Chapter 1

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Chapter—1

INTRODUCTION

1.1 Nature of the problems

The first Indian stock exchange was formed in Bombay in the year 1875. Since then, several other stock exchanges had come into existence in various parts of the country to discharge the important function of transfer of savings, especially of the household sector to companies, governments and public sector bodies. But buyback of shares or buying of its own shares by a company had never figured in the history of stock market operations in India. Moreover, since the enactment of the first corporate legislation of independent India in the year 1956 until recently, a general restriction had been imposed on the Indian companies from buying back its shares primarily because it was apprehended that such a practice, if allowed, might be prejudicial to the interests of the company's creditors and minority shareholders and might facilitate manoeuvring of stock prices and speculative activities in the stock market. However, with a severe downturn being noticed in the capital market operations in India towards the end 1980s and early 1990s, this perception had changed and the regulators, market operators and industry men collectively agreed to introduce buyback in India in order to help revive the sagging capital market. Accordingly, the Union Government promulgated the Companies (Amendment) Ordinance, 1998 approving buyback of shares for the first time in India.

The stock market, today, acts as the predominant source of capital for Indian companies and the success of the companies in procuring such capital depends a lot on the extent to which its management is able to meet the...
expectations of the shareholders regarding the favourable movement of its stock prices. This is because the investors focus on the market price of a company's stock for judging its intrinsic worth as these prices on the floor of the stock exchanges reflect the past performance, earning potential, business risk, capital structure, asset values and future prospects of the company. Thus, it can be said that maximisation of shareholder wealth is the primary objective of a firm and any mechanism that enhances shareholder value should become popular in the corporate sector. Buyback is one such tool which is expected to improve the stock price performance of companies. But it is often argued that the basic objective of improving the shareholder valuation and revamping the sagging capital market by way of introduction of buyback provisions shall be thwarted unless efforts are made to intrinsically strengthen the capital market, improve the standards of corporate governance and enhance the performance of corporate enterprises.

It naturally follows from the above discussion that determining the buyback price can be a critical issue particularly when the intention is to have a positive effect on the market price of shares. Buying back shares at a price higher than its book value may lead to corporate insolvency and the extent of freedom given to companies over determination of buyback price can be a cause of concern to the legislators.

Besides, the literature also cites boosting earnings per share (EPS), restructuring capital structure, increasing promoters' percentage holding, serving as a defence mechanism against hostile takeover bids and channelising investment into more promising sectors of the economy among other benefits of buyback. To what extent any of these factors have motivated the repurchase can be an area of interest to researchers. Moreover, the company management would be interested to know the effect of buying back a certain percentage of outstanding shares on financial parameters of the company and whether its shareholders will be well-off with the buyback activity.
Since buyback enables a company to pay off its surplus cash especially when the marginal return on its funds is relatively lower, the solvency and liquidity position of the company is bound to get affected by buyback. So, prescribing some specific solvency and liquidity norms is necessary in the context of buyback.

The company's creditors have an assurance that they have the buffer of the paid-up capital for their dues in the sense that losses made by the company will not affect the recovery of their dues so long as such losses do not exceed the paid-up capital. Hence, returning capital through buyback could prejudice the interests of the creditors if adequate safeguards are not provided while framing laws governing buyback.

In addition, issues relating to accounting and reporting for buyback and penal measures to be imposed in case of non-compliance with the legal provisions and improper use of the buyback tool need to be given due consideration while dealing with buyback in India.

A more careful insight into the existing Indian position helps in formulating the following issues:

- What is the rationale for buyback?
- Why and how do Indian companies buyback their shares?
- Is there any provision relating to pricing of shares for buyback?
- Where from an Indian company can procure the funds required for buyback?
- Are the companies going for buyback financially sound?
- Is there any specific solvency and liquidity norms required to be complied by the companies after buyback?
- Are the safeguards provided in the law for protecting the interests of the creditors and minority shareholders adequate?
• What would happen if a company announces a buyback but does not go for it? Is there any penal measure to curb such a practice?
• Are the Indian provisions on buyback internationally comparable?
• Are there any loopholes in the Indian provisions on buyback?
• What are the implications of buyback on various financial parameters having a bearing on the prospect of the company?
• Is the empirical evidence consistent with the contention that buyback enhances shareholder wealth?
• What should be the accounting treatment of the buyback transaction? How will the premium paid on buyback be accounted for? How to account for the cost of financing the buyback? What should be the acceptable accounting practices in case the law makers have left these questions unanswered?
• How to reflect buyback in balance-sheet? Does the law provide any specific disclosure norm in this respect? If not, then how to deal with the variations in reporting practices of corporate enterprises in relation to buyback?

Only a few important questions as outlined above have been raised here. Many more similar issues have been addressed in appropriate places. The present study makes an attempt to look into them. In Section 1.3, the objectives of the study have been given keeping in mind these issues. In the next Section, however, we attempt a review of literature to identify the gaps, if any, for justifying the instant research work.

1.2 Literature review

The legislation for buyback of shares has originated in the UK and the USA in 1980s. But it was not until the 1990s that the method of returning value to shareholders began to be widely used in the US and in the UK market.
practice as the end of recession and globalisation and liberalisation of world economies combined during this period to create a build up of surplus cash in the corporate sector. Extensive research work has been carried out in the US and UK to analyse the various pros and cons of the buyback regulations as laid down in these two countries and to examine the buyback practices followed by the US and UK companies.

Ferran (1999) opined that a company whose shares are not actively traded is not an attractive investment prospect to external investors because of the risk of being permanently locked into that investment. Also, the income that would be derived from such an investment may be low, if not minimal, with the bulk of the profits being re-invested in the business instead of paying a higher dividend. Although the other existing shareholders are the persons who are most likely to be interested in acquiring the shares of an investor who wants to leave the company, yet their personal circumstances may be such that they are unwilling or unable to commit more of their own resources to an investment in the company. In such conditions, the risk of being locked into an investment in the shares of a company which are not actively traded is lessened if the company is able to act as an alternative purchaser and, by being able to offer this possibility, companies may find it easier to raise share capital from external sources than would otherwise be the case. Redeemable shares are one such exit option to the external investors who are concerned about becoming locked into their investment. But the main disadvantage of the redeemable shares is that its holders are not absolutely guaranteed of the return of their capital since this will depend on the company having adequate funds at the time of redemption. Being able to sell the shares back to the company in pursuant of buyback offers another option of unlocking the investment. This provides a better exit option than the previous one because it overcomes the fund-adequacy problem associated with the redeemable shares by requiring only those companies having sufficient funds to go for buyback.
Hinkley, Hunter, Whittell and Ziff (1998) examined the prospect of buying back shares where there is an active market in the company's shares. Grullon and Ikenberry (2000) identified the regulatory environment, the level of market prices and the underlying condition of the economy as the factors affecting buyback activities of companies in any particular country. In determining the association between the level of buyback activity and market movements they observed that buyback announcements are inversely related to broader moves in the market i.e., when stock prices fall, announcements of repurchase rise.

It is often argued that instead of signalling through buyback that the company's stock is priced below its true value, the corporate managers could eliminate the pricing discrepancy by simply telling investors whatever good news they have. Yet, market analysts argue that such simple announcements are likely to lack credibility. In this respect, Grullon and Ikenberry (2000) viewed that if the costs of producing misleading forecasts is low, all managers, not just those with good news, have an incentive to tell the market about bright expectations for future earnings. In such an environment, investors cannot rely on any of the announcements they hear since they cannot distinguish between under- and overvalued firms. The finance literature refers to this phenomenon as a pooling equilibrium. In such a market, the investors may underreact to the signal conveyed by the buyback offer and hence share prices may not rise as expected. The news about earnings and true worth of a company, in such a case, shall be incorporated into stock prices only when the actual results are published.

In an attempt to focus more carefully on mispricing as opposed to other reasons for buyback, Ikenberry, Lakonishok and Vermaelen (1995) considered the book-to-market ratios of the companies when they announced their repurchase programs. If the propensity to repurchase shares is related to the
degree of underpricing, one would expect the most undervalued firms among those with high book-to-market ratios to be active in buyback. But their study suggests that the propensity for low book-to-market firms to announce buyback is nearly the same as for high book-to-market firms thereby indicating that companies buyback stock for reasons other than just market mispricing.

Millerchip (1990) and Llewellyn – Lloyd (1994) observed that buyback of shares can prove to be a useful application of surplus cash because it can have a positive impact on some of the performance ratios, namely, earnings per share (EPS) and operating income which are commonly used by analysts and investors to assess how well companies are doing. In support of this contention, Grullon and Ikenberry (2000) quoted a press account published in Wall Street Journal on 6th March, 2000 as follows: “The appeal behind a share repurchase is fairly straightforward. A company buys a portion of its shares outstanding which gives a boost to its earnings per share figures.” However, the empirical results of Grullon (2000) seem to contradict this hypothesis as the study finds a significant decline in operating income as a percentage of total assets post buyback.

It is believed that, as agents of the shareholders, managers work to increase shareholder wealth by always making decisions that increase the market value of the firm. But this view ignores one of the important consequences of the separation of ownership and control in joint stock companies, a concern that dates from at least as early as the 1930s. As shareholders lose control, managers have the ability to put their own interests ahead of their shareholders. For some managers in some circumstances, the perks of managing an organisation are likely to outweigh the benefits of having satisfied shareholders and, in such cases, the extent to which managers allocate capital into unprofitable activities for their own benefit may be a cause of worry for the shareholders. The costs that arise from this conflict between
growth and value maximisation are known in finance theory as "agency costs" of free cash flows. Share buyback is an effective tool for addressing this problem simply because by returning capital to shareholders it reduces the management's ability to divert capital to uses that are not in the best interests of the shareholders. Several research studies have examined this issue of whether share repurchases are at least partly motivated by the agency problems of free cash flow. Lie (2000) observed in this context that firms that announce buyback offers have higher levels of cash than their industry peers and that the market reaction to such announcements is positively related to the amount of excess cash in the announcing firm. Since holding excess cash may give rise to agency problems, Lie's observations clearly indicate that the buyback mechanism is also used by companies to tackle such problem.

The theory says that shrinking the size of the firm via buyback adds value only if the firm is failing to earn its cost of capital on its marginal investments. That is, since buyback is the means of reallocating capital to higher-valued uses, it is expected that the firms announcing share repurchase programs should experience a reduction in their investment opportunities. The empirical evidences reported by some of the recent studies also seem to be consistent with this explanation. In case of repurchase tender offers, Nohel and Tarhan (1998) found that, on an average, companies shrink their asset bases after the buyback transactions. In case of open market buyback programs, Grullon (2000) observed that the market reaction to buyback is negatively correlated with the firm's operating return on investment. In other words, the market reacts favourably to buyback programs announced by companies whose investment opportunities appear to have declined. Moreover, Grullon (2000) reported evidences which suggest that firms making buyback announcements show a subsequent reduction in their capital expenditures. Grullon and Ikenberry (2000) viewed in this light that although repurchases may have the effect of shrinking the size of an organisation, they are certainly not undesirable or
unhealthy, nor should they be considered as a sign of managerial failure or lack of imagination. They are essential to any dynamic economy that hopes to have voluntary reallocations of capital from less productive sectors to more promising sectors of the economy.

The literature also mentions that the buyback tool could be open to a few abuses like insider trading, artificial manipulation of share prices, impediment to market for corporate control, etc. Nevertheless, an analysis of buyback internationally shows that the companies have been known to benefit immensely from it in those countries where share buyback has prevailed for quite sometime. Studies by the researchers in the US have indicated that the stock of an average corporation repurchasing its shares out-performs the rest of the market. Although a number of researches have been conducted in the area of buyback in the West, Grullon and Ikenberry (2000) contended that just as share repurchases grow in popularity and importance, research about how and why firms buyback stock continues to evolve.

In India, share buyback has been permitted since the year 1998. The Securities and Exchange Board of India has laid down the guidelines for listed companies to buyback their shares. The purpose is to allow a company, which is financially strong and has good reserves created out of past profits and/or share premium account, to reduce its base of equity capital without, in anyway, affecting the working of the company so as to reflect the correct financial structure of the company and enhance the value of its equity shares. As the buyback legislation has originated recently in India, not much research work has been done in this area. Majority of these researches are in the form of articles published in journals and elsewhere.

Krishna Murthy (1999) contended that buyback as a financial engineering technique can be effective only if it is followed by strong earnings flow over the short and long term which will lead to multiplication of the share price based
on a higher EPS (due to a lower number of shares outstanding after buyback) and a constant price/earning (P/E) ratio. On the issue of the market responding to the undervaluation signal of the buyback offer, Thakur (1999) wondered whether, in a market where the investors are informed, wise and cynical, it is too much to expect that a simple announcement of buyback will convince them that the company is undervalued.

As regards pricing of shares for buyback, Krishna Murthy (1999) viewed that the buyback price, if different from the prevalent market price, should not be very high since it will have to be sustained by the earnings of the company after the buyback process is completed. In the opinion of Mathur (1999), if the buyback price is much lower than the market quotation of the shares proposed to be bought back, the response of the shareholders to the offer is likely to be very poor and low. As a result, the expenditure incurred in connection with buyback of shares will go waste. Krishna Murthy (1999), however, observed that in case of open market repurchase where buyback takes place at the prevailing market price of the company's shares, the above-mentioned risk of a company-determined incorrect buyback price (i.e., excessive or low) is avoided as it is left to the market forces to assess the strength of the company's future earnings and accordingly vary the market price.

Singh Sisodiya (2000) indicated, while commenting on the justifiability of the buyback decision, that the resolution on the part of the company to go for share buyback does suggest that it may not have any immediate expansion plans or major activities to pursue. In the same context, Khanna (1999) viewed that while some companies are perceived to be cash rich, the markets may actually react adversely to a decision to buyback their shares not because they don't generate cash but because the markets doubt the company's viewpoint that there is not much capital spending in the pipeline. That is, the markets may hold the opinion that investments in their business end up giving higher returns to the companies than what buyback could. Singh Sisodiya (2000), thus, observed that share buyback should be used to serve the long-term interests of the shareholders. Any gimmicks, on the part of a company, could prove to be a costly affair.
Besides, a few other articles have appeared in newspapers—The Economic Times, Business Line, Business Standard and The Financial Express and in journals like The Chartered Accountant, The Management Accountant, Chartered Secretary and Company Secretary (Student Edition) on buyback of securities since its enactment in the Indian Companies Act. These articles primarily deal with the legal provisions and possible implications thereof. However, a systematic research work on the subject has not appeared in published form as yet. Accordingly, the present study aims at fulfilling this vacuum.

1.3 Objectives of the study

In view of the above discussion, the main objective of this study is to examine the procedure and practice of buyback of shares in India in the light of legal provisions contained in the Companies Act, 1956. These include analysis of the adequacy of the procedure for buyback, buyback practices followed by the corporate sector, accounting and reporting for buyback, to mention a few. More specifically, the study attempts to:

- examine the theory underlying share buyback and to look into the developments that have led to the emergence of buyback in India;
- examine the provisions in the statute governing share buyback in India i.e., examine the eligibility criteria for Indian companies to go for buyback, identify the sources from where to procure funds for buyback, analyse the provisions regarding procedure and prohibitions for buyback and determine the scope for imposition of penal measures in case of non-compliance with the buyback provisions;
- analyse from an Indian perspective the share price reaction to buyback and to ascertain the effect of buyback on EPS, profitability, liquidity, promoters' percentage holding and debt-equity ratio of the sample companies through a case study;
- evaluate the accounting and reporting aspects of buyback in Indian context;
• examine the buyback provisions and practices prevailing in other parts of the globe with special emphasis on the scenario in the U.S. and in the U.K. and to compare the Indian provisions with those existing in these two countries;
• identify the problems and prospects of buyback provisions and practices prevailing in India i.e., identify the drawbacks of the buyback tool and the loopholes, if any, in the Indian provisions on buyback, and
• make suggestions and recommendations for effective use of the buyback mechanism and outline a few areas for future research in relation to buyback in India.

1.4 Methodology

The present study is both explorative and empirical in nature. The explorative part examines the concept of buyback, the importance of buyback and the need for its introduction in India. It also discusses critically the legal provisions on buyback prevailing in India and compares the Indian provisions with those existing globally to identify the lapses, if any, in the Indian provisions on buyback. This part of the study is predominantly based on existing literature on the subject. This includes provisions in the Companies Act and other guidelines issued in respect of buyback in India and books and journals published in respect thereof both in India and abroad.

The empirical part analyses the buyback practices in India through a case study. For the said purpose, a sample is selected from the public limited Indian companies in the private sector which opted for buyback of shares during the period 1998–1999 to 2000–2001. For each of the selected companies, a period of three accounting years have been considered — the financial year preceding buyback, the financial year in which shares are bought back and the financial year following that — so that a comparison with respect to several financial parameters and promoters' percentage holding can be made to judge the effectiveness, or otherwise, of the buyback action. Moreover, the case study analyses the share price movement of the sample companies in and around their period of buyback.
In order to carry out the above analysis, relevant data are collected from a number of secondary sources. As for example, the concerned stock market website is searched to study the stock price performance of the sample companies while the effect of buyback on EPS, promoters' percentage shareholding, future profitability and liquidity position and capital structure are studied on the basis of data obtained from the Annual Reports of the selected companies. Suitable accounting and statistical tools are then applied to process such basic data and make logical inferences.

1.5 Hypotheses framed

In the context of the proposed case study, several hypotheses have been framed.

1. Relative gain or loss between tendering and non-tendering shareholders should not be nil in a buyback deal.
2. Buyback does not have a favourable impact on the share price or the movement of the index.
3. Buyback does not lead to increase in EPS.
4. A company's profitability does not improve as a result of buyback.
5. Buyback does not affect the liquidity position of the companies.
6. Buyback does not have any impact on the financial risk of the companies.
7. Buyback does not enhance the promoters' percentage holding.

The hypotheses, thus formulated, have been examined with respect to the sample selected in the manner as mentioned in methodology section above and have been accepted or rejected based on findings.

1.6 Plan of work

In order to achieve the objectives highlighted in Section 1.3, various issues have been framed and examined threadbare chapter-wise. The study
has, thus, been divided into six chapters. A schematic representation of the design of the study is given below.

There may not be any unanimity in designing the break-up (chapterisation) of the instant research work. Nevertheless, keeping in view the overall objectives, we tried to be as rational as possible subject to the approval of the Ph. D. Committee.