Buyback of Shares – An Overview

*Dr. Rachna Garg

The buyback of shares definition itself gives a fair idea of what it means to companies. A buyback, also known as a share repurchase, is when a company buys its own outstanding shares to reduce the number of shares available in the open market. A stock repurchase, or buyback, occurs when a company uses cash on hand to buy and retire some of its own shares in the open market. A share repurchase takes outstanding shares off the market and returns capital to investors.

In other words, a buyback of shares

- Allows companies to invest in themselves.
- is a flexible practice of returning excess cash flow.
- can be seen as an efficient way to put money back into its shareholders' pockets.
- is an increasingly popular capital allocation tool to return cash to shareholders.

Reasons for buy back of shares :

Companies buy back shares for a number of reasons such as to reduce the cost of capital, ownership consolidation, preserving stock prices, undervaluation, and boosting its key financial ratio. Hence, there are several reasons, few of them are as under :

- A share repurchase can demonstrate to investors that the business has sufficient cash set aside for emergencies and a low probability of economic troubles.
- Another reason for a buyback is for compensation purposes. Companies often award their employees and management with stock rewards and stock options. To offer rewards and options, companies buy back shares and issue them to employees and management. This helps avoid the dilution of existing shareholders.
- Businesses that have expanded to dominate their industries, for example, may find that there is little more growth to be had. With so little headroom left to grow into, carrying large amounts of equity capital on the balance sheet becomes more of a burden than a blessing.
- Companies that have a bloated equity base due to historical reasons also resort to a buyback in order to reduce their future equity servicing requirements.

- This increase in share price results in enhanced shareholder value for all post-buyback shareholders.
- Ultimately, highly successful companies reach a position where they are generating more cash than they can reasonably reinvest in the business.
- To take advantage of undervalued stocks, while others do it to artificially boost the stock price.
- To avoid chances of acquisitions or takeovers by another party or prevent other shareholders from taking a controlling stake. To defend the company against the threat of a hostile take-over, the decision of buy-back can be taken.
- A buyback has a purpose to create a more desirable capital structure and the shares buyback influence the financial leverage; firms with high debt capacity may repurchase their shares in order to create a desirable capital structure.
- Management can have the goal of increasing the earnings per share because the number of shares gets reduced, the results can be divided over fewer shares.
- The buyback of shares is preferred alternative to dividend distribution for the company to distribute capital to shareholders.
- The buyback of shares does not result in any transfer of shares and does not attract any stamp duty.

Pitfalls in buy back of shares :

Buybacks have a number of pitfalls if not used carefully and in the right circumstances. These pitfalls include :

- The downside to buybacks is they are typically financed with debt, which can strain cash flow. Many companies finance stock buybacks because the loan interest is tax-deductible. However, debt obligations drain cash reserves, which are frequently needed when economic winds shift against a company.
- One great danger of buybacks is that they could be used to accentuate income inequality. Instead of redistributing earnings to the company's workers, or investing in projects and equipment to support future growth, companies use the money for returning cash to already wealthy executives and shareholders in the form of buyback. But, On the contrary, as a capital allocation tool, buybacks return cash to shareholders the same way dividends do, and in theory are no worse than dividends at contributing to income inequality. McKinsey & Company research found that there is no empirical difference between whether distributions take the form of dividends or share repurchases. By this logic, if dividends and buybacks contribute equally to income inequality.

- Management teams often say they like to buy their stock when it is undervalued, but companies do a poor job of timing the market, often buying at market peaks rather than troughs. Two factors contribute to this tendency. First, managers suffer from an overconfidence bias. . Executives believe in their own abilities to enhance the value of their company. This overconfidence bias leads managers to believe share repurchases at current valuation levels would be a good investment. Second, companies typically engage in share repurchases when the firm is doing well and generating excess capital, often when the stock is at or near its peak—the opposite of "buy low, sell high." From an investment point of view, it is best to do a buyback when market valuations are depressed— but rare is the company willing to announce a buyback program in the depths of a stock correction.
- Sometime, buyback is riddled with controversy that it is being done for the benefit of vested interest of management and top executives of the company. By mopping up extra stock and keeping EPS up, buyback is a convenient way for executives to maximize their own wealth. It's a way for them to maintain the value of the shares and share options. Some executives may even be tempted to pursue share buybacks to boost the share price in the short term and then sell their shares.
- A share buyback can give investors the impression that the corporation does not have other profitable opportunities for growth, which is an issue for growth investors looking for revenue and profit increases.
- Repurchasing shares puts a business in a precarious situation if the economy takes a downturn.
- The buyback of shares may result in underinvestment in innovation, may contribute to excess leverage and may lead to lower levels of resilience.
- When done with borrowing, share buybacks can hurt credit ratings, since they drain cash reserves that can serve as a cushion if times get tough.

However, these pitfalls may be mitigated to some extent by :

- Ensuring that the company is left with enough of a rainy day cushion while financing the buy back through excess cash.
- Ensuring that the buyback is aligned with company's long term strategy, including having adequate liquidity buffers and capital for other needs.
- Ensuring that the shares are undervalued. After all, companies are no different than regular investors. A company buying an overvalued stock is destroying shareholder value and would be better off paying that cash out as a dividend so that shareholders can invest it more effectively.

Conclusion:

- Dividend vis a vis buy back - Dividend treats all shareholders equal and does not create any wealth transfers. When companies choose the buy-back of shares over dividend in their payout policy, they expose the shareholders towards financial risk because companies do not want to take any risk and they want pass it on to the shareholders.

Unlike dividends, buybacks can be turned on and off. Whereas there is an implicit expectation that dividends generally are not cut, buybacks can fluctuate based on business results and the company's strategy. Buybacks also provide shareholders with flexibility. Unlike dividends, which are paid out to all shareholders, buybacks only create a transaction for those who choose to sell their shares; others can opt out if they believe their shares will rise in value.

- Impact on EPS - Buy-back of shares is a quick way to make a share more attractive because When a company buys back its own shares, it lowers the number of shares held by the public which means that even if profits remain the same, EPS increase. Hence, it is a general belief that Buybacks can boost earnings per share (EPS).

  Contrary to this popular wisdom, increasing EPS doesn't increase fundamental value. Companies have to spend cash to purchase the shares while value of shares gets adjusted in light of reductions in both cash and shares. The result, though, cancels out any impact on EPS.

- Implications of a buyback on the credit rating - A buyback programme essentially involves a reduction in the equity capital / free reserves. To this extent, the company's gearing would definitely increase although the extent of the increase would depend on whether the company funds the buyback through a reduction in its current assets (such as cash balance and marketable securities) or through incremental borrowings. Any increase in leveraging reduces the protection level available to creditors and hence, any buyback programme has a negative implication on the company's creditor protection levels. The extent of the negative impact depends on several factors such as the extent of the reduction in networth, nature of funding for the buyback programme, the strike price for the buyback and post-buyback financial ratios.

- Effect on financial ratios - A buyback programme has a negative impact on other financial ratios such as the company's profitability and its financial flexibility as well. Profitability would reduce because of the increase in the interest outgo if the buyback is funded through borrowings (or reduction in non-operating income if funded out of liquid investments). Similarly, the increase in gearing or the debt-equity ratio would negatively impact the company's financial flexibility to raise additional debt for its operations.

In nutshell, as share buybacks are carried out using a firm's retained earnings, the net economic effect to investors would be the same as if those retained earnings were paid out as shareholder dividends. It would be better for the minority shareholders, if the company uses excess cash for expansion rather than the buy-back of shares. The share prices can move in either direction after the buy-back announcement. One of the reasons for the fall in the price of stock, after the buy-back, could be the mismatch between the buy-back price announced by the company and investor expectations. The buy-back of shares is a destruction of value because the firms repurchase shares at a high price and the companies have more information about themselves as compared to their shareholders, as a result, they decide to repurchase shares as a signal of confidence but they put unnecessary risk on themselves and their long-term strategy because of the reduction in liquid funds. Buy-back of shares does not create value for the long-term. The increased EPS and share price is not a sign of improved earnings, but, it is a sign of fewer people eating the same cake and getting larger slices.

On the positive side, the company's share price would improve on account of the buyback programme. This improved share price, if sustained over a period of time, would open an opportunity to mobilise equity funds at a future date. Another positive implication is the reduction in the company's equity servicing obligations (dividend outflow), which would partly offset the shortfall in cash accruals due to the higher interest outgo.

Buybacks by themselves are neither magic bullets to increase a company's earnings per share (EPS) nor a nefarious means of enriching executives or shareholders. The investors should look at the promoters' stake pre buy-back, cash with company, proposed buy-back in terms of shares and the stake of promoter post buy-back. At last, the investors will have to take the decision whether they should involve in the buy-back of shares or hold the shares or sell the shares in the secondary market.

***Lecturer**
Department of ABST
Government Girls College
Dausa (Raj.)

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