# SHARE BUYBACK: A BLANK CHECK FOR MANAGEMENT?

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## Abstract

This paper introduces the increasing use of share buybacks in western countries with different motivations especially on the part of top management. After exploring the impact of share buybacks on earnings per share and cash, the paper critically examines if it is really a payout in order to return money to shareholders as claimed by some companies. In many cases, there are some traces of management's hidden motivation to use share buyback to their interest rather than the interest of minority shareholders, because most of the decisions are flexible giving choice to management. Finally, the paper suggests shareholders and investors to be careful in making share buyback decisions, and recommends regulatory authorities to be alert and protect the shareholders by tightening their legislation and regulations.

## บทคัดย่อ

บทความนี้แนะนำการซื้อหุ้นคืนที่เพิ่มขึ้นในประเทศตะวันตกด้วยแรงจูงใจที่แตกต่างกัน โดยเฉพาะอย่างยิ่งในส่วนของผู้บริหารระดับสูง บทความนี้สำรวจผลกระทบของการซื้อหุ้นคืนที่มีต่อกำไรต่อหุ้นและเงินสด และยังได้วิเคราะห์ว่าการซื้อหุ้นคืนเป็นการจ่ายเงินจริงเพื่อที่จะคืนเงินให้ผู้ถือหุ้นตามที่หลายบริษัทกล่าวอ้างหรือไม่ ในหลายกรณีมีร่องรอยของแรงจูงใจแฝงของผู้บริหารที่ใช้การซื้อหุ้นคืนเพื่อผลประโยชน์ของตนเองมากกว่าผลประโยชน์ของผู้ถือหุ้นส่วนน้อย เนื่องจากการตัดสินใจส่วนใหญ่มีความยืดหยุ่นจึงทำให้ผู้บริหารมีทางเลือก ในตอนท้ายงานวิจัยเสนอแนะให้ผู้ถือหุ้นและนักลงทุนระมัดระวังในการตัดสินใจการซื้อหุ้นคืน และเสนอแนะให้หน่วยงานที่ควบคุมระเบียบกฎหมายให้ตื่นตัวและปกป้องผู้ถือหุ้นโดยการทำให้กฎหมายและกฎระเบียบรัดกุมขึ้น

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## INTRODUCTION

According to Santicola (2011), there has been a shift in payout policy over the last 15 years with firms opting to conduct stock repurchases over paying dividends. For this paper, stock repurchase or share buyback or acquiring treasury stock means repurchase of shares by the issuing company regardless of the purpose, and these terms would be used interchangeably. Ikenberry D. L. and Vermaelen T. (1996) reports that during 1980s and early 1990s, thousands of US firms announced open market share repurchase programs. Thus, the number of firms that pay dividends has fallen and the number of stock repurchases has increased (Brav, Graham, Harvey,and Michaely [2004] and Fama and French [2001]). In this paper, the authors plan to differentiate between share buyback and dividend payment under payout policy, but have no intention to discuss about the substitution effect; however, the authors want to focus on the flexibility of share buyback programs.

## DIFFERENT MOTIVATIONS OF SHARE BUYBACK

On the part of management, there are different motivations for a share buyback program. Michel, Oded, and Shaked (2010) summarized motivations including signaling undervaluation, payout of free cash, share price support, takeover deterrence, earnings per share (EPS) enhancement, and prevention of dilution resulting from executive compensation. For example, the purpose of share buyback program as authorized by the Fiat Group's shareholders' general meeting on April 5, 2007 was to service stock option plans and to invest surplus funds. (Annual Report, 2007)

Again, they roughly classify the methods of share buyback as open market repurchase (OMR), tender offer and Accelerated share repurchase (ASR). Open market repurchase is a traditional method that usually makes a non-committing arrangement; then starts buying in the open market which usually takes one to three years to complete. Quicker than OMR, tender offer needs to pay a premium above market price depending on the urgency of the program. Like tender offer, accelerated share repurchase (ASR) is quicker but still needs some months to complete and to pay fees to an investment bank for their participation (Michel *et al.*, 2000).

## IMPACT ON EARNINGS PER SHARE (EPS)

A rise in the EPS is one of the spin-offs of share buyback provided that there is no change in earnings or a decrease in earnings proportionately lower than the relative decrease in number of shares outstanding. Proponents of share buyback used to present it as an advantage of attracting the investors, but this advantage is only superficial because substantively it does not reflect the profitability or management effectiveness. To evaluate the real EPS conservatively, it would be advisable to use the number of shares issued (i.e. without the number of buyback shares) because variableness of number of buyback shares would affect the credibility of EPS. The original assumption of calculating EPS is that the buyback shares are not eligible to the earnings. However, there is a possibility that those shares could be sold back in the market again.

Traditionally, EPS is a simple indicator from the point of view of a shareholder, and the figure could be easily looked in the daily announcement of stock market. A superficial investor can be easily swayed by a high or PER which remains constant at least for a quarter or up to one year until net income figure of a new year is confirmed.

On the other side, a rising EPS could create a fall in price earnings ratio (PER) provided market price remains constant or price increase is proportionately less than EPS increase. Besides, PER's effect is different depending on the status of an investor whether s/he is a buyer or a seller. The rise in PER is not favorable to a buyer especially it is coupled with the price rise, unless the entity is fundamentally prospective. However, it is favorable to a seller. When PER falls coupled with EPS rises, the buyer would have an advantage. The seller would have the opposite effect in each case. Trying to manipulate EPS by share buyback is tantamount to create advantage for the remaining (loyal) shareholders (mainly management holding the majority shares) by using the money of all shareholders.

## IMPACT ON CASH

Frequently, surplus cash was often cited as a reason for adopting a share buyback program by management. At this juncture, the question is the sustainability of the cash surplus whether it would be temporary or permanent. There is also another question if the management has ability to determine the cash surplus status. Even if it is determined to be a permanent surplus, it cannot be treated as the last resort to buy back shares since there are so many alternatives to make use of it. A cash-rich entity could think about investment portfolios, focusing on research for future survival, modernizing the technology, etc. It could give not only huge dividends but also special dividends as done by Apple in the past before cash was badly needed for new inventions and investment.

Even when there was definitely cash surplus, many leading corporations tried to preserve it without bothering ways to reduce them. For decades before 2008 recession and afterwards, U.S. companies had been compiling cash with the result that in November 2010, Microsoft alone had $43 billion cash followed by Cisco with $39.9 billion cash, to name a few. The main motivation was to serve for contingency using cash to hedge against risk (Schneiderman, R.M. and Ralph, J. A., 2011). Thus, it is questionable if spending surplus cash, including share buyback, is really a wise business decision.

Whatever the reason, real or imaginative, the approval of the general meeting of shareholders for share buyback can easily be obtained if the majority of shares are held or represented by top management. Hsieh, J. and Wang, Q. (2008) state that management recommends payout decisions to the board of directors who in turn review and approved the proposed policy.

Moreover, these payout decisions are less subject to shareholders' scrutiny and rarely regulated. However, at the time of the approval or at the time of implementation of the program, the financial status of an entity may be high-leveraged, incurring high interest expenses and even low times interest earned (TIE). A study by Lee C-H, Hsieh C., and Peng X. (2005) finds that real estate investment trusts appear to finance stock repurchases by issuing new debt and/or selling assets or investments, instead of using funds from operations. Kook (2010) also maintains that share repurchases use up excess funds, divert funds from internal investments, or cause the firm to incur debt. It is unrealistic to buy back shares while an entity has a large long-term debt, not to talk about short-term. Moreover, it is unreasonable to borrow money to finance share buyback. In fact, availability of surplus cash is only a condition for using cash but should not be a justification or motivation for share buyback.

The real motivation could come from the discretionary nature of management to serve their interest over those of minority shareholders. There are different motivations of management at different times, especially when their bonuses and stock options are linked to EPS. The approval of a share buyback program by general meeting of shareholders authorized by boards usually covers a large number of shares over a certain period as long as three years not only gives managers discretion as to when to acquire shares, but also whether to buy back the number of shares authorized (Ikenberry, D.L. and Vermaelen T., 1996), ultimately like a blank check to be used by management.

Especially, share buyback through open market repurchase (OMR) has no firm commitment on the part of management which, after receiving authority from the board and the annual meeting, waits for the opportunity of their interest to respond quickly. The management just wants to be in a position to legally purchase when the situation is right. Some of the programs are not started, and not all programs are fully completed (Ikenberry *et al.* 1998). The management is allowed flexibility to act such because the share prices may change from expectation at the time of authorization of the program. Share buybacks using OMRs are optional and often only partially executed because OMR takes more time to complete than other methods (Michel *et al.*, 2010). It is normally assumed that management needs to act for the interest of the entity. According to Stephens and Weisbach (1998), only 70-80 percent of the announced value in OMRs is on average actually repurchased, and 5 percent of announcing companies does not repurchase any shares.

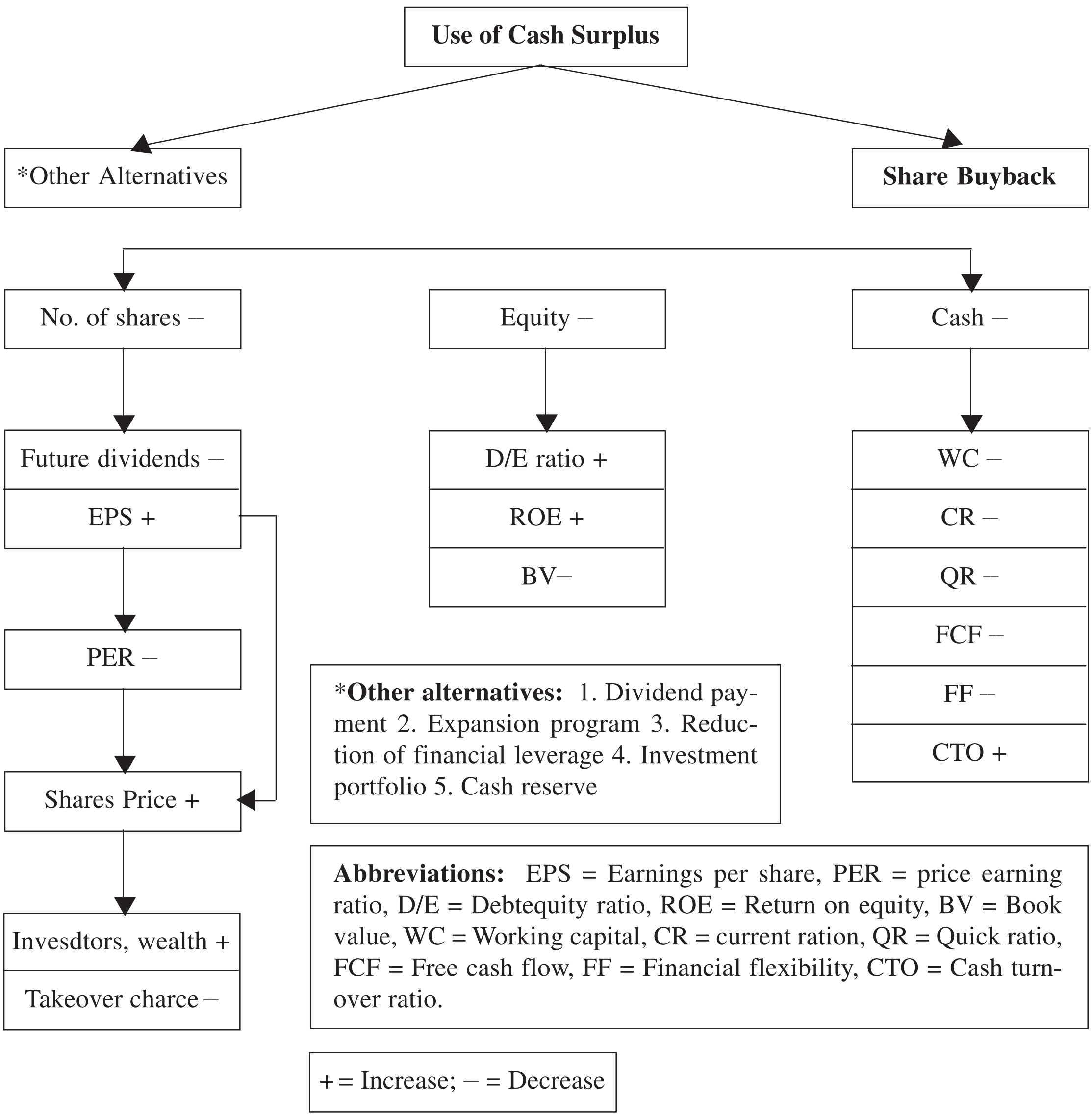
Of course, accelerated share repurchases (ASR) are more committed and more credible than OMR, but lack flexibility in such a way that they have to bear the price risks.

Ikenberry *et al.* (1996) observes that thousands of firms that adopted share buyback programs never completed them for several reasons. In fact, the decision to exercise buyback requires company resources, especially cash. While companies with excess debt capacity, excess cash, few growth opportunities, and potential mispricing would be able to exercise the program, all other companies will follow a wait-to-adopt approach.

The management may defend about the flexibility of share buyback program that can allow it to sell back those shares in the market, hopefully at a profit. Ironically, it could happen that the need to sell back shares comes at the time the business is failing and share prices are falling. It is also possible that hunters for take-over targets may be waiting for that opportunity.

As share buyback programs definitely reduce the cash balance, all cash related ratios will be affected, most of them unfavorably. To elaborate, it will drag down working capital, current ratio, quick ratio, free cash flow and financial flexibility but pop up cash turnover ratio. As an illustration, an impact flow chart of share buyback is shown on the next page.

**Impact Flow Chart of Share Buyback**



## "RETURNING MONEY BACK TO SHAREHOLDERS"

Another argument from the proponents of share buyback program is that shareholders' money is returned to them in a similar effect as the payment of dividends. Of course, it is undeniable that money is returned to shareholders; except that similarity there is nothing to compare between share buyback program and dividend payment.

Dividend payment is a regular activity for a normally successful entity, especially the one that disburses every quarter under a dividend policy and the same level of payout ratio as far as financial conditions allow. But share buyback is a phase-by-phase program covering more than one year. Again, the coverage of dividend payment is an indiscriminating obligation covering all the shareholders whereas the impact of share buyback program is only for those selected shareholders who decide to relinquish their shares. Moreover, the amount disbursed as dividend per share is usually less than par value or originally purchased price while the amount offered for buying back each share is usually around current price, but probably higher. After all, the big difference is that dividends shareholders still retain their right as the owners of the entity, and could expect dividends for the coming years until liquidation or until they sell out their shares.

For the share buyback program, once shareholders sell back their shares, they relinquish their rights as owners including over future dividends of the entity. In fact, the management expels the shareholders by giving a fair compensation mostly out of shareholders' own investment that had been accumulated for a number of years. To be blunt, the management representing the majority shareholders expels minority shareholders by using the money inside the entity, but not out of their own pocket. In fact, the management needs not return money back to shareholders except in the form of dividends. If the shareholders need cash for any reason, they can sell their shares easily in the market at any favorable time and for any required amount.

In one way, it can be treated as internal take-over eliminating the risk of internal revolt. Of course, there are knowledgeable independent directors in the board of directors who can object if they have a heart to, but as long as the entity's internal rules (like articles of association) permit, and securities and exchange commission's regulations allow, they may not be that serious to object that kind of program. One can still argue that majority of the shareholders may also sell part of their shares in the program, but that could be possible so long as it would not affect their majority position being strengthened by the same program, and the number of shares would be naturally negligent.

One of the strongest motivations of share buyback program is to prevent a hostile take-over. Even the threat of hostile take-over could be a cautious anxiety or an imaginary threat, not a real one. By announcing a share buyback program in proper timing, the share prices will increase at least for a certain period. It could also be a management ploy, to pop up the falling prices by buying some shares to provoke the market. Nevertheless, preventing hostile take-over is another way of strengthening their majority shareholding to such a scale that minority shareholders could not challenge effectively in annual meetings.

It could also be argued that the remaining minority shareholders are also better off together with majority shareholders, mainly in the sense that the future profits are shared among them fairly and equally on the basis of their shareholdings. However, the majority shareholders representing management still have other advantages such as executive bonuses and share option plans over and above their complete control of operations. In fact, they are sharing a shrunk business with low equity base due to cash drainage, increasing the debt equity ratio. Some of the buyback programs went so far that the common stock portion of equity was even less than the value of treasury stocks with a tendency to become negative equity but covered up by the retained earnings. The reason is the very high purchase price (although within a certain range of market price) resulting in an unreasonable and exorbitant gap between the par value and purchase price. One excuse for share buyback is to use surplus cash in the entity but it is a controversial evaluation depending upon the opportunities open to the entity, management's vision to expand the business and the corporate life cycle that could be extended through research and successive inventions. In this case, the long term perspective of the management is questionable.

## CONCLUSION

From the above observations, analysis and discussion, it can be concluded as follows:

1. Share buyback programs are adopted with various motivations, some of which declared while others are hidden especially by management.
2. Share buyback programs could enhance earnings per share (EPS) but only as immediate results, not inherently long-term. The enhancement is not because of increase in earnings but because of decrease in the number of shares outstanding, simply a denominator effect.
3. On the other hand, such programs will definitely increase debt/equity ratio, thereby lifting up the financial leverage, finally accelerating liquidity and solvency risks.
4. Practically, such programs are not the real "pay outs" or "returning money back to shareholders" like dividends because these programs eliminate rival or minority shareholders by giving attractive prices.
5. Many of such programs are allowed for long periods, sometimes extended or new programs added giving chance to management to take advantage.
6. Approving such programs by shareholders without proper examining, evaluating and monitoring will be tantamount to giving a blank check to management.
7. Such programs are not business operations but just a financial ploy to create illusion to shareholders or investors.

**RECOMMENDATIONS:**

1. Any securities and exchange commission should consider seriously whether to allow such programs by the companies (although it is already a normal practice around the world).
2. If such programs are already allowed, the financial authorities should consider detail conditions and procedure in such a way that management be unable to abuse to their advantage.
3. The shareholders should be aware of the tricks and traps of management before giving approval to these proposals.
4. If possible, company legislation should be upgraded to provide proper protection for shareholders and stakeholders in order not to be abused or exploited by management by using share buyback programs.

However, the author would like to recognize that there are some regulating authorities that are serious about protecting shareholders relating to share buyback programs, and many companies where managements are sincere about these programs.

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