Common Stock Repurchases: A Bane or Boon to Shareholders?

> Repurchases of common stock by corporations can be an attractive alternative to dividends. They may also affect share price. But what is their impact—to the corporation; to the shareholder?

Many companies have been repurchasing their common stock in recent years and some can involve hundreds of millions or even billions of dollars. Investors who own shares in a repurchasing firm are often confused as to why the company is buying back shares and what the import will be on their investment. There are advantages—as well as disadvantages—to stock repurchase programs from both the corporate and investor's standpoint. The programs also have an impact on stock prices. And there is the question of what a repurchase represents and how it can be valued.

The Corporate Alternative to Dividends

The acquisition of common stock represents an alternative to the payment of cash dividends. When common stock is repurchased, fewer shares will remain outstanding. Assuming the repurchase does not adversely affect the corporation's earnings, the earnings per share of the remaining shares will increase. This increase in earnings per share should result in a higher market price per share of the stock. Thus, capital gains are substituted for dividend income. The effects of a repurchase are illustrated by a hypothetical example. ABC Corp. had annual earnings of $8.8 million and its dividend policy is to pay out 50% of earnings to common stockholders. The company has 2.2 million shares of stock outstanding, with a current market price of $20 per share. Payment of the regular common stock dividend will require $4.4 million of the $8.8 million in earnings. ABC Corp. is considering whether to use the remaining $4.4 million to repurchase 200,000 of its shares through a tender offer for $22 a share, or to pay an additional cash dividend of $2 a share. The effect of the repurchase on the earnings per share—and thus the share price of the remaining stock—can be calculated as follows:

1. Current earnings per share (EPS) =
$$\frac{\text{Total earnings}}{\text{Number of shares}} = \frac{\$8.8\text{ million}}{2.2\text{ million}} = \$4$$

2. Current price-earnings (P/E) ratio $= \frac{\$20}{\$4} = 5$

3. Earnings per share (EPS) after repurchase of 200,000 shares $= \frac{\$8.8\text{ million}}{2\text{ million}} = \$4.40$

4. Expected market price after repurchase =
$$\left(\frac{\text{Price}}{\text{Earnings}}\right) \cdot \left(\frac{\text{Earnings}}{\text{Shares}}\right) = (5)(\$4.40) = \$22\text{ per share}$$

In this case, investors would receive benefits of $2 a share whether they received a $2 additional cash dividend or a $2 increase in stock price. This result is based on the assumption that shares could be repurchased at exactly $22 a share, and the price-earnings ratio would remain constant after the repurchase. The most critical assumption is the one concerning the price-earnings ratio, which could change as a result of the repurchase operation, increasing if investors viewed it favorably and decreasing if they viewed it unfavorably.

> "Distributions made through repurchases are taxed as capital gains, an advantage over cash dividends"

Advantages: The Investor's View

From the stockholder's point of view, there are several advantages to repurchases. Currently, profits earned on repurchased stock and qualified cash dividend distributions are taxed at similar rates, but there was a time when dividends were taxed at the investor's marginal personal income tax rate, which was generally higher than the capital gains tax rate.

Going back to when dividends and capital gains were taxed at different rates—or if a dividend isn't qualified—let's look at an investor with a marginal tax rate of 33% who also faces a 15% capital gains tax rate. This investor would clearly benefit if the cash distribution were in the form of a stock repurchase rather than a dividend. In our ABC Corp. example, if an investor owned 100 shares of stock, the amount of cash available after tax would be $134 if the distribution were in the form of a

dividend, compared to $170 if in the form of a repurchase.[1]

Obviously, there is a significantly greater amount of aftertax cash available if the stock is repurchased resulting in a capital gain, compared to the cash dividend distribution, when dividends were taxed at a higher rate than capital gains.

Given today's tax rate environment, however, there still are other advantages of share repurchases over dividends. One can sell or not sell stock back to the corporation. On the other hand, with a cash dividend, one must accept the payment and pay the tax. In addition, when excess cash is used to repurchase company stock, instead of increasing dividend payments, shareholders have the opportunity to defer capital gains if share prices increase.

Share buybacks also boost shareholder value. There are many ways profitable companies can measure the success of their stocks; however the most common measurement is earnings per share (EPS). Earnings per share are typically viewed as the single most important variable in determining share prices. It is the portion of a company's profit allocated to each outstanding share of common stock. When companies pursue share buyback, they will essentially reduce the assets on their balance sheets and increase their return on assets (ROA). Likewise, by reducing the number of outstanding shares and maintaining the same level of profitability, EPS will increase. For shareholders who do not sell their shares, they now have a higher percent of ownership of the company's shares and a higher price per share. Those who do choose to sell have done so at a price they were willing to sell at.

Lastly, when companies pursue buyback programs, this demonstrates to investors that the company has additional cash on hand. If a company has excess cash, then at worst the investors do not need to worry about cash flow problems. More importantly, it signals to investors that the company feels cash is better used to reimburse shareholders than reinvest alternative assets. In essence, this supports the price of the stock and provides long-term security for investors.

Corporate Advantages

There are also some advantages to a repurchase from the corporation's point of view. Research studies have shown that cash dividends are constant in the short run because corporations do not like to raise dividends if the new dividend level cannot be supported by future earnings. Firms do not like to cut cash dividends if it can be avoided. Therefore, if an increase in earnings or cash flow is thought to be only temporary, management may prefer a distribution in the form of a stock repurchase, rather than to declare, when increasing the cash dividend, that they believe it cannot be maintained in the future.

Another advantage is that repurchased common stock can be used for acquisitions or to service convertible debt and preferred stock. Many firms indicate that it is more convenient and less expensive to use repurchased stock than newly issued stock for their acquisition programs and for redemptions of convertible bonds or preferred stocks that are connected to common stock. By using the repurchased stock for these purposes, the amount of dilution in earnings per share that would otherwise take place with newly issued stock is reduced.

In addition, if the firm's directors and top management have large holdings, they may have a strong preference for a repurchase rather than a cash dividend payment because of the tax aspects.

Repurchases can be used to make large-scale changes in the corporation's capital structure proportion of debt to common stock equity. For instance, some firms with almost no long-term debt outstanding may decide to increase their financial leverage. This means that their optimal capital structure should have a higher proportion of debt and a smaller proportion of common stock equity. One way to achieve this objective in a short period of time is to sell long-term debt, in other words bonds, and use the proceeds to repurchase common stock. This would increase the proportion of debt financing, reduce the common equity proportion and increase the financial leverage of the firm.

> "Repurchases can be used by management to help ward off unfriendly takeover attempts"

Finally, repurchases could be used by management as part of a strategy to ward off or avoid attempted takeover by another firm. By acquiring its own shares, the supply of stock could be reduced and thus prevent the unfriendly "suitor" from obtaining enough common stock to have either a controlling interest or significant influence over the board of directors.

Effects Not Always Positive

At this point, investors may conclude that a stock repurchase would only represent a positive benefit either for themselves or for the corporation. Unfortunately, this is not the case—there are some disadvantages that could affect one or both parties.

If a substantial number of the stockholders of a corporation have a preference for dividends versus capital gains, the price of the stock might benefit more from an increase in cash dividends rather than from any stock repurchase. Cash dividends are generally thought to be relatively dependable,

while repurchases are not. If a firm announces a regular dependable repurchase program, it might involve some risk from a legal standpoint. If the Internal Revenue Service can establish that stock repurchases are primarily for the avoidance of taxes on dividends, penalties could be levied on the firm under the improper accumulation of the earnings provision of the Tax Code.

In addition, the U.S. Securities and Exchange Commission (SEC) may raise questions if it appears that, through frequent repurchasing, the firm is manipulating the price of its stock. For these reasons, a stock repurchase may not be a perfect substitute for a cash dividend, and the potential for price appreciation would be greater with an increased cash dividend.

> "Remaining stockholders can be hurt if the corporation pays too much for the shares"

In many instances, stockholders who sell their shares may not be fully aware of why the repurchase is being made or may not have all the necessary information about the corporation's current and future plans. This could represent a significant disadvantage to investors, although most firms seem to recognize this, and will announce a repurchase program before starting it.

Investors may also be hurt if the corporation pays too high a price for the repurchased stock. This will work to the disadvantage of the remaining stockholders. If the stock is relatively inactive, and if the firm wants to buy back a large amount of its stock, the price may be set at a level too high to be maintained and then fall after the firm finishes its repurchase. This could have happened to the ABC Corp. Originally, ABC Corp. was considering the distribution of the additional $4.4 million of earnings in the form of $2 per share extra dividend or the repurchase of 200,000 shares for $22 per share. If the tender offer repurchase price was raised to $25 per share, a number of things would happen.

First of all, the number of shares that can be repurchased at $25 per share for a total of $4.4 million is equal to 176,000. Thus, the number of shares outstanding after the repurchase is 2,200,000 – 176,000 = 2,024,000 shares. The earnings per share after the repurchase thus becomes:

$$\frac{8.8 \text{ million}}{2.042 \text{ million}} = \$4.35.$$

The expected market price after the repurchase is equal to:

$$\left(\frac{\text{Price}}{\text{Earnings}}\right) \cdot \left(\frac{\text{Earnings}}{\text{Shares}}\right) = 5 \times \$4.35 = \$21.75$$

Based on the assumption that the price-earnings ratio will remain constant at five after the repurchase operation, the expected market price is $21.75, while in the original example it was $22 per share. For remaining stockholders, the price would have appreciated only $1.75 per share based on a repurchase price of $25 per share, as compared to the $2 a share when the repurchase price was set at $22 a share.

Corporate Disadvantages

The disadvantage of repurchasing from the corporation's perspective involves not only the possible legal problem concerning the improper accumulation of earnings. It can also result in an unfavorable image. It has been argued that corporations that repurchase substantial amounts of stock often have lower growth rates and fewer profitable investment opportunities than corporations that do not. So there is a risk to the firm that stock repurchases will be regarded as indicating unfavorable growth opportunities that could have an adverse impact on the corporation's image and on the price of its stock.

> "The percent of shares repurchased may have an effect on the stock's price performance"

Studies Show Superior Performance

A number of research studies have looked into the impact of repurchase programs on the corporate stock price. One of the most informative examined several thousand repurchases from 1955 to 1972. The market price performance for the corporations repurchasing their stock was compared to the price performance of firms that did not buy back their stock for a period covering 10 years after the repurchase. The study found that the stock price performance of the repurchasers was superior to the stock of those that did not buy back their stock, but this superiority did not emerge until about two years after the repurchase.

ln addition, the study found performance differences according to the percent of shares repurchased. The greatest price appreciation was in stocks of corporations buying back a moderate amount of stock, 3.25% to 4.24% of total outstanding shares, compared to firms repurchasing either small amounts, 0.25% to 1.24% of all shares, or large amounts of 5.25% or more.

The explanation that has been advanced for these results is that the difference in stock price performance of the repurchasing firms comes from the nature of the repurchase decision.

When the stock market assigns a low value to a firm's stock, management feels the need to repurchase shares to express its disagreement with the undervaluation. After several years, during which time management has many opportunities to prove itself, the confidence of investors is restored and management's judgment concerning the undervaluation of its stock is confirmed.

> "Corporations repurchasing large amounts of their shares have tended to be involved in major reorganizations"

Companies repurchasing only small amounts of their shares were doing so to service executive stock option plans and convertible securities, to avoid the expense and dilution of issuing new shares. These repurchases were not motivated by the undervaluation of the firm's stock and, therefore, little difference existed between the subsequent market price performance of these companies and firms that did not repurchase stock. On the other hand, corporations repurchasing large amounts of their shares tended to be involved in major reorganizations. Since their reorganizations were often in response to severe difficulties, it was not surprising that the subsequent price performance of these firms was not as good as those firms repurchasing their stock because they thought it was undervalued.

Another study compared financial ratios and the performance of groups of repurchasing firms with groups of non-repurchasing firms for the year before a repurchase. The findings indicated that repurchasing firms had lower historical rates of return on investment, low rates of asset expansion, lower share values, poorer operating performance and were smaller in size than the groups of firms who did not repurchase shares. The larger the amount of stock repurchased in any one year, the more important these results become in differentiating between the two groups.

> “Corporations that buy back more than 5% of their shares probably have had problems in their immediate past”

One of the conclusions of the study is that large stock repurchases resulted in a more efficient allocation of capital. The capital was moved away from poor-performing companies and firms with limited investment opportunities back to the stockholders at a possible tax-preferred rate.

Weighing the Pros and Cons

Investors can draw a number of conclusions from the pros and cons and research results. Repurchases on a regular, systematic basis, like quarterly dividends, may not be possible because of the tax treatment of such a program and the uncertainties as to the price of the shares. However, repurchases do offer some significant tax advantages over cash dividends, and the individual investor should give this procedure careful consideration on the basis of the corporation’s own situation. Just because the earnings per share goes up as a result of the repurchase, which could cause an increase in the short run market price of the stock, this does not mean that this increase will be sustained over the long run. It would appear that corporations that buy back more than 5% of their shares have experienced problems in the immediate past and may face limited profitable investment alternatives for the future. To remain invested in or to buy shares of such firms will require, as in all investment decisions, a careful analysis of information about the repurchasing firm and a comparison with other alternatives.

[1]If the distribution were in the form of a dividend, the investor would receive a total of $200 from the company, which would be taxed at a rate of 33%, or $66, leaving him $134. If the company repurchased all his shares at a gain of $2 per share, he would have a total capital gain of $200, taxed at a rate of 15%. His tax bill would be $30, leaving him with $170.

This is an updated and revised version of an article that John L. Houston contributed to the February 1984 issue of the AAII Journal. *At the time, he was a professor of finance at DePaul University in Chicago, Illinois.*