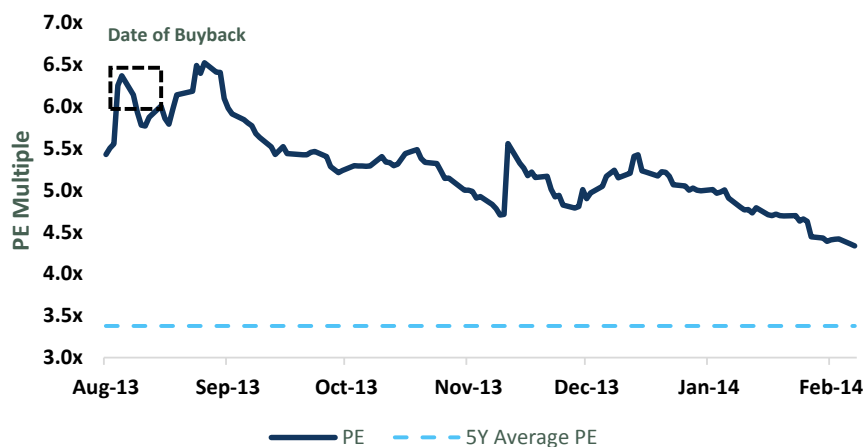
Source: Bloomberg, SEBI website; * Announcement date ** Adjusted returns = Stock return less BSE Sensex return over the period *** Recent EV has been considered for Sinclairs

JBF Industries

JBF management offered to buy back 0.4 Cr of its own equity stock at a premium of roughly 25%. A 25% premium meant management strongly believed its shares were undervalued and a market intervention would allay fears, and stock prices would rise. However, within a month of the buyback announcement, the shares underperformed Sensex by 3.6%. As if this wasn't enough, JBF shareholders lost 20% of their investment value over the next 6 months. Surprisingly, the broad-based BSE Sensex reported a positive return of 13% during the same period.

JBF and Sinclairs Hotels misread the markets and initiated buybacks at a time when valuations were sky high

JBF Industries Limited



A look at JBF's P/E multiples reveals a very different story. Management, it seems, offered to buy back shares at the peak of the valuation cycle. The Company seemed to have offered the buyback at a time when its current P/E multiple (5.5x) seemed much higher than its

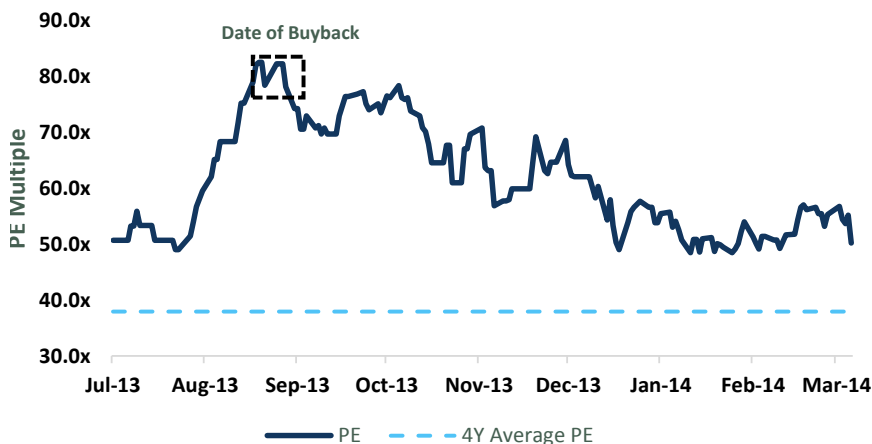
preceding 3-year average of 3.4x. Surely, the "timing" was off. Valuable cash was used to buy back shares and the market seemed to punish the company for its wrong timing. Not only did the share price suffer, the EV contracted too. A mistimed buyback offered returns only to shareholders who bowed out of the investment at premium prices.

Sinclairs Hotels and Resorts

Sinclairs' management offered to buy back 0.5 Cr of its own equity stock at a premium of roughly 25%. Management may have gauged that a buyback of undervalued shares may be a sound investment. However, the market didn't seem to be too impressed. Sinclairs' stock lost 7.4% in the first month post the announcement and reported an adjusted return of negative (45%) over the six-month period.

Valuable cash was used to buy back shares and the market seemed to punish the company for its wrong timing. Not only did the share price suffer, the EV contracted too

Sinclairs Hotels & Resort



Similar to the JBF story, management seemed to have initiated the buyback at the peak of the valuation cycle. JBF offered to buy back shares at a time when its P/E multiple (79x) had reached a level much higher than its previous 4-year average of 38x.

Conclusion

A buyback decision may always seem like an attractive option when management has excess cash on hand. Do buybacks always create value? Certainly not. Not surprisingly, buybacks make sense and help create value only when the timing is right — when the stock is undervalued. Investors have a hard time deciphering the right time to enter/exit and beat the market. Managers seem to be no different.