

Share buybacks

From Update 2001/1

1 Definition

A share buyback is the term describing the actions of a company that buys some of its own shares and then either:

- Cancels them
- Holds them in treasury or escrow until the directors decide to reissue them

2 Methods of share buyback

Shares are bought from shareholders:

- In the open market from current sellers of the stock (market buyback).
 - From each shareholder in a set proportion to each holding (proportional buyback).
 - By tender from selected investors (tender buyback).
- The effect is to reduce the number of shares available

3 Reasons for buying back shares

The purpose of a share buyback should be to increase net assets per share or earnings per share, generally by using up surplus cash¹ or by increasing debt.

This option is usually recommended by directors after they have reviewed alternative investment opportunities and other financial considerations such as the:

- Level of borrowing
 - Need for research and development
 - Possibility of beneficial takeovers
 - Payment of a special dividend²
- and
- Expect that it would result in an increase in future earnings per share and is in the best interests of shareholders generally.

It may be that the purpose of raising the share price (or reducing the discount) is included as a reason for a share buyback. However share price depends on the market and is outside the control of the directors.

4 Legal considerations

Most companies annually seek shareholder permission to buy their own shares. This will usually be one of the resolutions at their Annual General Meeting. The request usually takes a standard form, limits being set for the number of shares not to exceed 10% of the issued shares, the minimum price not to be less than the nominal share value, and the maximum price not to exceed by 5%, the middle market price for the shares for the 5 business days immediately preceding the day of purchase (as required by Chapter 15 of the stock exchange listing rules).

When more than 15% of any class of a company's equity is to be purchased, the listing rules together with the Companies Act do require companies to give maximum as well as minimum purchase prices.

Unless a court has given permission to a company to write down its own capital, companies can only buy back their own shares with money they could otherwise have paid out in dividends. Laws, regulations and codes of practice are regularly reviewed and frequently changed.

5 Consequences of a share buyback

5.1 Share value

In principle, the underlying value of the company is reduced because the company's net assets have been reduced (i.e. surplus cash has been spent or debt has been increased).

However, the reduced number of shares in issue should counterbalance this, so the underlying value of each share remains broadly the same.

If the company's share price is significantly lower than the net asset value per share, (e.g. investment trusts often trade at a discount), the buyback should in fact directly and measurably increase the value per share of the company.

5.2 Share price

The risk level for the prospects of the company may have increased. This could be due either to the perception that there:

- Is a higher chance of defaulting on the new debt (the level of debt worries the market)
- Would be difficulties in raising capital when it is needed (for cash flow or for investment in the business)

In both cases the share price is likely to be depressed.

If the company buys back its shares too vigorously there will be the risk of chasing up the share price only for it to fall back after the trade is done. This is likely to be viewed as poor handling of the buyback and bring into question the abilities of the management. The share price will probably fall.

There are a number of examples of share buybacks taking place followed by a significant fall in share price! There could be a number of different reasons for this, as share price is a function of supply and demand. These may be based on the points raised above (perceived value) or market sentiments that include out of favour sectors and 'lemming like' behaviour!

Of course the share price may also rise provided a significant number of investors believe that the buyback has been well handled and:

- The risk reward factors are relatively unchanged or improved
- The improvement in net asset value and/or earnings per share is sustainable in the longer term

5.3 Share earnings (or EPS)

The total company earnings are now divided between fewer shares. However, the total company earnings are reduced because either:

- Cash assets are lower leading to a lower total return on interest rates
- Debt is increased so that the company pays a higher total interest charge

All things being equal, this would result in no change to the earnings per share (EPS): in other words lower company earnings divided between fewer shares equals no net change to EPS.

However all things very rarely are equal. Earnings per share should increase in due course if:

- Cash (which has now been used for the buyback) was earning a lower rate of return than the rest of the company's activities
 - Cost per share of servicing the debt is less than the financial returns per share using the borrowed cash
- Similarly the reverse would be true if the returns were lower or the cost was higher.

5.4 Share options

Share options are usually awarded to directors and employees as an incentive for improving the company's performance. They would not be part of the buyback. As a result, because the number of shares in circulation has been reduced, the number of share options as a percentage of this new lower figure increases.

5.5 Shareholders

If shares are bought back from each shareholder (proportional buyback) then this may incur a capital gain. It will depend on each person's circumstances whether tax would be payable on this gain. A loan note option could however be made available so that payment can be deferred.

If shares are bought in the market then large shareholders (usually institutional) may find the proportion of shares owned to the total available brings their holding above a particular threshold.

For example:

- If the holding is just below 3% the buyback may bring it above 3%. This makes it a significant holding that will be reported in the Annual Report.
- It may increase control of the company exercised by a dominant shareholder or shareholders, especially when they are directors or associates of the directors.
- Similarly an owner of a larger holding (just below 30%) could find itself in a position of making an unintended takeover bid (>30%).

5.6 Risk assessment

The risk assessment for any company is closely related to the level of cash reserves or debt, so a buyback is likely to increase the company's level of risk. However, if a buyback is properly handled, it should also increase the potential rewards for remaining shareholders, because profits and assets will be divided between fewer shares.

Many investors will welcome a higher level of risk in return for a higher level of likely reward, within limits: good managers should ensure that the levels of risk do not go beyond what the shareholders are willing to accept.

6 Tax implications for the company

There may be a situation whereby a share buyback is claimed to have tax advantages for the company itself. If this is the case there should be an explanation to this effect.

7 Tax implications for shareholders

The tax treatment of different categories of shareholder is likely to bring different interests into conflict. Capital gains tax (CGT) is a complicated area of tax thresholds made even more confusing by the application of devices such as indexation and/or taper relief.

It is probably fair to say that a proportional buyback, on its own, is unlikely to take most private shareholders over a tax threshold but it may do so when combined with other dealings.

As an example: if in the tax year 6 April 2000 to 5 April 2001 a person buys 1,500 XYZ Company shares at, say, £7 and these are then sold as a result of a takeover at just over £12 then the capital gain is £7,500. The threshold is £7,200 so this person is now liable to capital gains tax and any enforced buyback may not be welcome. All tax rules are liable to regular changes.

7.1 Private shareholders non-taxpayers

A non-taxpayer is unlikely to make a return on share dealing that exceeds the CGT threshold. It would be tax efficient but might reduce a small holding into an insignificant holding. In these circumstances a facility to buy out the remaining shares could be offered.

7.2 Private shareholders paying standard rates of tax

A number in this category may exceed the CGT threshold and may, on balance, prefer to receive the return as a special dividend. If not then a share buyback would be tax efficient. A facility to buy out insignificant holdings could be offered.

7.3 Private shareholders paying higher rates of tax

This category may also exceed the CGT threshold but otherwise would probably favour the share buyback.

7.4 Institutional shareholders

Institutions may welcome the opportunity to offload a large number of shares at an attractive price without having to negotiate a price in the open market. They may also be able to take advantage of tax benefits that are not available to the private shareholder.

7.5 Foreign shareholders

Tax agreements between different countries and within foreign countries are likely to influence these holders towards a preference (special dividend or share buyback) that may vary from other categories of shareholders. For example income may be taxed more heavily than capital gains or vice versa.

8 Questions

Private shareholders should formulate suitable questions for the directors in a way that extracts as much useful information as possible. Simple questions put clearly can be very effective and have the added benefit of being understood by fellow private shareholders. Shareholders can then take an informed view about the validity of the director's arguments for the buyback. A selection of these follows.

8.1 Payment of special dividend

Why has the company recommended a share buyback rather than the payment of a special dividend?

8.2 Use of surplus cash

If the company is planning to use surplus cash to buy back its shares will the benefits to shareholders be greater than could be obtained elsewhere?

Would the surplus cash be better spent on upgrading facilities, refurbishing buildings etc?

8.3 Level of borrowing

Is the company planning to increase its debt in order to buy back its shares? If so will the cost of servicing the debt be less than the financial returns per share using the borrowed cash?

8.4 Risk assessment

Are the directors exposing the company (and therefore its investors) to excessive risk by increasing borrowings or reducing cash holdings?

Do the performance targets in the directors' performance incentive schemes take account of any increased level of risk?

8.5 Beneficial takeovers

As an alternative to a share buyback could the company gain a better competitive position by making suitable takeovers?

8.6 Research and development

Has the board fully explored, considered and debated the research and development needs of the company?

8.7 Increase in earnings

What is the expected immediate increase in earnings per share as a result of the buyback?

Will the buyback reduce the longer-term potential earnings per share?

8.8 Share options

Will there be an adjustment of the share options to maintain the proportion of options offered against the reduced number of shares in circulation?

8.9 Price of shares

Why is it thought that the stock is selling well below its intrinsic value? Is there a material fact that has been overlooked by the board but which, has been spotted by the market?

8.10 Chasing share prices upwards

What tactics will be adopted to avoid the situation where the buy back itself forces up the share price significantly only for the share price to fall back after the trade has been completed?

8.11 Overpayment for the shares

There are a number of examples recently where the share price has significantly dropped below the price paid by the company. How will the board avoid this situation?

8.12 Strategy of the company

Share buybacks could be interpreted as a signal that the company is no longer in a growth sector because it is returning capital to shareholders. Would you agree with this or are you confident that the company will continue to generate cash, grow its markets and prosper mightily?

8.13 Share ownership

Will the share buyback shift any group into a position whereby it:

- Becomes a significant holding (e.g. >3%)?
- Technically moves into a takeover bid (>30%)?
- Makes it easier for a management buyout?
- Increases the influence of a dominant shareholder (e.g. taking the company private)?

9 UKSA view

All shareholders should be treated equally and a special dividend should be discussed as an alternative. However, a company is probably justified in buying back its shares if the underlying assets are very clearly worth more than the share price. This is often the case with investment trusts. In order to establish this, directors should be asked pertinent questions.

10 Conclusion

Most of the matters raised in this paper concern those between the board and the shareholders. Appropriate questioning and group action can handle these. However, company law and tax are in the hands of governments and regulating authorities. Frequent changes to policy and rules are difficult to follow. These matters are best handled through representative bodies such as UKSA.

We are indebted to Nick Steiner for preparing the first of a series of information sheets which can be useful to members.

Explanatory notes

1 In this context **surplus** can be defined as having more cash than is required for normal trading purposes. If the cost of equity capital averages 10% to 12% then companies need to earn more than this on their equity capital to be profitable. If at the same time cash is earning a lower rate (e.g. 5% to 6%) and is held in large quantities it will be costing the shareholders more than it is earning them. If the directors cannot identify investment opportunities that will earn more than the cost of capital (i.e. 10% to 12%) then in principle it is probably better that they return the cash to shareholders who can seek to reinvest the proceeds at a better return.

2 The payment of a **special dividend** paid to all shareholders would be based on similar reasoning but there is no change in the number of shares in circulation.