CHAPTER 1: INTRODUCTION

- Share buyback: The Concept
- Share buyback in India: Historical Perspective
- The Regulatory framework.
- The present trend of share buyback in Indian and developed countries (like US and UK)
- The Modes of share buyback
- Gap Identified
- Motivation of the Study

1.1 SHARE BUYBACK: THE CONCEPT

Share buyback refers to the process of a company buying back its shares from its existing shareholders (Damodaran, 2008). (Damodaran, 2008) has listed the following impacts of share buyback on a company brought forward here.

- Reduction in cash: Repurchases will result in reduction of the free cash of the company since cash has to be spent to repurchase the shares.
- Reduction in the outstanding shares: Share repurchase results in less number of outstanding shares left with the company since the shares that are bought back, are to be cancelled.
- Reduction in book value of equity: Reduction in outstanding shares will result in a reduction of book value of equity.

2 Ibid 1
• Improvement in EPS: Reduction in the number of outstanding share increases the EPS, provided PAT and preference dividend remain the same.

Companies have the objective of maximizing returns for shareholders. Whenever the return generated by the company is greater than the opportunity cost of capital it is profitable to redeploy these funds. However when the company cannot generate returns greater than its opportunity cost of capital it is preferable to distribute the excess cash to its shareholders either in the form of dividends or may be even in form of share buyback.

Past studies on drivers of buyback like (Badrinath & Ferling, 2001)\(^3\) suggest that firms buyback when they feel that their shares are undervalued or in case when they have to sustain a high leverage ratio, also study by (Weston, 2007)\(^4\) emphasize that a lower debt to equity ratio would lead to a lower cost of capital for the repurchasing firm resulting in a higher share price and value of the firm. Further (Badrinath & Ferling, 2001)\(^5\) also suggest that share buybacks can enhance a company’s earnings per share and it can be an alternate investment when the company has met its capital investment need.

Similar studies on motivation of buyback by (Konan Chan, 2010)\(^6\) have evaluated that share buybacks act as tools to mislead investors. Managers under pressure to boost share price use share buybacks as false signals. In case of longer time horizons share buybacks do not improve the economic performance.

Dividend payout is another factor identified by (Badrinath & Ferling, 2001)\(^7\) where they have found out that the companies repurchased only up to 5% of their outstanding shares and although dividend payout is lower for repurchasing firms it becomes comparable to the firm’s industry group once the buyback program is over. Also (Badrinath & Ferling, 2001)\(^8\) suggest repurchasing firms are trying to match up their EPS with their industry using buyback and there is a modest increase in the debt to equity ratio of repurchasing firms.

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\(^6\) Ibid 5
\(^7\) Ibid 3
\(^8\) Ibid 3
Agency problem is another factor which is studied by (Rodríguez & Yue, 2008)\(^9\) as they have examined managerial opportunism and market response hypothesis both of which predicts that managers will manage earnings down prior to an open market repurchase. Using 2,939 share repurchase announcements between 1980-1999 they find evidence that managers do manage earnings before share repurchase.

The present study is organized in ten chapters. Chapter 1 discusses the concept of buyback, its historical and regulatory perspective in India and share buybacks in developed countries like United States of America(US) and United Kingdom(UK). Chapter 2 discusses the gaps identified, the motivation of the study, the objectives of the study, the hypothesis for the study, review of existing literature, data, data description, the operational definition of variables used and the testing methodology. Chapter 3 compares the regulation of buyback in India with developed countries with special reference to US. Chapter 4 discusses the drivers of buyback in India during the study period with specific reference to signaling, excess cash, capital structure correction, substitute to dividends and lower profitability. The number and volume of share buybacks during the study period is further presented here. The impact of size of firms on buyback drivers is also analyzed in this chapter. Chapter 5 identifies the set of drivers relevant for the two different modes of buyback in India during the study period. The impact of size of firms on the buyback is further discussed here. Chapter 6 discusses the result on the financial benefits if any arising out of share buyback for fixed price tender offer and open market repurchase. Chapter 7 presents the summary of findings for the testing procedures. Chapter 8 presents the objective wise conclusions and the recommendations of the study. Chapter 9 presents the limitations of the study. Chapter 10 discusses the further scope of the study. The study concludes with the references and appendices.

1.2 SHARE BUYBACK IN INDIA: THE HISTORICAL PERSPECTIVE

In 1996, the Indian government and business houses became greatly concerned about the prolonged depression in the stock market. All the efforts of the government to revive the market

had not been successful. Business houses lobbied for it with the Government which readily accepted it and decided to implement it on urgent basis through an Ordinance. (Gupta, 2006)¹⁰

The buyback activity in India stared in 1998. In 1998, section 77A was introduced in The Companies Act 1956, which applies to all types of shares and other securities that may be bought back. With this amendment companies were allowed to buy back their shares, subject to statutory regulations. Companies in Indian may buy back their own shares or other specified securities from the existing security holder on a proportionate basis through the tender offer or from the open market through either book building process or through stock exchange or from the odd-lot holders. India has witnessed 144 share buybacks announcements between years January 2004 to September 2013.(SEBI) Out of these 54 announcements were for tender offer buybacks and 90 were for open market buybacks.

1.3 REGULATORY FRAME WORK OF SHAREBUYBACKS IN INDIA

(Gupta, 2006)¹¹ 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 own shares. Section 77 (1) of the Act stated: “No company limited by shares, and no company limited by guarantee and having a share capital, shall have power to buy its own shares, unless the consequent reduction of capital is effected and sanctioned in pursuance of Sections 100 to 104 or of Section 402.” Such reduction of capital could be effected only after shareholders’ approval through a special resolution and also the creditors’ consent and the court’s sanction.

1.4 THE PRESENT TREND OF SHARE BUYBACK

Studies in the past based in United States like (Bagwell, 1989)¹² suggest that in 1977 in US dividends were the main source to make cash distribution. By 1986 dividend had fallen to 40% of cash distribution. Between 1977 to 1987 dividends grew by 61.3% while share repurchase grew up by 824%. A similar studies like (Weston, 2007)¹³ suggests that from 1984 to 2005 the

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¹¹ Ibid 10


compounded annual growth rate of share repurchase is 11.2% against 7.8% of dividends. Further (Weston, 2007) suggests that fixed price tender offer peaked in 1985 with 35.8% of total repurchase, while Dutch auctions peaked in 1988 at 17.2%. According to (Reimers & Singleton, 2010) between 1994-1999 open market repurchases represent 955 to 98% of the repurchase activity. During this period fixed price tender offer were 1% to 1.5% while Dutch auctions were about 2 to 3% of the total repurchases. Also other authors like (Reimers & Singleton, 2010) have seen that although the stock market started declining in 1999 and accelerated in 2000 still some buybacks continued in this time interval. In late 1990s share repurchases increased 25 to 30% of cash dividends.

Figure 1: Time series plot of Buyback Activity in US between 1972-2005

Figure 1 represents the 33 years times series plot for the buyback activity in US. Till 1994 we see minimal activity in buybacks in the United states however after that there has been an increasing trend.

Source: Plotted in SPSS using Buyback data from SEC website. (Year 1 is 1972)

14 Ibid 13
16 Ibid 15
Studies in united kingdom like (Rau & Vermaelen, 2002)\(^\text{17}\) examine the motivation and consequences of share buyback in U.K. In U.K. tax and regulatory framework is different than U.S. Companies are not allowed to buy back when managers have superior information about future earnings. Tax treatment of dividend and share repurchase changed on several occasions during the study. As per Securities data corporation (SDC) only 489 repurchases have taken place from January 1980 to June 1998 by European firms. The reason for lack of European repurchase activity are:

1. In some European countries share repurchase was illegal till recently.

2. In countries where tax on dividends is higher and low on capital gain specific provisions discourage buybacks.

3. In many European countries companies do not have to disclose share buyback authorization. Share buyback are only mentioned in annual reports.

4. European corporate culture is more of stakeholder value maximization hence they are not interested in buybacks.

In September 1994 investment banks introduced agency buyback. Agency buyback are open market repurchase that are purely tax driven, where the seller is aware that he is selling to the corporation. In October 1996 tax authorities abolished the loophole in tax making open market repurchase tax inefficient. The study by (Rau & Vermaelen, 2002)\(^\text{18}\) suggest that tax changes have major implication on the importance and method of repurchase. In between September 1994 to October 1996 there was only one tender offer. When all tax incentives were abolished in 1997(even with dividends) share repurchase became attractive again. A similar study suggests that corporate payout policy is sensitive to tax law changes in U.K. (Dharmawan, 1997)\(^\text{19}\) have investigated the managerial view on share buybacks, the underlying motivations, expected share price response to their announcements and reasons for current conservatism towards undertaking buy-backs. Responses on motivation are different across five types of buyback. In case of open market


repurchase information signaling represents the motivation. The questions addressed to the managers were

1. What are the motives of share buy-backs?
2. Why are share buy-backs not popular in Australia as in United States (US)?
3. What is the expected share price response to a share buy-back announcement?
4. Have recent Corporation law amendments altered management’s perception of the merit of share buyback.

Reasons for survey on corporate management are firstly the Australian corporate cultural and legal context differs from the US environment. Secondly as the share buybacks have only been permitted from November 1, 1989, limited research has been conducted in Australia. Thirdly various claims have been made for and against share buybacks and it is necessary to ascertain management’s view on those claims. Finally the survey assesses whether recent legislative amendments to the buyback provisions have impacted upon management’s perception of the merit of share buy backs.

The study hypothesized that firstly the motivations identified are considered to be important to corporate management. Secondly there are differing degrees of importance between various motivations. Thirdly there are differing degrees of importance for the motivations across the different types of buy-backs. Finally management motivations differ between companies that have conducted buy-backs altered their articles of association and random sample. The motivations were listed into five categories namely

- Excess liquidity (surplus cash effect),
- Capital structure (leverage effect),
- Information signaling (investment effect),
- Wealth transfer (expropriation effect) and
- Miscellaneous motivations (other effects).

Excess liquidity (surplus cash effect) was measured by dividend –v-capital gain(personal tax savings) and return of surplus capital. Capital structure (leverage effect) was measured by gearing (corporate restructuring). Information signaling (investment effect) was measured by signal future expectations (underpricing), limited investment(less speculative opportunities), limited growth opportunities and declining (improve) financial performance. Wealth transfer (expropriation effect
was measured by removal a major (minor) shareholder and defense against a potential takeover offer. Miscellaneous motivations (other effects) include poor economic activity, illiquid (non-existent) market, administration burden on registry and removal of subsidiary’s shareholding in parent.

Other studies like (Guthart, 1967)\textsuperscript{20} tried to investigate the reasons why companies repurchased their own shares. His sample consisted of 20 companies which had repurchased 10% or more of their outstanding shares during the past decade. The motives to repurchase were identified as desire to reduce the equity base, to prevent expansion in equity base, good investment, support to market, eliminate small stockholders and gain to improve control.

Similarly (Baker, 1981)\textsuperscript{21} examined management’s view on share buyback in the U.S. This study attempted to document the reasons underlying the current proliferation of common stock repurchases and to compare the rationale of financial managers with theory. Although many theoretical reasons exist for corporations repurchasing its own stock, the relative importance of these reasons may change over time. Consequently, changing market conditions may cause managers to rank certain theoretically correct arguments as unimportant in the repurchase decision.

- One often mentioned reason for stock repurchase is that management may feel that buying its own stock is an effective means of utilizing idle cash.
- Companies also repurchase share for merger and acquisition purpose.
- Companies may also consider repurchasing to adjust their leverage position.
- Repurchasing shares may also create additional demand in the marketplace and thus provide price support or yield a higher price.

Numerous other reasons cited in the literature for share repurchase include

- eliminating a large block of stock overhanging the market,
- thwarting an attempted takeover,
- reducing the number of small investors to lessen servicing cost and obtaining greater control of the company,


• serving as a substitute for paying dividends, fulfilling stock option and employee stock purchase program, and
• using the reacquired stocks for the conversion of convertible preferred or debentures.

To determine the underlying reasons for the current trend in stock repurchase a survey of the chief financial officer of two groups of firms repurchasing and non repurchasing firms were performed. The repurchase group consisted of a random sample of 150 NYSE listed firms. The non-repurchasers consisted of a random sample of those NYSE firms not on repurchase list. The response rate was quite high, 48.7 percent (73 out of 150) for the repurchase group and 42.0 percent (63 out of 150) for the non-repurchase group.

Authors like (Tsetsekos, 1991) conducted a comprehensive survey of the stock repurchase programs of major U.S. corporations. In this study financial executives were asked which factors they considered most important in their stock’s repurchase decision. The specific objective of the research was (1) to ascertain from a set of predetermined responses to the precipitating circumstances or factors leading to the adoption of stock repurchase programs; (2) to identify the primary motivations for firms adopting repurchase programs; (3) to examine the prevailing methods used to finance stock repurchases; (4) to assess the perceived success of repurchase programs; and (5) to gather opinions relating to the repurchase of shares.

A total of 1,000 firms were selected to participate in the study, including the fortune 5000 industrial firms and 500 firms selected from the compustat database.

Studies conducted have tried to list the common methods of buyback. One of such study by (Tsetsekos, 1991) lists the methods used to repurchase stock as

1. Open market repurchase
2. Tender offer
3. Open market repurchase and other (exchange, unsolicited block, private placement)
4. Unsolicited block purchase
5. Individual share purchase

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23 Ibid 22
6. Others (private placement and combination of tender offer and open market repurchase)

Further (Tsetsekos, 1991)\textsuperscript{24} lists the reasons for ongoing repurchase program as

1. Employee Bonus or stock option plans
2. Good investment of excess cash
3. Possible acquisitions
4. Stock dividends
5. No answer

Also (Tsetsekos, 1991)\textsuperscript{25} lists the reasons for not repurchasing stocks as

1. No Excess cash
2. Stock not needed for Employee benefit plans, acquisition or other purpose
3. Forbidden by a constraint
4. Not an attractive investment
5. Current debt level too high
6. Optimal capital structure required more, not fewer, shares outstanding
7. Others
8. No answer

Few studies like (Tsetsekos, 1991)\textsuperscript{26} also lists the disadvantages of stock repurchase as

1. Reduces equity capital which may be detrimental to the capital structure or impair debt capacity.
2. Reduces funds for future growth, dividends, or other investments.
3. Implies lack of internal growth or better investment opportunities.
4. Provides no disadvantage under the right circumstances.
5. Appears as a manipulation
6. Results in accounting problems.

\textsuperscript{24} Ibid 22

7. Affects stock price adversely.
8. More costly than issuing new shares.
9. No answer.

1.5 MODES OF BUYBACK

There are several modes of share buyback for example it is briefly summarized in (Subramanyam, 2008)\textsuperscript{27}. The list of these three modes is presented below.

1. Repurchase Tender Offer: The firm specifies a price at which it will buy back shares, the number of shares it intends to repurchase and the period of time for which it will keep the offer open. It invites shareholders to submit their shares for repurchase. It has the flexibility to cancel the offer if sufficient number of shares is not submitted for repurchase. At the same time it can extend the offer beyond the original specified time. Tender offers are the most expensive form of share repurchase. (Medury, 1992)\textsuperscript{28}

2. Book Building method: It this process shareholder is invited to put in bids for repurchase of their shares. The maximum price allowed for buyback should be specified by the board resolution. The company in its announcement should tell about the maximum price, the number of securities it intends to buy back and the method by which shareholders can bid. The company fixes the buyback price based on highest bid price received from the shareholder.

3. Open market repurchase: Firms that intend to buy a small percentage of the outstanding stock can buy it from open market repurchase (Aaquith & Jr., 1986)\textsuperscript{29}. Here the firm pays the prevailing market price to the stockholders rather than paying any premium as required in tender offer. The firm need not show its intent to buyback its share in market. Another advantage of open market repurchase is that the repurchase is spread over a long time period. (Medury, 1992)\textsuperscript{30}


\textsuperscript{29} Aaquith, Paul and David W. Mullins Jr. 1986. Signalling with dividends, stock repurchases and equity issues. Financial Management. 15(3) : 24-44

It is believed that signaling effect of tender offer is more pronounced than open market repurchases due to its size and the premium associated (Medury, 1992). In India there is no restriction on the method of repurchase. The companies are free to deploy any of the methods provided they appoint one merchant banker for the same.

1.6 GAP IDENTIFIED
The study in India does not empirically test any of the reasons for buyback. The author has analyzed some ratios for the buyback candidature but did not make any attempt to test the impact of these ratios on the incidence of buyback. The findings of the author need to be empirically tested to arrive at sound conclusions. Other study talks only about the impact on the share price post buyback announcement for open market repurchase while tender offer is not separately studied. In the present study we are concerned with identifying the drivers of buyback and also relating it to the mode of buyback. The share price performance also has to be studied but separately for open market repurchase and tender offer.

1.7 THE MOTIVATION BEHIND SELECTING THE TOPIC
Studies conducted in India so far have not analyzed the drivers for share repurchase and furthermore no study so far has analyzed open market repurchase and fixed price tender offers separately. Hence there arises a need to conduct research in the present area.

- US has less restrictions for buyback than India like raising debt for buy back, no cancellation of bought back shares and no fixed duration for buy back. There is no evidence in literature that draws lessons from the regulations of developed nations for Indian set up. The study by (Gupta, 2006) suggests that the US regulation is very liberal towards the buyback companies.

- Studies on Buy back conducted in India so far have not analyzed the relative importance of drivers for share repurchase in India. (Mishra, 2005) Suggests that signaling is the most prevalent use of buybacks but its misuse can lead to huge penalty. While buyback

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31 Ibid 30
brings a lot of movement in the capital market it also costs a lot. Companies need to think about the appropriate need for returning the shareholders money through buyback against reinvesting it in the business.

- So far in India literature does not have evidence to the analysis of drivers for different modes of repurchase like open market repurchase or fixed price tender offers separately.

- There are very few studies which measure the financial gains of share repurchase for shareholder and promoter in India. (Mishra, 2005)  

  Find that share buybacks have not been very successful in yielding return to its shareholders. (Mishra, 2005)  

  suggests that share buybacks have been tools to increase the promoters stake. (Banarjee, 2014)  

  Suggests that promoters often use share buybacks to consolidate their holdings.

34 Ibid 33
35 Ibid 33