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EQUITY IN A NUTSHELL

LEVEL

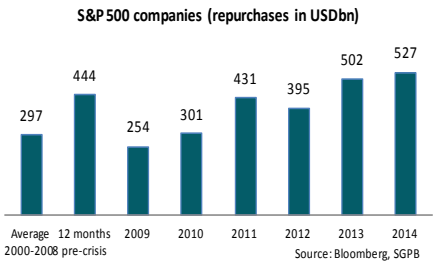
Share repurchases

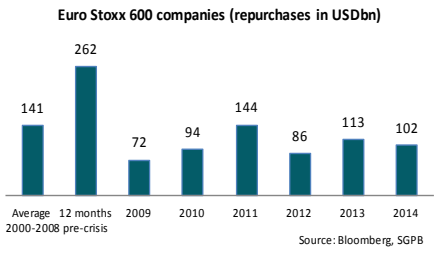
A share repurchase (or "stock buyback") is a transaction through which a company purchases a part of its own outstanding shares. Companies can cancel them, thus reducing effectively the number of outstanding shares. Otherwise, the re-acquired shares become "treasury shares" (or "treasury stocks") with modified properties: they do not pay a dividend and have no voting right. A priori, share repurchases is just another way of returning excess cash to shareholders, like dividends. We will see that repurchasing shares is also motivated by other considerations, is restricted by certain rules and conditions and poses different criticisms and risks.

Let's start with numbers

In 2014, USD 527 bn were spent in repurchases by S&P 500 companies, a record high, and USD 339 bn in dividends, according to Bloomberg data. More than 70% decided to repurchase their shares vs. ~60% before the 2008 financial crisis and ~40% in the early 2000s. In Europe, share repurchases still have not recovered (USD 102 bn in 2014 vs. the USD 262 bn pre-crisis level for Euro Stoxx 600 companies).

In 2015, the biggest part of the approximate USD 2,000 bn in the balance sheets of S&P 500 companies should again go to share repurchases.





Who makes the decision and how?

The board of directors determines the payout policy which includes the portion of earnings that will be paid back to shareholders through dividends or share repurchases. The decision of repurchasing shares is voted by shareholders in the annual general meeting. After the decision to repurchase shares has been made, the company has the choice between using its own cash, issuing new debt, or both, to finance the operation.

Repurchasing methods

• ***Open-market*** is the most widely used method (almost 75% of all share repurchases in the US). It involves purchasing shares directly on the stock market through the course of several months or even years.

• ***Fixed price tender offer*** involves predetermining a particular price at which the shares will be bought, the number of shares and the duration of the offer. If the number of shares tendered by shareholders is below the minimal number of shares sought (i.e. the offer is undersubscribed), the company may extend the duration of the offer or cancel it. If there are more shares tendered than sought (i.e. the offer is oversubscribed), the company repurchases the shares tendered on a pro rata basis.

• ***Dutch auction*** is a more recent alternative to the fixed price tender offer. The company proposes to shareholders a predetermined price range and shareholders need to tender their shares at a price in that range. The purchase price is the lowest price that allows the company to buy the number of shares sought in the offer, and the company pays that price to all shareholders who tendered at or below that price. In this option also, if the offer is undersubscribed, the company cancels the offer. If it is oversubscribed, the company buys less than all the shares tendered at or below the price on a pro rata basis.

• ***Direct negotiation*** is less common. In this method, the company negotiates with a specific shareholder to repurchase its shares. This is mostly used to prevent 'activist' shareholders from getting on board.

Restrictions: the 10% threshold

All share repurchase programmes must be authorised by the relevant market regulator. The company is obliged to disclose details such as the objective of the programme, the purchase price, the number of shares sought, the duration and agenda of the offer etc.

Limitations exist such as the typical 10% self-ownership threshold (the company cannot repurchase more than 10% of its shares on a rolling period), limitation on the duration of the offer and amounts repurchased in terms of trading volume (for open-market repurchases).

Accretion of EPS

The main benefit of share repurchases from a valuation point of view is that they result in the accretion of Earnings Per Share (EPS), as the denominator, number of outstanding shares, decreases.

This will attract new investors who will perceive this operation as an opportunity to buy the share at an interesting price given its new attractive return on equity.

It's about sending signals

Share repurchases are often used to send a signal to the public investors that the company considers its current share price to be undervalued (under its fair price), that it is in good financial health and that it is able to return cash to shareholders. This is aimed at providing a support to the share price. When it is a fixed price tender offer, it gives a clear positive signal: the company wants to reward its shareholders.

Another positive message that is intended to be conveyed to the shareholders is when the company is unable to find any profitable investment opportunity for its excess cash (after meeting working capital requirements, capital expenditure and debt obligations) also called free cash flow, and return it to shareholders instead of 'wasting' the money in projects that will decrease the fundamental value of the company.

Flexibility is the key

Share repurchases can also be an alternative to paying dividends to investors. The substitution effect is largely due to the fact that share repurchase programmes are more flexible.

Indeed, the company can cancel the programme anytime, which is much difficult in case of dividends as companies cancelling or reducing dividends, especially during recession periods, face more adverse market reactions than companies cancelling share repurchase programmes (Subramanian R. Iyer, University of New Mexico, and Ramesh P. Rao, University of Oklahoma: *Share Repurchases and the Flexibility Hypothesis*, January 2015).

Other motivations

• **Employee compensation plans**: It is quite common that companies distribute re-acquired shares to their employees. Typically, this is used as an incentive given to the salaried management of the company (CEO, COO, CFO etc.) through a long-term compensation plan. The purpose is to increase the company's operating performance by incentivising employees with a participation in the capital.

• **Change the ownership structure**: Less frequently, controlling majority shareholders use share repurchases to reduce the number of minority shareholders and better control the company in order to prevent it from receiving a hostile takeover bid.

• **Tax efficiency**: Companies can be interested in repurchasing shares mainly based on an arbitrage between the different taxation rules that exist for share repurchases and dividends. For this reason, it is easy to observe a correlation between the volume of share repurchases in periods when taxation rules are more favourable to share repurchases. For instance, dividends might be taxed at the ordinary income tax rate while repurchases are taxed at a lower capital-gain tax rate. Tax considerations can also motivate some companies to use debt to repurchase shares (e.g. Apple issuing a USD 6.5 bn bond in February 2015 to finance a repurchase programme despite its massive USD 178 bn net cash position as of the end of 2014).

Impact on the equity market

Although there is no precise and effective way to measure their impact on equity markets in the long run, share repurchases have an immediate impact on the evolution of share prices following the announcement: they are globally well received by investors (viewed as reflecting company's view that the stock is undervalued) and tend to push share prices up as the supply of shares available in the market is reduced. Over the past five years, US companies that repurchased their shares outperformed the S&P 500 by 29%.

Not the best use of money?

Share repurchases can face criticisms in various cases and scenarios:

• **Overvalued shares**: When shares are considered overvalued (above their fair price), repurchasing them can be viewed as a poor investment decision, as it destroys shareholders' value.

• **Earnings manipulation**: One could argue EPS accretion does not really increase the fundamental value of the company as it only artificially inflates the EPS by reducing the number of shares. Value creation depends on other factors, such as that the induced higher debt leverage (as the cancellation of shares reduces equity) should translate into better performance of the management of the company, pressurised by the increased debt burden. Also, debt-financed share repurchases can increase, decrease or not affect the EPS, depending on the after-tax borrowing rate.

• **Execution risk**: Although share repurchases offer more flexibility than dividends, they lead to an execution risk that investors might not appreciate. As a result, share price might be pressurised when announced repurchases are not fully executed.

• **Solvability**: If the company does not have solid cash generation, questions can be raised on its solvability (especially when it decides to repurchase shares using debt), as it becomes riskier by increasing its debt leverage (which can imperil the company in case of an economic downturn). As a result, the company can undergo rating downgrades from credit rating agencies.

Conclusion

Over the past few years, share repurchases have provided support to share prices and this should continue going forward.

Is a share repurchase good or bad? Undoubtedly, it is generally welcomed by investors as it is a way of returning cash to them. However, as is often the case in finance, the question does not have a definitive answer.

It is necessary that investors take into consideration factors such as what led the company to return cash to shareholders (is it just to provide a short-term relief to an ailing share price and prop up ratios or does the company genuinely intends to reward shareholders?) and the consequences in terms of leverage and operational performance of the company.