All The Hullabaloo About Share Buybacks

Sometime in 1999, a large Indian company will announce, and complete, a major share buyback program. No, it won't be a software company or a pharmaceutical company - sectors, where current market valuations are hardly cheap. Most likely, it will be a cash-rich company in a cyclical business, whose shares sell well below their fair value. The buyback will be done at a premium to the prevailing market price of the shares and the buyback announcement will be welcomed by the market through an immediate increase in the stock price.

The economic rationale for share buybacks is easy to understand. All companies in the world are essentially in the same business - the business of managing capital entrusted to them. Companies that manage capital well, are rewarded by the markets, through an increase in the market value of that capital. Value is created. Companies that manage capital poorly, are punished by the markets, through a reduction in the market value of that capital. Value is destroyed.

One vital aspect of capital management is how businesses deal with excess capital. Markets reward businesses which return surplus capital to their investors and punish businesses which retain surplus capital. (That is why shares of companies which distribute a large proportion of their earnings to their shareholders as dividends typically sell at high PE ratios).

There are only two ways in which public companies can return excess capital - through cash dividends, or through share buybacks. Before share buybacks were allowed, the only way to return surplus capital to investors was through cash dividends. Share buybacks, then, should simply be viewed as one more way of returning excess capital to investors.

Sometimes it will make sense to return excess capital though cash dividends, and sometimes it will make sense, instead, to buy back shares. When a company's shares are undervalued by the market, share buybacks may make more economic sense than cash dividends. Since the shares bought back are immediately cancelled, the buyback will increase the fair value of the remaining outstanding shares. When a company's shares are fairly valued, or over-valued, then cash dividends may make more economic sense than share buybacks.

Economic rationale, however, is not likely to be the only reason why companies will buy back shares. Some companies may buy back their shares, even though they are overvalued. (What makes economic sense for the promoters, may not make economic sense for other investors.) Doing so will result in a transfer of wealth from shareholders who do not sell their shares to the company at the overvalued price to the shareholders who do. Should market regulators do something to prevent such acts? No, they should not. It is not the job of the market regulators to determine the value of shares of each company. That is the market's job. In the long run, markets will punish companies which buy back their shares at inflated prices for whatever reason.

What should you do when a company announces a share buyback program? If you already own shares in the company, and if you believe the shares to be undervalued, then you should interpret the buyback announcement as good news. If the buyback price is above what you believe to be the fair value of your shares, you should consider tendering your shares in the buyback program, or alternatively, selling them in the market, if the market price has appreciated to around the buyback price. If the buyback price is significantly below what you believe to be the fair value of your shares, you should not tender your shares, but hope that other investors will.

What should you do if you do not own shares in a company which has announced a share buyback program? If the market price of the shares is well below your estimate of their fair value, then you should consider buying shares in this company. By announcing the share buyback programme, the company is signalling to the market something that you already believe to be true - that its shares are undervalued.

The presence of a workable share buyback mechanism will, over time, make the market more efficient, which will result in a more sensible allocation of capital across companies and industries. Over time, markets will learn not to undervalue companies which have demonstrated their willingness to buy back shares whenever it makes economic sense.

Note

Sanjay Bakshi is Managing Director, Corporate Investment Research Private Limited. He can be contacted at sanj@vsnl.com.