Financial Decisions

9 Dividends v. Share buy-backs

1. Reasons for stock Repurchases
2. Effects of stock repurchases
3. Practical aspects

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References:

Ross, Westerfield Jordan: Ch. 14
Emery, Finnerty & Stowe: Ch. 17
Shapiro & Balbirer: Ch. 15

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Stock Repurchase

A way for a firm to distribute cash to shareholders by buying back its own stock. The share repurchase is essentially a liquidating dividend for those stockholders who opt to sell their shares.

1. Reasons for Share Repurchase

- **Tax Assymetries**
  - Dividends are taxed as ordinary income
  - Repurchases are taxed as capital gains
  - Repurchases are optional and allow timing advantage
- **Signal of Management's Confidence**
  - Signals shares are currently undervalued (most common reason)
  - Signals corporate governance: management prefers not to keep idle cash or invest wastefully
    - » Jensen's free cash flow theory
- **Give one time cash without increasing dividend level (no future expectations)**

Example: Michelin & Cie (Les Echos May 2, 2005)

- Gave the following reasons for Buybacks
  - Activate the share market or its liquidity through a Investment Service Agency
  - Using the shares to pay for mergers and acquistions
  - For convertible debentures
  - To give to directors and managers on exercise of stock options
  - To annul the shares to optimise own funds and to “manage” EPS

Factors Influencing Share Repurchase

- Reaction of investors
  - Consolidate insiders' control position
  - Executives with options prefer it
    - Buybacks leave price constant or signal increases
    - Dividends would lead to temporary lowering of price
- Impact on debt ratings
  - D/E goes up if E goes down
  - But same is the case with dividends
- Anti-LBO
  - Less chances of being bought
    - if no surplus cash flow and if D/E increases
    - If price increases
- Eliminating small shareholdings adds value
  - Reduces costs of servicing the small shareholders

2. Effects of Share Repurchases

- In perfect markets, if share are repurchased at their fair value, the stock price remains unchanged.
- If shares are repurchased at a price higher than their fair market value, there is a transfer of wealth from the remaining shareholders to the selling shareholders.
    - Example Greenmail: repurchase of shares from an unwanted suitor at a high price

Example 1: Share Repurchases

Interstate Batteries has $10 million in cash available for distribution to its shareholders. There are 20 million shares outstanding, currently priced at $10 each.

Evaluate the impact of:

- 1 Paying the cash out as dividends.
- 2 Repurchasing shares at $10 each.
- 3 Repurchasing shares at $16 each.

Example 1.1 Cash Dividend

- The total value of the firm's equity is currently $______ million (___ million shares x $___).
- Since there are ______million shares, the dividend per share will be ______
- The ex-dividend price will be ______.
- After the dividend, the shareholder will own one share worth ________ and have ______ in cash, for a total of $_______.
- Shareholder wealth is unchanged.

Example 1.2 Share Repurchases at $ 10

- With $____________ in cash , IB can repurchase 1 million shares at $___ each.
  - Number of remaining shares = _______.
- The value of the firm will be $_________ after the repurchase, since $__________ will have “left” the firm.
- The share price is therefore unchanged at $______.
- Shareholder wealth is unchanged.

Example 1.3 Share Repurchases

- With $___________ in cash , IB can repurchase ___________ shares at $_____ each.
  - Number of remaining shares = ______
- The value of the firm will be $_________ after the repurchase, since $_________ will have “left” the firm.
- The price of each remaining share is thus $________.
- Wealth is transferred from non-selling shareholders to selling shareholders.

Example 2: The Effects of a Cash Dividend versus a Share Repurchase

- Assume no taxes, commissions, or other market imperfections
- Consider a firm with 50,000 shares outstanding and the following balance sheet

Before: Market Value Balance Sheet

Cash	$ 100,000	$ 0	Debt
Other Assets	900,000	1,000,000	Equity
Total	$1,000,000	$1,000,000	Total

Example 2: (question)

- Price per share is ___________________
  Net income is $100,000, so EPS = $______________
- The P/E ratio is ________
- The firm is considering;
  - 1) paying a $1 per share cash dividend
    or
  - 2) repurchasing 2,500 shares at $20 a share

Example2: (answer)

- 1. Choose the cash dividend
  (all stockholders get $1 per share)

After: Market Value Balance Sheet

Cash			Debt
Other Assets			Equity
Total	$	$	Total

- Price per share is $________________

- Net income is still $____________, so EPS = $___________
  The P/E ratio becomes ______________

Example 2: (answer concluded)

- 2. Choose the repurchase
  (2,500 shares are repurchased at $20 a share)

After: Market Value Balance Sheet

Cash$			Debt
Other Assets			Equity
Total			Total

- Price per share remains _____________
- Net income is still $_____________, so EPS = $_______
- The P/E ratio is _________

Problem 14.7 of Ross (2nd edtion)

- Sleight Corporation is evaluating an *extra* dividend versus a share repurchase. In either case, $6,000 would be spent. Current earnings are $6 per share, and the stock currently sells for $52 per share. There are 500 shares outstanding. Ignore taxes and other imperfections in answering the first two questions.

  a. Evaluate the two alternatives in terms of the effects on the price per share of the stock and on shareholder wealth.

  b. What will be the effects on Sleight's EPS and P/E ratio under the two different scenarios?

  c. Which of these actions would you recommend? Why?

Solution to Problem 14.7

a. Cash dividend:

Wealth of a shareholder =

Repurchase: __________________ shares will be repurchased.

If you let your shares be repurchased, you have _____in cash;
if you keep your shares, your total wealth is still $__________.

Solution to Problem 14.7 (concluded)

b. Extra Dividend Plan:

Repurchase Plan:

c.

In reality

- Note: markets are not perfect and buyback price usually higher than current market price
  - Buyback pushes up price
    - First buyback has more effect than subsequent buybacks
    - Large buybacks have more effect on price

3. Practical Aspects: Accounting Treatment

- Share repurchases are often kept as treasury stock to be reissued later
    - Debit treasury Stock
    - Credit Cash
- Treasury stock is then reported as a negative item under share capital
- Shareholder approval is not required to resell treasury stock

Implementing a Share Repurchase Program

- Open-market purchases (at market prices)
- Cash tender offers
  - Offer price > market price
  - Over-subscription: firm keeps all or pro-rata
- Privately negotiated block purchases
  - Greenmail: buying back from unwanted suitor at higher price

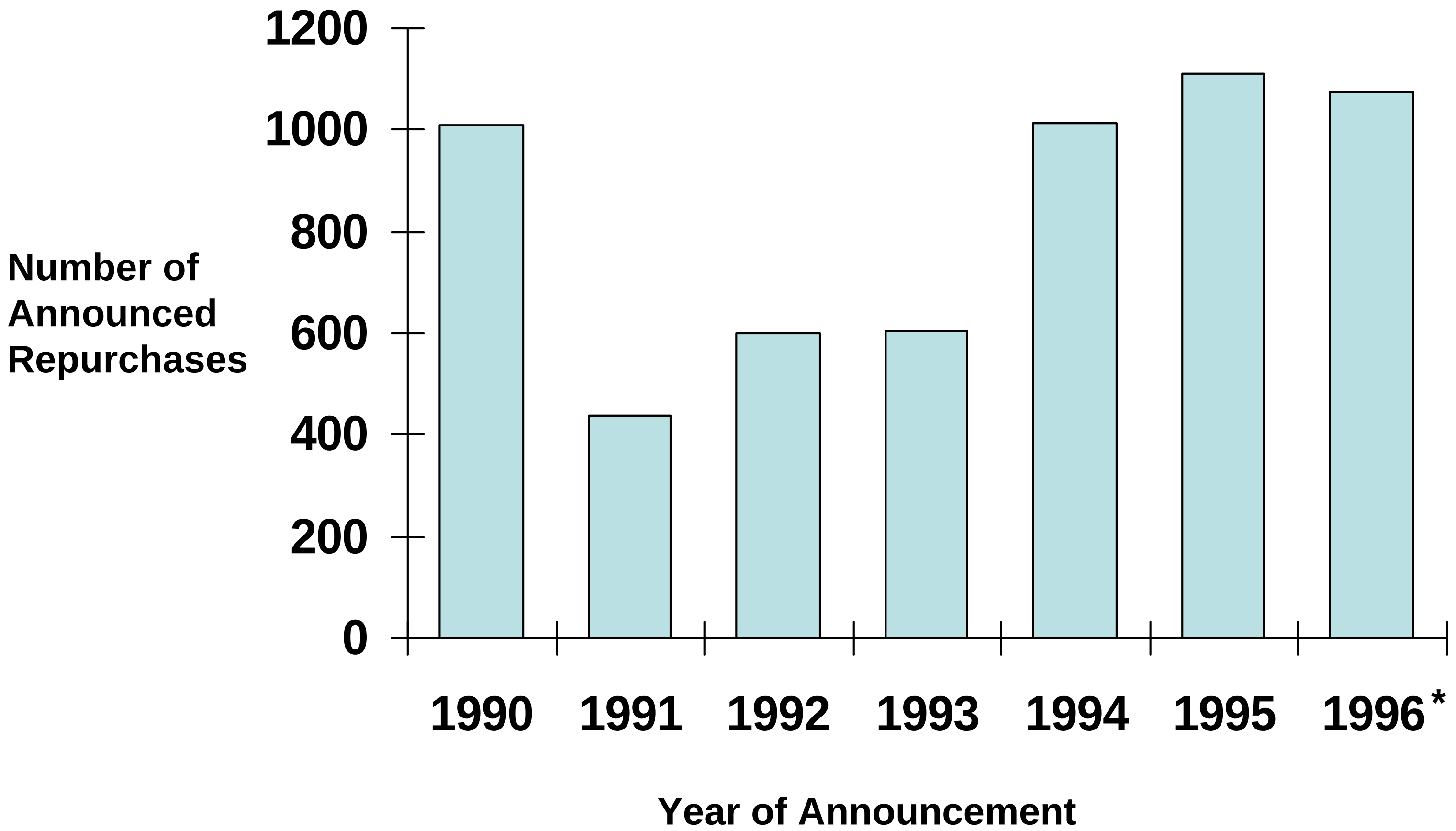
Example: Stock Repurchase Announcement

"America West Airlines announced today that its Board of Directors has authorized the purchase of up to 2.5 million shares of its Class B common stock on the open market as circumstances warrant over the next two years. . . .

"Following the approval of the stock repurchase program by the company's Board of Directors earlier today, W.A. Franke, chairman and chief officer said 'The stock repurchase program reflects our belief that America West stock may be an attractive investment opportunity for the Company, and it underscores our commitment to enhancing long-term shareholder value.'

"The shares will be repurchased with cash on hand, but only if and to the extent the Company holds unrestricted cash in excess of $200 million to ensure that an adequate level of cash and cash equivalents is maintained."

The Number of Announced Share Repurchases 1990-1996



* Through 9/23/96

In France

- Till 1998, share repurchase not allowed except for
    - reducing capital (not for losses) (L 225-207 Code Comm.)
    - Supporting the share price (similar to L 225-209) but strict conditions
- Since then, share repurchases allowed for quite a few other reasons
    - Giving shares to employees (L 225-208)
    - Managing the capital requirements of the firm (L 225 -209) but less strict conditions
        - ➢ Reduce the total cost of capital, especially if no new projects immediately

General Procedure in France

- 10% of capital can be bought back for
    - Managing the price
    - Managing capital requirements
    - Returning excess cash flow
- Minimum and maximum prices fixed for buying
- Each authorised procedure is for 18 months
- The company can
    - sell the shares later
    - Give them to employees
    - Cancel the shares (within limit of 10% every 24 months)

French taxation

- Buyback Gain = buyback price - purchase price
- If buyback is to reduce capital
    - Buyback gain is like liquidating dividend
    - But no avoir fiscal
- If buyback is to give shares to employees or in a general purchase plan
    - Buyback gain is treated as capital gains

Homework

- Questions 7 & 8
- Q. 18