IS BUYBACK OF SHARES A DOUBLE EDGED SWORD

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ABSTRACT

The buyback of shares is an important financial strategy with many facets. It is a double edged sword, which can be used for the benefit of the shareholders or for the benefit of the promoters alone. In view of the benefits of a buyback, both for the company as well as the investors, and the scope for manipulation and price rigging by unscrupulous promoters, the Government of India appointed a working group on the companies Act in 1996. The recommendations of the working group also involved the buyback of shares. The legal position then was that a company was prohibited, under section 77 of the companies Act, 1956, to buy its own shares unless a reduction of capital is effected in pursuance of section 100-104 or section 402 of the Act. Currently buyback of shares is allowed in India. For the purpose of this study the listed shares from National Stock Exchange and Bombay Stock Exchange who announced the buyback of shares in the year 2011 is included and the returns to the investors since the announcement 0f buyback of shares is calculated.

INTRODUCTION

In India, repurchase of stock is commonly known as buyback of shares. There are three methods of share repurchase:

1. Repurchase tender offer: Here the firm specifies the number of shares it proposes to buyback, the fixed price it would pay and the time period for the offer would be open for the shareholders to tender their shares. For example in the year 2000, Bajaj Auto made tender offer to buy its shares at Rs. 400 per share, when the shares were trading at around Rs. 300 per share.
2. Open market repurchase: Here the firm buys from the market at the prevailing market price. For example in March 2008, Madras Cements completed its buyback offer, amounting to Rs. 67 crores, within two months of making the open offer.
3. Targeted repurchase: Here the firm buys shares from a select group of investors. For example the Great Eastern Shipping Company bought shares from select investors to protect itself from a hostile takeover bid led by the Abhishek Dalmia group.

The advantages of share buyback are:

1. Unused cash: If a corporate has huge cash reserves with not many new profitable projects to invest in, and if the company thinks the market price of its share is undervalued, it will buyback its shares. For example: Hindustan Unilever.
2. Market signal: when a corporate buys its own shares at a price higher than the market price, it gives a signal that its valuation should be higher. For example: Madras Cements
3. Shore up promoter' stake: Sometimes the company buyback its own shares to increase promoters stake. For example: Nestle India.
4. Substitute the equity with debt: The corporate can substitute the debt with equity and derive tax advantage.
5. Increase the ROE: When a corporate uses its cash to buy stock, it reduces outstanding shares and also assets in the balance sheet. Thus return on assets (ROA) and return on equity increases as there is less outstanding equity. For example: Essar Shipping.

Common provisions applicable to companies:

In 1998, the Indian government gave in to the corporate sector's demand for permitting buyback, under section 77A and 77B through amendment to the companies Act, 1956. The salient features of buyback of securities that all companies have to comply with in terms of the provisions of sections 77A and 77B of the Companies Act are listed below:

1. The buyback shall be approved by a special resolution in general meeting
2. The buyback by the company has to be financed out of free reserves or securities premium account or from the proceeds of earlier issue of dissimilar shares or other bsecurities
3. The buyback has to be permitted under articles of association and the requisite authority has to be accorded by a board resolution, if the quantum of buyback does not exceed 10% of the paid up capital and free reserves and through a special resolution in general meeting if it exceeds 10%.
4. The buyback in value terms of shares or other securities shall not exceed 25% of the paid up capital of the company in any given financial year.
5. The residual debt equity ratio shall not exceed 2: 1 after the buyback. Therefore this purpose is reckoned as capital and free reserves.
6. The maximum time allowed for the completion of the buyback process is 12 months from the date of the relevant resolution.
7. A declaration solvency has to be filled with the registrar of companies (ROC) and securities and exchange board of India (SEBI) with verification through an affidavit by the board of directors of the company that they believe that the company would remain solvent for a period of 12 months from the date of such declaration.

8. Two buyback programmes shall be separated by a period of 12 months even if they are for dissimilar securities.

HYPOTHESIS

It was hypothesized that the buyback of shares would be a double edged sword.

LIMITATIONS

The study is limited to few shares listed in the BSE and NSE.

OBJECTIVES OF THE STUDY

1. To find out the returns on shares, since the announcement of buyback of shares.
2. To make the investors to take an investment decision rather than an emotional decision.

METHODOLOGY

The methodology is to find out the price relationship after the buyback announcement is made by the corporate and to calculate the return to the investor. Because Warren Buffett, displayed rare mixed emotions after his company, Berkshire Hathaway disclosed a share buyback plan last year. Indian investors bought shares, after the promoters of many Indian companies unleashed a flurry of buybacks during the 2008 crises and made abnormal returns. But buyback has lost luster in the current downturn with the stocks of many companies undertaking buyback languishing at 52- week lows. But, on the other hand Unifi has an insider shadow fund, which only in companies with a buyback plan. Therefore, the methodology involves the use of interpolation and extrapolation approach simultaneously.

RESULTS AND DISCUSSIONS

The results are presented below:

Company	Buyback announcement date	Returns since announcement
Gemini comm..	18/7/2011	-53.30
Amitek Auto	25/8/2011	-30.80
Jindal Films	31/10/2011	-27.80
Praj Industries	3/12/2011	-34.80

RECOMMENDATIONS

1. The investor should understand the strategic intent behind the promoter's buyback of shares.
2. Buy only the shares of top performers in the industry under buyback scheme.
3. Buyback of shares arrest falling stock price in a market correction scenario and even lead to faster recovery when the market bounce back.
4. As the buyback is extremely price sensitive, instances of insider trading and price manipulations are bound to increase.

5. The buyback of shares can also be a stumbling block in the process of takeovers and the replacement of existing management.
6. Contrary to the popular belief that buyback of shares improve share prices, in many cases the prices of shares of companies, that bought back their own shares have fallen sharply below the buyback price.

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