Business Standard

# PSUs offer safety at cost of returns

**As the surplus cash is deployed in low-yielding deposits, it tends to suppress overall return ratios and, consequently, stock valuations**

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The popular market adage is the larger goal of every company is to maximise shareholder value. However, some of India's listed public sector units (PSUs) seem to be lagging on this front or, at the least, aren't generating value proportional to their potential. A key reason is many of these have ended up accumulating cash, which is deposited in banks and yield 8-10 per cent, compared to the high return on equity (upwards of 25 per cent) in their core businesses. And, this is hurting shareholder valuations.

Many of these companies are potentially running their business without any investment, considering the cash and bank balances are higher than their net worth. For instance, Coal India's FY13 net worth was Rs 48,472 crore, while its cash and bank balance stood at Rs 62,236 crore. The case is similar for construction company NBCC, which undertakes projects on behalf of the government.

Typically, this situation arises when through the long run, the business generates high cash flows even after meeting future capex needs to sustain growth. The flipside of this, however, is the lower return on equity (RoE). As many of these companies aren't returning the surplus money to shareholders and aren't able to redeploy it in business, it is also impacting shareholder value. For instance, Bharat Electronics reported an overall RoE of 14.5 per cent. But if the ideal cash is adjusted from the equity invested in the business and the respective other income from profits, the RoE will rise to 32.6 per cent. So, despite the fact that core businesses record good RoE, this is suppressed due to the impact of cash in the books.

"Keeping money in the bank is the dumbest thing to do. But PSUs are not alone; there are many private sector companies that are hoarding cash. I think many of these PSUs have a huge opportunity and can deploy this money in businesses that inherently have high RoEs, as and when the environment improves," said U R Bhat, managing director, Dalton Capital Advisors.

Many experts agree. "The underlying objective of a company is to create shareholder wealth. You do not do this by locking (money) for years in investments that yield 8-10 per cent. That is not what a company is founded for. Firms can invest in core business that yield high returns or diversify. If not, they should give to shareholders higher payouts and let shareholders take the risk," says Gaurav Parikh, managing director, Jeena Scriptech Alpha Advisors.

## HURTING VALUATIONS

| | Current mkt price (₹) | M-cap (₹ cr) | Reported RoE (%) | Non-cash adj. RoE (%) | Cash as % m-cap |
|---|---|---|---|---|---|
| MOIL | 321 | 5,398 | 16.6 | 56.1 | 42.2 |
| NBCC | 315 | 3,785 | 23.8 | NWLC* | 40.6 |
| Oil India | 573 | 34,466 | 19.4 | 35.7 | 35.2 |
| Bharat Electronics | 2,044 | 16,349 | 14.5 | 32.7 | 32.6 |
| NMDC | 179 | 70,889 | 24.4 | 74.7 | 29.7 |
| NHPC | 26 | 28,507 | 9.2 | 7.8 | 28.0 |
| Balmer Lawrie | 528 | 1,504 | 20.6 | 28.3 | 27.4 |
| Coal India | 382 | 241,380 | 39.0 | NWLC* | 25.8 |

Note: To calculate the non-cash adjusted RoE, cash is deducted from the net worth and other income with the impact of respective tax is deducted from the net profits; *Networth less than cash, Financial data for the year ended March 2013

Many fast-moving consumer goods (FMCG) giants such as Nestle, Colgate and HUL generate RoEs of 80-100 per cent year after year. This is possible because the excess money generated by the business every year is returned to shareholders and, therefore, the RoE isn't distorted. High RoEs and growth in business means these FMCG stocks attract valuations of 20-30 times their earnings and five-six times their book value. This is true for companies across industries in the private sector. Page Industries is an example. If a business makes good returns, it tends to attract higher valuations because of investors' perception about the quality of earnings and its cascading impact on the share price through the long term.

"PSUs aren't worried about valuations. They are not run for valuations, compared to private players who might try to milk their valuations through distribution of cash (dividends) or buybacks. This, to an extent, shows why despite good fundamentals, some PSUs continue to trade at low valuations compared to their private peers," said Abhishek Asthana, executive director of deANALYST, a financial research company.

Apart from paying dividend, PSUs can create value through buyback of shares, but only if the situation is attractive. "Buyback only makes sense when you are running out of any idea to deploy funds, which can create shareholder value by way of generating higher returns," said U R Bhat.

In the recent past, NHPC, despite the nature of its business, which requires huge equity and debt (to set up hydro power projects), announced plans to use surplus cash to buy back shares. At the time of the announcement, its shares were being traded at just 0.6 time its book value and seven times (PE) its earnings, based on FY15 estimates. Theoretically, seven times PE means an earnings yield of 14 per cent, 400 basis points higher than the rate on bank fixed deposits. Experts say this route is good for firms unable to deploy surplus cash in high-RoE businesses.

"I think for companies in the PSU space that do not have reinvestment opportunities, the next best thing is to buy back shares, particularly at the time when stocks trade significantly below their intrinsic value. This is true in many cases such as NMDC, Coal India, Bharat Electronics and NBCC, where a buyback could have been actually considered. However, at times, it is difficult for PSUs to take a call on the markets and prices and the safest thing is to sit on the cash," said Vikas Gupta, fund manager at Arthveda Fund Management.

One obstacle in the buyback route could be the high promoter stake in these companies, the reason why the government is considering divesting shares to meet Securities and Exchange Board of India's mandate of at least 25 per cent public holding.

In the recent past, hopes of better management under Prime Minister Modi and of an economic recovery have seen PSU stocks outperform markets. If these are unable to live up to expectations and start generating higher returns, the markets are likely to be disappointed.