Share Buyback : A Risky Endeavour

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ABSTRACT

In a buyback programme the excess cash flows are distributed among the shareholders by purchasing own shares generally at a premium. The most common reason for this repurchase is that to disclose to the shareholders the confidence level of companies. The impact of Buyback on share price comes from changes in a company's capital structure and more critically, from the signals a buyback sends. But sometimes this signal can be negative as investors can perceive that the management team sees few investment opportunities ahead, suggesting to investors that they could do better by putting their money elsewhere. So this signal can be risky for the company which has gone for buyback. This paper focuses on the risk aspect associated with buyback of shares which directly reduces equity in the firm's capital structure. Buyback may also lead to abnormal increase of prices posing heavy risk to those who value shares based on fundamentals. This may also lead to reduction in investors' interests in the market particularly with de-listing of good shares.

***Keywords:** Buyback, capital structure, investment, risk*

Introduction

One of the most noteworthy corporate phenomena of recent months has been the increasing prevalence of companies buying back their own shares. Share buyback now a days have become an important part of the corporate restructuring mechanism. In a buyback programme, the excess cash flows are distributed among the shareholders by purchasing own shares generally at a premium. The provisions regulating buy back of shares are contained in Section 77A, 77AA and 77B of the Companies Act, 1956. These were introduced by the Companies (Amendment) Act, 1999. The most common reason for this repurchase is that to disclose to the shareholders the confidence level of the company. By buying their shares at a price higher than prevailing market price, company signals that its share valuation should be higher.

Earlier to 1998 Indian companies were allowed to buy back its shares only for the reduction of share capital or giving relief in appeal of mismanagement and oppression under the company law board order under section 402. In 1998 Indian government on request of the corporate world introduced the concept of buyback of shares.

Since then, several companies have come up with Buyback offers. According to CNI Research Ltd.,[1] "It is

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the ripe time for the promoters to increase stake in their respective companies through the buyback route. The icing on the cake is, of course, that there is no outlay of the promoter's personal funds as buybacks are funded by the companies themselves". The securities can be bought back from existing shareholders on proportionate basis. Open market, odd lots. Shares are bought back by companies because of various reasons like to increase promoters holding and earning per share, support share value and to prevent takeover bid CNI Research Ltd

There are three main benefits to share repurchases.

* Corporate tax savings: Increase in debt amount to buy back shares, borrowed money to lowers its corporate tax bill, as interest is a tax deductible expense.

* *Agency costs reductions: Share prices increase* because the market expects excess cash to be wasted in value-destroying projects. Of course, this assumes that managers are unwilling or incapable of "parking" excess cash in investments that don't destroy value.

Information signaling: To the extent that managers are also owners, buying back stock is, in some ways, a form of indirect insider buying at a premium over the prevailing market price should be a good sign market.

Buyback's impact on share price comes from changes in a company's capital structure and more critically, from the signals a buyback sends. But sometimes this signal can be negative; investors can perceive that management team sees few investment opportunities ahead, suggesting investors that they could do better by putting their money elsewhere. So this signal can be risky for the company which has gone for buyback. This paper focuses on the risk aspect associated with buyback of shares which directly reduces equity in the firm's capital structure. Buyback may leads to abnormal increase of prices posing heavy risk to those who value shares based on fundamentals. This may also lead to reduction in investor interest in the market particularly with de-listing of good shares.

Impact of Share Buyback

The literature has studied many aspects of buyback activity. Some of the topics studied include why firms repurchase common stock, how stock prices react to repurchases and repurchase announcements, and how different repurchase methods (open market share repurchases, fixed-price tender offers, and Dutch-auction repurchases) affect the repurchase experience. Research has clearly shown that repurchase announcements lead to stock price increases. In fact, the market reaction to share repurchase announcements is often quite strong although the size of the reaction can depend on such factors as the form of the repurchase method and the reason for the repurchase. Theory suggests five major motives for firms to repurchase shares of their common stock: to signal positive inside information, to transfer wealth from creditors to stockholders, to change the firm's capital structure, to minimize stockholder taxes, and to fight a takeover attempt. **Chakraborty (2004)** examined the effect of buyback on EPS of the selected companies in India and analyzed the change in their operating profit during the period surrounding buyback so as to offer an explanation to the observed change in EPS of the sample companies as a result of buyback. **Lehi (2006)** investigated the prior record of share repurchases matters in the market reaction to the subsequent repurchase announcements. He find that upon the announcements of share repurchase, stock markets respond more positively to those made by firms that have greater actual repurchases following their previous repurchase plan announcement. **Firth (2005)** examined various aspects of open market share buybacks using data from Hong Kong and the results suggested that the firms initiating share repurchases have surplus cash and are undervalued. He further analyzed that market-adjusted stock returns surrounding the first share repurchase are a function of undervaluation, as proxied by prior abnormal stock returns, and the number of shares acquired.**Nohel and Tarhan** observed the difference between information signaling and free cash flow hypothesis around share buy back and conclude that the positive investor reaction to repurchases is best explained by the free cash flow hypothesis. **Banerjee and Chakraborty (2004)** examined the effect of buyback on EPS of the selected companies in India and analyzed the change in their operating profit during the period surrounding buyback so as to offer an explanation to the observed change in EPS of the sample companies as a result of buyback. **R.L. Hyderabad (2009)** analysed the methods of buyback and examined that open market repurchases have greater signalling ability than the fixed price tender offers in the Indian context.

Risk aspect of the Buyback

Buybacks "give a temporary, one-time artificial boost to earnings, they cause creaky cash-poor companies to load up on debt, leaving them vulnerable should the economy unexpectedly deteriorate and they pulverize credit ratings, causing borrowing costs to soar." Some buybacks are motivated by the aspiration to reduce the number of shares outstanding and therefore increase the earnings per share. Assuming that the firm's price earnings ratio will remain constant, reducing the number of shares will usually lead to a higher price. This provides a simple rationale for many companies going on for equity repurchases.

There is a problem with this reasoning, however, although the reduction in the number of shares might increase earnings per share, the increase is usually caused by higher debt ratios and not by the stock buyback perse. This will lead to increase in riskiness of the company and lower price earning ratio.

Investors Perspective

Majority of investors always perceive that buyback will lead to increase in share prices but the increase or decrease in share price will depend upon whether the company is moving towards its optimal capital structure. In case company moves towards optimum capital structure the price of stock will increase but if the structure is not optimum the price will decrease as the company relies on debt for repurchasing its shares from market.

To illustrate, assume that an all-equity financed firm in the specialty retailing business, with 100 shares outstanding, has Rs. 100 in earnings after taxes and a market value of Rs.1,500 . Assume that this firm borrows Rs.300 and uses the proceeds to buy back 20 shares. As long as the after-tax interest expense on the borrowing is less than Rs 20, this firm will report higher earnings per share after the repurchase. If the firm's tax rate is 50%, for instance, the effect on earnings per share is summarized in the table below for two scenarios: one where the interest expense is Rs 30 and one where the interest expense If we assume that the price earnings ratio remains at 15, the price per share will change in proportion to the earnings per share.

Table 1
Share Price moments before and after by back

	BEFORE REPURCHASE	AFTER REPURCHASE INTERST EXP-Rs 30	AFTER REPURCHASE INTERST EXP-Rs 55
EBIT	Rs 200	Rs 200	Rs 200
-INTEREST	Rs 0	Rs 30	Rs 55
=TAXABLE INCOME	Rs 200	Rs 170	Rs 145
-TAXES	Rs 100	Rs 85	Rs 72.50
=NET INCOME	Rs 100	Rs 85	Rs 80
/SHARES	100	80	80
EPS	Rs 1	Rs 1.125	Rs 0.91

Source: Designed by the author

Realistically, however, we should expect to see a drop in the price earnings ratio, as the increase in debt makes the equity in the firm riskier. Whether the drop will be sufficient to balance or compensate an increase in earnings per share will depend upon whether the firm has excess debt capacity and whether, by going to 20%, it is moving closer to its optimal debt ratio. For executives, the temptation to use debt to finance earnings-boosting share purchases can be hard to resist, too.

Company's perspective

Firms generally choose among several alternative options for their excess cash. These typically include dividend payments, share repurchases, and cash accumulation (no Payout).Considering each of these alternatives show that the value of an investor's holdings is invariant with respect to the choice of payout policy, yet each alternative provides a unique risk-return tradeoff which is reflected in the EPS pattern. These results conflict with the commonly accepted intuition that increasing EPS through repurchase creates economic value for the investor.

The company might believe that the cash flow it uses to pay off debt will continue to grow, bringing shareholder funds back into line with borrowings in due course. If the companies' decision is right investors will be benefited. If they're wrong, investors will suffer. Managers, moreover, have a tendency to assume that their companies' shares are undervalued - regardless of the price. When done with borrowing, share buybacks can hurt credit ratings also, since they consume cash reserves that can serve as a cushion during tougher times.

One of the reasons given for taking on increased debt to fund a share buyback is that it is more efficient because interest on debt is tax deductible, unlike dividends. However, debt has to be repaid at some time and company's position can become difficult because of shortage of cash. In a repurchase, the firm retires safe cash and as a result its assets become more risky. With the increased risk the expected return increases and this is reflected in the higher expected EPS.The key fundamentals in determining success in corporate investment is through rigorous evaluation of company's earning per share can be fully evaluated when earnings and both number and prices of ordinary shares are known in the capital markets.

There is also common apprehension that if companies are allowed to buy back and reissue shares, management may resort to manipulation. They may, through collective trading, depressed prices, create anxiety among investors and tempt them to sell the shares to the company by making apparently attractive offers. Corporate energies may be diverted from the main business of the company to share market games that were hard the more gullible shareholders.

Critics of buy back also argue that when a company buys back its shares, it may make a bargain purchases that give an unfair advantage to the continuing, non-selling shareholders (which typically includes corporate insiders). The underlying premise is that buy back programmes represent a zero-sum game, in which one group (the non-selling group) benefit at the expense of another group (the selling group).

Conclusion:

The Share repurchase strategy has been criticized as (i) an attempt to enhance a droping share price, (ii) a means to mask poor performance and (iii) a sign that management has run out of ideas. This procedure can be injurious to the company's health if it does not have adequate funds to buy back the share and they are replaced by debt. Since a share buy back weakens the company's balance sheet by reducing cash, buying back shares can be downright risky for debt heavy companies. For any company, buy back shift the weighting of the balance sheet toward debt and away from equity. This helps a company post a higher return on equity, but only at the expense of riskier balance sheet.

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