Shareholder Reward and its Impact on Capital Structure and Dividend Policy: Financial Innovation by Hindustan Lever Limited

Yatin Bhagwat*
Associate Professor of Finance
Seidman School of Business
Grand Valley State University
Grand Rapids, MI 49504
E-mail: Bhagwaty@gvsu.edu
Fax: (616) 336-7445
Phone: (616) 336-7431

Vijay Gondhalekar
Assistant Professor of Finance
University of Michigan - Flint
E-mail: Vijayg@umich.flint.edu
Phone: (810) 762-3268
Fax: (810) 762-3282

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* Contact Author

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Case Description

This case is a classic example to demonstrate the innovation that is taking place in contemporary corporate finance. It deals with dual subject categories of capital structure and dividend policy. The case may also be used in International Finance classes as the corporate culture encompasses the emerging markets. The class room discussion may extend well over two hours. Students are expected to take about four hours to answer all questions in a pertinent manner.

Case Abstract

The objective of this case is to make students realize the implications of various methods of shareholder rewarding available to a corporation. The corporation has to weigh the consequences of each alternative in the context of expected sustainability of future earnings and their growth. The case discussion may center on corporate finance issues, agency issues, and ownership issues. EVA analysis adds rigor to the student understanding of income and cost of capital estimation.

Hindustan Lever Limited (HLL), a 51% owned subsidiary of Unilever (U.K.) is listed on the Bombay (Mumbai) Stock Exchange. It recently announced a bonus debenture issue in the ratio of one debenture per one share held. The debentures will be redeemed in three years and bear interest of 9% per annum. The issue has wide implications on capital structure, dividend policy and managerial incentives.

I. Background

Hindustan Lever Limited (HLL) is India's largest Packaged Mass Consumption Goods (PMCG) Company. Unilever PLC (U.K.) holds 51.6% of HLL. With an excellent marketing strategy and cutting-edge distribution network, HLL has made enviable penetration in the widely scattered rural markets of India. It is a leader in Home and Personal Care Products, and Foods and Beverages. *Forbes Global*, has rated HLL as the best consumer household products company worldwide.

The company was exploring ways of providing 'extra' dividend to the shareholders. Instead of distributing a 'special' cash dividend or distributing 'bonus' shares to the existing shareholders (which is common in India), the company made an innovative choice. It announced on October 10, 2001 that shareholders will be eligible for one bonus debenture (secured against the assets) with a face value of six Indian rupees and a coupon of nine percent a year for every share they hold. The proposed debentures will be redeemed in two equal installments on the second and third anniversary of the issue. This innovative technique has important implications for the capital structure of the company, the dividend policy and the agency relationship between managers and shareholders.

Section II provides an historical account of the company performance. In Section III, the cash distribution alternatives available to HLL to reward its shareholders are presented including the proposed debenture issue.

II. Business and Performance

About thirty years ago, HLL offered stock to Indian investors to meet the statutory requirements for operating in India. The prospectus to the issue then described the company as - " A company known better by its brands than its name." In 2001, the company markets about 110 brands in 950 packs, most of which have become household names in the country. HLL's most valuable assets are its brand name products. The company is presently engaged in aligning its resources behind some of its strongest brands, about 30 in number, to lead its growth in the future. The company strives to maintain its lead in the distribution of soaps and detergents, health and hygiene, beauty care, wholesome nutrition, tasty and exhilarating food segment.

The diverse product range is manufactured in about 100 factories located across the country, 28 are located in areas classified as 'industrially backward' by the government. This allows the company to take advantage of fiscal incentives provided for creating employment in the industrially backward areas. The company has also been engaged in successfully converting sick enterprises into viable economic operations in response to requests from government authorities to save precious jobs and continue development of local economies. Also, since the liberalization of Indian markets, starting in 1991, the restrictions on internal growth and acquisitions were lifted. HLL immediately seized the opportunity to achieve horizontal and vertical integration via external acquisitions.

The operations of this company involve 2,000 suppliers and associates and its products are distributed through a network of about 7,500 redistribution stockists. HLL's distribution network directly covers the entire urban population, and also reaches as far as villages with over 2,000 people. An online communication system, high-speed telecom and internet-based links, the first such network in the PMCG industry support the nationwide supply chain management.

Relevant innovation to meet changing consumer needs and aspirations is not possible without technological advancement. The company has set up two research centers employing over 100 highly qualified scientists and technologists to develop new products and processes, improve benefits and quality of existing products, and optimize the use of material and energy resources.

A summary of the financial performance including the Profit and Loss Account and the Balance Sheet for the past ten years is provided in Exhibit I. Exhibits II and III provide the Profit and Loss Statement and the Balance Sheet for the fiscal year ended December 31. The earnings per share have jumped from 2.1US cents in 1991 to 12.6 US cents in 2000. The earnings measured in US dollars reflect the depreciating value of the Indian Rupee. The Economic Value Added by the company in 1991 was US$ 9.62 million compared to US$ 182.55 million in 2000. The EVA computation for the period 1991-2000 is included in Exhibit IV.

III Alternative Means of Distributing 'Extra' dividends

HLL has been steadily increasing the cash dividends per share over the years and was exploring a possible way of distributing something extra to the shareholders. In the

U. S., one way of distributing retained earnings is to declare a ‘special’ or ‘one-time’ dividend. Such a dividend can theoretically be declared up to the level of retained earnings (anything in excess of retained earnings comes out of paid-in surplus and is considered as a liquidating dividend). However, under The Indian Companies Act (1956), a company in India can pay dividend out of retained earnings within specified limits only when it has incurred a loss or there is inadequacy of profit.

In the past the firm has rewarded shareholders by issuing bonus shares (akin to a stock split). A new bonus issue increases the shares outstanding and if a company maintains the level of dividends per share then such a bonus issue results in a permanent increase in the level of dividends. This can come back to haunt a company if revenues and earnings start to level off.

Share buy-back was another option available to the company. The board of directors opined that a buyback is not equitable to every shareholder, because not all shareholders would have diluted their holdings. Also, in the Indian capital markets, share buyback schemes have received only lukewarm response. Besides a buyback would need to be staggered over a period of at least three years and would have accounted for only under three percent of HLL’s equity.

The company therefore came up with an innovative way of distributing profits to the shareholders without permanently increasing the level of dividends. It declared an issue of one debenture (secured against the assets of the company) per share. This debenture has a face value (par value) of six Indian rupees and a coupon of nine percent a year. The proposed debentures are to be redeemed in two equal installments on the second and third anniversary of the issue. The markets reacted positively to this news. The debentures will entail an outflow of Rs.13,200 million (US$ 280.85 million) on full redemption. Though the coupon on the debentures is 9% per annum, interest burden would dilute the earnings per share by only Re.0.40 per share as the interest is fully tax deductible. The company declared those original allottee small debenture holders with less than 1,000 debentures would be eligible to tender their debentures to the company at any time on a first-come first served basis for repurchase at par. This facility would be available to a maximum extent of Rs. 1000 million (US$ 21.28 million) per year. Financial analysts commented that HLL’s objectives go beyond finding a means to reward shareholders.

The issue of bonus debentures is a leverage-increasing transaction. By opting for leveraged re-capitalization of its sources of capital, HLL has signalled its intent and capability to produce steady cash flows. The leveraged re-capitalization will have a favorable impact on the net income, profit margin, return on equity and return on capital employed. The bonus debentures would reduce the slack available to HLL’s managers for experimenting with projects with marginally positive NPV projects. It would compel managers to invest in cash enhancing projects by improving effectiveness and efficiency of capital allocation process. HLL will have to generate sufficient amounts of cash to pay the higher interest burden and redemption of capital within a short period of three years. HLL has set itself a range of managerial objectives through magnificent financial engineering. HLL has devised a scheme whereby inside debt may prove to be a superior alternative to outside debt. The Chairman of the Board outlined two principal areas of thrust. First, HLL has decided to concentrate its resources behind 30 powerful brands, down from 110 brands today. Second, HLL has decided to build a pro-active, flexible, and fast moving organization culture. Both areas of thrust are better served if the pressure of debt is directed at HLL's managers.

TEACHING NOTES

The Questions are split into two levels. Level A questions may be used for upper level undergraduate finance majors. Level B questions are recommended for graduate level courses along with level A questions.

(LEVEL A).

1. What has been the compounded annual growth rate in earnings and dividends for the data provided?
2. Compute the dividend pay-out ratio for the period 1991 to 2000.
3. The EVA computation is demonstrated in Exhibit IV. Compute EVA for year 1999. Also compute the growth rate in EVA from 1991 to 2000. What assumption has been made by HLL in computing EVA? (Hint: Examine the cost of equity.) Is this a valid assumption? Why or why not?
4. Describe the proposed bonus debenture issue. How many bonus debentures will be issued to HLL shareholders?
5. Show the two instantaneous changes that will occur in the balance sheet due to the bonus debenture issue.
6. Based on year 2000 income, how would the issue of debentures affect EPS?
7. The debentures with a face value of Rs.6/ bear a coupon of 9%. The after tax cost of the interest on each debenture is expected to be Re. 0.40/. Why? Can you estimate the marginal tax rate of HLL?
8. Why did the market treat the announcement of the debenture issue positively?
9. How will the cash flow of the company be affected in each of the next three years, assuming that debentures to the tune of Rs.1,000 million are redeemed in the first and second year? (Hint: Include the tax savings due to additional interest burden. Redemption of debentures is return of capital.)
10. What will be the impact of the debenture issue on the ROE and ROI in year 2001? (Hint: Prepare a pro-forma income statement based upon past growth performance and the fact that future growth is not expected to be scintillating.)

(Level B)

1. How would the creation of internal debt affect managerial behavior and incentives?
2. What are the pros and cons of a deemed dividend to shareholders of HLL in the form of debenture coupon and principal? (Hint: Students should consider the uncertainty associated with dividends, agency implications, and dilution of earnings.)
3. What are the implications on the leverage ratio under the different alternatives that are available to the management of HLL in rewarding its shareholders with cash distribution?
4. What are the signalling effects of a bonus debenture issue? Could the markets have treated this signal negatively?

REFERENCES

1. Hindustan Lever Limited Annual Report for Year 2000.
2. "HLL surges on bonus debenture proposal" - Reuters, October 10, 2001.

Financial Innovation and Capital Structure
-Hindustan Lever Limited

Yatin Bhagwat*
Associate Professor of Finance
Seidman School of Business
440-C Devos Hall
Grand Valley State University
Grand Rapids, MI 49504
Email - Bhagwaty@gvsu.edu
Fax- (616) 336-7445
Phone- (616) 336-7431

Vijay Gondhalekar
Assistant Professor of Finance
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Phone - (810) 762-3268

*** Corresponding Author. Please do not quote without authors' permission.**