

# Why Private Shareholders Should Oppose Many Share Buy Backs – With Examples from Rank Group et al

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Share buy backs are becoming more common, and the UK Shareholders Association (UKSA) believes that they are often to the disadvantage of private shareholders. Share buy backs usually take place by a company purchasing its own shares in the market, thus reducing the number of ordinary shares that it has in issue. Obviously surplus cash which was previously on the balance sheet has to be used to do this, or in extreme cases the company may take on more debt to give it the necessary cash. But there is one aspect that is all too plain – any use of cash for this purpose is obviously no longer available to pay out as a dividend to shareholders!

This note covers some of the issues associated with share buy backs, and looks at specific examples which well illustrate why this modern fashion should be discouraged. A more extensive discussion of the issues and the formal UKSA policy on this matter is given in a position paper which is available on our web site at: [www.uksa.org.uk/Share\\_Buybacks.htm](http://www.uksa.org.uk/Share_Buybacks.htm)

## Why Do Companies Buy Back Shares?

The argument is often put that this is an “efficient” way to return surplus capital to shareholders. If the company has surplus cash available, for which it can see no good investment opportunities, then the company should rightly seek to return it to shareholders. After all, investors would much rather have the choice of what to do with it than have the company sit on the surplus cash, typically earning a relatively low rate of interest from normal deposit rates.

But why do they do this rather than simply increase the annual dividend, or pay a “special” dividend? One suggested motivation is that some institutional shareholders, to which many large companies are beholden, may prefer a capital gain to an increase in income. This is particularly the case with US institutions where the tax on capital gains may be less than on dividends.

Buying back shares has the impact of reducing the number of shares, and hence the earnings per share will rise. As shares are often valued on a price/earnings ratio or earnings yield, this should in due course result in a higher share price.

## Managing the Share Price

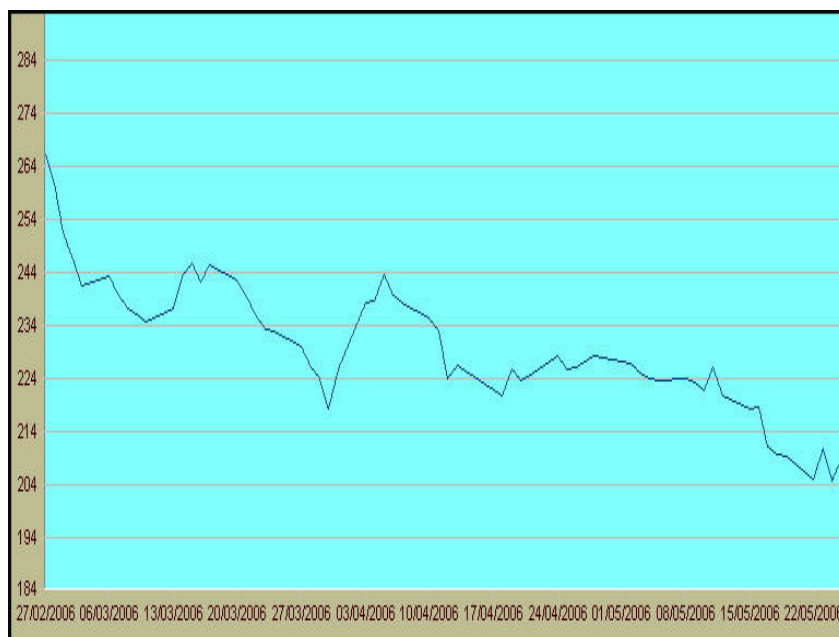
But there is another very simple motivation. Share buy backs are believed to have a positive short term impact on the share price, and also enable institutions to “unload” large blocks of shares into the market that they would otherwise be unable to dispose of without depressing the share price.

If a company is buying back its shares, the effect is often to “mop up” any shares that are being offered for sale, and if done at the opportune moment, can stop a fall in the share price that may result from other events. So company directors may see a share buy back programme as a way of “managing”, if not simply “manipulating” the share price. But it is worth pointing out that this effect is only temporary, and as the market price ultimately depends on the balance of buyers and sellers of a share, and their independent view of how much the company is worth, as soon as the company’s intervention ceases the market price tends to revert to the norm. Thus the company only delays the loss in the value of shareholders holdings whilst at the same time using up money which you could have received as dividends.

In addition, as share prices are often set by future expectations, if investors look beyond the company share buy backs, they often take a very jaundiced view of the company’s prospects, so you see the share price falling as the company continues to buy back shares.

A good example of the lack of a positive impact of share buy backs on the share price is that of Rank Group, a company which I will cover in some detail as a particularly good example of the genre. They commenced a share buy back programme in March 2006 and a graph of the share price up to the time of writing is shown below.

#### **Rank Group Share Price (March 2006 to end May 2006)**



The first purchase in March 2006 was made at an average price of 239 pence, and over £45 million had been expended by the 25<sup>th</sup> April. But the share price has continued to fall and was as low as 204 pence recently.

Perhaps an announcement that the previous dividend was to be maintained, or at least not so savage a cut imposed, would have had a more positive effect on the share price?

Another example is Compass Group who wasted many millions of shareholders' money in 2003/4 buying back shares at approximately 330 pence – just before a profit warning dropped the price by circa 100 pence. A Compass shareholder would have done better if the company had paid out the amount it spent on buy backs via a special dividend which shareholders could have simply banked and later increased their shareholding at the lower price. That would have mitigated the impact.

Or consider the case of software company Surfcontrol. This company has never paid a dividend but has been running one of the largest buy-back programmes. Commencing in May 2004 they commenced purchasing the shares at an average price of 573 pence. This continued through 2005 while the share price fell from 549 pence to 520 pence and dipped as low as 405 pence at one point. If they had spent the equivalent amount of cash on funding a dividend then the yield would have been 4.8%.

### **The “Hubris” of Company Directors**

Another simple motivation of company directors is that sometimes they think the share price is too low. On “fundamentals” they believe the share price should be higher, and hence the shares are cheap. Who is to say whether they are right or wrong, but should shareholders permit the directors to back their hunch against the open market?

Was this a factor in the decision of the directors of Surfcontrol to start a buy back programme, bearing in mind that the share price previously peaked at 1067p in 2003 during the “dotcom” boom (ie. almost twice what it was when buy backs commenced)? Who knows? But bearing in mind that profits had grown in the meantime, the shares certainly looked cheaper on a “fundamental” basis.

### **Where the Value Argument Does Stand Up**

There is one case though where there is good justification for the “shares are cheap” argument. This is where the company has a net asset value (NAV) that is significantly higher than the share price. The commonest situation where this occurs is with investment trusts which normally trade at a discount to their NAV. If the discount becomes excessive then a buy-back improves both the assets per share and future profits and dividends for all shareholders (I would emphasise the last point however – if the dividends are zero then no enhancement can take place).

### **Gearing Up the Company and the Impact on Share Price**

One of the reasons why share buy backs have less positive impact on the share price than many people expect, is the impact on the balance sheet. We all know that “highly geared” companies are riskier and so will be viewed less positively by the market than those with strong balance sheets. So if a company borrows money, however cheaply, to fund a share buy back, the changed perception of the company in the market place may offset any positive impact from share purchases.

The suggestion above that an enhanced earnings per share (EPS) will improve the valuation of the company is a mirage if all the cash in the company disappears and the balance sheet starts to look fragile. Also of course, any valuation of a company on a price/earnings basis is often done by adding back “surplus” cash at the end so it is a mirage to suggest that using the cash to enhance future EPS has any benefit.

### **The Directors, and Managers, May Like Share Buy Backs**

The directors and senior staff in a company are often shareholders. And nobody would begrudge them benefiting from an apparently simple wheeze to improve the share price or underlying value of a share which will be of benefit to all shareholders (if it was really that easy). But these same people are also often the beneficiaries of share options or other schemes such as LTIPs that give them shares in the future.

Share options and LTIPs are often based on meeting performance criteria such as earnings per share. This is on the assumption that if they work hard, do a good job of managing the company, and use its resources effectively, then they should get a bonus. But unfortunately a share buy-back improves future earnings with no managerial skill being required at all. In an ideal world, share options and other such schemes would be adjusted when share buy backs or other changes to the capital of a company take place. But on practical grounds, they rarely are, so there is a motivation here which is contrary to the interests of shareholders other than the “insiders”. The directors of Rank Group have both share options and LTIPs of course, partly based on earnings per share performance.

### **A Bird in the Hand is Worth Two in the Bush**

This old saying is particularly relevant to share buy backs, and is something that shareholders of a certain age should particularly bear in mind. The effect of an enhanced earnings per share in the future is effectively a benefit that is deferred. As any student of finance will tell you, the present value of an investment can be calculated by the future cash streams that the investment generates, discounted back to allow for the uncertainty of receipt and the alternative investment returns that could be obtained.

The effect of a company buying back shares instead of paying the same cash out as a dividend certainly results in a deferred gratification. And the big problem, as we saw with such examples as Compass Group above, is that the future may be very uncertain indeed. As many private shareholders are more elderly, they can be particularly disadvantaged as they simply may not live long enough to collect the full return of the deferral.

### **Shareholders Should Have the Choice as to Where Their Cash is Reinvested**

Another problem with buy backs is that instead of cash being paid out to shareholders, who could choose to spend it on a wild party, or prudently reinvest it in some other sound company, they are being forced effectively to reinvest it in the same company. And as we have seen with such examples as Rank Group or Compass Group, that reinvestment may not be a good one.

## **Jam Tomorrow and Jam Yesterday, but Never Jam Today**

Regretfully the deferral of the return of cash to shareholders and the use instead of share buy backs, and the way these are often presented to shareholders by bullish company chairmen, reminds me of what was said to Alice in “Through the Looking Glass” (by Lewis Carroll) – “*The rule is, jam tomorrow and jam yesterday – but never jam today*”.

## **The Idea that Share Buy-Backs Improve Fundamental Intrinsic Value is Wrong**

UKSA is not alone in thinking that share buy-backs are not all they seem. Consider this quotation from a recently published article by Richard Dobbs and Werner Rehm of McKinsey (Financial Times 28/6/2006): “*The idea, expressed by some commentators, that share buy-backs improve earnings per share, return on equity, return on capital employed, economic profit and fundamental intrinsic value is simply wrong*”. Indeed they point out that share buy-backs can actually prejudice the long-term health of a company if they are chosen as an alternative to value-creating investments. And they suggest that any increase in the earnings per share is offset by a corresponding reduction in the price-earnings ratio (p/e) used to value the company because cash has effectively a much higher p/e than earnings from operations.

## **Particular Issues at Rank Group**

One point worth making about the use of share buy-backs at Rank Group is that the company is already quite highly geared. It has £858 million of borrowings (see page 72 of the last annual report). Financing costs (i.e. interest on that debt) totalled about £63 million last year, which took more than half the operating profits of £115 million. Would it not have been better to apply any surplus cash to reducing the debt level rather than undertaking a share buy-back? Apparently the company is even considering doing a sale and lease-back of some of its properties, to presumably raise even more cash which is also often a way to generate short term paper profits at the expense of longer term returns. So one gets the distinct impression that the policies being pursued by Rank may have more to do with massaging the short term financial figures as against improving the long term interests of shareholders.

Rank Group has a particularly poor long term record. Profits have been very volatile in the last ten years, with no real substantial growth. For example these are the figures for the two years of 1995 and 2005 for profits and dividends (excluding exceptionals):

	Earnings per share (p)	Dividend per share (p)
1995	60.3	15.8
2005	-33.5	15.3

So your dividends are less than they were ten years ago, even ignoring the pending dividend cut. In addition profits in the Gaming division declined last year, even in the Blue Square online gambling operations, when on-line gaming is otherwise known to be growing rapidly and other businesses in this sector have been reporting good results.

In essence therefore there seem to be a number of reasons why the financial performance of the company may well justify a review of the dividend policy, but in that case it would also suggest that returning cash to shareholders via share buy-backs is also inappropriate.

### **What Shareholders Should Do About the Problem**

Share buy backs have to be authorised by a resolution at the Annual General Meeting (typically for the forthcoming year). **Shareholders are advised to vote against such resolutions unless there is a clear and pressing need for them.** Do not accept the suggestion of the directors that they need the flexibility to do them as they think fit. Unless they provide a very specific justification (for example, that they are an investment trust and they can use it to reduce the “discount” in a profitable way for all shareholders), do not go along with a general approval mandate.

**If the company can justify purchasing its own shares, you could also suggest that a tender offer is a much more equitable way to return cash to all shareholders than the use of market share buy backs. Alternatively the company could consider a capital reorganisation as recently proposed by Topps Tiles Plc where shareholders had the option of receiving the return of cash as either income or capital.**

Although the appropriate setting of a dividend rate is beyond the scope of this note, you could also suggest that a balance needs to be established between maintaining a dividend, reducing debt in the company, reinvesting to develop the activities of the business and using any spare cash for some share buy backs. In the case of Rank Group, all three of the alternatives may be more appropriate than undertaking a buy-back programme.

These matters can of course be raised by shareholders at any General Meeting of a company, but as the directors will have decided on their policies in this area well before the meeting, it is well to write to the Chairman some time before. A single voice may not be attended to, but if you think there is a strong case for a change of policy then you can always call on UKSA to assist you in a campaign for change. The more shareholders who voice an opinion on the issue, the more influence you will have. The UK Shareholders Association certainly considers this growing problem as worthy of more publicity and hence our recent efforts in this area.