Stock buy-backs

–

What is a buyback?
A stock buyback is exactly what it says it is-a company buying back its own shares. Investors love it. For several reasons.

First, a buyback, to be effective, has to be at more than market value. So investors gain.

Second, the announcement of a buyback is enough to send the stock up in the market, so investors gain again.

Third, a buyback announcement is a very strong signal from the company management that they believe the market has underpriced its stocks. It is a chest-thumping way of saying that we're better than what the market thinks.

Four, stock buyback effectively sets a floor for the scrip. It's like the management saying--Look, this is what we think our price should be, and we'll buy if it goes below that.

Five, stock buybacks increase earnings per share, which is nothing but the net profit divided by the number of shares. Since the number of shares comes down in a buyback, the EPS obviously rises.

Six, these days many companies offer stock options to their employees, which is nothing but the right to buy stock at a certain price at a certain time. The effect is to dilute equity, that is increase the number of shares, which means a lower EPS. A buyback counters the effect of this dilution.

Restrictions are blamed for the paucity of buybacks in India
Sounds too good to be true? No wonder market bulls kept on telling the finance ministry that the absence of share buybacks was what contributed to the bear market. Well, buybacks have since been allowed in India, but few companies have come forward with buyback plans. Marketmen now say that the restrictions that hedge in

buybacks are too severe.

For example, all shares that are bought back will have to be extinguished, which means they can't be issued again. If this restriction wasn't there, companies could buy their own shares when they are underpriced and sell them when they're overpriced, making a tidy profit. The counter-argument, of course, is that managements would abuse their position, using insider information to manipulate share prices. And secondly, companies that go for buyback have restrictions on tapping the market for more funds. Small wonder that companies are not too keen on buybacks.

But that's not the real reason
Note that the real reason could be very different. At a time when share prices are down it makes sense for company managements to signal the intrinsic price (at which they believe it should trade) of their shares by announcing a buyback when the scrip goes below that price. When prices are quoting at very high valuations, company managements are reluctant to offer buybacks at high prices.

Why is that? Because the real question should be: is a stock buyback the best use for the company's money? In other words, could the company have received a higher rate of return if it had invested that money in some other asset besides its own stock? Analysts say there's a simple way to find that out.

Buyback should depend on intrinsic value of a stock
This is what an analyst has to tell company management. "The rule is to buy back stocks is that as long as you are buying your stock for less than its intrinsic value, you are creating more value for shareholders. Intrinsic value is what a stock is worth, based not on temporary stockmarket bullishness or bearishness, but on the business prospects of the company. The moment you start paying a premium to buy back your stock, you are destroying value. You will then be using company money to buy an asset which is going to lower your rate of return."

Of course, there may be differences about what a company's share is intrinsically worth. Nevertheless, it can be said that in bull markets, when values are inflated, it doesn't make much sense to go in for buybacks. It's the same as using shareholder money to buy an asset

at an artificially high price, thus losing money in the process.

ROCE is a good indicator

The simplest benchmark one can use to see if a buyback adds value is to compare the ROCE (Return on Capital Employed) of the company with its cost of debt. If a company has a ROCE in excess of its cost of debt, it makes sense for the company to take on debt and buy back its equity. This is neither a sufficient condition in itself or for that matter a necessary condition. But ignoring all other factors for the moment this is the best criterion to judge if a buyback adds value or not.