SIMPLE IS BETTER

JIMIT ZAVERI 12/15/18 LUCKY IDIOT

SIMPLE IS BETTER – ISSUE -13 – BUYBACK

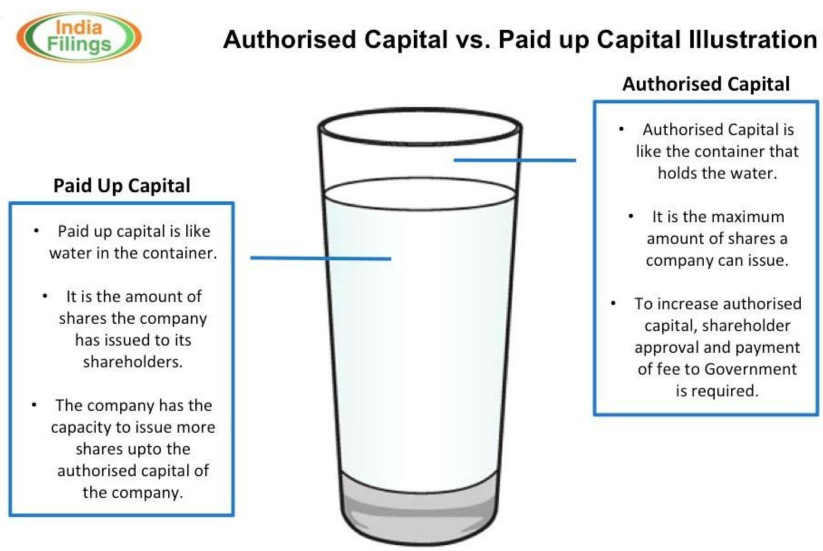
I have mentioned during the series of Warren Buffett's letter that buyback done by the company considers good. Also when the market value of the company is available at discount from intrinsic value and company does not have a better opportunity to make an investment then company has to repurchase own shares. We have heard that the company having a good management then they come up with a buyback and other will come up with a dilution of capital. The buyback is one of the criteria for judging a capital allocation decision of management that whether good or not.

Currently, many buybacks coming up due to taxation on dividend so that we need to check in detail regarding management. Here, I am going to explain what is buyback and how it is impacting to the per share intrinsic value of the company.

We try to understand it in a simple manner.

The company first decide **"Authorized share capital"** at the time of formation of the memorandum of association.

"Authorized share capital is the number of stock units (shares) that a company can issue as stated in its memorandum of association or its articles of incorporation. The authorized share capital is often not fully used by management in order to leave room for future issuance of additional stock in case the company needs to raise capital quickly." - *Investopedia*



What is Outstanding Share capital?

"Outstanding shares refer to a company's stock currently held by all its shareholders, including share blocks held by promoters, management, institutional investors and individual shareholders." - *Investopedia*

The company first decide authorized share capital and from those authorized share capital, the company issued share capital as per the need which knows as **outstanding share capital / Issued / Subscribed share capital**.

Outstanding shares keep on fluctuating with the fund requirement by the company. When management needs to raise capital for the company, they issue additional share capital (outstanding shares will get issued- also known as a dilution of share capital) and when the company does not require further additional capital then they reduce an outstanding share capital which is also known as buyback or repurchase of shares.

What is Buyback?

"Stock buybacks refer to the repurchasing of shares of stock by the company that issued them. A buyback occurs when the issuing company pays shareholders the decided value per share and re-absorbs that portion of its own that was previously distributed among public and private investors." - *Investopedia*

So that buyback reduces a no. of shares outstanding which are considered good because it will reduce partners of the company and also improves per share value of a company.

<u>Few points to focus</u>

- Buyback of shares should be authorized by the article of association or need to pass through a special resolution by shareholders
- The buyback does not exceed 25% of the total paid-up capital and free reserves of the company
- The ratio of the debt owed by the company is not more than twice the capital and its free reserve after such buy-back
- After the buyback company cannot issue new shares within 24 months of the period from the competition of buyback. Only bonus share issuance is allowed
- The time gap between two buybacks should be one year

How buyback and dilution of share capital affect to the different financial factors?

1. <u>Balance sheet</u>

Buyback of share has an impact on the balance sheet and it does not have any impact the profitability. Share capital, shareholder's fund, cash balance, assets base, etc get impacted due to buyback.

2. Share capital

As company repurchase issued share capital, No.of issued shares get reduced. I have shown the same in the above image.

	As at March 31, 2011 Rs. in Million	As at March 31, 2010 Rs. in Million
1. SHARE CAPITAL		
ISSUED & SUBSCRIBED		
16,79,16,044 (20,90,13,144) Equity Shares of Rs.2/- each	335.8	418.0
TOTAL	335.8	418.0

3. Shareholders' Fund

	Note No.	As at March 31, 2012 ₹ in Crores		As at March 31, 2011 ₹ in Crores	
EQUITY AND LIABILITIES					
Shareholders' Funds					
Share Capital	4	34.51		33.58	
Reserves & Surplus	5	11,207.52		11,802.84	
			11,242.03		11,836.42

As the company has utilized reserve created for the repurchase of shares so that reserve and surplus got to reduce and no.of shares got reduced also (In the above image the company has issued shares due to the demerger, else share capital get reduced from 41.80 cr to 33.58 crore).

4. Cash balance

Cash balance got reduce in the balance sheet due to the buyback. The company need to pay the amount to the shareholders who wish to tender shares to the company.

Current Assets					
Current Investments	17	386.22		1,100.72	
Inventories	18	465.60		382.56	
Trade Receivables	19	436.65		374.74	
Cash and Bank Balances	20	57.82		1,770.26	
Short-Term Loans and Advances	21	225.77		479.52	
Other Current Assets	22	105.32		1,912.12	
			1,677.38		6,019.92
TOTAL			14,696.98		13,851.00

5. Assets base

As cash balance gets reduced due to the buyback, overall assets base also get reduce in many of the cases. Here, we have to check other aspects of assets also. If other aspects keep on increasing after the buyback then overall assets base will also increase. If the company does not acquire any new assets then due to reduction into the cash assets base get reduce.

(₹ in Crore)

Particulars	Note No	Figures as at the end of current reporting Year 31-March-2017	Figures as at the end of previous reporting Year 31-March-2016	Figures as at the date of transition to Ind As 01-April-2015
ASSETS				
Non-Current Assets				
a) Property, plant & equipment	2.1	1,733.39	1,652.77	1,230.95
b) Capital work-in-progress	2.2	11,855.45	9,747.08	7,742.09
c) Goodwill	2.3	93.89	93.89	93.89
d) Other intangible assets	2.3	267.85	311.80	128.10
e) Financial assets				
i) Investments	2.4.1	612.30	591.64	614.41
ii) Loans	2.4.2	92.48	86.25	84.29
f) Deferred tax assets (Net)	2.5	453.36	263.18	177.88
g) Other non-current assets	2.6	2,698.76	1,873.09	2,166.18
Total non-current assets		17,807.48	14,619.70	12,237.79
Current Assets :				
a) Inventories	2.7	540.04	622.05	682.73
b) Financial assets				
i) Trade receivables	2.8.1	1,043.52	796.07	947.82
ii) Cash and cash equivalents	2.8.2	80.17	49.63	193.38
iii) Bank balances other than (ii) above	2.8.3	5,240.34	14,756.51	18,290.55
v) Other financial assets	2.8.4	281.87	851.40	1,193.00
c) Current Tax assets (Net)	2.9	564.37	869.43	620.90
d) Other current assets	2.10	181.24	190.64	186.21
e) Assets held for disposal	2.11	44.63	0.35	0.37
Total current assets		7,976.18	18,136.08	22,114.96
Total Assets		25,783.66	32,755.78	34,352.75

6. ROA (%)

We have seen that assets base got reduced due to the buyback so that with similar profit also Return on Assets will get an increase.

Pre-Buyback		Pre-Dilution	
Net Profit	100	**Net Profit**	100
No. of outstanding share	10	**No. of outstanding share**	10
Total Assets	1000	**Total Assets**	1000
RoA (%)	10%	**RoA (%)**	10%

Post-Buyback		Post-Dilution	
Net Profit	100	**Net Profit**	100
No. of outstanding share	9	**No. of outstanding share**	11
Total Assets	900	**Total Assets**	1100
RoA (%)	11.11%	**RoA (%)**	9.09%

Here, Company has made a buyback of 1 equity share.

Here, Company has issues 1 new equity share.

(₹ in Crore)

Particulars	Note No	Figures for the current reporting year 31-March-2017	Figures for the previous reporting year 31-March-2016
XIII. Profit for the year (IX + XII)		2,583.03	2,703.65

(₹ in Crore)

Particulars	Note No	Figures as at the end of current reporting Year 31-March-2017	Figures as at the end of previous reporting Year 31-March-2016	Figures as at the date of transition to Ind As 01-April-2015
Total Assets		25,783.66	32,755.78	34,352.75
ROA (%)		10.02%	7.89%	

Here, we can see that RoA (%) has increased due to the decline in assets base (As buyback has done in FY2017) through profit has reduced.

7. <u>ROE (%)</u>

Shareholder fund considers as an Equity into the RoE calculation. As we have seen that shareholders fund get reduced due to buyback so that return on equity will increase.

Pre-Buyback		Pre-Dilution	
Net Profit	100	**Net Profit**	100
No. of outstanding share	10	**No. of outstanding share**	10
Total Equity	600	**Total Equity**	600
RoE (%)	17%	**RoE (%)**	17%

Post-Buyback		Post-Dilution	
Net Profit	100	**Net Profit**	100
No. of outstanding share	9	**No. of outstanding share**	11
Total Equity	500	**Total Equity**	700
RoE (%)	20%	**RoE (%)**	14%
Here, Company has made a buyback of 1 equity share.		**Here, Company has issues 1 new equity share.**	

(₹ in Crore)

Particulars	Note No	Figures as at the end of current reporting Year 31-March-2017	Figures as at the end of previous reporting Year 31-March-2016	Figures as at the date of transition to Ind As 01-April-2015
Equity				
a) Equity share capital	2.12	316.39	396.47	396.47
b) Other Equity	2.13	22,265.82	28,783.62	32,095.49
Equity attributable to owners of NMDC Ltd		22,582.21	29,180.09	32,491.96
Non-controlling interest		15.39	16.85	16.47
Total Equity		22,597.60	29,196.94	32,508.43

(₹ in Crore)

Particulars	Note No	Figures for the current reporting year 31-March-2017	Figures for the previous reporting year 31-March-2016
XIII. Profit for the year (IX + XII)		2,583.03	2,703.65
RoE (%)		11.43%	9.26%

8. ROCE (%)

The formula of capital employed is shareholders fund + borrowings. As we have seen that due to the buyback shareholders fund get reduced which also bring down the overall capital employed to the business. So that with the similar profit, return on capital employed will get improve.

Pre-Buyback		Pre-Dilution	
EBIT	170	EBIT	170
No. of outstanding share	10	No. of outstanding share	10
Total Equity	600	Total Equity	600
Borrowing	100	Borrowing	100
Capital Employed	700	Capital Employed	700
RoCE (%)	24.29%	RoCE (%)	24.29%

Post-Buyback		Post-Dilution	
EBIT	170	EBIT	170
No. of outstanding share	9	No. of outstanding share	11
Total Equity	500	Total Equity	700
Borrowing	100	Borrowing	100
Capital Employed	600	Capital Employed	800
RoCE (%)	28.33%	RoCE (%)	21.25%

Here, Company has made a buyback of 1 equity share.

Here, Company has issues 1 new equity share.

9. Earning Per Shares (Rs.) (EPS)

Here, we can see that the profit of the company remains the same but per share earning has changed due to changes in outstanding shares. As outstanding shares got reduced, per share earning get improved with similar profit and as outstanding shares got increased, per share earning get reduced with similar profit.

Pre-Buy back

Net Profit	100
No. of outstanding share	10
EPS (Rs.)	10

Pre-Dilution

Net Profit	100
No. of outstanding share	10
EPS (Rs.)	10

Post-Buyback

Net Profit	100
No. of outstanding share	9
EPS (Rs.)	11.11

Here, Company has made a buyback of 1 equity share.

Post-Dilution

Net Profit	100
No. of outstanding share	11
EPS (Rs.)	9.09

Here, Company has issues 1 new equity share.

10. **Price to Earnings (P/E)**

Pre-Buy back

Net Profit	100
No. of outstanding share	10
EPS (Rs.)	10
Price (Rs.)	210
P/E (x)	21

Pre-Dilution

Net Profit	100
No. of outstanding share	10
EPS (Rs.)	10
Price (Rs.)	210
P/E (x)	21

Post-Buyback

Net Profit	100
No. of outstanding share	9
EPS (Rs.)	11.11
Price (Rs.)	210
P/E (x)	18.90

Here, Company has made a buyback of 1 equity share.

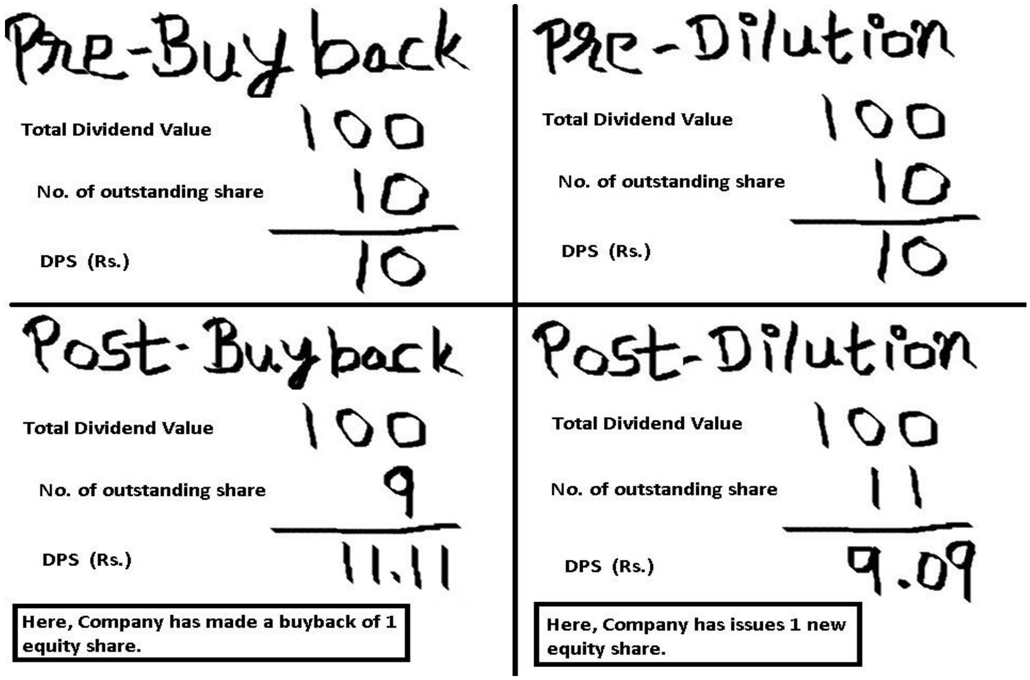
Post-Dilution

Net Profit	100
No. of outstanding share	11
EPS (Rs.)	9.09
Price (Rs.)	210
P/E (x)	23.10

Here, Company has issues 1 new equity share.

If the company remain trade on the similar price pre and post buyback or dilution then also P/E of the company get change. P/E has getting impacted due to price or EPS. Here, we can see that price remains the same but EPS get an increase in case of buyback which reduces the P/E and EPS get reduced in case of dilution which increases P/E.

11. Dividend per share (Rs.)



Here, we can see that if the company declares the similar amount of total dividend then also dividend per share get improved after buyback and dividend per share get reduced after new issues of shares.

Indian companies examples

Buyback when company available at a cheaper valuation

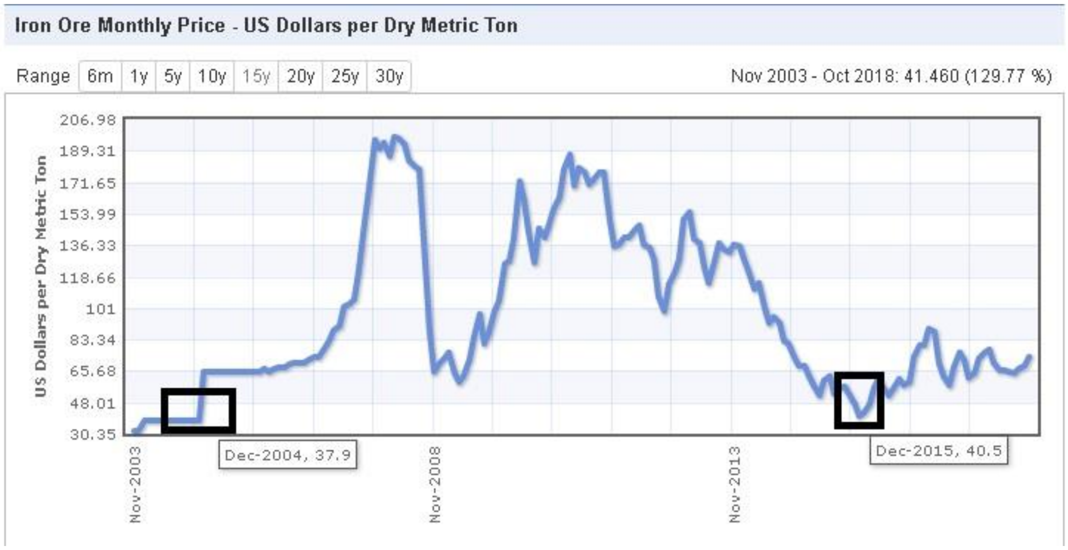
One of the Pharma Company of India which has sold one of the business segment into the FY2011 and company becomes a Cash bargain. The company has done a buyback at that time.

	As at March 31, 2011 Rs. in Million	As at March 31, 2010 Rs. in Million
9. CASH AND BANK BALANCES		
TOTAL	17,702.8	411.8
10. OTHER CURRENT ASSETS		
Interest, Rent & Claims Receivable	449.2	78.6
Receivable on Sale of Domestic Formulation Business (Refer note 6, Sch.22)	71,360.0	-
Forward contracts Receivable	5,262.4	-
TOTAL	77,071.6	78.6

The company has a total Cash balance of Rs.1770.28 crore + Upcoming cash due to the sale of the business worth of Rs.7136.00 crore = Rs.8906.28 crore. And the company was available at MCap of ~Rs.7830 crore. Entire continuing business was not given valued by the market.

Bottom of the cycle

One of the metal company in the year 2016 has come up with the buyback. In the year 2016, the price of iron ore was traded lower.



Balance Sheet										
Rs Cr	Mar-06	Mar-07	Mar-08	Mar-09	Mar-13	Mar-14	Mar-15	Mar-16	Mar-17	Mar-18
Equity Share Capital	132	132	132	396	396	396	396	396	316	316
Reserves	3,871	5,647	8,171	11,231	27,122	29,550	31,870	28,784	22,266	24,101
Borrowings	-	-	-	-	-	-	-	1,497	-	500
Other Liabilities	443	468	769	1,220	3,286	1,507	2,207	2,208	3,335	4,003
Total	**4,446**	**6,247**	**9,072**	**12,848**	**30,805**	**31,454**	**34,474**	**32,885**	**25,918**	**28,921**
Net Block	530	505	568	747	1,267	1,366	1,468	2,058	2,095	3,457
Capital Work in Progress	56	113	112	248	3,247	5,297	7,801	9,747	11,855	12,545
Investments	74	74	83	71	261	219	319	592	612	673
Other Assets	3,786	5,555	8,309	11,782	26,030	24,571	24,886	20,488	11,355	12,246
Total	**4,446**	**6,247**	**9,072**	**12,848**	**30,805**	**31,454**	**34,474**	**32,885**	**25,918**	**28,921**
Working Capital	3,342	5,087	7,540	10,562	22,744	23,064	22,679	18,280	8,019	8,243
Debtors	317	284	489	1,016	1,082	1,448	1,752	796	1,044	1,473
Inventory	128	129	166	301	637	681	692	622	540	572
Cash & Bank**	3,109	4,849	7,199	9,741	21,027	18,661	18,486	14,806	5,321	5,461

Profit & Loss Account / Income Statement										
Rs Cr	Mar-06	Mar-07	Mar-08	Mar-09	Mar-13	Mar-14	Mar-15	Mar-16	Mar-17	Mar-18
Sales	**3,711**	**4,186**	**5,711**	**7,564**	**10,704**	**12,058**	**12,356**	**6,456**	**8,828**	**11,615**
% Growth YOY		*13%*	*36%*	*32%*	*42%*	*13%*	*2%*	*-48%*	*37%*	*32%*
Expenses	1,029	964	1,381	1,733	3,331	4,287	4,703	3,957	5,234	5,868
Operating Profit	**2,682**	**3,222**	**4,330**	**5,832**	**7,374**	**7,771**	**7,653**	**2,499**	**3,594**	**5,747**
Operating Profit Margin	*72%*	*77%*	*76%*	*77%*	*69%*	*64%*	*62%*	*39%*	*41%*	*49%*
Other Income	200	355	671	885	2,239	2,135	2,155	1,682	910	723
Depreciation	114	80	60	74	139	151	173	218	197	257
Interest	-	-	-	-	13	2	0	66	21	37
Profit before tax (PBT)	2,768	3,497	4,941	6,643	9,461	9,753	9,636	3,897	4,287	6,176
PBT Margin	*75%*	*84%*	*87%*	*88%*	*88%*	*81%*	*78%*	*60%*	*49%*	*53%*
Tax	942	1,178	1,696	2,276	3,122	3,340	3,346	1,380	1,704	2,373
Net profit	**1,826**	**2,318**	**3,245**	**4,367**	**6,339**	**6,413**	**6,289**	**2,517**	**2,583**	**3,803**
Net Profit Margin	*49%*	*55%*	*57%*	*58%*	*59%*	*53%*	*51%*	*39%*	*29%*	*33%*

Company had a cash balance of Rs.14806 crore in FY16 and PAT of Rs.2517 crore. Company was available at MCap of ~Rs.28440 crore. Entire continuing business ex-cash was available at 5.94x of PAT (MCap Rs.28440 crore - Cash Rs.14806 crore + debt Rs.1497 crore = Rs.15130.86 crore; EV Rs.15130.86 crore / PAT Rs.2517 crore = 5.94x).

Future prospect of the company looks good and available at a decent valuation

One of the petrochemical company which has transform business to high margin products from commodity

(₹ Lacs)	As at 30-06-2011	As at 30-06-2012	As at 30-06-2013	As at 30-06-2014
Long-term borrowings	10666.59	9408.57	3209.45	930.00
Current Liabilities				
Trade payables	42886.75	50772.48	49085.24	49072.73
Current Assets				
Inventories	26015.22	26345.92	21953.30	17925.97
Trade receivables	21889.56	24328.92	32659.56	33720.41
Profit for the year	8769.07	3137.47	7282.33	3058.99

The company has come out with the buyback during June-July 2013. Here, we can see that the majority of the working capital is getting covered from trade payables and also the company has generated a profit which takes care of assets and other needs. The company also has repaid debt during the worst business cycle. If we read an annual report then we can come to know that management focus is on the expansion of margin through new high margin products and withdrawal of existing low margin products. Such efforts have contributed to the shareholders.

Business does not require a fund to invest or business does not have a huge growth available

TRENDS:	10 YEARS	7 YEARS	5 YEARS	3 YEARS
Sales Growth	14.0%	14.4%	11.8%	9.8%
PBT Growth	12.8%	11.8%	9.8%	5.7%

Common Size Balance Sheet										
Rs Cr	Mar-08	Mar-09	Mar-10	Mar-11	Mar-12	Mar-13	Mar-14	Mar-15	Mar-16	Mar-17
Equity Share Capital	1%	1%	1%	1%	1%	0%	1%	2%	1%	1%
Reserves	81%	82%	82%	80%	81%	77%	75%	80%	81%	79%
Borrowings	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%
Other Liabilities	18%	17%	17%	19%	18%	22%	24%	18%	18%	19%
Total Liabilities	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**
Net Block	21%	18%	17%	14%	15%	15%	17%	18%	17%	16%
Capital Work in Progress	3%	1%	1%	2%	2%	2%	1%	1%	2%	2%
Investments	0%	13%	0%	1%	5%	8%	3%	3%	20%	15%
Other Assets	76%	67%	82%	83%	78%	76%	78%	78%	62%	67%
Total Assets	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**
Receivables	17%	13%	15%	15%	15%	15%	15%	15%	15%	16%
Inventory	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%
Cash & Bank	44%	38%	53%	53%	47%	45%	46%	43%	27%	25%

Here, we can see that the company has a sluggish revenue and profit growth, also cash + investment is getting accumulated with the company. So that company should return capital to the shareholders. And the company has performed buyback.

Buyback has done instead of debt repayment

One of the largest tea manufacturing company which has sold assets and done a buyback rather repay the debt in the FY19

The company has sold off its tea estate for the repayment of debt but they come out with the buyback of Rs.100 crore. It is acceptable that the business cycle is experiencing a tough time so buyback also advisable. But debt repayment should be a first priority of the management.

High-value buyback

One of the adhesive company has made a buyback in FY18

The company has made a buyback where P/E (x) ~52x, EV/EBITDA ~33x, P/BV ~14x, MCap to sales ~7.62x. The company is the market leader, having a decent financial though repurchasing shares at such valuation can be harmful. And raw material of the company is crude oil and its derivative so due to lower price of crude oil company enjoys higher margin in last ~10+ years.

We have to check that whether the buyback decision of the company is good capital allocation at a particular time and at a particular price or not. Not all buyback should be considered as a good capital allocation decision of the management. If we repurchase our shares at a higher value then it does not add value to the existing shareholders of the company.

Love to read again and again

- Session by Mr. Durgesh Shah -2nd Value Investing Pioneers Summit 2018 , Delhi
- Hidden Risk of Investing in High PE Stocks

My Popular articles

- LEARNING INVESTMENT LESSONS FROM MOVIE CHAL MAN JEETVA JAIYE
- WHY CONSIDERING ROCE (RETURN ON CAPITAL EMPLOYED) WITH ROE (RETURN ON EQUITY) IS BETTER????
- WHAT IS ROE (RETURN ON EQUITY)? AND WHY ALWAYS CONSIDER DEBT WHEN CALCULATING ROE?

Simple is Better Series

Issue - 1	Issue - 2	Issue - 3	Issue - 4	Issue - 5	Issue - 6
Issue - 7	Issue - 8	Issue - 9	Issue - 10	Issue - 11	Issue - 12

Disclaimer

Above article is just my perception, and perception can be wrong. For me, my perception can be right but for others, it might be wrong.

I am Grateful to

I am really grateful to - Mr. Neeraj Marathe Sir, Prof. Sanjay Bakshi Sir, Mr. Vishal Khandelwal Sir, Dr. Vijay Malik Sir, Mr. Rajeev Thakkar Sir, Mr. Raunak Onkar Sir, Mr. Vijay Kedia Sir, Mr. Howard Marks, Mr. Warren Buffett, Mr. Charlie Munger, Mr. Benjamin Graham and Mr.Walter Schloss.

I am especially grateful to Mr. Vishal Khandelwal Sir for getting inspiration to start series of articles.

I am grateful to Dr.Vijay Malik Sir for the idea of an article.

I am really grateful to my parents and almighty for providing me always support whenever I needed.

Please forgive me, if I forget to mention any person who has contributing value to my journey.

Author: Jimit R. Zaveri (Founder of Lucky Idiot)

Blog address: https://jimitzaveri.wordpress.com/

As a founder of Lucky Idiot; My mission through "Lucky Idiot" is to educate novice investors and to distribute learning to more and more people in a simple manner.

Follow me: @ **Twitter** Jimit Zaveri