The valuation leak we blissfully ignore is worsening

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If you attend the Annual General Meeting (AGM) of any well-regarded company, you will meet many gentle senior citizens. As shareholders for decades, they, have seen the company through cycles, are known to the Board and, are treated with care. They listen for the most part except for one resolution when they invariably speak: dividends. They often ask the Board to consider paying out all cash that's not needed by the company. Perhaps they rely on dividend income to make a good part of their frugal living.

The bad news is that the bad news they have been putting up with is getting worse. It is getting worse for anyone who thought that the value of a company is in its dividends. Of the many ways of reaching earnings to owners, cash dividend is the most popular, consistent and sensible. Others, like buybacks, are restrictive and cumbersome. Looks like successive Governments have also found that out and are claiming an ever growing share. The Dividend Distribution Tax (DDT) reintroduced in FY 2004 started at 8% - measured on gross amount paid out, and has now more than doubled to 17% in FY 15. This is without counting the added "10%" tax introduced on some next fiscal.

That is bad for the value of a good business. Consider a firm paying 30% of what it earns as dividends. If DDT were 100% these payouts are worthless for owners and should be discarded in the assessment of value. Consequently the value will drop by 30%. This is irrespective of the company's economics, its past performance or its future prospects. Of course DDT is not 100% but taking it to the extreme helps us see that it is different from direct and indirect taxes. It is a tax levied when shareholders decide to consume what they earned. It is effectively an 'earnings consumption tax' that eats into the valuation pie. Naturally, it should be an important consideration when arriving at value.

I am therefore perplexed that analysts, the experts on valuation, give it a miss. They use many models to arrive at the firm's value encapsulating a deep understanding of the business and the markets. They use various measures like P/E, P/B, EV/EBIT, P/FCF and so on to arrive at valuations precise to the ₹. Maybe, you are tempted to think, this DDT is too small to matter.

Nearly all well regarded companies pay a dividend every year and all the Nifty 50 companies save Tata Motors paid one last year. Those that pay forever are considered quite dear like HUL, the consumer goods giant. HUL has paid out more than three out of the four Rupees it earned, on average every year, since 2001. Likewise Asian Paints paid out 44% on average and TCS, the most valued company, paid out 77% last year. This means they also give away annually 13.2%, 6.4% and 13.4% of *Profits after Tax* as DDT; creating a permanent dent in value. Such companies do not reduce the quantum paid out to shareholders except under unusual circumstances. The net effect is that shareholders will lose this DDT year after year forever, i.e., in annuity. The capitalised value of this annuity loss may be taken at a multiple of 13 times DDT by discounting DDT at the risk free rate for ₹ today. Since earnings are always expected to grow, the payout, and hence DDT will also grow. That makes the loss more than 13 times DDT. A prudent investor will capitalise it at the PE multiple provided by the analyst, assuming the multiple is fair. So if the PE multiple is 15 and the DDT is about 10% of earnings the loss in value is 10% of the value computed without the DTT impact. This assumes that the DDT rate won't grow (fat chance). Of course this lowering of value may have the effect of lowering the PE multiple as well.

Proverbially a frog sloooowly boiled from ambient temperature does not leap to escape. What about profit maximising entities? Do they notice the slow yet steady increase in the earnings consumption tax? The short answer is, they have not only taken notice, but also responded. They responded by reducing the amount they give out for every ₹ they earn.

Table 1 shows the Nifty 50 companies' behaviour in aggregate.

Table 1: Growth in Earnings, Dividends and DDT

	FY 2015 over FY 2005, times
Earnings	**5.3**
Dividends reaching owners	**3.7**
DDT	**5.1**

Notes:

1. Nifty 50 as on date excluding 5 firms without history in FY 2005
2. Earnings are consolidated
3. DDT was estimated for 2 companies as they were not provided in their Annual Reports

The table shows that even as earnings grew by 5.3 times over 10 years owners received far less as their dividends grew only 3.7 times. However DDT grew in line with earnings. The behaviour is clear. Firms manage DDT rate hikes by restricting dividend raises. If the past is any guide, the payout ratio should fall next year as taxes have been dramatically increased for some. But retaining instead of consuming earnings has a downside. The additional capital so retained should grow at the same rate as rest of the capital to maintain returns as before. But the firm has retained earnings only with a view to minimise taxes and not to maximise marginal returns. Consequently, atleast in theory, the returns should fall.

Dividend seekers may be left pressing their nose against the glass looking at all the earnings hoarded up but not meant to be given out.

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