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# BRITANNIA INDUSTRIES LTD – A CASE STUDY IN FINANCIAL INNOVATION, DISTRIBUTION OF PROFITS AND ISSUANCE OF BONUS DEBENTURES

**BHAGWAT, YATIN, MARINUS DEBRUINE & WILLEY, THOMAS**

**Abstract**

*Dividends and share repurchases have been two primary ways for firms to transfer cash to shareholders. The case discusses the motives of this method of profit distribution, its impact on capital structure and the signaling aspect of such a declaration.The primary use of the case would mostly likely be a corporate finance class. However, other potential uses could be in international finance, due to a focus on emerging markets.*

***Keywords:*** *Shareholder distributions, bonus debentures, financial innovation*

## 1. INTRODUCTION

Dividends and share repurchases have been two main ways for firms to transfer cash to shareholders. Recently, Britannia Industries, a familyowned business listed on the Mumbai Stock exchange and managed by the Wadia family issued bonus debentures to its shareholders. The Wadia family holds more than 50% of the shares in the company through various holding companies and individuals in the family. The case discusses the motives of this method of profit distribution, its impact on capital structure and the signaling aspect of such a declaration. Stickiness of dividends, sustainability of earnings growth, and future investment plans of the company play a role in this decision. The case also provides an opportunity in the foray of alignment of minority shareholders' interests with those of the majority interests.

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 could be used in International Finance classes, as the corporate culture encompasses the emerging markets. The classroom discussion may extend well over two hours. Students are expected to take about four hours to answer all questions in a pertinent manner. The objective of this case is to make students realize the implications of various methods of

* Grand Valley State University, *E-mail: willeyt@gvsu.edu*

shareholder rewards 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.

## 2. COMPANY HISTORY

The company web site provides a glimpse into the path of the company from its humble beginnings. In 1892, a biscuit company was started in a Calcutta (now Kolkata) with an initial investment of Rs. 295. (US$60). The data provided in the case is obtained from the annual reports of the company. All information provided is from public documents.By 1910, with the advent of electricity, Britannia mechanized its operations, and in 1921, it became the first company east of the Suez Canal to use imported gas ovens. Britannia's business was flourishing. However, more importantly, Britannia was acquiring a reputation for quality and value. As a result, during World War II, the Government reposed its trust in Britannia by contracting it to supply large quantities of "service biscuits" to the armed forces. As time moved on, the biscuit market continued to grow… and Britannia grew along with it. In 1975, the Britannia Biscuit Company took over the distribution of biscuits from Parry's, who untilthen distributed Britannia biscuits in India. In the subsequent public issue of 1978, Indian shareholding crossed 60%, firmly establishing the home country's acceptance of the firm. The following year, Britannia Biscuit Company was re-christened Britannia Industries Limited (BIL). Four years later in 1983, it crossed the Rs. 100 crores revenue mark. On the operations front, the company was making equally dynamic strides. In 1992, it celebrated its Platinum Jubilee. In 1997, the company unveiled its new corporate identity - "Eat Healthy, Think Better" - and made its first foray into the dairy products market. In 1999, the "Britannia Khao, World Cup Jao" (Eat Britannia Biscuits and attend World Cup) promotion further fortified the affinity consumers had with 'Brand Britannia'.

Britannia strode into the 21st Century as one of India's biggest brands and the pre-eminent food brand of the country. It was equally recognized for its innovative approach to products and marketing: the Lagaan Match was voted India's most successful promotional activity of the year 2001, while the delicious Britannia 50-50 Maska-Chaska became India's most successful product launch. In 2002, Britannia's New Business Division formed a joint venture with Fonterra, the world's second largest Dairy Company, and Britannia New Zealand Foods Pvt. Ltd. was born. In recognition of its vision and accelerating graph, Forbes Global rated Britannia 'One amongst the Top 200 Small Companies of the World', and The Economic Times pegged Britannia India's 2nd Most Trusted Brand.

Today, more than a century after those tentative first steps, Britannia's fairy tale is not only going strong but blazing new standards, and that miniscule initial investment has grown by leaps and bounds to millions of rupees in wealth for Britannia's shareholders. The company's offerings are spread across the spectrum

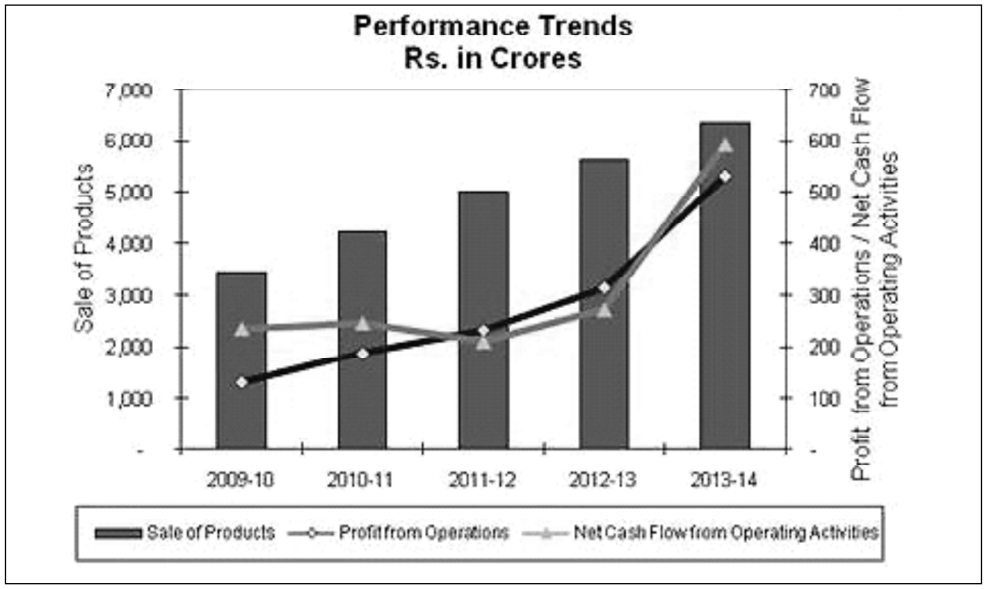
with products ranging from the healthy and economical Tiger biscuits to the more lifestyle-oriented Milkman Cheese. Having succeeded in garnering the trust of almost one-third of India's one billion population and a strong management at the helm means Britannia will continue to dream big on its path of innovation and quality. Moreover,millions of consumers will savor the results.

## 3. 2013-2014 PERFORMANCE

The company ended the period with exceptional performance in profitability, based on profit from operations, of Rs. 533.24 crones versus Rs. 314.45, a change of 69.58 percent. In terms of cash flow from operating activities, an increase of 125.91 percent (Rs. 272.01 to Rs. 614.51) was achieved, based on period over period results. In addition, Earnings per share (EPS) grew from Rs. 19.57 to Rs. 30.87, a change of 57.74 per cent over the same period. The firm attributes these excellent results to a revenue growth rate of twelve percent and a focus on profitability, capital productivity and working capital management. Figure 1 shows trends in performance across key parameters.

In the fiscal year ended 31 March 2014, the company's return on equity was 43.3 percent versus 36.7 percent from the previous year. Year over year, the profit margin increased to 8.9 percent from 5.9 percent, the total asset turnover improved to 4.86 times from 4.65 times and, the most dramatic change, was in the degree of financial leverage which decreased by 25.3 percent (from 1.3386 times to 1.0001 times).The excellent performance led to an increase in the book value per share of 33.83 percent (from Rs. 53.2 to Rs. of 71.2). Tables 1, 2 and 3 contain significant financial ratios and the ten-year results for the company.

**Figure 1: Performance Trends during 2009-2014**



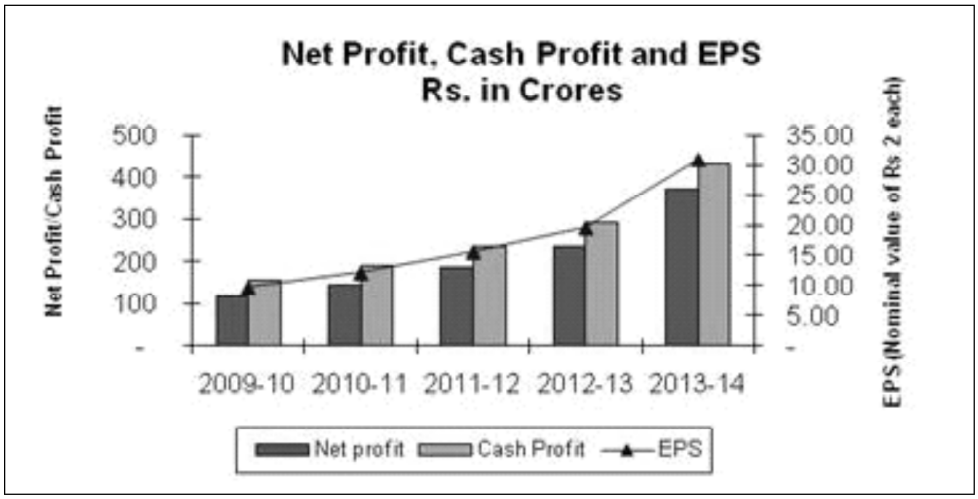



**Table 1**
**Significant Ratios**

| | | *2013-14* | *2012-13* |
|---|---|---|---|
| | *Measures of Investment* | | |
| Return on equity | $\frac{Profits\ after\ tax}{Shareholders'\ funds}$ | 43.3% | 36.7% |
| Book value per share (Rs.) | $\frac{Shareholders'\ funds}{Number\ of\ equity\ shares}$ | 71.2 | 53.2 |
| Dividend cover | $\frac{Earnings\ per\ share}{Dividend\ (+tax)\ per\ share}$ | 2.2x | 2.0x |
| | Measures of Performance | | |
| Profit margin | $\frac{Profit\ before\ tax\ and\ exceptional\ items}{Net\ sales + other\ income}$ | 8.9% | 5.9% |
| Debtors turnover | $\frac{Gross\ sales}{Debtors + bills\ receivable}$ | 118.2x | 73.3x |
| Stock turnover | $\frac{Gross\ sales}{Stock}$ | 41.8x | 40.7x |
| | Measures of Financial Status | | |
| Debt equity ratio | $\frac{Borrowed\ capital}{Shareholders'\ funds}$ | 0.1% | 33.9% |
| Current ratio | $\frac{Current\ assets}{Current\ liabilities}$ | 0.9x | 0.7x |
| Tax ratio | $\frac{Tax\ provision}{Profit\ before\ tax}$ | 31.8% | 29.6% |

**Table 2**
**Ten Year Financial Statistics over 2005-2014 (in Crores)**

| *As/at Year ended 31st March* | *2005* | *2006* | *2007* | *2008* | *2009* | *2010* | *2011* | *2012* | *2013* | *2014* |
|---|---|---|---|---|---|---|---|---|---|---|
| Assets employed | | | | | | | | | | |
| Fixed assets less depr. & amort. | 134 | 152 | 214 | 251 | 284 | 292 | 315 | 459 | 580 | 643 |
| Investments | 330 | 360 | 320 | 381 | 423 | 491 | 545 | 429 | 280 | 373 |
| Other assets, net | (49) | 31 | 60 | 207 | 116 | 44 | 22 | 67 | (8) | (162) |
| Miscellaneous expenditure | 46 | 34 | 16 | 26 | 23 | 27 | 0 | 0 | 0 | 0 |
| Totals | 450 | 558 | 620 | 862 | 850 | 826 | 883 | 955 | 852 | 854 |
| Financed by | | | | | | | | | | |
| Equity shares | 24 | 24 | 24 | 24 | 24 | 24 | 24 | 24 | 24 | 24 |
| Reserves & surplus | 420 | 525 | 591 | 732 | 801 | 372 | 427 | 496 | 613 | 830 |
| Loan funds | 6 | 9 | 5 | 106 | 25 | 430 | 431 | 435 | 216 | 1 |
| Totals | 450 | 558 | 620 | 862 | 850 | 826 | 883 | 955 | 852 | 854 |

**Table 3**
**Ten Year Profits and Appropriation over 2005-2014 (in Crores)**

| *As/at Year ended 31st March* | *2005* | *2006* | *2007* | *2008* | *2009* | *2010* | *2011* | *2012* | *2013* | *2014* |
|---|---|---|---|---|---|---|---|---|---|---|
| Sales | 1,615 | 1,818 | 2,317 | 2,617 | 3,143 | 3,427 | 4,231 | 5,006 | 5,650 | 6,348 |
| Profit before depr., amort. & tax | 261 | 218 | 151 | 254 | 287 | 205 | 243 | 300 | 389 | 626 |
| Depr. & amort. | 19 | 22 | 25 | 29 | 33 | 38 | 45 | 47 | 57 | 63 |
| Profit before tax and exceptional items | 242 | 196 | 126 | 224 | 253 | 167 | 198 | 252 | 332 | 563 |
| Exceptional items | (22) | 5 | (8) | 8 | (21) | (47) | 0 | 0 | 0 | (20) |
| Profit before tax | 220 | 201 | 118 | 232 | 233 | 121 | 198 | 252 | 332 | 543 |
| Tax | 71 | 54 | 11 | 41 | 52 | 4 | 53 | 66 | 98 | 173 |
| Net profit | 149 | 146 | 108 | 191 | 180 | 117 | 145 | 187 | 234 | 370 |
| Dividend | 33 | 36 | 36 | 43 | 96 | 60 | 78 | 102 | 102 | 144* |
| Tax on dividend | 5 | 5 | 6 | 7 | 16 | 10 | 13 | 16 | 17 | 24# |
| Profit for the year after dividend and tax | 111 | 106 | 66 | 141 | 69 | 47 | 55 | 69 | 115 | 201 |

* Proposed dividend. # Tax on proposed dividend.

## 4. BONUS DEBENTURES

Britannia Industries Ltd fixed March 09, 2010, as the 'Record Date' for determining the Members of the Company who will be entitled to receive one fully paid bonus debenture of Rs. 170/- each for every one existing fully paid equity share of Rs. 10/

- each of the Company ('Bonus Debentures'), pursuant to a Scheme of Arrangement sanctioned by the Calcutta High Court. The aggregate amount of bonus debentures issued is to the tune of Rs. 4060 million. On May 26, 2009, Britannia Industries Ltd announced the approval by the board of directors the issue of bonus debentures by transferring the funds from the general reserves and surplus of the company. The proposed issue will be in the ratio of one fully paid debenture of 170 rupees for every 10-rupee equity share held to be redeemed in three years from the date of issue. Britannia said it expects to apply for the listing of the debentures on the Bombay Stock Exchange and the National Stock Exchange. The said debentures will carry an interest rate of up to 8.5 per cent per annum**.** For the company, the transfer improves its Return on Net Worth as retained earnings decline. In addition, there is no immediate cash outflow.

The company has been steadily increasing its cash dividends (please refer to Table 4) over the years and was exploring a possible way of "extra' distribution to its shareholders. Such a dividend can theoretically be declared to a level of accumulated earnings only when a company incurs a loss under the provisions of the Indian Companies Act (1956). In the past, the firm has rewarded shareholders by issuing bonus shares (akin to a stock split). A bonus issue increases the number of shares outstanding and if the dividends are not increased on an adjusted basis, the markets do treat the firm stock favorably.

**Table 4**
**Distribution of Dividends**

| *Year* | *Dividend Percentage of face value of Rs.10/ per share* |
|---|---|
| 1998 | 50 |
| 1999 | 55 |
| 2000 | 45 |
| 2001 | 55 |
| 2002 | 75 |
| 2003 | 100 |
| 2004 | 110 |
| 2005 | 140 |
| 2006 | 150 |
| 2007 | 150 |
| 2008 | 180 |
| 2009 | 400 |
| 2010 | 250 |
| 2011 | 325 |
| 2012 | 425 |
| 2013 | 425 |
| 2014 | 600 |

*Note:* The company has an uninterrupted record of distributing dividends for several decades.

Table 5 shows the allotment of bonus shares to equity stockholders. Share buyback was another option. However, due to the tenuous majority holding in the company by the Wadia family this was a risky path if the minority shareholders decided against tendering their shares.The issue of bonus debentures is a leverage increasing transaction. By opting for leveraged re-capitalization of its sources of capital the firm signaled its intent and capability to produce steady cash flows. The bonus debentures will also reduce the slack available to managers for experimenting with marginally profitable projects. On the other side, the creation of homemade debt will force the management to improve future cash flows to pay the interest on debentures and redemption of debt.

**Table 5**
**Allotment of Bonus Shares to Equity Stockholders**

| Year | Bonus Particulars |
|---|---|
| 1961 | One equity share for every two shares held |
| 1966 | Four equity shares for every ten shares held |
| 1968 | Two equity shares for every three shares held |
| 1971 | Two equity shares for every three shares held |
| 1976 | Seven equity shares for every ten shares held |
| 1984 | Two equity shares for every five shares held |
| 1987 | Two equity shares for every five shares held |
| 1990 | One equity share for every two shares held |
| 2000 | One equity share for every two shares held |

## 5. QUESTIONS

1. How would you rate the performance of Britannia Industries in the past several years? Use various parameters to support your findings?
2. Has the firm added value to itself after compensating its capital contributors? How is this measured? Estimate the cost of equity at which the Economic Value Added (EVA) is zero for each year? Critically evaluate your finding.
3. Discuss the changes in the Balance Sheet if the debentures are allotted instantaneously. Will the debentures have an adverse impact on the bond ratings of the company?
4. Measure the ROA, ROE, and EPS prior to the allotment of bonus debentures. What will be the impact of immediate issuance of bonus debentures on the three measures of performance?
5. Estimate the following:
   i. After tax cost of debt to the firm
   ii. Increase in interest payments for each year on allotment of bonus debentures
   iii. Changes in cash flow due to the interest payments for Years 1 and 2 of allotment of bonus debentures

iv. Changes in cash flow in the year of redemption of the debentures

6. Will the company be able to raise dividends in the future in spite of the debenture issue?
7. Why did the company adopt a bonus debenture allotment? In what other ways could the management have allotted shares?
8. Why did the firm not buyback the shares in the open market? Why did the firm not make a tender offer to its shareholders to distribute past profits? Why did the firm not raise its dividends?
9. The bonus debentures bear an interest rate of 8.5%. The consumer price index rose at an annualized rate of 10.85% in the past year and inflation is unlikely to abate? What is the real rate of return on the bonds? Why would an investor continue to hold the debentures, even if the bonds are likely to have negative real returns?
10. Do the promoters' and public's divergent interests force the management to issue bonus debentures instead of bonus shares? If yes, what is the source of misaligned interests?

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*Notes* : Methods of Cash distribution to shareholders

This is an innovative way of increasing homemade leverage without gaining additional cash *via* a book transfer of equity into debt. We provide a brief overview of the extant literature devoted to capital structure, dividend policy, signaling theory, agency theory of free cash flow, and theory of multinational corporation. The discussion in the ensuing paragraphs draws heavily from Stern Stewart Roundtable on Capital Structure and Stock Repurchase[1] and several other papers published in *Journal of Applied Corporate Finance and Journal of Financial Economics.*

Maximizing shareholder wealth by boosting earnings per share (EPS) is one of the important objectives of managers. Clifford Smith (2001) observes that in real world situations, corporate leverage is neither zero, nor at 99%. The tax savings of corporate debt financing are exaggerated by the failure to account for taxes paid by holders of corporate debt. However, John Graham shows that for a U.S. company with an average 25% debt to capital, the tax benefits of debt amount to about 7-10% of total firm value. The indirect costs of financial distress that may take the form of value-reducing managerial behavior when operating under abnormal levels of debt were examined. Stewart Myers (1977) deciphered the firm value into two pieces: (1) "assets in place", those more or less tangible assets that are generating the firm's current cash flows; and (2) intangible "growth options," or opportunities to earn future cash flows. The firms with high value concentration in the tangible assets use more leverage than the firms with high value comprised of growth options.

Debt financed companies are more likely than firms financed with equity to pass up valuable investment opportunities when faced with a downturn in operating cash flows. Debt laden companies face the "under-investment" problem that is exacerbated in the firms with significant value embedded in the intangible form of growth options. Thus, in the 70s and early 80s, capital structure aimed at achieving the balance between real tax benefits from debt and the perceived indirect costs of debt.

Jensen (1986) argued that unless free cash flow[2] is paid out to investors, managers have a tendency to destroy value through inappropriate decisions. Firms with significant value in "assets in place" that generate substantial cash flow but have few positive NPV projects in hand have a tendency to develop the free cash flow problem. High leverage in such firms is likely to add value, according to Clifford Smith (participant in the Stern Stewart Roundtable in footnote 1.) because it *commits* the managers to pay out free cash flow to investors. Clifford Smith combines Myers and Jensen scenarios to generalize as follows: "For companies with lots of free cash flow and limited growth opportunities, it makes sense to weigh the capital structure toward debt, both to shield income from taxes and to reduce managerial incentives to waste free cash flow. At the other end of the spectrum, companies whose current value consists mainly of future growth opportunities will find that it generally makes sense to avoid debt financing."

Tim Opler, earlier an academic theorist and then a practitioner of corporate finance, found results in his study to be consistent with Clifford Smith's views. Tim suggests that corporate decision to hold or not to hold cash turns out to be closely related to the decision to issue debt. He found that small companies tend to hold significantly larger cash balances as a percentage of total assets than larger companies, *ceteris paribus*. Smaller firms tend to have lower leverage ratios. He also found that firms with high market-book value ratios as well as large R&D budgets as a percent of sales tend to hold more cash as a percentage of total assets. Thus, firms with high growth options tend to hold low levels of leverage. Firms that generate a lot of cash flow also make large distributions to stockholders in the form of dividends and stock purchases. Firms may resort to this to mitigate the agency problems of free cash flow. Companies attempt to balance potential agency costs associated with having too much cash against a variety of financial distress costs with having too little.

David Ikenberry has provided several reasons that motivate managers to repurchase their corporations' stock. He finds that stock repurchases are means of adjusting capital structure. A stock repurchase restores debt-equity ratio for firms with excess equity and deficiency in debt. Stock repurchase is also market mechanism to get rid of a company's free cash flow. Use of excess cash flow for repurchases is an act of managerial humility opposed to indiscrete use of excess cash flow reflecting managerial hubris. Repurchases provide a more flexible and tax-advantaged substitute for dividend payments – which are the more conventional way of returning excess capital to shareholders. Repurchases also have a signaling content – a signal that the firm wants to profit from the perceived under valuation or "market mispricing" as denoted by Ikenberry.

Stock repurchases are signal to the market that the firm has confidence in its prospects and is mispriced based upon the private information in possession of the managers.

We now provide a discussion on dividends and recent findings by Fama and French (2001) on the changing patterns in dividend payments from 1973 until the present. According to their study 52.8% of publicly traded firms (excluding utilities and financials) trading on the *NYSE, AMEX, and NASDAQ* markets paid dividends in 1973. This proportion rises to 66.5% in 1978 and then falls to reach 20.8% in 1999. The three characteristics that tend to affect the likelihood that a firm pays dividend is profitability, growth rate and size. Dividend payers typically have higher measures of profitability than non-payers. Firms that have never paid dividends have the strongest growth. The average market-book value ratio is higher for firms that have never paid dividends. Higher R&D expenditures are also associated with the firms that have never paid dividends. Firms that have never paid dividends are less profitable than payers. Yet the same firms have more growth opportunities. However, firms that are former payers are victims of a double whammy – low profitability and low growth. Dividend paying firms tend to be much larger than non-payers. There is inertia associated with dividend decisions. Hence, the likelihood that a dividend payer will continue to pay is higher than the likelihood that a non-payer with the same characteristics will initiate dividends. The secular decline after 1978 in the proportion of firms issuing dividends is due in part to the surge in the number of newly listed firms with the time worn characteristics – small size, low earnings, and strong growth opportunities – of firms that have typically never paid dividends. Fama and French find firms in general have become less prone to declare dividends.

In 1978, 72.4% of firms with positive common stock earnings pay dividends. In 1998, 30.0% of profitable firms pay dividends. The proportion of dividend payers among firms with earnings that exceed investment outlays falls from 68.4% in 1978 to 32.4% in 1998. These results suggest that dividends become less common among firms with positive earnings and lower growth rates. Fama and French attribute the declining propensity to pay dividends to the tax disadvantage. This is supported by the fact that aggregate share repurchases are about 4.0% of aggregate stock earnings between 1973 and 1982. For 1983 –1998, repurchases are 31.42% of earnings. The aggregate dividends of payers are 47.22% of their aggregate common stock earnings in 1983-1998 and 42.71% in 1993-1998, versus 45.19% in 1963-1977. The large share repurchases of 1983-1998 are mostly due to an increase in the desired payout ratios of dividend payers, who are nonetheless reluctant to increase their cash dividends.

## *Notes*

1. Stern Stewart Roundtable on Capital Structure and Stock Repurchase, February 27, 2001 published in Journal of Applied Corporate Finance, 14(1), Spring 2001, pp. 8-41.
2. Defined as that portion of a company's operating cash flow in excess of the amount necessary to fund all available positive NPV projects.