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SHARE BUYBACKS

RELEVANT TO ACCA QUALIFICATION PAPER P4

In recent years, share repurchases, or buybacks, have become an important part of the financial landscape. This article considers the reasons why buybacks are undertaken and examines the concerns raised about this method of returning funds to investors.

BUYING BACK SHARES

A share buyback occurs when a business purchases its own shares and then either cancels them or holds them in treasury for re-issue at a later date. To implement a buyback, a business may acquire its shares in the open market in much the same way as any other investor. It may, however, make a proportional offer, where a set proportion from each investor is purchased, or a universal tender offer, where a fixed number of shares is acquired at a particular price.

The law normally requires public companies to buy back shares from funds generated either from distributable profits or from the proceeds of a fresh issue of shares.

Buybacks can be undertaken either on an intensive basis or over a period of time. A recent example of the latter is when Microsoft Corporation announced, in September 2008, its intention to buy back $40bn worth of its own shares over a five-year period.

BUYBACKS VERSUS DIVIDENDS

Share buybacks offer an alternative to dividend payments as a means of returning funds to investors. This raises the question as to which of the two methods investors prefer. If we assume perfect capital markets, they will be indifferent. A simple example makes this point clear.

EXAMPLE 1

Yen plc has one million shares in issue, and surplus cash of £2m which is to be distributed to investors. Following this distribution, profits are expected to be £1m per year, and the price/earnings ratio is expected to be eight times.

The distribution will be made by either:

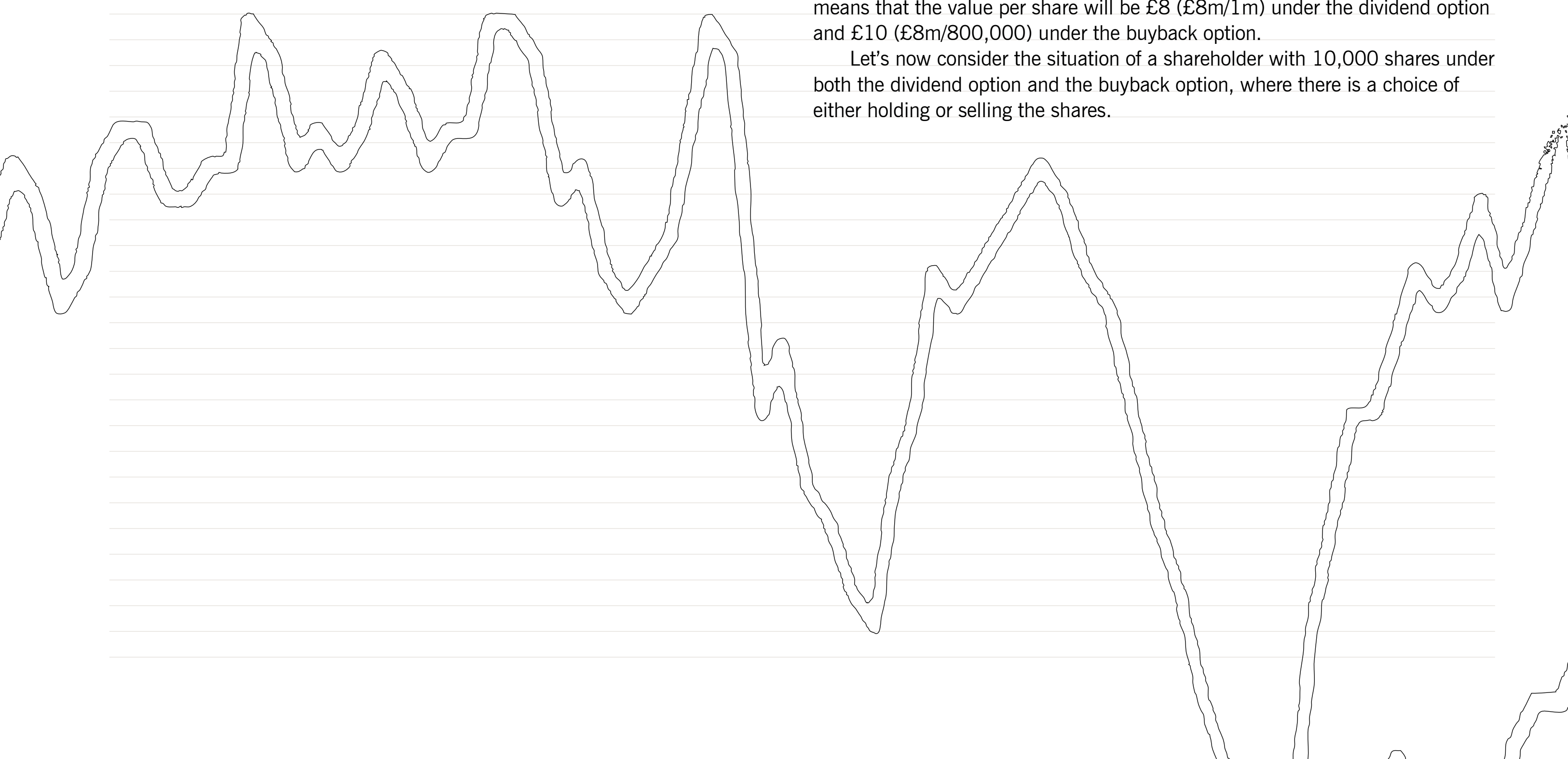
- a dividend of £2 per share, or
- a tender offer of 200,000 shares at £10 per share.

Whichever distribution method is chosen, the total market value (TMV) of the shares will be the same, as the risks will be unaffected by the choice of method. TMV can be calculated as follows:

TMV = profit x p/e ratio = £1m x 8 = £8m.

Under the dividend option, however, there will be one million shares in issue, and under the buyback option there will be 800,000 shares in issue. This means that the value per share will be £8 (£8m/1m) under the dividend option and £10 (£8m/800,000) under the buyback option.

Let's now consider the situation of a shareholder with 10,000 shares under both the dividend option and the buyback option, where there is a choice of either holding or selling the shares.



	Dividend option	Buyback option	
		Hold	Sell
	£	£	£
10,000 shares held at £8 per share	80,000		
10,000 shares held at £10 per share		100,000	
10,000 shares sold at £10 per share			100,000
Dividend received (10,000 x £2)	20,000		
	100,000	100,000	100,000

We can see that the total wealth is the same under each option and so the investor should be indifferent as to which option is chosen. This is comparable to the Miller and Modigliani proposition concerning the indifference of investors towards dividends and capital gains.

The above analysis rests on the assumptions underpinning perfect capital markets, such as no transaction costs, similar tax treatments, and so on. In our world of imperfect capital markets, however, there are two important reasons why a share buyback may be preferred:

Flexibility
Where a business has surplus funds to return to investors, managers will view dividends differently to share buybacks. Various studies have shown that managers usually feel committed to maintaining a sustainable level of dividend payments. This means they are unlikely to respond to a temporary cash surplus by increasing dividends, which will then have to be decreased in subsequent periods. Share buybacks, on the other hand, tend to be regarded as a residual. Thus, where there is surplus cash to be distributed, a buyback is likely to be viewed as the more appealing option.

Postponing, or even abandoning, a share buyback programme does not incur the kind of adverse reaction from investors that would normally accompany a cut in dividends. For this reason, perhaps, managers do not always display the same commitment to implementing buyback programmes as they do to paying dividends. The particular method of share buyback employed, however, will influence the level of commitment that must be made. Where a programme of open market purchases over a period of time is adopted, managers have considerable discretion over the timing and amount of shares purchased. There is much less discretion, however, where a tender offer or proportional offer is adopted.

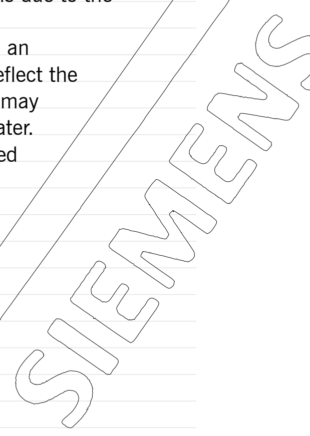
Taxation
Share buybacks can be a more tax-efficient method of returning funds to investors. Any gains arising from the sale of shares will be subject to capital gains tax. In some countries, the taxation rules treat capital gains differently to dividends. In the UK, for example, capital gains below a certain threshold (£9,600 for 2008/9) are not taxable, whereas all dividends are taxable. Thus, investors may prefer to receive funds from the business in the form of capital gains. Furthermore, it is possible for an investor to exert some control over the timing of capital gains by choosing when to sell shares, whereas the timing of dividends normally rests with the managers of the business. If buybacks are made on a regular and frequent basis, however, the tax authorities may conclude that their purpose is simply to avoid taxation: this runs the risk that they will be treated for tax purposes as dividends.

WHY DO BUSINESSES BUY BACK THEIR SHARES?
Various reasons have been put forward to explain why managers have increasingly relied on buybacks to return funds to investors. These include:

Undervalued shares
Where share values are temporarily depressed, open market purchases will benefit investors who continue to hold their shares. In effect, the purchase of shares below their intrinsic value will transfer wealth from those investors that sell to those that continue to hold. Critics argue that this is unfair to the investors that sell. Instead, a proportional offer, or tender offer, where shares are purchased at a premium to their current value, would provide a more equitable way to return funds. If, however, the market recognises that open market purchases are being undertaken because shares are undervalued, share prices are likely to rise quickly. Assuming they rise to their intrinsic values, the real wealth of investors that continue to hold will not be increased, although it will now be reflected in the market value of the shares.

Market signalling
In an imperfect world, managers have access to information that investors do not have. If managers believe that the market undervalues the business, they may send a signal to the market concerning this fact. Whereas investors may discount bullish statements and favourable predictions, concrete actions (such as share buybacks or increased dividends) are likely to be taken more seriously. Various studies have shown that the market responds positively to news of a share buyback, and some suggest that this is due to the information effects. (See, for example, **Reference 1**)

A share buyback announcement may, however, send an ambiguous signal to investors, as not all buybacks will reflect the managers' belief that the shares are undervalued. There may be other non-value enhancing motives, as we shall see later. Details of a proposed buyback will therefore be scrutinised by investors to see whether it can be interpreted as a signal that the shares are undervalued. Thus, for example, a decision by managers to hold on to their shares in the business, and a decision to buy back a large proportion of shares, may both be viewed as a positive sign.



To alter the capital structure
A business may increase its level of gearing in order to achieve an optimal financial structure. By embarking on a share buyback programme, the capital structure of a business can be shifted in favour of debt. Because of the tax shield effects, this can lower the cost of capital. A recent survey of finance directors of the top 200 UK businesses found that achieving an optimal capital structure was the main reason cited for undertaking share buybacks (see **Reference 2**).

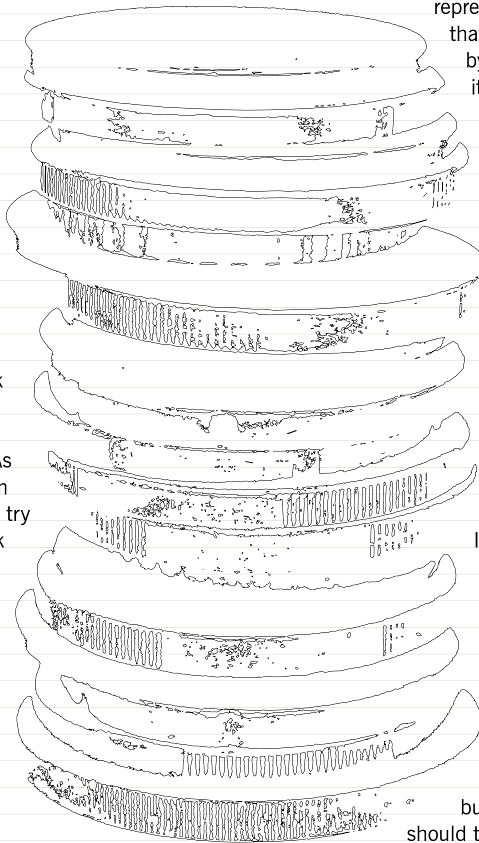
A recent example of a business using a share buyback to change its capital structure is Siemens, the large engineering and technology business. In November 2007, it announced an intention to optimise its capital structure and simultaneously announced a share repurchase programme of up to €10bn to achieve this. The new capital structure will be in place by 2010.

Returning surplus funds
Where a business has no profitable opportunities in which to invest, returning any surplus funds may be the best option for investors. More mature, low-growth businesses are likely to find themselves in this position than younger, high-growth businesses. Various studies indicate that returning surplus funds is an important reason for undertaking buybacks. One UK study found that the returns of businesses that engaged in share buybacks were lower, when compared with a control group, for up to two years before and three years after the share buyback, but not during the buyback year (see **Reference 3**). Lower returns before a buyback could be interpreted as the market punishing the business for not distributing surplus funds, whereas lower returns following a buyback may be due to relatively few investment opportunities.

Reducing agency costs
There is always a risk that the managers, who act as agents for the investors, will use the resources of the business unwisely and, perhaps, in ways that benefit them rather than investors. To reduce this risk, managers

may decide to distribute any temporary cash surplus to investors through a share buyback. As a consequence, managers will have to submit to the judgment of the market when fresh capital is required. Although this is less comfortable for managers, it may ultimately be in their own interests. By demonstrating a commitment to the interests of investors, managers may secure their confidence which, in turn, may lead to greater job security and/or higher rewards.

Agency costs may also be reduced where a share buyback is used to alter the capital structure of the business. If debt capital is substituted for equity capital, the increase in interest payments that occurs will subject managers to much tighter financial discipline, as it will reduce the discretionary funds available.



NON-VALUE-ENHANCING REASONS

Although we have just seen that share buybacks can be used to help reduce agency costs, it is also possible for them to increase agency costs. In some cases, buybacks may be carried out for the benefit of managers rather than investors. The following two examples illustrate the problems that might arise:

Increasing earnings per share

Where a business has surplus funds, buying back shares will reduce the number of shares in issue but may have little or no effect on earnings. The result will be an increase in earnings per share. As this measure is often used in managers' long-term incentive plans, there is a risk that managers will try to improve this measure through a share buyback in order to boost their rewards. Although suitable safeguards should be in place to ensure that increasing earnings per share in this way will not affect managerial rewards, this does not always occur.

Perhaps it is worth making the point that increasing earnings per share is not the same as increasing shareholder value. This investment ratio is influenced by accounting policy choices and fails to take account of the cost of capital and future cash flows, which are the determinants of value. Thus, a change in this investment ratio may be of no real significance to investors. Although some appear to believe that analysts mechanically apply a multiple to the earnings per share figure in order to derive a value for share prices, this is not the case.

Management share options

Management share option schemes start from the premise that investors are concerned with share price increases and that managerial incentives should reflect this concern. Excessive focus on share price, however, may not be in the best interests of investors. Share price represents only one part of the investors' total return: the other part is dividend income. There is a risk that undue concern for share price may lead managers to restrict dividend payments so that profits are retained to fuel share price growth. We saw earlier that, following a dividend payment, the share price will decrease and will be lower than the share price following a share buyback. Managers therefore have an incentive to employ buybacks rather than dividend payments, as they can increase the value of their options. For this reason, some share option schemes prohibit the restriction of dividends.

When management share options are exercised, the number of shares in issue will increase. Share buybacks may be used to offset the dilutive effects of share options, an action which does not necessarily benefit investors. One study has found that the market does not react as well to buyback announcements from businesses with significant management share option schemes (see **Reference 4**).

INFORMING INVESTORS

As buybacks do not always enhance the wealth of investors, there have been calls for a much stronger light to be shone on this type of activity. To subject buyback decisions to closer scrutiny, however, greater disclosure is required.

The United Kingdom Shareholders' Association (UKSA), which represents the interests of private investors, has argued that a buyback announcement should be accompanied by a clear explanation of the reasons for a buyback and its likely effect on future profits, capital structure and dividends. The particular method of buyback should also be justified. UKSA further argues that the annual report should set out a detailed account of any share buybacks, along with a report by the directors on the extent to which the buyback programme has achieved its objectives (see **Reference 5**).

SUMMARY AND CONCLUSIONS

We have seen that in a world of perfect markets, it will not matter whether funds are returned to investors through a share buyback or through a dividend payment. In an imperfect world, however, financial flexibility and taxation considerations may favour a share buyback. While share buybacks may be used to enhance the value of an investor's shares, they can also be used for non-value-enhancing purposes. Investors must be alert to this risk and should closely scrutinise share buyback proposals. To help them in this task, much fuller disclosure is required.

Share buybacks have become a very popular method of returning funds to investors. During 2007, it was estimated that nearly 15% of Europe's large and mid-cap businesses carried out buybacks of more than 2% of their market capitalisation (see **Reference 6**). The changed economic climate, however, may make it impossible for businesses to fund buybacks on the same scale as in the recent past. We should therefore expect far fewer buyback announcements over the next year or two. ■

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