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Buyback of Shares in the Indian Scenario

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Abstract

A buyback occurs when the issuing company pays shareholders the market value per share and re-absorbs that portion of its ownership that was previously distributed among public and private investors. In recent decades, share buybacks have overtaken dividends as a preferred way to return cash to shareholders. The present study attempted to know why the company chosee buyback shares. This study aims at identifying the various methods of buyback shares and analysing the buyback shares in eastern countries. This study also analyzes the buyback scenario of the Indian capital market

Introduction

The Buyback of shares is a method of financial engineering. It can be described as a procedure that enables a company to return to the holders of its shares and offer to buy the shares held by them. Buyback helps a company by giving a better use for its funds than reinvesting these funds in the same business at below-average rates of return or going in for unnecessary diversification or buying growth through costly acquisitions. When a company has substantial cash resources, it may like to buy its shares from the market, mainly when the prevailing rate of its shares in the market is much lower than the book value. This mode of purchase is also called shares repurchase. A company can utilize its reserves to buy back equity shares to extinguish these or treasury operations. The former

option reduces the paid-up capital and, consequently, higher earnings and book value per share. Naturally, the market price of equity goes up. The decline in share capital strengthens the promoter's control and enhances the equity value for shareholders. In the latter option, companies buy their shares from the open market and keep these as 'treasury stock'. This enables the promoters to strengthen their control over the shares bought back without any investment. In treasury operations, there is a diversion in the company's funds to purchase shares and a reduction in the equity value for shareholders. The main aim of shares repurchase might be reducing the number of shares in circulation to improve the share price or to return to shareholders resources no longer needed by the company. The shares repurchase may be by purchase from the open market or by a general tender offer to all shareholders made by the company to repurchase a fixed amount of its securities at a pre-stated price.

Statement of the Problem

Buy back in India gained popularity after the amendment of the company Act 1999. After this amendment, many companies used this path to achieve various corporate goals. But the success rate of Buyback is not very high; the impact of a buyback decision on investor sentiment is also not uniform. Fiscal 2017 has been in the news for buyback announcements made by companies. The Government introduced an additional dividend tax on April 1, 2016, in which a dividend received more than Rs.10 lakh was taxed at 10 per cent at the hands of the recipient. This is in addition to the dividend distribution tax, which the company already pays.

During fiscal 2016, the company's lack of expansion plans due to low growth rates of fixed asset creation would also have contributed to though most big manufacturing companies have stayed away from buybacks, except for government firms. Gross fixed capital formation as per cent of GDP for the economy has been coming down over the years and as per CSO's first advance estimate for FY 18, is expected to decline further to 26.4 per cent. In FY 16, it was 29.3 per cent. Also, it would try to understand the motivating factors for the buyback. Many companies spend serious cash for Buyback but fail to support the falling share price. At the same time, company market capitalization also falls. Hence existing shareholders lose their wealth. It is observed that small companies find it challenging to attract shareholders' attention to buy back offers. The study will understand the impact of buy-back decisions on companies of different sizes and industries. Try to understand the

relation between before and after the announcement of taxes and its effect on the size of the amount of Buyback and the number of companies.

Objectives of the study

1. To know the reasons for Buyback
2. To see the financing aspect of the Buyback
3. To understand the different types of buyback methods
4. To know the buyback scenario of the Indian capital market

Review of Literature

The U.S. has the most extended history among the countries that allow share buyback by companies. Share buybacks appeared in the U.S. in the late 1960s and had become very popular by the mid-1980s. The buyback system was not subject to any special federal regulation till 1982, although the U.S. SEC had been contemplating it for a long time[1].It may be pointed out here that companies in the U.S. are incorporated under a particular state's statute and not under any federal statute[2].

The U.S. share buyback system is also the most liberal regime. It allows companies to repurchase shares by borrowing funds, and there is no statutory requirement for the repurchase to be out of reserves or undistributed profits. This means that companies can replace share capital with debt. Further, the shares repurchased are not required to be cancelled in the U.S. and can be re-issued. The buyback system spread to Canada in the early 1980s and grew rapidly[3].

Outside the American continent, share repurchases started in the U.K. in the early 1980s and occurred with considerable frequency. Share buybacks were almost non-existent or very minimum in other European countries until the mid-1990s because governments in these countries either prohibited buybacks or made them unattractive through harsh tax laws. Of the 489 share repurchase announcements made by European firms between January 1980 and June 1998, firms in the UK alone accounted for 60% (293) of such buybacks[4].

The European countries gradually began realising the usefulness of share buybacks in distributing the accumulated surplus cash[5]. They began to relax the prohibition of Buyback. Between 1995 and 2000, share buyback activity increased in many European countries[6].

The worldwide acceptance of share buyback in the 1990s as a tool of corporate finance is reflected in its strong advocacy by *The Economist* in the context of the continental countries of Europe. It is worth quoting as it applies to India also[7]:

"Equity buybacks are a crucial ingredient of efficient capital markets. European governments would do well to realize this".

Share buybacks were permitted both in France and Germany in 1998. From a modest start of only 49 buyback announcements in 1998, the annual average number of buyback announcements in France shot up to about 400 for 1999-2001. Similarly, in Germany, as against a negligible number of 4 buyback announcements in 1998, the average number of buyback announcements has gone up to 55 for 1999-2002. An international comparison of the major industrial countries regarding the volume of buyback activity. As in Europe, share buybacks began to be permitted in the late 1990s in Asian countries. Buybacks were allowed in Japan in 1995, Malaysia (1997), Singapore and Hong Kong in 1998, and Taiwan in 2000.

India recognized the usefulness of the share buyback system in late 1998. Till then, the Companies Act in India had strictly prohibited companies from buying back their shares. Section 77 (1) of the Act stated: "No company limited by buoyancy into share prices because share buyback price is invariably higher than the market price prevailing before the buyback announcement by a company. Business houses lobbied for it with the Government, which readily accepted it and decided to implement it urgently through an Ordinance[8].

Multiple repurchase offers have received less research interest in both US and India. Jagannathan and Stephens (2003) analyse motives and market reactions for a sample of 3,598 distinctive OMR multiple announcements. The study concludes that reasons vary across multiple buybacks. Frequent repurchasers are much larger, have significantly less variation in operating income and adopt higher dividend payout ratios. Systematic repurchasing firms may use regular repurchases as a substitute for increasing dividends but are unlikely to repurchase shares because the firm is undervalued. Smaller firms with potentially high degrees of asymmetric information make infrequent repurchases. Infrequent repurchases tend to be preceded by relatively poor market performance, more volatile operating income, and significantly lower institutional and managerial ownership. Further,

infrequent repurchasers have lower market-to-book ratios, suggesting they are more likely to be undervalued.

The market reactions to the repurchase announcements are consistent with these ideas; infrequent repurchases are greeted much more favourably than frequent repurchases. The announcement of a first or irregular repurchase programme is accompanied by abnormal returns averaging about 3.4%; the subsequent repurchase programmes result in significantly lower abnormal returns. The average abnormal returns around the announcement of the second and third repurchase programmes in five years are only 2% and 1.1%, respectively.

Skjeltorp (2004) analyses the market reaction to share repurchases by Norwegian companies for the 1998-2001 period and finds a statistically significant two-day CAR of 0.88% for 100 companies announcing the first repurchase. For subsequent repurchases, the CAR shows a decreasing trend. The CAR for the second Buyback of 81 companies is 0.39%. The CAR became negative when 22 Norwegian companies announced the 10th Buyback. Howe and Jain's (2006) study share repurchase programmes of banks in the US and find a CAR of 1.86% for the first Buyback, 2.15% for the second Buyback and 0.50% for the third Buyback, which is statistically insignificant.

India has few cases of buyback announcements and academic studies. Gupta (2006) finds a significant CAR of 12.89% for 46 buybacks for a 61-day event. The announcement day average abnormal return (AAR) is 1.68%, effective at 1% level.

Mohanty (2002) analyses 12 buybacks and finds an AAR of around 0.56% on the announcement day and an overall CAR of 11.26% for 61-day event period. Mishra (2005) finds that the positive announcement day returns are not sustained long-term, and the market price in the post-offer period falls to the pre-offer level. Kaur and Singh (2003) and Thirumalvalvan and Sunitha (2006) analyse the market reaction to buybacks in India.

Gupta (2006) attempts his study to find the announcement returns for seven subsequent repurchases. He observes a decline in the AAR for -1, 0 and +1 days for five companies announcing the second repurchase programmes compared to the first repurchase announcement.

Reasons for Buyback

There are a number of reasons why a company would opt for Buyback:

1. To improve shareholders' value, buyback provides a means for utilizing the companies' surplus funds with unpleasant alternative investment options since a reduction in the capital base arising from Buyback would result in higher earnings per share (EPS).
2. It is used as a defence mechanism where the threat of corporate takeovers has become real. Buyback provides a safeguard against a hostile takeover by increasing the promoter's holdings.
3. It would enable corporate to shrink their equity base, injecting much-needed flexibility.
4. It improves the intrinsic value of the shares by the reduced floating stock level.
5. It would enable corporate to use the buyback shares for subsequent use in the process of mergers and acquisitions without enlarging their capital base.
6. The Buyback enables the promoters to increase their voting power and control over the company without any investment.
7. The buyback offer is an exit from an investment for the financial institution. It becomes more economical to sell through negotiated deals.
8. The small investor gets a better price than the market in the tender offer.
9. The company can liquidate an inactive share/stock.
10. Investors can gain from a higher market price due to the buyback announcement reaction.
11. The investors have the choice to decide whether to accept the offer of Buyback.
12. The company enjoys a return on capital employed (ROCE), which is significantly higher than the average cost of borrowing.
13. The market price of the company's share is far lower than its intrinsic value
14. The company wants to prevent tough takeover bids.
15. It is resorted to supporting the share price during periods of temporary weakness.
16. The share buyback can be used to achieve or maintain a target capital structure.
17. It can be used to undertake treasury operations.

Financing aspects of Buyback

Finance is the nerve centre for business activities, and success depends more on the efficient management of funds. To Buyback of shares and securities in large numbers, the company needs vast amounts of capital, which may be mobilized through one or more sources, viz.

1. Internal sources
2. Sufficient cash position
3. Selling of temporary investments with the least possible loss
4. Raising working capital needs
5. Raising cash by issuing fixed deposits
6. Raising by the issue of debentures and loan bonds
7. Cash credit from commercial banks
8. Overdraft from commercial banks

Methods of Buyback

1. **Tender Offer Method**: In this method, it is the company which fixes and announces a price (which will be at a premium over the prevalent market price to act as an incentive to the shareholders to offer their shares for Buyback and also to signify in its opinion, the correct share valuation) at which it is prepared to Buyback at a fixed number of shares determined by it from its shareholders. Suppose the number of shares offered for Buyback by shareholders at this price exceeds the total number of shares determined by the company to be bought back. In that case, shares shall be bought from each shareholder proportionately. In this method, it is permissible for the promoters to offer their shares for Buyback provided specified disclosures.
2. **Open Market Repurchase through Stock Exchange**s is the most commonly practised method. In this method, the company buys shares through the stock exchanges for cancellation till it reaches the maximum number of shares it had initially started to Buyback and cancel. In this method, the price is market-determined, that is prevalent share price on the stock exchange. This method does not enable the company directly signal any undervaluation in the share price, which the tender process permits. By its very nature, this method does not allow any premium payment over the market price for buy-backs. However, it is the easiest method to implement since the company uses the established stock exchange mechanism to buy shares that are then cancelled by it.
3. **Open Market Repurchase through Book Building** This method is popularly known as '*dutch auction method'*. Under this method, the shareholders are invited to quote a range of prices and the number of shares at each price level that they would be interested in offering for Buyback. Based on this information provided by all the quoting shareholders, a standard

price and the respective number of shares against quoted by all the shareholders. The Aggregate, which will equal the total number of shares that the company would like to Buyback, will decide the price and the number of shares to be bought back from the participating shareholders.

Research Methodology

The SEBI's Annual Report on buybacks in India shows that from 2016-17 the number of the company engaged in buyback offers increased from single digit to double-digit, and the size of the amount for Buyback also increased from thousand crores to more than ten thousand crores to keep their Earning per share and avoid taxes. These companies go for these routes in the case of open market operations. The multiple regression tools with dummy variables are applied because of before and after the announcement of the dividend distribution tax and its impact.

Scope of the study

This study is limited to the financial years 2010-11 and 2017-18.

Result and Discussion

Table 1: Impact of DDT

Year	No. of companies Reported (n)	Buyback-open market (BB)	Impact of DDT (X_1)
2010-2011	5	2900.3	0
2011-2012	1	9.62	0
2012-2013	3	191.6	0
2013-2014	7	2913.4	0
2014-2015	4	147.5	0
2015-2016	11	1601.5	0
2016-2017	36	31977	1
2017-2018	51	50220	1

The first thing we need to do is to express dividend distribution tax (DDT) as one or more dummy variables. How many dummy variables will we need to completely capture all of the information inherent in the categorical variable DDT? We look at the number of values (k) DDT can

assume to answer that question. We will need k-1 dummy variables to represent DDT. Since DDT can take two values (before or after), we will only need one dummy variable to define DDT. Therefore, we can express the categorical variable DDT as a single dummy variable (X_1) like so:

X1=0 for before charging dividend distribution taxes.

X1=1 for after charging dividend distribution taxes.

At this point, we conduct a routine regression analysis. No unique tweaks are required to handle the dummy variable. So we begin by specifying our regression equation. For this problem, the equation is:

$$\hat{Y} = b_0 n + b_1 BB + b_2 X_1$$

Where y is the predicted number of companies, buyback value, X_1 is the dummy variable representing Dividend distribution tax and b_0, b1, and b_2 are regression coefficients. Values for Buyback value and X_1 are known inputs from the data table. The only unknowns on the right side of the equation are the regression coefficients, which will estimate through least-squares regression.

Table 2: Regression Result

Model	Unstandardized Coefficients		Standardized Coefficients	T	Sig.
	B	Std. Error	Beta		
(Constant)	.949	.101		9.360	.000
No. of companies Reported	.010	.021	.379	.462	.664
Buyback-open market	1.429E-5	.000	.590	.718	.505
Dependent Variable: Impact of DDT					
Independent Variable: No. Of. Companies Reported, Buyback – Open market					
Multiple R: 0.966					
R square: 0.934					
Adjusted R square: 0.907					
F statistics: 35.329					

R square value (0.934) indicates that the amount of variable explained by the independent variable for 93.2 per cent of the variance in the dependent variable, and remaining 6.6 per cent is by some other unknown variables. The value of F = 35.329 ($p>0.05$) indicates that the model is statistically

significant at 5 per cent level of substantial, and it ensures the regression fit. Hence it is concluded that there are statistically significant differences among variables.
Regression Equation as Impact of DDT = 0.949 + 0.010 (No. of. Companies) + 1.429 (Buyback open market)

Buybacks shares outside India

While studying the buyback shares in India, a quick go-through about the same in Eastern countries like Australia, china, and other countries will give us a better view of it.

In Hong Kong, buyback shares are approved during the shareholder meeting for 12 months. The volume of buyback shares is restricted to 10 per cent of the total share, 25 per cent of the monthly volume. A firm may not repurchase its shares for the month before the annual earnings announcement.

In Australia, buyback shares are approved by the Board and shareholders' meeting within a period of 12 months. Price of the shares is restricted to not more than 5 per cent above the average market price. While financing the share repurchase will not prejudice the ability to pay creditors.

Conclusion

This is perhaps the most critical factor that determines the choice of a company, whether to go for a buyback or a dividend payout. In the Indian context, dividends are subject to taxation at three levels. Firstly, the dividend is a post-tax appropriation; hence, the tax shield is not available to dividends. Secondly, when companies pay out dividends, there is a dividend distribution tax (DDT) that the company has to pay on the dividends paid out. To that extent, it reduces the dividend payable to the shareholder. Effective the Union Budget 2016, there is an additional complication. All shareholders receiving more than Rs.1 million as equity dividends each year will also have to pay an extra 10 % tax. These three levels make dividends quite tax-inefficient for the shareholders. Of course, the small shareholders are not impacted, but large shareholders with substantial holdings are indeed affected. For them, the Buyback is more meaningful as it is also tax efficient, considering that long-term gains are tax-free in the Indian context.

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