Why I always vote against trading company share buyback authorisations

by Mohammed Amin

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It has become very fashionable for listed companies to repurchase their shares. Even when they have no immediate plans, most listed companies annually seek authorisation from their shareholders to permit share buybacks.

This article explains why, for trading companies, I always vote against such authorisation resolutions. It follows my article on investment trusts which appeared in the May issue. Investment Trusts are different.

Reasons management put forward for share buybacks - one, or both of two reasons are typically offered.

Reduction in excess cash

One of the oddities of listed companies' share valuation is that investors often value cash held by the company at below face value. In other words, if a company holds, say £10 million of cash on its balance sheet, and then “gets rid” of that cash, its market value is likely to go down, but by a lower number than £10 million. Accordingly, the repurchase of listed shares is often justified as a mechanism for the company to return surplus cash to its shareholders. The logic that shareholders having the cash + having shares of a reduced value adds up to more than having the shares of the company with the cash inside it.

Special dividends as an alternative way of reducing excess cash

The main alternative to a share repurchase as a way of “getting rid” of excess cash is a "special dividend." This is simply a cash dividend paid equally on all shares of the company. It is normally referred to as a special dividend to ensure that shareholders do not expect it to be paid every year but instead recognise it as a special event.

Increase earnings per share

The use of company cash to repurchase shares may cause the earnings per share to increase. For example, if a company’s shares are quoted at £20 each, and they trade at a price/earnings ratio of 10, that means that the earnings per share are £2 per share. Interest rates are currently well below 10% p.a. so the interest that the company will be earning on £20 will be less than £2. If that £20 is used to repurchase one share, the arithmetic consequence is that the earnings per share for the remaining shares in issue will now be slightly greater than £2 per share.

Company managements are often keen on such share repurchases because their remuneration targets are often linked to achieving particular levels of increases in earnings per share. I believe that company remuneration committees should always adjust management’s earnings per share targets to exclude any benefit to management from the increase in earnings per share arising from a company share repurchase.

As a justification for the repurchase, in my opinion this rationale is wholly specious. Nothing has changed

about the company's business and the increase in earnings per share is simply an arithmetical consequence of the share repurchase. This rationale for a share repurchase becomes even worse if the share repurchase is funded by extra debt (which inevitably increases the riskiness of the company).

How share repurchases are conducted

There are two basic ways in which a company can buy back some of its shares. They have very different implications for the continuing shareholders. As explained below, in the case of a market purchase the continuing shareholders involuntarily reduce their stake in the company's cash holdings and increase their stake in the company's trading business. In the case of a tender offer, they have a choice.

A tender offer

The company writes to all of its shareholders offering them the right (but not the obligation) to tender a specified proportion of their shares to the company for repurchase.

In that situation a shareholder can either tender no shares, or tender the maximum number of shares allowed under the offer's terms, or tender some number of shares in between. The choice rests with the shareholder. If the shareholder tenders no shares, or indeed tenders fewer shares than the maximum, he is making a conscious decision to increase his fractional holding in the company's trading business compared with the situation before the tender offer, while reducing his fractional interest in the cash that was held by the company.

A repurchase on the stock market

The company can simply go into the stock market and purchase some shares on the market. These shares are normally then cancelled. When a company repurchases shares on the market, all continuing shareholders effectively have an involuntary increase in their proportionate shareholding in the company's business and an involuntary reduction in their proportionate interest in the cash that has been used to make the share repurchase.

Does the price at which a repurchase takes place matter?

My perception is that company management generally believe that, provided the share repurchase price does not materially deviate from the market price, then the price does not matter. In the case of a repurchase conducted by a tender offer to all shareholders, that is obviously correct. Provided something is given to all shareholders equally per share, the price does not matter. For example, with an ordinary dividend or a special dividend the company simply hands over an amount of money per share to each shareholder. However, my perception is that company management take the same attitude, "the market price must be right" when repurchasing shares on the stock market.

This is a dramatically different approach to that taken by individual shareholders. I do not know of any individual investor who, when buying shares, takes the approach that "whatever the market price is, it must be the correct price." Instead individual investors always go through some kind of assessment process of the value of a share (whether a rough and ready mental assessment or a detailed spreadsheet valuation model) and then only buy a share if the quoted market price is below their assessment of the value per share.

This leads me to conclude that company management will typically engage in share repurchases on the stock market at times when share prices are excessively "high" since those periods are typically associated with high profitability and the generation of significant amounts of corporate cash.

At such times acquisitive managements will often also conclude that there are very few corporate targets worth buying and will instead repurchase the company's own shares, justifying it by a combination of the "returning cash to shareholders" argument and the "increasing earnings per share" argument. Conversely, times when stock-market valuations are "low" are likely to be associated with reduced profitability within companies, lower amounts of cash potentially available for share repurchases, and greater pessimism amongst investors and company management deterring management from engaging in stock market share repurchase transactions. Accordingly, I believe that in most cases companies engaged in stock market share repurchase transactions are likely to damage the interests of their continuing shareholders because the repurchases are much more likely to happen when valuations are "high" than when they are "normal" let alone "low."

I have therefore adopted the practice of always voting against giving trading companies' managements the authority to repurchase shares. As a single individual shareholder, my voting will not make a difference but it still makes a "statement".

More importantly, if other shareholders start to focus on this issue, the practice of trading companies will change because ultimately listed companies belong to us, the shareholders, and we collectively have the voting power to compel management to act in accordance with our wishes. That is why I have published this article and encourage readers to share it.

Instead, I believe that if there is genuinely excess cash inside a company, it should be used to pay a special dividend to all shareholders.

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