The forensics of share buybacks

Companies are increasingly using share-buybacks but who wins and who gains from these transactions? CHRISTINE BROWN looks at the evidence.

SHARE BUYBACKS

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S hare buybacks have grown increasingly popular in the US, so much so that in 1999 the total distribution via share repurchases exceeded that paid out using dividends for the first time. There, under a classical tax system, cash received through a share buyback (for both on- and off-market) is taxed as a capital gain, whereas dividends are taxed as normal income. Thus shareholders in the US would generally prefer to receive a cash disbursement through a repurchase, and it has long been a puzzle to academics as to why US firms pay dividends at all, when they are tax disadvantaged relative to other cash disbursement mechanisms.

The situation in Australia is quite different. Companies were unable to undertake buybacks until 1989, and it was not until after December 1995 when the laws governing buybacks were substantially liberalised, that there were large increases in the number of share repurchase programs.

However, the growth in the dollar value of buybacks has not paralleled that in the US as yet. First, we have a much shorter history of buybacks. Second, dividends are tax-advantaged here because of our dividend imputation system.

An interesting feature arising from the dividend imputation system is that the cash received by shareholders via on- and off-market buybacks is treated quite differently for tax purposes.

The sale of shares to the company via an on-market buyback occurs in just the same way as any sale of shares into the market and the cash received is subject to capital gains tax. In contrast, for off-market repurchases a proportion of the buyback price may be treated as a dividend.

Companies engaging in off-market repurchase programs seek a ruling from the Tax Commissioner, the result of which may be that a proportion of the buyback price can be designated as a fully franked dividend, and the remainder is defined as a capital amount. This structure may have tax advantages for shareholders such that they are willing to sell shares back to the company at a price that is below the market price; shareholders gain from the imputation credits attaching to the dividend component of the buyback and their after-tax position may be further advantaged if there are resultant capital losses.

Trends in payout policy

Table 1 shows the payout of all ASX listed firms over the years 1996-2003. Ordinary dividends remain the dominant form of cash disbursement, although there has been significant growth in the dollar value of repurchases since the easing of the legislation governing buybacks in December 1995. Although there are substantially more on-market buybacks than off-market over this period (some 350 versus 45), the dollar value of off-market repurchases ($12.1bn) over the
sample period exceeds that of on-market repurchases ($10.5bn). Over these years Australian firms have paid out on average 61% of net profit after tax to shareholders either through dividends or buybacks.

Figure 1 shows the equally-weighted payout ratio of all firms listed on the ASX over 1996-2003. Clearly share buybacks have played a role in increasing the average payout ratio of Australian firms, but their importance appears to have diminished somewhat in the last two years of the sample.

### TABLE 1 PAYOUT CHARACTERISTICS OF ALL ASX LISTED FIRMS, 1996-2003

<table>
<thead>
<tr>
<th>Year ($m) (Sum across all ASX listed firms)</th>
<th>1996</th>
<th>1997</th>
<th>1998</th>
<th>1999</th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net profit after tax (NPAT)</td>
<td>35,034.4</td>
<td>40,172.4</td>
<td>39,833.1</td>
<td>38,149.1</td>
<td>60,524.5</td>
<td>62,912.4</td>
<td>57,825.9</td>
<td>63,924.2</td>
</tr>
<tr>
<td>Ordinary dividends</td>
<td>17,746.1</td>
<td>23,605.9</td>
<td>23,472.3</td>
<td>20,948.1</td>
<td>28,284.4</td>
<td>35,734.2</td>
<td>38,383.5</td>
<td>1,986.2</td>
</tr>
<tr>
<td>Special dividends</td>
<td>46.3</td>
<td>31.3</td>
<td>95.3</td>
<td>54.4</td>
<td>307.3</td>
<td>417.5</td>
<td>127.5</td>
<td>260.0</td>
</tr>
<tr>
<td>All dividends (Divs)</td>
<td>17,792.4</td>
<td>23,637.2</td>
<td>23,567.7</td>
<td>21,002.4</td>
<td>28,591.7</td>
<td>36,151.6</td>
<td>38,666.0</td>
<td>32,246.1</td>
</tr>
<tr>
<td>On-market buybacks</td>
<td>6.5</td>
<td>196.4</td>
<td>2,132.3</td>
<td>2,134.4</td>
<td>3,055.4</td>
<td>1,753.1</td>
<td>792.4</td>
<td>402.3</td>
</tr>
<tr>
<td>Off-market buybacks</td>
<td>–</td>
<td>5.2</td>
<td>650.6</td>
<td>679.8</td>
<td>3,708.0</td>
<td>5,715.3</td>
<td>625.1</td>
<td>729.6</td>
</tr>
<tr>
<td>All buybacks (Rep)</td>
<td>6.5</td>
<td>201.6</td>
<td>2,783.0</td>
<td>2,814.2</td>
<td>6,763.4</td>
<td>7,468.4</td>
<td>1,417.5</td>
<td>1,131.9</td>
</tr>
<tr>
<td>(Divs + Rep)</td>
<td>17,798.8</td>
<td>23,838.8</td>
<td>26,350.6</td>
<td>23,816.6</td>
<td>35,355.1</td>
<td>43,620.1</td>
<td>40,083.5</td>
<td>33,378.1</td>
</tr>
<tr>
<td>Divs/NPAT</td>
<td>50.7%</td>
<td>58.8%</td>
<td>58.9%</td>
<td>54.9%</td>
<td>46.7%</td>
<td>56.8%</td>
<td>66.6%</td>
<td>50.0%</td>
</tr>
<tr>
<td>Rep/NPAT</td>
<td>0.0%</td>
<td>0.5%</td>
<td>7.0%</td>
<td>7.4%</td>
<td>11.2%</td>
<td>11.9%</td>
<td>2.5%</td>
<td>1.8%</td>
</tr>
<tr>
<td>(Divs+Rep)/NPAT</td>
<td>50.8%</td>
<td>59.3%</td>
<td>66.2%</td>
<td>62.4%</td>
<td>58.4%</td>
<td>69.3%</td>
<td>69.3%</td>
<td>52.2%</td>
</tr>
</tbody>
</table>


**FIGURE 1 EQUALLY WEIGHTED AVERAGE PAYOUT RATIOS OF ALL LISTED ASX FIRMS, 1996-2003**

**Share Buybacks**

**Buybacks in Australia**

Off-market repurchases can occur at a fixed price or at a price determined by a Dutch auction pricing technique, and they are often structured with offer prices below the market price of the shares at the announcement date.

In the case of Dutch auctions the indicative price range generally has an upper limit below the market price of the shares at announcement of the buyback. Under the rules governing off-market equal access repurchases, a company engaging in an off-market share repurchase can designate the breakdown between capital and dividend components in the buyback price. Then because Australia operates under a dividend imputation system, companies with accumulated tax credits can fully frank the dividend distributing imputation tax credits to participating shareholders, possibly creating capital losses (with resulting tax benefits) for participating shareholders depending on the price at which the shares were originally purchased.

Brown and Efthim (2004) present a model to show that top marginal taxpayers are generally not better off selling shares in an off-market buyback, whenever the buyback price is less than or equal to the market price, irrespective of the breakdown between dividend and capital components in the offer.

The Australian Tax Office has recognised that shareholders on low marginal tax-rates are generally not better off selling shares in an off-market buyback, whenever the buyback price is less than or equal to the market price, irrespective of the breakdown between dividend and capital components in the offer.

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amount, rather than the difference between the buyback price and dividend amount. This may reduce the tax advantages of off-market buybacks, but as quoted in *The Age* the recent CBA buyback appears to be an example that these ATO changes to the treatment of off-market buybacks have not made them less attractive to shareholders.³

Off-market repurchases are fewer in number, but the total payout via off-market repurchases is greater than for on-market repurchases, as shown in Table 1. In addition off-market repurchases tend to be larger: over the sample of on- and off-market repurchases during 1996–2003 listed in Tables 2 and 3, the average percentage of shares bought back was 6.4% and 14.8% respectively.

On-market buybacks are repurchases that can be undertaken by firms listed on the ASX in the ordinary course of trading on the stock exchange, at a price no greater than 5% above the average of the last sale price for each of the past five trading days. Both on- and off-market repurchases are subject to the 10/12 rule; that is, the company is limited to buying back 10% of the smallest number, at any time during the last 12 months, of votes attaching to voting shares of the company, unless by ordinary resolution at a general meeting of shareholders.⁴

What do companies give as reasons for undertaking buybacks?

When companies initially announce to the ASX their intention to undertake a buyback they often include a statement about the motivation behind the repurchase, but not always.

<table>
<thead>
<tr>
<th>Reason</th>
<th>Number of firms</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital management</td>
<td>57</td>
</tr>
<tr>
<td>Improve S and EPS</td>
<td>48</td>
</tr>
<tr>
<td>Improve EPS, net asset backing, S&lt;c&lt;NTA</td>
<td>10</td>
</tr>
<tr>
<td>Excess cash</td>
<td>7</td>
</tr>
<tr>
<td>Extension, DRP, Employee share plan, share accumulation</td>
<td>2</td>
</tr>
<tr>
<td>No reason given</td>
<td>3</td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td><strong>214</strong></td>
</tr>
</tbody>
</table>

TABLE 2 REASONS GIVEN BY COMPANIES FOR ON-MARKET REPURCHASES OVER 1996–2003

When companies initially announce to the ASX their intention to undertake a buyback they often include a statement about the motivation behind the repurchase, but not always.

<table>
<thead>
<tr>
<th>Reason</th>
<th>Number of firms</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital management</td>
<td>21</td>
</tr>
<tr>
<td>Improve S and tax benefits</td>
<td>2</td>
</tr>
<tr>
<td>Enhance shareholder value</td>
<td>2</td>
</tr>
<tr>
<td>Excess cash</td>
<td>2</td>
</tr>
<tr>
<td>Improve EPS and tax benefits</td>
<td>3</td>
</tr>
<tr>
<td>No reason given</td>
<td><strong>30</strong></td>
</tr>
</tbody>
</table>

TABLE 3 REASONS GIVEN BY COMPANIES FOR OFF-MARKET REPURCHASES OVER 1996–2003

As seen in Table 2 for a sample of on-market repurchases over the years 1996 – 2003, the most frequently cited reason is capital management followed by enhancement of shareholder value. Of the 214 companies in this sample however, 43% of companies announcing buybacks to the market gave no reason.

For off-market (equal-access) repurchases, companies also cite capital management as the predominant reason for the buyback as shown in Table 3. Of course, both on-and off-market repurchases can be used to reconfigure the company’s capital structure, with off-market repurchases generally completed in a shorter time frame. The major difference from the company and the shareholder perspective is that an off-market buyback provides the opportunity for the company to distribute franking credits with the distribution, and to effect the repurchase at a price below the market price.

There has been substantial debate in the financial press about whether companies undertaking off-market repurchases are disadvantaging particular groups of shareholders. As stated previously, Brown and Efthim (2004) prove generally that for most off-market buybacks only very low marginal tax rate shareholders would be better off selling via the buyback as opposed to simply selling shares on market. The intuition behind this result is the fact that shareholders are basically trading off capital gains against income that will be taxed at their marginal rate. For high marginal tax rate shareholders, capital gains are treated favourably as compared to income tax.

But how is the wealth of non-participating shareholders affected by the buyback? This is a very difficult question to answer, because the answer hinges on whether the imputation franking credits that the company
holds are valued in the current share price. There is an ongoing debate in the academic literature and amongst practitioners as to whether this is the case. If the dollar value of franking credits that the company holds is either fully or partially embedded in the share price (because shareholders value the franking credits), then the gain to shareholders who do participate in the buyback may come at the expense of those who do not participate. In other words, non-participating shareholders may actually suffer a loss as a result of the buyback, contrary to what many commentators have posited.5

Academic studies
Academic studies into buybacks provide some insights into factors that drive the percentage of shares bought back, and whether we can predict the long-term performance of companies buying back shares from particular market variables. One of the most popular theories is ‘information signalling’. If managers have more information about the company's prospects than outsiders, and they believe that the shares are undervalued, then one way of credibly signalling this undervaluation is to announce and undertake a buyback. If this is the case then we ought to see a positive share price reaction on the announcement day.

Figures 2 and 3 show the share price reaction to announcement of on-market and off-market buybacks. Figure 2 presents the results from a study of on-market buybacks undertaken with data from 1996 to 1998. These figures document the cumulative abnormal returns from 20 days before the announcement to 20 days after the announcement. The abnormal returns on the announcement day are statistically significant for both on- and off-market buybacks, although the returns for on-market buybacks are greater than those for off-market. These results provide some support to the notion that companies may be undertaking buybacks because their shares are undervalued.

Off-market buybacks exhibit an extremely interesting pattern in the abnormal returns, with large and statistically significant abnormal returns on announcement day and the day after, and then large negative abnormal returns four and five days after the announcement which are also statistically significant. A possible explanation for this observation is that the ex-entitlement date is often around five days after the announcement and there is upward pressure on the share price at announcement as superannuation funds increase their holding in the stock in order to take greater advantage of the favourable terms of the buyback.

Theoretical explanations for buybacks in the finance literature could be summarised under the following headings (this list is not exhaustive):
- Information signalling
- Free cash flow hypothesis
- Maturity hypothesis

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**FIGURE 2** ANNOUNCEMENT EFFECTS FOR ON-MARKET BUYBACKS 1996-1998

Source: Lamba and Ramsay, Share Buybacks In a Highly Regulated and Less Regulated Environment, 2003

**FIGURE 3** ANNOUNCEMENT EFFECTS FOR OFF-MARKET BUYBACKS, 1996-2003

SHARE BUYBACKS

- Leverage hypothesis
- Investment hypothesis
- Tax driven
- Dividend substitution.

If a firm has excess free cash flow then returning cash to shareholders might make sense. Indeed a repurchase may signal that the firm’s investment opportunity set is declining and that it is moving to a different stage in its life cycle. When shares fall below some intrinsic value, then a share buyback can be viewed as the firm making a positive net present value investment in itself. The graphs in Figures 2 and 3 are supportive of both the signalling and underinvestment hypotheses for Australian firms.

In fact, for data collected for on- and off-market repurchases over 1996 to 2003, Australian studies find that there are certain financial characteristics of firms that significantly influence the percentage of outstanding shares that are repurchased. These studies show that firms may be using repurchases for signalling purposes, because they face a declining investment opportunity set. Firms may also use repurchases to increase their leverage, and this is supported in some instances by the Australian data. Brown and Efthim (2004) find that off-market repurchases in Australia are tax driven. While firms could use share buybacks as a substitute for dividends, O’Day (2004) finds this not to be the case in Australia.

On a positive note, Lamba and Luan (2004) find that on-market buyback programs have a positive and significant effect on firms’ operating performance. This effect is more pronounced for firms announcing frequent buyback programs.

Conclusions
Share buybacks are a relatively new phenomenon in the Australian market, but have become an increasingly popular mechanism for companies to return cash to shareholders, increase leverage, manage their capital structure, improve EPS, manage the share price when it is trading at a significant discount to the net tangible asset ratio and manage the dilution caused by the issue of new shares in fulfillment of executive and employee share option schemes.

Off-market repurchases are an effective mechanism to pay out excess imputation credits to those shareholders who can use them, but they are not without their critics. Until we know for certain whether the value of imputation tax credits in a company’s Franking Account Balance are reflected (partially or wholly) in the share price, we cannot conclude emphatically that this mechanism of returning cash to particular groups of shareholders (who are advantaged by this mechanism) does not disadvantage non-participating shareholders.

John Ralph, the chairman of Telstra, announced on 21 June 2004 that the Board of Telstra expected to return $1.5 bn to shareholders over the next three years, either through share repurchases or special dividends. An off-market repurchase of $750 million was subsequently announced to the market on 27 September. On 5 October 2004 BHP Billiton announced its intention to buy back between $1bn and $1.5bn via an off-market repurchase. In fact, due to strong demand, on 23 November BHP Billiton announced that it had successfully completed repurchasing $2.272 billion of capital. This tender is the largest repurchase undertaken thus far in the Australian market. It looks like buybacks are here for the long run.

References


Notes
1 First Corporations Simplification Bill, December 1995.
2 For off-market share buybacks of listed company shares, the market value of the share at the time of the buyback should be determined as the volume weighted average closing price (VWACP) of the company’s share on the ASX over the last five trading days before the first announcement of the buyback, adjusted for the percentage change in the S&P/ASX 200 Index from the commencement of trading on the first announcement date (the Opening S&P/ASX 200 Index) to the close of trading on the day the buyback closes (the Closing S&P/ASX 200 Index).
4 Corporations Act, 2001, Section 257B.
5 See, for example, Stephen Bartholomeusz, “Big Australian buyback”, The Age, October 6, 2004.

Under the assumption that the value attaching to the franking credits is embedded in the share price, there may be some shareholders worse off even though the off-market buyback is an effective mechanism to direct the franking credits to those who can use them. Because there is a group of Australian investors for whom participating in the buyback is suboptimal, superannuation funds and low marginal tax rate individuals gain at the expense of this group and the subgroup of foreign investors who would choose not participate in the buyback because the franking credits cannot be used. These subgroups of shareholders lose out because the franking credits are valued and there is an inequitable distribution of these franking credits.