Stock Market Review

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Returning excess cash to shareholders

Successful and profitable companies eventually end up in a situation of generating more cash than they can reasonably reinvest in their business at attractive returns on capital. As cash holdings on a company's balance sheet increase, there is normally increased pressure from shareholders to return some of this excess cash to them.

Cash could be returned to shareholders either via dividends or through share buy-backs. Regular dividends to shareholders are an important feature for investors when selecting companies for their investment portfolio. Dividends are especially sought after by local investors who seek regular cash inflows as another means of supplementing their other forms of income.

While cash dividends from a number of companies are paid regularly and are normally established through a pre-determined dividend payout ratio, the return of excess cash to shareholders in the form of special dividends is less common. In Malta, the only two recent cases of a return of excess cash via special dividends were those of HSBC Bank Malta plc and FimBank plc.

During the period from 2004 to 2007, as HSBC Malta retained too much cash on their balance sheet, a number of special dividends were distributed. This helped improve investor sentiment towards the Bank as investors sought to increase their holdings of HSBC shares to also take advantage of the strong returns by way of dividends to shareholders. This led to a sharp increase in the share price to record levels.

Similarly, although the size of the special dividend was much lower when compared to that of HSBC, the concept was also adopted by FimBank plc in early 2008 when following the sizeable capital gain generated from the sale of the Indian associate company, a special dividend was distributed to all shareholders.

Internationally, some of the larger companies also use special dividends as a means of returning cash to shareholders. In the UK, the retailer WH Smith plc has been adopting this approach coupled with share buy-backs.

Although some company executives may be reluctant to return excess cash to shareholders since this may be interpreted as a failure of management to find other alternatives to grow their business, retaining large amounts of cash may prove problematic and lead to expensive or ill-fated acquisitions. Unfortunately, the most vivid local example that comes to mind is the large investment made by Go plc in the Greek company Forthnet.

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Prior to this investment, Go boasted an enviable balance sheet with a large cash pile and practically zero debt. The cash in Go's balance sheet had accumulated from the strong cash flow generation over the years and especially following the sale of its 20 per cent shareholding in Vodafone Malta Ltd in 2003.

While that cash could have been distributed to all shareholders (including the government) at the time of the government's sale of its 60 per cent equity stake in May 2006, the new board of directors and management team at Go had resisted the many calls from shareholders to return this cash in the form of special dividends. However, the use of the idle cash and additional bank borrowings for the investment in Forthnet was 'sold' to shareholders on the premise that this overseas acquisition could be the only possibility for Go to achieve higher profitability levels in future years. Unfortunately, the opposite has happened and the immense negative impact of this Greek investment over the past three years provides a clear case of the dangers of holding excess cash. The decision by Go to invest rather than return excess cash has been extremely detrimental as evidenced by the loss of shareholder value and the decline in the share price.

In a similar vein, Microsoft shareholders and analysts are placing increased pressure on the company to distribute excess cash. Microsoft pays regular but small dividends compared to its overall cash pile, and the company is regarded as over-paying for acquisitions. This criticism was again leveled at Microsoft following its recent acquisition of Skype for $8.5 billion.

A more popular mechanism used by numerous international companies for returning excess cash to shareholders is by conducting share buy-backs. Buying back shares which are subsequently cancelled implies that a company's profits are distributed among fewer shares. It also results in higher earnings per share over time. Theoretically, a higher earnings per share (and therefore lower price to earnings multiple) should translate into a higher share price.

A major advantage of a share buy-back is that this enables a company to use its excess cash without raising the dividend. Some companies are reluctant to establish a dividend that may not be sustained in the future and therefore companies opt to buy back shares rather than raising a dividend.

A share buy-back is also normally regarded as a signal to the market that a company's shares are regarded as under-valued. This may have a psychological effect on the market. The lower the share price of a buy-back, the greater the impact on a company's return on equity. In fact, last month the Financial Times reported that following the sharp sell-off across equity markets in early August, companies were taking advantage of this development to accelerate the pace of share buy-backs. The article indicated that large multi-nationals that have aggressively steeped up share repurchases include Rio Tinto plc, Glaxosmithkline plc and Vodafone plc. It was reported that Vodafone bought an average of 30.2 million shares per day between 8 and 11 August 2011 compared to previous daily averages of circa 4.4 million shares.

The more publicised share buy-back in recent weeks was that by Warren Buffett's Berkshire Hathaway. As at June 30, Berkshire held about $47.9 billion in cash and following a 20 per cent decline in the company's share price this year, Berkshire issued a statement on September 26 that the "underlying businesses are worth considerably more". Warren Buffett's investment vehicle announced that it will repurchase its own shares provided that it does not pay more than a 10 per cent premium to its book value and also provided that its overall cash position does not fall below $20 billion.

Locally, share buy-backs have never been used by any listed company despite the ability by some companies to conduct such programs. Such a development may prove to be a good tool to inject much needed liquidity into the secondary market. If a company opts to dedicate a small part of its overall dividend distribution or its reserves accumulated over many years to conduct a share buy-back on the market, it will provide a welcome exit route for some shareholders and help improve the two-way market in a company's shares.

On the other hand, the use of the secondary market to conduct buy backs of fixed-interest securities was taken up by two local bond issuers, Gap Developments plc and Pavi Shopping Complex plc. Over recent weeks and months, Gap and Pavi announced that they repurchased €1.05 million and €1.3 million respectively of their bonds for cancellation. This provided an exit route for some bondholders and continuous bidding by such companies on the market also enables other investors to consider following suit in due course.

The more frequent use of buy-backs, in both the equity and the corporate bond markets, is one example of how to create a more liquid market. However, other more permanent mechanisms by allowing market makers to operate would be required for the local financial market to attract increased investor participation and grow further.

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