Deloitte.

Buy back of shares
Key considerations

May 2020

Strictly private and confidential

Overview and relevance in current scenario

Buy back scenario

As per recent trends, one can observe an increasing use of buy back as means of financial/ capital restructuring by India Inc.

Share buy backs predominantly help in improving key ratios and also provide protection from potential takeovers

Relevance

At this juncture, management decision between retaining money for investment vis-à-vis payout to shareholders would be critically viewed, due to widespread uncertainty

Few cash rich companies have already made a move as covered in the ensuing slides

Prominent share buy backs announced in light of Covid-19*

Sun Pharma

BOD on 17 March 2020 approved share buy back of up to INR 1,700 crores from open market. Promoter stake to increase pursuant to buy back

Supreme Petrochem

BOD on 10 March 2020 approved share buy back of up to INR 62.67 crores from open market

Emami

BOD on 19 March 2020 approved share buy back of up to INR 194 crores in order to distribute cash to shareholders and increase promoter stake

Dalmia Bharat

BOD on 21 March 2020 approved share buy back of up to INR 500 crores to provide support to its share price

Granules India

Shareholders on March 10 2020 approved share buy back of up to INR 250 crores from all shareholders on proportionate basis

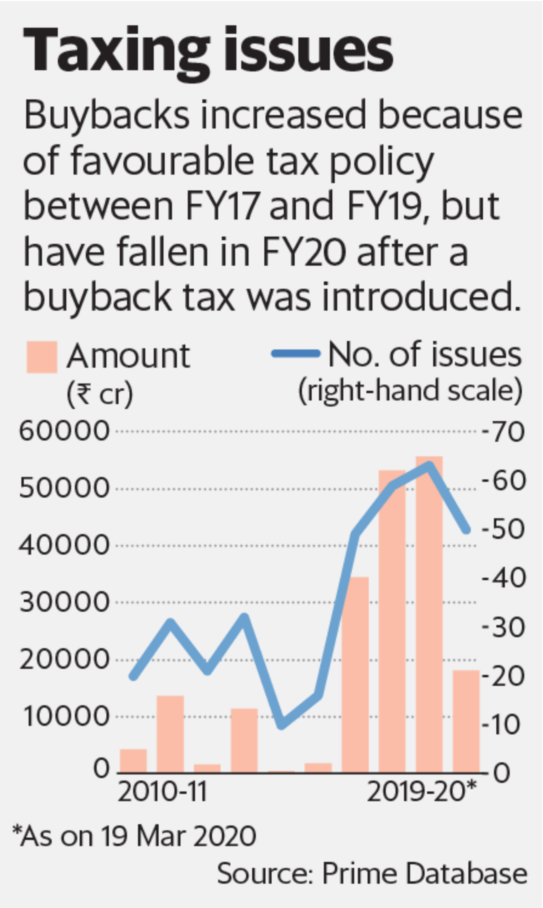
In less than three months, about 17 companies have announced buy back of shares. Companies such as Sun Pharmaceuticals Ltd, Supreme Petrochem, Dalmia Bharat Ltd, Emami Ltd and Granules India Ltd have announced **buy back** at a **15-72% premium to their prevailing market price**

*__Source:__ information available in public domain

Tax and Regulatory aspects

Buy back of shares – Covid-19 scenario#

- With the stock markets in India falling in the past two months, an often asked question in investors' minds is whether the markets have bottomed out.
- It would appear so if one were to go by the number of buy back announcements by companies, as well as share purchases by promoters in their companies.
- Promoters of around 200 companies from the Nifty 500 index have acquired shares from the open market to increase stakes in their companies.
- **Share purchases by companies as well as promoters are indeed a positive sign** for investors about the confidence of the management in the underlying fundamentals of the business.
- Representations have also been made for reducing the tax burden on investors by considering temporary removal of tax on share buy backs and exempting long-term capital gains (LTCG).
- These measures could be part of an ongoing exercise to provide relief and exemptions to India Inc. and investors, amid the turmoil caused by the stock market meltdown, due to a halt in economic activity.

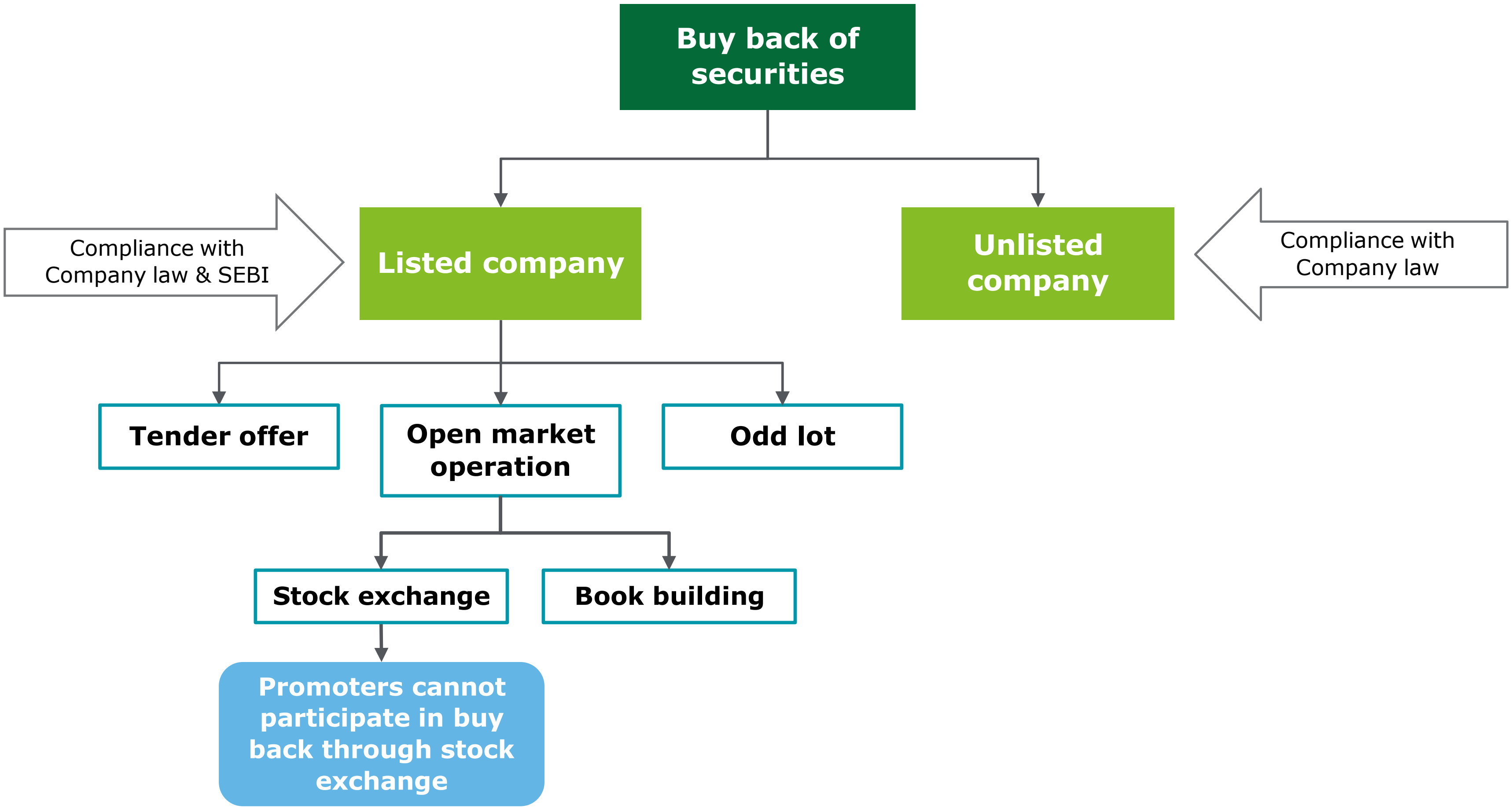


The abolishment of DDT in FY21 resulting in an increased tax incidence in the hands of individual resident shareholders may make buy backs more attractive

 # https://www.livemint.com/market/mark-to-market/does-a-buy back-flurry-point-to-bottoming-of-markets-11584904221541.html

https://www.business-standard.com/article/markets/centre-sebi-likely-to-remove-tax-on-buy backs-ltcg-to-lift-sentiment-120032401848_1.html

Modes for buy back



As per SEBI regulations on buy back, specified securities include ESOPs

Tax and regulatory framework

Tax

- Company to pay tax on buy back @ 23.3%
- Amount received on buy back exempt in the hands of shareholders
- Tax credit on buy back may not be available to non resident shareholders. However, one needs to analyse the tax provisions of the foreign jurisdiction on allowability of the credit.

Company law

- Maximum buy back limit – 25% (paid up capital + free reserves)
- Debt – equity ratio post buy back to not exceed 2:1 (on consolidated basis for listed companies)

SEBI

- Trading window to be closed for designated persons and their immediate relatives
- Stock exchanges to be given prior intimation about the board meetings to consider proposals for buy back
- There may be an obligation to make an open offer if certain limits are breached on buy back

FEMA

- Pricing guidelines to be adhered to
- Compliance with reporting requirements

- During pendency of buy back, promoter group are restricted from dealing in shares on the stock exchange or off-market, including inter - se transfer promoters
- Buy back through open market operations to be restricted to 15% of paid up capital + free reserves (both on standalone and consolidated basis)
- No public announcement of buy back can be made during the pendency of any scheme of amalgamation or compromise or arrangement pursuant to the provisions of the Companies Act
- Company cannot not raise further capital for a period of one year from the expiry of buy back period, except in discharge of its subsisting obligations. However, SEBI has recently relaxed the cooling off period temporarily for raising further capital to 6 months until 31 December 2020.

Buy back vs. Dividend

Buy back vs. Dividend - Brief overview

Recent amendment

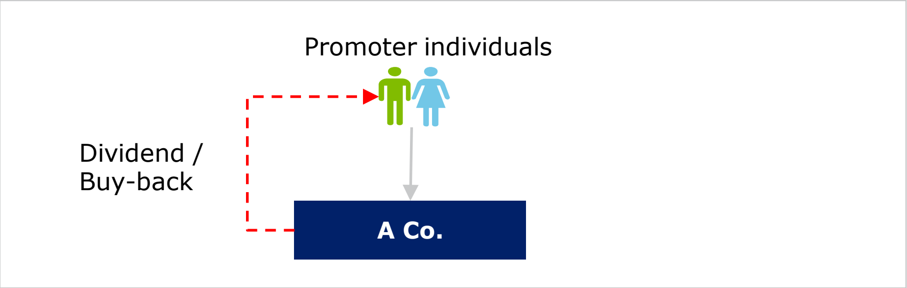
- Pursuant to amendment vide Budget 2020, domestic companies are no longer required to pay DDT and dividend income is instead taxable in the hands of shareholders at the applicable tax rates.

Buy back

- Maximum permissible buy back is 25% of paid up capital and free reserves
  - provided total shares to be bought back do not exceed 25% of paid up equity capital; and
  - debt equity ratio < 2:1 (on consolidated basis for listed companies)
- Buy back can be done out of free reserves, securities premium account, proceeds of issue of any shares or other specified securities

Dividend

- Dividends can be declared out of the profits of the company for that year, after providing for depreciation; or
- Out of the profits of the company for any previous financial year arrived at after providing for depreciation



	Buy Back Scenario	**Amount**
	Cash available for distribution (inclusive of tax)	100.0
Less:	Buy Back Tax @ 23.3%	(18.9)
A	**Cash received by shareholders#**	**81.1**
	Dividend Scenario	**Amount**
	Cash available for distribution	100.0
Less:	Tax in the hands of resident individual shareholders @ 35.88%*	(35.9)
B	**Net Cash in the hands of resident individual shareholder**	**64.1**
C	**Indicative tax Impact - Buy Back vs Dividend (A-B)**	**17.0**

 # The amount received on issue of shares has been considered as Nil in computing the buy-back tax

**For the purpose of dividend tax, we have assumed the highest tax slab and surcharge applicable to resident individual shareholder*

Indicative tax impact of ~ 17% on cash repatriation through buy back vis-à-vis dividend.

Industry perspective

Buy back of shares - Industry perspective (1/2)

In addition to the dividend options, Companies have been using buy back as a means to return cash to shareholders

Companies ordinarily aim to achieve certain objectives when it chooses to undertake buy back - it could be:

- Fairer valuation of the company's stock price;
- Improve key return ratios like return on net worth, return on assets etc., over a period of time;
- Improve market perception and provide cushion to weakening share prices
- Create long term value for shareholders;
- Enhancing the overall return to shareholders in the long run;
- Provide exit to investors in times of volatility

Other relevant considerations are:

- Cost involved for buy back such as SEBI Charges, exchange fees, advertisement etc.
- Intended debt equity ratio: It may not suit highly leveraged businesses since debt equity ratio has to be 2:1
- Future fund raising plans: Rights issue not allowed within six months

Buy back of shares - Industry perspective (2/2)

Procedurally dividend is most efficient. However, SEBI approval is required for buyback by a listed entity

Buy back can be done subject to the prescribed threshold limits- less flexibility in certain cases

Buy back of shares may be tax efficient compared to dividend distribution in case of certain class of shareholders

Buy back for listed companies may involve complex tax computation under the current rules

Institutional Investors may possibly prefer buy back as opposed to retail / small investors

Filing and other registration procedures with SEC if shareholding percentage of US Persons including FIIs/ FPIs exceeds 10%

Valuation aspects

Valuations for Buy back - Tax and Regulatory requirements

Listed company

- No methodology prescribed under SEBI Regulations for listed companies.
- However the board needs to determine a ***fixed price*** in a tender offer or ***a maximum price*** in case of open market operations.
- Typically a ***premium to the prevailing market prices*** at the time of the announcement.

Valuations for buy back - Tax and Regulatory requirements

Unlisted company

Tax

- No methodology prescribed
- Reference check to Rule 11 UA valuation / ***Fair Market Valuation principles*** to be kept in reckoning from a good governance perspective
- Transfer Pricing – Fair Value considerations to be borne in mind and taken into account

Company law

- No methodology prescribed
- Generally will be ***Fair Market value***
- A disclosure of the basis of arriving at the buy back price is required for which ordinarily a valuation report may be obtained

FEMA

- Pricing guidelines to be adhered to
- Listed company - the price worked out in accordance with the relevant Securities and Exchange Board of India guidelines – typically the Preferential Allotment guidelines
- Unlisted Company - the valuation of equity instruments done as per any ***internationally accepted pricing methodology for valuation on an arm's length basis*** duly certified by a Chartered Accountant or a Merchant Banker registered with the Securities and Exchange Board of India or a practicing Cost Accountant.

The buy back price may become a price point for tax purposes for future transactions – fresh issue or internal restructurings

Methods of valuations

Market approach

- **Market Prices method**: For listed company - The valuation derived from the quoted market prices of the shares of the company.
- **Comparable Companies Multiples Method (CCM)**: An approach that entails looking at market quoted prices of comparable companies and converting that into the relevant multiples. The relevant multiple after adjusting for factors like size, growth, profitability, etc. is applied to the relevant financial parameter of the Company.
- **Comparable Transactions Multiples Method (CTM)**: Valuation based on price paid in recent transactions which includes reviewing published data on actual transactions involving either minority or controlling interests in either publicly traded or closely held companies. Similar to comparable companies analysis, the transaction price is converted into a relevant multiple and applied to the relevant financial parameter of the Company.

Asset/Cost approach

- **Net Asset Value**: The asset based valuation approach is based on the underlying net assets and liabilities of the Company on a book / replacement / realisable value basis. It is also relevant for evaluating surplus / non-operational assets and contingent / off balance sheet liabilities.

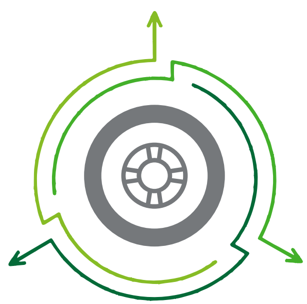
Income approach

- **Discounted Cash Flow Method (DCF)**: Discounts forecasted cash flows to the present using a relevant discount rate. The discount rate, WACC or Cost of Equity (depending on the cash flows being used), reflect the return expectations from the asset depending on the inherent risks in the cash flows.

Key valuation considerations

Comparable Companies Multiple (CCM)

- **Identification of the comparable companies**
  - Public domain
  - Adjustments / selection based on current and past trends
    - Financial parameters (Revenue, EBITDA, EBIT, PAT, etc.)
    - Geographical reach
  - **Premium / Discount**
- **Valuation Multiples to be applied**
  - Commonly used multiple: **Enterprise Value to Revenue / EBITDA or Price to Earnings**
  - Period of earnings to which to be applied



Discounted Cash Flow Method (DCF):

- Assumptions
- Financial model
- Sensitivity analysis

Comparable Transactions Multiple (CTM):

- Identification of comparable transactions
- Past transactions in the company / businesses being valued

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