Financial Indicators for Buy Back of Shares

There are a number of ways in which a company can return wealth to its shareholders. Although stock price appreciation and dividends are the two most common ways in which companies return wealth to its shareholders, there are other useful, and often overlooked, ways for companies to share their wealth with investors. This article dwells upon one of those methods, which is termed as Buy Back of Shares and goes through the mechanics of a share buyback and what it means for investors. Are share buybacks good or bad? As it often happens in cases of finance, the question may not have a definitive answer. If a stock is undervalued and a buyback truly represents the best possible investment for a company, the buyback and its effects can be viewed as a positive sign for shareholders. However, if a company is merely using buybacks to prop up ratios, provide short-term relief to an ailing stock price or to get out from under excessive dilution, then it may not be successful and the whole process of buyback may go for a toss.

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Meaning of "Buybacks"

A stock buyback, also known as a "share repurchase", is a company's buying back its shares from the marketplace. Buyback is a reverse of the issue of shares by a company where it offers to take back its shares owned by the investors at a specified price; this offer can be binding or optional to the investors. We can think of a buyback as a company investing in itself, or using its cash to buy its own shares. As we all know that a company can't act as its own shareholder, repurchased shares are absorbed by the company, and the number of outstanding shares in

the market is reduced. As a result of which, the relative ownership stake of each investor increases because there are fewer shares, or claims, on the earnings of the company. In other words, stock buyback is the purchase of a long position by a company to offset a short position.

Why Should a Company Go for Buyback of Shares

A company can go for buyback for many reasons but the most prominent and viable reasons are as follows:

1. **Increasing Shareholders' Wealth:** According to the law of demand and supply, if there are less number of shares in the market and the demand of the shares are increasing, then the price of the shares will rise. This will result in increasing the wealth of the existing shareholders.
2. **Higher Price of Share:** Buying back of stock means that the company earnings are now split among fewer shares, meaning higher earnings per share (EPS). Higher earnings per share generally command a higher stock price.
3. **Transferring Surplus Cash to Shareholders:** Buying back stock allows a company to pass on extra cash to shareholders without raising the dividend. If the cash is temporary in nature, it may prove more beneficial to pass on value to shareholders through buybacks rather than raising the dividend.
4. **Tool for Financial Re-engineering:** In the case of profit making, high dividend-paying companies whose share prices are languishing, buybacks can actually boost their bottom lines since dividends attract taxes. A buyback and the subsequent neutralisation of shares can reduce dividend outflows, and if the opportunity cost of funds used is lower than the dividend savings, then the purpose of buy back is served.
5. **Increasing Investors' Confidence in Management:** It might enhance the confidence of its investors on the company's board of directors, as these investors know that the directors are ever willing to return surplus cash if it's not able to earn above the company's alternative investment or cost of capital.
6. **Avoiding Takeovers:** Buying back stock uses up excess cash. The returns on excess cash in money market accounts can drag down overall company performance. Cash rich companies are also very attractive takeover targets. Buying back stock allows the company to earn a better return on excess cash and keep itself from becoming a takeover target.
7. **Psychological Effect:** When a company purchases its own stock, it is essentially telling the market that they think that the company's stock is undervalued. This can have a psychological effect on the market.
8. **Tax Benefits:** Exemption is available only if the shares are sold on a recognised stock exchange and if securities transaction tax (STT) on the sale has been paid. In a buyback scheme, neither does the sale take place on a recognised exchange nor is the STT paid. So, the shareholder will have to pay income tax on long-term capital gain on the buyback, after deducting the acquisition cost of the shares plus the benefit of indexation from the year of purchase to the year of buyback. On the resultant gain, the tax would be 20% plus the applicable surcharge, if any, plus 3 % education cess or we may also work out the tax at 10% of the gain without considering indexation. The tax liability will be limited to the lower of the two calculations.
9. Stock buybacks also raise the demand for the stock in the open market. Since the company is competing against other investors to purchase shares of its own stock the demand is increased, which leads to increase in the prices.

Characteristics of Companies Going for Buyback

Companies with some of the following characteristics may opt for a share buy-back scheme:

- Companies having high net surplus cash position.
- Companies having a low debt/equity ratio may go in for a share buyback so that the debt/equity ratio may be increased.
- Companies which do not have a high capital expenditure requirements in future.
- Companies having a high dividend yield.
- Companies, where the intrinsic value of the shares of the company is substantially higher than the market price of the shares of the company.

Methods of Buyback

Buyback of shares can be done by the following categories of companies:

1. Public Limited Companies or Listed Companies
2. Private Limited Companies or Unlisted Companies

Public Limited Companies or Listed Companies can go for buyback through tender offer or from open market through stock exchange.

1. Tender Offer

Shareholders may be presented with a tender offer by the company to submit, or tender a portion or all of their shares within a certain time frame. The tender offer will stipulate both the number of shares the company is looking to repurchase and the price range they are willing to pay (almost always at a premium to the market price). When investors take up the offer, they will state the number of shares they want to tender along with the price they are willing to accept. Once the company has received all of the offers, it will find the right mix to buy the shares at the lowest cost.

2. Open Market

The second alternative a company has is to buy shares on the open market, just like an individual investor would, at the market price. It is important to note, however, that when a company announces a buyback, it is usually perceived by the market as a positive thing, which often causes the share price to shoot up.

Effects of Share Buyback

When a company goes in for buyback of shares, there may be positive effects or negative effects on the shareholders and/or the company.

A. Effects on the Shareholders.
B. Effects on the Company.

A. Effects on the Shareholders.

A.1 Tax Advantages - When a company is having surplus cash, it can either pay it off as dividend or go for buyback of shares. When a company pays dividend they are entitled to pay dividend distribution tax. This cost has to be indirectly borne by the shareholders, who receive fewer dividends as a consequence of tax payments. Therefore by Buying back shares, a company gives surplus cash to the shareholder and saves tax for the shareholders.

Example: A company has surplus cash of ₹100 crore and if they declare ₹100 crore as dividend then the company has to pay dividend distribution tax of ₹15.00 crore. So, the net amount which would be received by the shareholders would be ₹85.00 crore.

If a company decides to go for buyback of shares, then the entire amount of ₹100 crore is received by the shareholders. Thus, shareholders save tax of ₹15.00 crore, which they would have incurred, if the company would have given them surplus cash by way of dividend.

A.2 Higher Proportion of Shares - When a company goes for buyback, the number of outstanding shares reduces. That means the proportion of investment of an individual investor increases in the company.

A.3 Higher Price of Shares - One of the reasons why a company goes for a buyback is that they think that their shares are undervalued. That is why they buyback shares at a premium or at a price that they think it should command in the market.

Example: The Market price of a share of ABC Ltd. is ₹150 and the company believes that the price of their share should be at ₹250 based of their fundamental and technical analysis. Therefore, the company buys back shares at ₹250 from the market, thus increasing the market value of the share from ₹150 to ₹250.

B. Effects on the Company.

B.1 Change in the Shareholding Pattern

Particulars of XYZ Ltd.	
Total number of Shares	1,000
Face Values of Shares	₹10.00
Equity Capital	₹10,000.00
Buyback of Equity Shares (numbers)	200
Maximum Offer Price	₹25.00

Shareholding Pattern of XYZ Ltd.				
Particulars	Before buyback	After buyback		
		Case 1	Case 2	Case 3
Promoters (no. of shares)	400	400	320	200
Non-promoters (No. of shares)	600	400	480	600
Promoters (percentage)	40.00%	50%	40.00%	25%
Non-promoters (percentage)	60.00%	50%	60.00%	75%

Assumptions

Case 1: The original proportion of promoters and non-promoters share in the total equity capital was 40.00% and 60.00% respectively. It is assumed that there is a 100% buyback of 200 shares which the company has proposed to make. Therefore, all the shares that are proposed to be bought are bought from the non-promoters group and nothing has been offered by promoters. Thus, the proportion of promoters share in the total equity capital increases from 40.00% to 50.00% and that of non-promoters decreases from 60.00% to 50.00%.

Case 2: The company decides to keep the shareholding same as before i.e. promoters 40.00% and non-promoters 60.00%.

Case 3: The Company decides to bring down the promoters shares in the company's equity share capital to 25%.

It can be seen from the above example that depending on the policy of the company, the shareholding pattern of the company changes. Promoters and non-promoters shareholding can increase, decrease or remain unchanged.

B.2 Financial Ratios of the Company is Strengthened

Another reason a company might pursue a buyback is solely to improve its financial ratios - metrics upon which the market seems to be heavily focused. If reducing the number of shares is not done in an attempt to create more value for shareholders but rather make financial ratios look better, there is likely to be a problem with the management. However, if a company's motive for initiating a buyback program is sound, the improvement of its financial ratios in the process may just be a bye-product of a good corporate decision. When a company decides to go for buyback, the financial ratios of the company are impacted to a greater extent. The ratios that are generally impacted are Return on Assets (ROA), Return on Equity (ROE), Earnings per Share (EPS) and Price Earnings Ratio (P/E). The same has been explained with an example:

Company – ABC Ltd.		
Particulars	Before buyback	After buyback
Number of Shares	150	125
Cash Balance	₹1,000.00	₹625.00
Total Assets	₹10,000.00	₹9,625.00
Earnings	₹1,500.00	₹1,500.00
Equity Share Capital	₹1,500.00	₹1,250.00
Reserves	₹200.00	₹75.00
Total Shareholders' Funds	₹1,700.00	₹1,325.00
Market Share Price	₹10.00	₹15.00
Financial Ratios		
Return on Assets (ROA)	0.15	0.16
Return on Equity (ROE)	0.88	1.13
Earnings per share (EPS)	10	12
Price-Earnings Ratio (P/E)	1	1.25

Explanation

Return on Assets: We can see that ROA has increased after buyback. The reason behind this increase is that there is a reduction in the total assets. The total assets have gone down from ₹10,000.00 to ₹9,625.00 whereas the income has remained the same.

Return on Equity: It has also increased from 0.88% to 1.13%. This is due to the decrease in the shareholder's equity, which has gone down from ₹1,500.00 to ₹1,250.00

Earnings per Share: It has increased from ₹10 to ₹12. The reason behind the increase of EPS is that, although the earnings of the company is unchanged, the numbers of shares have come down from 150 to 125, causing the EPS to increase.

Price to Earnings Ratio: Here, the market value of the share has increased from ₹10 to ₹15, which is a 50% hike in the price. On the other hand, the EPS has also increased from 10 to 12, which is a 20% hike. Since the overall increase in the market value of the share is much more than the increase of EPS, we can, therefore, see an increase in the price-earnings ratio.

B.3 Send Negative Signals

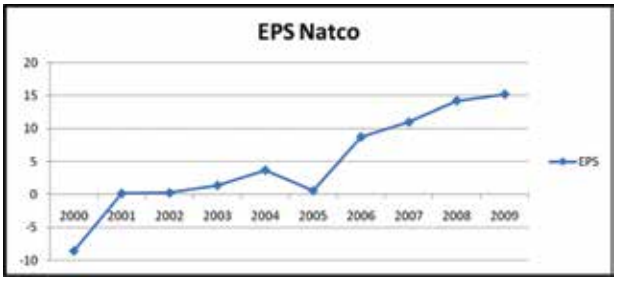
An announcement for buyback can send negative signals to the investors against the companies. A typical example is the Hewlett Packard (HP) case: The Company spent $ 8.2 billion to buy back 128 million of its shares from the market during the period November 1998 to October 2000. The aim of the company was to make opportunistic purchases of HP stock at attractive prices—in other words, at prices they felt that undervalued the company. Instead of signaling a good operating prospect to the market, the buyback signal drowned out more powerful contradictory signals about the company's future which are an aborted acquisition, a protracted business restructuring, slipping financial results, and a decay in the general profitability of key markets.

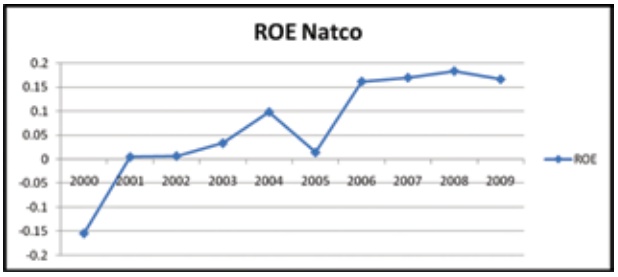
The share buyback scheme might become a big disadvantage to the company when it pays too much for its own shares. Indeed, it is not advisable to buy in an overpriced market. Instead, the company should put the money into assets that can be easily be converted back into cash. This way, when the market swings the other way and is trading below its true value, shares of the company can be bought back at a discount; ensuring current shareholders receive maximum benefit. Strictly, a company should repurchase its shares only when its stock is trading below its expected value and when no better investment opportunities are available.

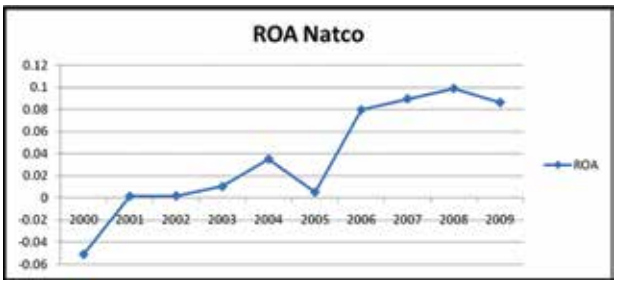
Now let us look at an example of buyback of shares which happened in the year 2007. Natco Pharma decided to go for buyback of its shares in the year 2007. The company went for buyback on 12th February 2007 and completed the buyback on 30th July 2007. The price that was offered by the company for the buyback of shares was ₹150.00 per share and the total outflow of cash was ₹7.00 crore.

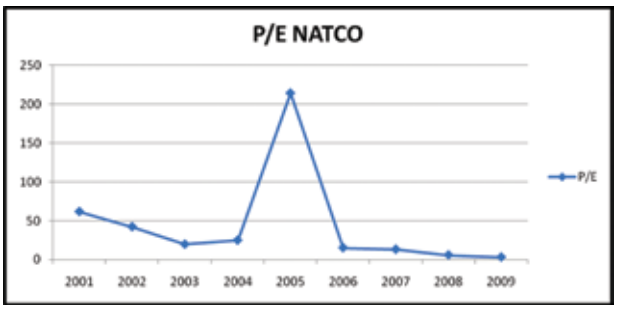
Effect on Financial Ratios

	2001	2002	2003	2004	2005	2006	2007	2008	2009
ROA	0.002	0.002	0.010	0.035	0.005	0.080	0.090	0.099	0.086
ROE	0.004	0.006	0.033	0.098	0.014	0.161	0.169	0.183	0.166
EPS	0.200	0.260	1.410	3.730	0.600	8.760	11.020	14.280	15.240
P/E	61.750	42.308	19.716	24.853	214.417	15.234	13.203	5.935	3.166





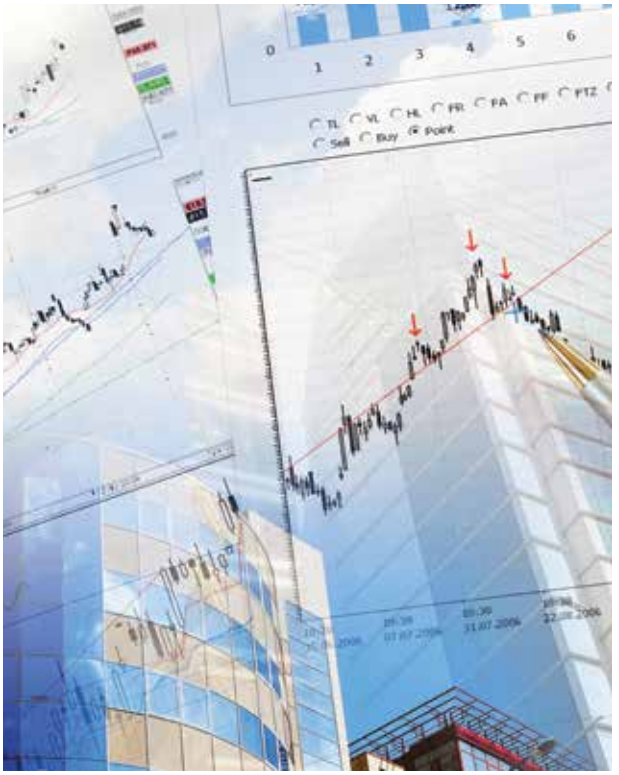




It can be seen from the graphs below, that after the buyback of shares by the company, the earnings per share, return on assets and return on equity have increased remarkably. This proves that the decision to go for buyback was a very valid and successful decision by the management.

Conclusion

Are share buybacks good or bad? As it often happens in cases of finance, the question may not have a definitive



answer. If a stock is undervalued and a buyback truly represents the best possible investment for a company, the buyback and its effects can be viewed as a positive sign for shareholders. However, if a company is merely using buybacks to prop-up ratios, provide short-term relief to an ailing stock price or to get out from under excessive dilution, then it may not be successful and the whole process of buyback may go for a toss. Finally, the decision for buyback of shares would depend on the analysis of the various facets to which the company is exposed. ■