42. What are share buybacks and how do they work?

Short Answer

A company may in certain circumstances buy back its own shares and either keep them on the balance sheet or cancel them, in which case there is said to be a capital decrease or capital reduction.

Example

Table 1.37: Fifty share buybacks of European companies in 2010

	Group	2010 Share buy-backs (cm)	As % of end-of-year market capitalization	Dividends paid in 2010 (cm)	2010 share buy back and dividend paid (cm)	As % of the market (cm)
1	TELEFONICA	802	1.0%	5 218	6 020	7.6%
2	TOTAL	0	0.0%	5 093	5 093	5.4%
3	SANTANDER	172	0.2%	4 919	5 091	6.6%
4	GDF SUEZ	499	0.8%	3 257	3 756	6.2%
5	FRANCE TELECOM	2	0.0%	3 705	3 707	8.6%
6	ENI	0	0.0%	3 622	3 622	5.5%
7	SANOFI-AVENTIS	328	0.5%	3 131	3 459	5.2%
8	DEUTSCHE TELEKOM	2	0.5%	3 386	3 388	7.9%
9	ENEL	0	0.0%	2 959	2 959	8.1%
10	E ON	0	0.0%	2 858	2 858	5.8%
11	UNIBAIL-RODAMCO	0	0.0%	2 564	2 564	21.1%
12	RWE	28	0.1%	1 867	1 895	6.3%
13	BBVA	280	0.7%	1 574	1 854	4.4%
14	ALLIANZ	−6	0.0%	1 850	1 844	4.7%
15	BNP PARIBAS	47	0.1%	1 778	1 825	2.9%
16	CARREFOUR	1 025	4.1%	740	1 765	7.0%

Table 1.37: (*continued*)

Group	2010 Share buy-backs (cm)	As % of end-of-year market capitalization	Dividends paid in 2010 (cm)	2010 share buy back and dividend paid (cm)	As % of the market (cm)
17 VIVENDI	0	0.0%	1 721	1 721	7.3%
18 BASF	0	0.0%	1 561	1 561	3.6%
19 NOKIA	−1	0.0%	1 519	1 518	4.8%
20 IBERDROLA	24	0.1%	1 469	1 493	4.9%
21 SIEMENS	0	0.0%	1 388	1 388	2.0%
22 MUENCHENER RUCK.	250	1.2%	1 072	1 322	6.4%
23 REPSOL YPF	0	0.0%	1 254	1 254	5.6%
24 UNILEVER CERTS.	0	0.0%	1 254	1 254	3.7%
25 AXA	0	0.0%	1 245	1 245	3.8%
26 BAYER	0	0.0%	1 159	1 159	2.8%
27 INTESA SANPAOLO	−4	0.0%	1 124	1 120	3.8%
28 DEUTSCHE BANK	616	1.5%	465	1 081	2.6%
29 CREDIT AGRICOLE	−7	0.0%	1 039	1 032	3.9%
30 TELECOM ITALIA	−67	−0.5%	1 061	994	7.2%
31 DANONE	205	0.7%	737	942	3.3%
32 L'OREAL	0	0.0%	879	879	1.8%
33 LVMH	71	0.2%	784	855	1.8%
34 VINCI	0	0.0%	850	850	4.0%
35 SAP	220	0.5%	594	814	1.9%
36 AIR LIQUIDE	3	0.0%	609	612	2.5%
37 GENERALI	0	0.0%	545	545	2.2%
38 ANHEUSER-BUSCH INBEV	−75	−0.1%	605	530	0.8%
39 SCHNEIDER ELECTRIC	0	0.0%	530	530	2.2%
40 SAINT GOBAIN	0	0.0%	509	509	2.8%
41 CRH	0	0.0%	435	435	3.8%
42 DEUTSCHE BOERSE	0	0.0%	391	391	3.9%
43 ALSTOM	0	0.0%	364	364	3.0%
44 SOCIETE GENERALE	124	0.4%	182	306	1.0%
45 PHILIPS	−65	−0.3%	296	231	1.0%
46 DAIMLER	54	0.1%	0	54	0.1%

(*continued overleaf*)

Table 1.37: (*continued*)

Group	2010 Share buy-backs (cm)	As % of end-of-year market capitalization	Dividends paid in 2010 (cm)	2010 share buy back and dividend paid (cm)	As % of the market (cm)
47 AEGON	0	0.0%	0	0	0.0%
48 ING	−26	−0.1%	0	−26	−0.1%
49 ARCELORMITTAL	−1 027	−2.6%	873	−154	−0.4%
50 UNICREDIT	−3 916	−10.5%	550	−3 366	−9.0%
Total	−442	0.0%	75 586	75 143	4.5%

Long Answer

We know that no earnings retention policy is attractive unless the company can invest its funds at a rate of return greater than or equal to the weighted average cost of capital. Let us take the reasoning here to its logical extreme. Every euro reinvested by the company must earn at least the rate of return required by providers of funds; if it does not, value will be destroyed. Rather than destroy value, it is better to return that euro to the owners.

From a theoretical viewpoint, when a business no longer has any investment projects that are sufficiently profitable, it should not only pay out all its earnings but also return all or part of its equity capital.

Equity capital is also needed to finance the risk of the business. Without it, the company could find itself in a serious cash crisis at the first downturn in the economy. On the other hand, when the company has acquired a strategic position in its market strong enough to ensure continued profitability and value, the normal course of action is to reduce equity financing and increase debt. Free cash flow has become sure enough to support the regular fixed repayments required on borrowings.

Equity capital serves to bear business risk. When that risk appears under control, equity can normally be replaced in part by debt capital.

A capital decrease corresponding to a distribution of cash can be accomplished in a number of ways.

- **By reducing the par value of all shares**, thereby automatically reducing authorized capital.
- **By buying back shares on the open market**. The shares acquired may be cancelled and the purchase cost deducted from the par value of the repurchased shares, with any excess cost charged against distributable reserves. The repurchased shares may also be kept in treasury by the company to serve as acquisition currency or to fulfill the exercise of stock options held by employees. Lastly, they can be sold on the open market for the purpose of stabilizing the share price. If the shares are not cancelled, however, the repurchases cannot really be described as a capital decrease.

On the company's books, repurchased shares appear on the consolidated balance sheet as marketable securities if they were acquired for the purpose of stabilizing the share price or fulfilling employee stock options. In all other cases, the purchase cost is subtracted from shareholders' equity. Under IAS and US accounting standards, repurchased shares are always deducted from consolidated equity.

- **By tender offer**. In practice, the board of directors, using an authorization that must have been granted to it at an extraordinary general meeting, makes an offer to all shareholders to buy all or part of their shares at a certain price during a certain period (usually about one month). If too many shares are tendered under the offer, the company scales back all the surrender requests in proportion. If too few are tendered, it cancels the shares that are tendered. If management decides on a tender offer, it has the option of considering the traditional fixed-price offering or the *Dutch auction method*. In Dutch auctions, the firm no longer offers to repurchase shares at a single price, but rather announces a *range* of prices. Each shareholder thus must specify an acceptable selling price within the prescribed range set by the company. If the shareholder chooses a high selling price, he or she will increase the proceeds provided the shares are accepted by the company, but reduces the probability that shares will be accepted for repurchase. At the end of the offer period, the firm tabulates the received offers, and determines the lowest price that allows repurchasing the desired number of shares. The French food and facilities management company Sodexo used this technique in 2008, for example.

In some other European countries, a share buyback can be accomplished by issuing *put warrants* to each shareholder, each warrant giving the holder the right to sell one share to the company at a specified price.

A capital decrease changes the capital structure and thereby increases the risk borne by creditors. To protect the latter, law generally allows creditors to require additional guarantees or call their loans early, although they cannot block the operation outright.

Jagannathan et al. (2000) have measured the growth in open market stock repurchases and the manner in which stock repurchases and dividends are used by US corporations. Stock repurchases and dividends are used at different times from one another, by different kinds of firms. Stock repurchases are very pro-cyclical, while dividends increase steadily over time. Dividends are paid by firms with higher 'permanent' operating cash flows, while repurchases are used by firms with higher 'temporary', non-operating cash flows.

Repurchasing firms also have much more volatile cash flows and distributions.

Finally, firms repurchase stock following poor stock market performance and increase dividends following good performance. These results are consistent with the view that the flexibility inherent in repurchase programs is one reason why they are sometimes used instead of dividends.

Several different considerations might explain why a company would buy back its own shares.

- Absence of opportunities to invest at the required rate of return. Managers therefore pass the funds to shareholders, who take it upon themselves to find investments elsewhere that meet their requirements.
- Signaling good news (managers believe the shares are undervalued).
- Increasing financial leverage, to take fuller advantage of the corresponding tax break (not very persuasive!).
- Direct tax incentive: if the object is to transfer cash from the business to shareholders, it is more tax-efficient to buy back shares than to pay a dividend.
- Hurting creditors: buying back shares increases the risk of the business and therefore diminishes the value of its debt. Creditors may try to block it.
- Transferring value between shareholders who decline the offer for reasons of power (they want to increase their stake in the company) and shareholders who agree to sell back their shares at a price exceeding their value.

Empirical analysis confirms that share buybacks are mainly undertaken for signaling purposes. On this point, Jagganathan et al. (2000) have established that, compared with dividends, share buybacks give little indication of future earnings. Companies that raise their dividends do in fact see their earnings increase, but this is not the case when companies buy back shares. In a way, declaring a dividend represents an undertaking by the company's managers to maintain that dividend, whereas a share buyback entails no such moral commitment. Thus, cyclical businesses are more likely to use share buybacks than businesses with steady growth.

Dittmar (2000) has investigated the relation between stock repurchases and distribution, investment, capital structure, corporate control and compensation policies over the 1977–1996 period. He finds that firms repurchase stock to take advantage of potential undervaluation and, in many periods, to distribute excess capital. However, firms also repurchase stock during certain periods to alter their leverage ratio, fend off takeovers, and counter the dilution effects of stock options.

Grullon and Ikenberry (2000) argue that repurchases add value in two main ways:

1. for the tax efficiency in returning excess capital to shareholders;
2. for the signal managers send to investors about their belief that the company is undervalued.

If stock repurchase and dividends serve the same economic function, why is repurchasing popularity growing so rapidly? Basically for two reasons:

- they are more efficient tax wise in distributing excess capital; and
- they provide corporate managers with the flexibility to make small adjustments in the capital structure in order to correct perceived undervaluation of the firm's shares.

A capital decrease by itself does not reduce a company's cost of capital and thus cannot create value. At best, it can avoid value destruction by preventing the company from investing cash at less than the cost of equity.

Only if the company manages to buy back its shares at less than they are worth could it hope to create value. The theory of markets in equilibrium leaves little hope of being able to do this.

A share buyback should nowadays be regarded as a normal transaction.

The message that it signals is this: the company's managers take the shareholders' interest to heart and exceptionally, for want of adequate investment opportunities, they are paying out part of a large cash flow to avoid destroying value.

Because the announcement of a share buyback draws media attention, it probably has more impact than an increase in the dividend – even one that might signal a lasting change in the company's dividend policy.

Repurchase of shares by the company results in:

- an increase in earnings per share (accretion) whenever the reciprocal of P/E is greater than the after-tax rate of interest paid on incremental debt (or earned on short-term debt securities). If E/P is less than the rate of interest, there is a decrease in earnings per share (dilution);
- an increase in the book value of equity per share whenever book value per share before the purchase is greater than the purchase price per share.

Bear in mind that, although the calculation of the change in EPS is of interest, it is not an indicator of value creation. The real issue is not whether a capital decrease will mechanically dilute EPS, but whether:

- the price at which the shares are repurchased is less than their estimated value;

- the increase in the debt burden will translate into better performance by management; and
- the marginal rate of return on the funds returned to shareholders by the buyback was less than the cost of capital.

These are the three sources of value creation in a capital decrease.

References and Further Reading

Dittmar, A., Why do firms repurchase stocks? *Journal of Business*, **73**(3), 331–355, July 2000.

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