Share Buyback and Indian IT Firms: Any Signal?

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Seven software companies in India have either announced or discussed buyback of shares programme within a span of 45 days, between 31 January 2017 and 15 March 2017. Excepting one company (Mindtree), others have also declared the size of buyback totaling US$5.8 billion. The seven companies have more than US$23 billion in cash, cash equivalents and short-term investments. Therefore, the proposed buyback amounts to 30% of the free cash available with these companies. TCS has announced India's biggest buyback offer till date (Rs. 160 billion) surpassing Reliance Industries Ltd's buyback offer of Rs.104 billion in 2012. The buyback price of Rs.2850 represents a 13.7% premium to the closing share price of 20 February 2017 when the announcement was made. The buyback will involve 2.85% of the company's outstanding shares. Interestingly Tata Sons, the holding company, has decided to participate in the buyback of TCS shares. Tata Group owns 73% of TCS and hence if the holding company does not participate in the buyback, the promoter group may reach closer to 75% mark endangering listing of TCS in the exchange. Legal technicalities apart, participation of a holding company in any buyback programme sends a wrong signal to the market.

Reports suggest that the Board of Wipro is seriously considering distributing 25-30% of its free cash reserve to its shareholders. Wipro had a free cash reserve of US$3 billion in March 2016 which grew to US$4.9 billion in December 2016. The expected buyback size is US$1.25 billion. This is in addition to the interim dividend of about Rs. 500 crore (US$75 million) declared by the company in January 2017. Cognizant, the US-based Nasdaq-listed company, had announced in January 2017 its decision to return US$3.4 billion cash to shareholders over next two years through dividend (US$0.7 billion) and buyback (US$2.7 billion). The company has free cash reserve of US$5.3 billion as on 31 December 2016.

Responding to the pressure of select founders, Infosys is likely to soon announce share buyback to the tune of US$2.5 billion. Infosys has more than US$5 billion of free cash and hence the expected buyback would consume almost 50% of the cash reserve of the company. However, Infosys has no plans to implement the buyback programme before 2018. If approved, this will be Infosys's first share buyback programme. One may note that in the recent past there was a bit of tension between the founders and the Board of Infosys on issues of severance pay to the CFO of the company and compensation for the CEO. Founders presently hold about 13% of the company.

HCL Technologies has announced a share buyback programme to the tune of US$500 million. It represents 2.45% of paid up equity capital of the company and about 14% of the consolidated

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equity of the company. HCL has cash reserve of close to US$1.9 billion. The proposed buyback at Rs. 1000 per share reflects a premium of 15% to the closing price of the share on the day before the announcement. Mphasis has obtained shareholders' nod for its buyback programme of US$200 million, which is 8.2% of the paid up capital of the company. Similarly, Mindtree is also going to announce its buyback programme soon.

Signalling

Buyback is typically used to return free cash flows to shareholders. Announcement of share buyback, therefore, sends several signals. *First,* large distribution of cash reserves indicates that a firm may not have immediate profitable investment opportunities and thus allowing its investors opportunity to earn better return on their investments. *Second*, it indicates confidence of the company to replenish its cash reserve quickly after buyback with insignificant negative impact on the net earnings (profit) of the firm. *Third*, it may also signal lack of confidence on the part of management in facing future uncertainties. For example, in view of severe restrictions imposed by the US on H1B visa the Indian IT firms fear substantial drop in business volume from USA. If a software firm in such a situation announces share buyback, it may send a signal that the firm is unsure of its future and therefore wants to keep its shareholders happy by way of share buyback.

It is clearly evident (Table 1) that these software firms were earning suboptimal returns on their free cash (yield on free cash is very low) and hence their decision to return the cash to shareholders is justified. It is also noticed that the firms, due to very nature of their business, need little investment in real assets (capital expenditure) and hence distribution of large cash to shareholders would not materially affect the business. Experts believe that the recent developments in the US have provided an opportunity to the Indian firms to revisit their strategy and tweak their model away from labour-intensive low-margin business. These firms have to explore opportunities in the area of artificial intelligence, machine learning and cognitive analytics much of which are outside the present domain of these entities. Indian firms need to adopt the 'acquisition' route to quickly get into these new areas of high-margin business. Inorganic growth requires availability of cash reserve. The leading software firms (Table 1) have already distributed more than US$9 billion in the past three years by way of dividend and still hold more than US$20 billion of cash and short-term investments. This implies that proposed buyback offers of the seven companies would not compromise with the long-term business objective of these firms. The only challenge it to learn how to identify potential candidates for acquisition.

Table 1: Free Cash Flow Usage	2016	2015	2014	Total
TCS				
Net Capex	225.02	1703.33	1621.86	3550.21
Cash and Cash equivalents	28827.1	19746	15649.5	

Cash Dividend	8571.38	15473.87	6267.33	30312.58
Yield of free cash	6%	8%	8%	
Cognizant Technology Solutions				
Net Capex	-530.78	-365.67745	25.241504	-871.213
Cash and Cash equivalents	35,137.00	32,778.96	23,865.54	
Cash Dividend	0	0	0	0
Yield of free cash	2%	2%	2%	
Infosys				
Net Capex	1,193.00	1,073.00	1,389.00	3655
Cash and Cash equivalents	29,178.00	28,471.00	26,849.00	
Cash Dividend	5570.00	5111.00	3618.00	14299
Yield of free cash	9%	9%	8%	
Wipro				
Net Capex	189.50	95.50	(66.40)	218.6
Cash and Cash equivalents	21,139.00	20,131.30	16,394.10	
Cash Dividend	1482.30	2963.60	1973.60	6419.5
Yield of free cash	10%	8%	8%	
HCL Technologies				
Net Capex	368.51	759.37	114.36	1242.24
Cash and Cash equivalents	11852.90	9999.80	4204.30	
Cash Dividend	2251.74	2385.59	700.27	5337.6
Yield of free cash	5%	8%	13%	
Mindtree				
Net Capex	26.10	97.80	71.10	195
Cash and Cash equivalents	402.50	901.20	633.50	
Cash Dividend	176.20	142.40	104.10	422.7
Yield of free cash	4%	2%	1%	
Mphasis				
Net Capex	23.83	9.13	-0.41	32.55
Cash and Cash equivalents	1388.51	944.73	1032.91	
Cash Dividend	0.00	336.23	147.13	483.4
Yield of free cash	4%	5%	1%	
Source: Ace Equity and Bloomberg. *Net Capex= Capital expenditure-Depreciation*				

Shareholder Activism

Another reason for a company to announce share buyback could be the pressure of shareholders. Promoters majorly control the equity ownership of most of the software companies in India. Cognizant Technologies, which is a US-based company, is an exception where investment and hedge funds hold major shares (Table 2). One may wonder why all these seven companies announced share buyback this year? Wipro, of course, had declared another buyback in the recent past. The reason could be pressure from the institutional investors. For example, foreign portfolio investors are known to exert pressure on companies to distribute cash to shareholders. It is observed that foreign portfolio investors held 40.24% of Infosys shares, 26.94% of HCL's and 10.93% of Wipro's in 2016 and these group of shareholders did not hold any shares of these companies in 2015 or earlier. Empirical evidence suggests that shareholders often put pressure on firms to distribute idle cash, which is not earning optimal returns. Such active shareholders always demand a transparent capital return policy. For example, Elliott Management, which holds 4% stake in Cognizant Technology Solutions (CTS), demanded a $2.5 billion share buyback, interim dividend and a shakeup in management of the company to improve profitability. Incidentally, CTS has never paid any dividend since its inception. Similarly in 2014 two former chief financial officers and a serving board member of Infosys had formally written to the board of the company demanding share buyback worth US$2 billion. Generally shareholders of IT firms in India were not happy with the returns over the past three years and believed that buyback may boost the share price and hence value of their investment.

Table 2: Shareholding Pattern	2016	2015	2014
TCS			
Promoters	73.42	73.9	73.9
Institutions	22	21.64	21.47
Public (Non-Institutions)	4.58	4.46	4.64
Cognizant Technology Solutions			
Investment Advisor	83.64	88.73	84.74
Institutions (incl hedge fund)	13.51	9.09	13.05
Public (Non-Institutions)	2.85	2.18	2.21
Infosys			
Promoters	12.75	13.08	15.94
Institutions	57.69	53.06	55.76
Public (Non-Institutions)	28.58	17.66	12.2
ADR	0.98	16.2	16.1
Wipro			
Promoters	73.34	73.39	73.47
Institutions	16.18	15.07	13.62
Public (Non-Institutions)	9.93	9.58	10.97
ADR	0	1.96	1.94
HCL Technologies			
Promoters	60.38	60.58	61.64
Institutions	32.63	33.45	32.58
Public (Non-Institutions)	7	5.97	5.77

Source: Ace Equity. Figures in percentage

Market Reaction

The IT firms had three choices with regard to their capital return policy: (a) do nothing (i.e., retain the free cash), (b) distribute the free cash as a special dividend, and (c) share buyback. Table 3 shows the implications of these three choices.

It is assumed that if every firm does nothing with existing free cash, the share price would not change and the price shown is the share price on the date of announcement of buyback. Further, the special dividend is assumed to be equal to the size of buyback announced or discussed. The ex-dividend price is estimated by deducting dividend per share from the share price under 'retain cash' option. Loss of income due to use of free cash (equivalent to yield of free cash multiplied by the proposed buyback size) is deducted from earnings estimates for dividend and buyback options.

Table 3	**Share Price (Rs.)**	**2018 Earnings (Rs. million)**	**Number of Shares (million)**	**EPS (Rs.)**	**DPS (Rs.)**	**#shares repurchased (million)**
TCS						
Retain Cash	2502.2	283721.9	1970.4	144.0	0.0	
Special Dividend	2430.9	275535.4	1970.4	139.8	71.3	
Repurchase Shares	2489.9	275535.4	1914.3	143.9	0.0	56.2
One-week Market Reaction	-1%					
Cognizant Technology (figs in USD)						
Retain Cash	57.4	2227.7	607.0	3.7	0.0	
Special Dividend	53.0	2173.7	607.0	3.6	4.4	
Repurchase Shares	58.0	2173.7	560.0	3.9	0.0	47.0
One-week Market Reaction	-1%					
Infosys						
Retain Cash	936.5	155847.7	2296.9	67.9	0.0	
Special Dividend	930.2	141461.7	2296.9	61.6	6.3	
Repurchase Shares	981.8	141461.7	2118.1	66.8	0.0	178.9
One-week Market Reaction	5%					
Wipro						
Retain Cash	488.6	91861.1	2470.7	37.2	0.0	
Special Dividend	454.7	83725.0	2470.7	33.9	33.9	
Repurchase Shares	495.1	83725.0	2299.3	36.4	0.0	171.4
One-week Market Reaction	2%					
HCL Technologies						
Retain Cash	842.9	89700.3	1410.4	63.6	0.0	
Special Dividend	818.4	87825.7	1410.4	62.3	24.5	
Repurchase Shares	864.4	87825.7	1375.8	63.8	0.0	34.6

One-week Market Reaction	2%					

Source: Bloomberg for consensus estimates of earnings for 2018

It is observed that earning per share (EPS) would not increase in most of the cases after buyback. The market reaction, based on share price change in one week after the announcement of buyback), has been positive in three out of five cases. Market reaction is estimated as excess return over NIFTY (NASDAQ in case of Cognizant). Thus, there is no guarantee, as some shareholder activists argue, that share buyback would improve EPS and share price. Buyback should be used more as a signalling mechanism.