Stock Market Review

The strategy of share buybacks

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A share buyback is the purchase by a company of its own shares. This is a very common practice by large multinational companies. However, there are mixed views as to whether such a strategy is positive for the company and its shareholders or whether the benefits are purely of a short-term nature.

Public companies usually distribute profits in the form of cash dividends to shareholders while retaining some of the profits in the company, either to improve the overall financial strength of the company or to finance future growth. While some companies find ways of reinvesting most of their retained earnings profitably, others may find that some of their annual retained earnings cannot be reinvested to produce acceptable returns for shareholders. This usually happens in companies or sectors with few opportunities for organic growth. In such cases, share buybacks are used as an alternative and sometimes also concurrently with cash dividends.

Generally, a company can buy its own shares directly from the market or offer its shareholders the option to tender their shares directly to the company at a fixed price. One of the main advantages is that a buyback reduces the number of outstanding shares in issue and assuming that profits will as a minimum remain unchanged, the earnings per share will automatically increase.

Another feature of a share buyback is the positive impact on the share price. An announcement of a share repurchase is usually a strong message of support by the company's management in the future potential of the company.

At times, a company also offers a premium to the prevailing market price. This positively impacts investor sentiment and sends a strong signal to the market that the equity is undervalued. The company's directors and top management are the persons who ultimately know the company in great detail. Therefore such an announcement is positively recognised and given more recognition than that made by any independent analyst of the company. A share buyback programme could be an important corporate action to boost shareholder returns.

In some countries, companies can benefit from tax advantages by adopting a buyback rather than paying cash dividends and this is one of the reasons why some companies prefer larger buybacks as opposed to cash dividends.

On the other hand, one of the criticisms for a buyback is that when a company opts for this strategy, it can portray the message that it lacks investment ideas. Moreover, some argue that share buybacks may be widely used by management to boost their remuneration since executive pay in many countries is dependent on earnings per share and share price targets. A buyback is an easy way of influencing such indicators in the short-term and, as such, some analysts argue that buybacks in certain companies may have been carried out for the wrong reasons.

Other critics believe that a cash dividend on a regular basis is a better way of returning cash to shareholders rather than the buyback strategy. Many multinational companies actually use both approaches and declare a regular cash dividend while the extent of the buyback is determined by the level of excess cash in a particular period and the share price at the time.

Unfortunately, the timing of many company share buybacks in recent years drew criticism from some shareholders and analysts. For instance in the US, the record year for buybacks was in 2007 just before the market correction. The debate on the benefits and drawbacks of share buybacks have hit international headlines again in recent months after two of the largest global IT companies announced record buybacks.

Apple bowed to shareholder pressure in recent months and increased its share buyback programme initiated in 2012 after an activist investor encouraged the company to return more of its huge cash pile to shareholders. Apple is, meanwhile, again under pressure from another investor who recently purchased a stake of more than $1.5 billion. After acquiring this shareholding, this investor openly stated that he will discuss the magnitude of the next buyback programme with Apple's CEO. He also suggested that Apple should even consider borrowing money to increase the buyback.

Moreover, on September 17, Microsoft raised its quarterly dividend by 22 per cent and announced that its Board of Directors had authorised a new share buyback programme of up to $40 billion.

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No local company has so far bought back its own shares for cancellation. In certain cases over recent years, resolutions were approved during Annual General Meetings of some companies in which shareholders empowered directors to repurchase shares within a certain price range. However, none of the companies actually went down this route and no share buyback has taken place as yet despite instances where companies had excess cash reserves and their share price was low. This could have warranted a buyback.

Companies should not resist shareholder pressure to distribute excess cash to them in the form of dividends or share buybacks unless the company is on a clear growth path requiring substantial funds. Leaving too much idle cash in a company could be detrimental over the longer term, especially if these are channelled to other uses and the investment does not achieve the desired results.

Unfortunately, the acquisition by GO plc of a minority stake in Forthnet immediately comes to mind. This investment may have resulted from the necessity to utilise the excess cash on the balance sheet after the company's privatisation and not as a result of a well-planned international expansion strategy for GO. While the timing was very unfortunate, a share buyback by GO would have reduced pressure on management to employ the excess cash outside the company.

In addition to some of the benefits explained above, in the local context, a share buyback would also be welcomed by shareholders generally since it would inject much needed liquidity into the secondary market. The local equity market very often suffers from lack of depth with the larger shareholders generally finding it problematic to sell largish positions. A company repurchasing its own shares would therefore provide liquidity for such investors and the market at large.

An issue that may need to be looked into further, in the event that local companies begin to favour share buybacks, would be the amount of shares held by the public, i.e. the free float.

The Listing Rules of the Malta Financial Services Authority indicating the conditions for a company to be authorised to list its shares, stipulates that at least 25 per cent of the issued share capital must be considered as "free float". As such, the acquisition of shares from the public and subsequent cancellation of such shares by a company could result in such a 25 per cent threshold being breached.

The adequate level of the free float has been debated over the years and different levels ought to be considered depending on the overall size of the company. It would be sensible to consider a lower threshold for companies exceeding a market capitalisation of say €200 million and other thresholds for smaller companies.

The flexibility in this approach may instigate more companies to list their shares on the equity market offering investors a wider investment choice. This is an important consideration ahead of the introduction of the third pillar pension. Having a deeper local securities market is essential for such a pension scheme to be successful.