

Is Buying Back of Shares a Dangerous Financial Strategy?

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Abstract

The motives for the share repurchase is the increase in the value per share, and enhance the price-earnings (P/E) multiples, replenishment of the pool of share available for employee incentive options, prevention of hostile takeovers, and an effective way to return surplus cash to shareholders. Share repurchase programs can convince the capital structure of the company in a more direct way. Buy back stock reduces the market capitalization of a particular company, which makes the company able to strengthen capital gearing ratio as per its preference. The study found that if a company uses buying back of shares as a financial strategy, it will lead to increase in its capital gearing when financing is made for stock repurchase in the form of debt.

Index terms— price-earnings (P/E) multiples, replenishment of the pool of share, financial strategy, it will lead to increase in its capital gearing.

1 Introduction

Buying back of shares means to repurchase of shares by the issuing company at more than the current market price. The shares held through stock repurchase is treated as a treasury stock. Many research papers investigated phenomenon of the buying back of shares and gave its theoretical explanation. Share repurchase activity became a global phenomenon in the late twentieth century. Previously restricted largely to the US, repurchase programs have been widely adopted in Europe and other countries such as Japan (Dhani and Roberts, 2009).

2 a) Literature Review

The discussions of the researchers were centered on two points, such as enhanced flexibility and decrease in tax liability of shareholders. It was pointed out that buying back of shares can eliminate an individual or group of shareholders considered undesirable, avoid earnings dilution caused by either acquisition or exercise of options, act as a profitable investment, and enhance earnings per share (EPS) without altering earnings (Richard and Enorgaard, 1974). It may be taken place in the form of tender offer in which case a company could place shareholders with a formal tender offer, whereby they have the alternative to produce a part or all shares within a specific period, at the predetermined price, usually at premium that is more than the current market price. Buying back of shares can also be made in the form of open market buyback where the issuing company has to declare a maximum and minimum buyback price, while the actual price is determined by the market. The intention to buy back shares is certainly good and aims at improving the market valuations by facilitating more efficient allocation of resources and imparting stability to prices. The reasons for buying back of shares are enhancement of the underlying share value, increase in price-earnings (P/E) multiples, replenishment of the pool of share available for employee incentive options, prevention of hostile takeovers, and an effective way to return surplus cash to shareholders (Mishra, n.d.). Decision regarding buying back of shares instead of enhancement of dividend is positively correlated to executive options and volume of shares repurchased is positively related to the number of options exercisable (Kahle, 2002). Capital gearing is a combination of debt capital and equity capital in a company's capital structure which leads to change in shareholders return due to the variation of sales revenue and earnings before interest and taxes (EBIT). Financial strategy is a future course of actions that a firm or a

business unit adopt for making it profit oriented and it incorporates maintaining of financial flexibility in order to sustain growth and keeping an optimum capital structure.

A company may declare buying back of shares for distributing the cash flow which may possibly otherwise have been made investment in a project with negative NPV or comparatively less profit making investment opportunity. As a result, repurchase of shares by the issuing company lessens the level of cash flow which is available in the managers' hand as well as minimize the agency conflict over the utilization of excess cash flow (Hyderabad, 2009). Buying back of shares can be used to oppose the impacts of higher personal taxes, since more tax rate is applicable on dividend whereas capital gains enjoy favorable tax treatment. It may influence the investors for preferring capital gains on buying back of shares rather than dividends (Hyderabad, 2009). Undervaluation reasons is a stronger signal than other repurchase motivation, and oppose to the forecasting of the standard signaling theories, management statements bear some value for the market (Akyol and Foo, 2013).

3 II.

Buying Back of Shares as a Financial Strategy diversity of interrelated rationales. Some are reasonable advantageous from the shareholders point of view, whereas others are more beneficial when considered from a corporate director's perspective. If share buyback is selected instead of enhanced cash dividend payments, shareholders' payment of tax will be decreased. Buying back of shares program may also increase in EPS. As long as total earnings are uninfluenced by the share repurchase, a lessened number of shares outstanding leads in relatively higher EPS and a tendency on the road to the increase in share market price. Another benefit for shareholders is that a share buyback may be a indication that directors are conveying shareholders that shares are undervalued. Share prices may then increase for the residual shareholders as stock is repurchased. At the same time, those who have their stock repurchased will have a profitable investment opportunity through capital expenditure. It is also mentionable that treasury stock available to the issuing company by stock repurchased can be used in an employee stock option, retirement plan, or other option. Share buying back programs also put forward benefits for the firms. One of these is that account serving expenses can be lessened by eradicated small accounts. The companies which likely to buying back their own shares should possess some criterion. The firms sometimes create significant amount of free cash, have a lower debt as a fraction of total capital, and tend to be owned by individuals and not by institutions. Moreover, the corporations' P/E multiples are generally below the current market average, show large amounts of cash per share on their balance sheet, and have made large divestitures over the previous few years (Reyher and Smith, 1987).

According to the views of some analysts, buying back of shares represents that a firm is relatively mature and, as a result, has a an inadequate number of profitable investment projects for internal investment. Other group of analysts, suggest that constantly buying back of shares with excess funds represents that the firm's managers are not very winning in identifying and pursuing attractive investments. Another disadvantage of buying back of shares can also be connected to risk involved in dealing with either the SEC or the IRS. The SEC may query any transaction if a suspicion is made by the SEC that a firm is manipulating share prices. On the another side, IRS might audit any company suspected of improperly accumulating earnings if the IRS doubts that the firm is buying back in order to avoid taxes on funds usually used for making payment of dividends. In some situations, buying back of shares may work against company creditors, as while share buyback may enhance financial risk to the present creditors as well as bondholders without compensation for the augmented risk. As per the company directors and shareholders, a number of factors influence the outcomes of buying back of shares by the issuing company. For instance, excess cash is available without the requirement for further financing, and a determination has been made that it is a strategic time for repurchase in terms of market situations and stock price, and then the outcomes of buying back of shares may be advantageous. Another factor may be helpful in effective buying back of shares programs are the alternative to pay premiums over market prices to make attraction with buybacks, and buybacks performed independently of other programs. The buying back of shares program may not be adequate enough to attain effective outcomes, and a general market assembly or other situation may cause shares prices to increase before the program is ended. Moreover, there is a possibility that the premiums presented may not be adequate for motivating shareholders to sell their shares.

A firm can use buying back of shares as an effective tool to achieve an optimum capital structure which leads to either the minimum cost of capital for a given level of risk or maximum level of return for given level of risk. It is probable if repurchase of shares is financed in the form of debt capital. The liability side of a firm's balance sheet is influenced by the use of debt capital for buying back of shares in two ways, namely an increase in debt capital and decrease in equity capital. Therefore, a firm shifts closer to its optimum financing ratio (Vermaelen, 1981; Opler and Titman, 1996). Further, decrease in equity capital lessens free float in the market, whereas the risk of a given firm is increased. Both these impacts may play an important role to prevent hostile takeover initiatives by the competitors (Bagwell, 1991 and Dittmar, 2000). A corporation buys back its own share for making adjustment of its debt-equity-ratio. This is a significant reason for buying back of shares in the form of tender offer as a firm characteristically retires a large portion of shares in such type of transaction, and therefore its leverage ratio increases. In case of open market operation, the said motive is comparatively less compelling. Though repurchase of shares in the form of open market buy back has only a little impact on the financing ratio in the short-run, it is likely that a company buy back its own shares in the open market in order to avoid having to make larger adjustments in its leverage ratio. For this reason, a firm may use tiny open market operation as

a means to fine-tune its leverage over a period of time ??Grullon and Ikenberry, 2000). When a firm distributes excess funds to its shareholders, it reduces its equity and enhances its leverage ratio. Therefore, it is assumed that an optimum leverage ratio be present, the given firm may use a stock repurchase to attain such target ratio ??Bagwell and Shoven 1988;and Opler and Titman 1996). A company can repurchase its own stock more if its leverage ratio is below its target leverage ratio. Therefore, a firm's capital structure will influence its decision to repurchase. Ownership of the institutional investor influences the buying back of shares positively that may be explained by the reality that distribution of the on hand free cash flow in the form of repurchases in a means to control the managers and repurchases. It is accounted for the entrenchment power which may be a determinant for the repurchase by enhancing the proportion of manager stockholdings (Houcine, 2013). Buying back of shares programs can persuade a firm's capital structure in a more direct way. Share buying back lessens the market capitalization of a given company which enables a company to increase its gearing ratio as preferred. A firm which believes that it is under-gearred may reduce its level of equity through buying back a portion of its shares. To the extent that a firm uses long-term debt to finance its repurchase program, gearing ratio will make adjustment quickly as level of debt is enhanced, whereas the extent of equity is decreased (Dhani and Roberts, 2009).

III.

4 Conclusion

The motives for buying back of shares are increase in the underlying share value, enhance priceearnings (P/E) multiples, replenishment of the pool of share available for employee incentive options, prevention of hostile takeovers, and an effective way to return surplus cash to shareholders. Buying back of shares programs can persuade a firm's capital structure in a more direct way. Stock repurchase reduces the market capitalization of a given company which makes a company able to enhance its capital gearing ratio as per its preference. A firm which thinks that it is undergeared may decrease its level of equity through buying back a portion of its shares. To the extent that a firm uses long-term debt to finance its repurchase program, gearing ratio will make adjustment quickly as level of debt is enhanced, whereas the extent of equity is decreased. It can be conclude that if a company uses buying back of shares as a financial strategy, it will lead to increase in its capital gearing when financing is made for stock repurchase in the form of debt.^{1 2}

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