MOTIVES OF BUY-BACK: AN EMPIRICAL STUDY OF SELECT INDIAN COMPANIES

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***Abstract*- This paper examines share buyback as a tool of corporate restructuring, the regulation of buyback practices in India, the choice of repurchase program and the announcement period price reactions. The magnitude of buyback activities in India has been studied. This empirical study shows the effect of share buyback on the share price of the company, which is not always positive. The stock buyback practice has also been analyzed from the shareholder's angle, which is shown using the effect of announcement of buyback and comparing the share price at different point of time in the pre-buyback period and the post-buyback period. Furthermore, effect on earning per share has also been studied.**

Key words: share buyback, announcement effect, pre-buyback effect, post-buyback effect, earning per share.

In order to survive in the intensely competitive environment and in the phase of increasing globalization, it has become necessary for the corporate to go for corporate restructuring. Various Operational, managerial and financial strategies are needed to gain a competitive edge over the rivalries and to ensure a sustainable existence of the corporate. Restructuring a corporate entity is often a necessity when the company has grown to the point that the original structure can no longer efficiently manage the general interests of the company. Financial restructuring involves either internal or external restructuring (joint ventures, mergers & acquisitions, etc). In the internal restructuring the company goes through a series of changes in terms of change in the composition of assets and liabilities and stock buyback is one of the mode of internal corporate restructuring or "corporate control".

Section 68 of the Companies Act, 2013 (earlier Section 77A, 77B and 77AA of the Companies Act, 1956) allows the companies to buy back their own shares following the recommendations of committee on corporate restructuring. This will enable the companies to get near to other developed markets. Share buyback has emerged as a tool of financial re-engineering.

Share buybacks have become a common event in the financial markets worldwide. In a share buyback program, the company distributes the excess cash flow among the shareholders by way of repurchasing its own shares, generally at a premium. Among the various reasons for doing so, the most prominent is the fact that the company wants to indicate to the share holders that it has huge confidence in itself.

According to Securities and Exchange board of India, the total buyback offer size during 2011-12 was Rs. 13,057.92 crore as compared to total buyback offer size of Rs. 5315.8 crores in 2010-11 reflecting an increase of 145.6 percent in the offer size. The large rupee volume of stock buybacks has stimulated a considerable amount of academic research on this topic.

INTRODUCTION

A 'Share Buy-back' is defined as the process by which a company can buy back its own outstanding shares from the shareholder(s). The shares so bought back effectively reduce the issued share capital of the company. This is achieved by cash outflow from the company, which equals the quantum of shares bought multiplied by the price at which shares were bought. In other words, buy back is akin to a company investing in itself.

Among the countries which allow share buyback, the U.S. has the longest history. Share buybacks had appeared in the U.S. in the late 1970s and had become very popular by mid-1980s. The U.S. companies can be regarded as having innovated this corporate practice. In India share buybacks were introduced in 1998 and has received attention of all major companies.

India recognized the usefulness of the share buyback system in late 90's, almost after one and a half decade of the system got popular in United States. Prior to the amendment of the 1999 of the companies act, there was no way a company could buy its share back from the shareholders without the prior sanction of the court (except for the preferential shares). The laws as to the buying of its share by the companies were very stringent. Till then, the Companies Act in India had strictly prohibited companies from buying back their own shares. Section 77 (1) of the Companies Act,1956 stated: "no company limited by shares, and no company limited by guarantee and having a share capital, shall have power to buy its Sections 100 to 104 or of Section 402." Such reduction of capital could be effected only after own shares, unless the consequent reduction of capital is effected and sanctioned in pursuance of shareholder's approval through a special resolution and also the creditor's consent and the court's sanction. This was done to protect the rights of the creditors as well as the shareholders. But the need of less complex ways of buying its shares back by the company was always felt. The much needed change in the companies act was brought about by the Companies (amendment) Act, 1999. Sections 77A, 77AA and 77B were inserted in the companies act.

As per provisions of Section 68 of the Companies Act, 2013, the buy-back of shares and securities can be made out of its free reserves; or the securities premium account; or the proceeds of any shares or other specified securities: provided that no buy-back of any kind of shares or other specified securities shall be made out of the proceeds of an earlier issue of the same kind of shares or the same kind of other specified securities.

As per the Companies Act, no company shall purchase its own shares or other specified securities unless:

- The buy-back is authorized by its articles;

- A special resolution has been passed in general meeting of the company authorizing the buy-back;
- The buy-back is of less than twenty-five per cent of the total paid-up capital and fee reserves of the company and that the buy-back of equity shares in any financial year shall not exceed twenty-five per cent of its total paid-up equity capital in that financial year;
- `The ratio of the aggregate of secured and unsecured debts owed by the company is not more than twice the capital and its free reserves after such buy-back;
- All the shares or other specified securities for buy-back are fully paid-up;
- There has been no default in any of the following in repayment of deposit or interest payable thereon; redemption of debentures, or preference shares or; payment of dividend or; repayment of any term loan or interest payable thereon to any financial institution or bank;
- There has been no default in complying with the provisions of filing of Annual Return, Payment of Dividend, and form and contents of Annual Accounts;
- The buy-back of the shares or other specified securities listed on any recognized stock exchange shall be in accordance with the regulations made by the Securities and Exchange Board of India in this behalf; and
- The buy-back in respect of shares or other specified securities of private and closely held companies is in accordance with the guidelines as may be prescribed.

After the passing of resolution but before making buy-back, a declaration of solvency needs to be filed signed by at least two directors of the company with the Registrar and the SEBI.

A company shall not directly or indirectly purchase its own shares or other specified securities –

- through any subsidiary company including its own subsidiary companies;

  or
- through any investment company or group of investment companies.

Indian regulations required that the shares bought back be extinguished. Every buy-back shall be completed within twelve months from the date of passing the special resolution or Board resolution as the case may be.
A company which has bought back any security cannot make any issue of the same kind of securities in any manner whether by way of public issue, rights issue up to six months from the date of completion of buy back

There were some important factors which encouraged the Indian authorities to consider introducing the share buyback system. Around 1996, the Indian government and business houses became greatly concerned about the prolonged depression in the stock market. The business houses made a case for share buyback as a possible way of reviving the capital market, as it was believed to inject some buoyancy into share prices.

MOTIVES BEHIND SHARE BUYBACK IN INDIA

The motives of Share buyback in India include the following:

- Returning to shareholders the surplus cash not required by the business in the foreseeable future.
- Enhancing the earning per share.
- Conveying to investors the management's view that the market is currently undervaluing the company's share in relation to its intrinsic value.
- Stabilizing the market price of the company's share.
- Providing an exit route to shareholders in case of illiquid shares.
- Raising the promoter's voting power.
- Off-setting the equity dilution caused by allotment of shares against employee stock option plans.
- To prevent takeover bid.
- Raising the debt-equity ratio of the company.

METHODS OF BUYBACK

Indian regulation provides broadly two methods of buyback:

- **Tender offer method:** the company commits to buyback a definite number of shares on a proportionate basis from the shareholders either at a fixed price or at a price arrived through book-building.
- **Open market method:** the company does not commit itself to buy a definite number of shares. There is no commitment about the buyback price also. Maximum price has little relevance as the actual buyback is at the prevailing market price on the date of buyback.

REVIEW OF LITERATURE

Effect on Market Price of the Share

How buyback of shares by a company affects the market price of its shares is a question which is of wide interest. In theory, the effect of share buyback on share price is supposed to be positive but it may not hold true in all cases. Measuring such effect requires defining the pre-buyback and post-buyback prices and comparing the two. However, if it becomes known to the public in advance that a particular company is intending to make to make a buyback offer in the near future, defining the pre-buyback price becomes somewhat problematical and will require tracing back the price sufficiently prior to the buyback announcement.

A research by Dr. L.C. Gupta, Naveen Jain and Anil Kumar (2006) examined the effect of share buyback on share prices. They distinguished between announcement effect and actual post buyback effect. A comparison was made regarding share prices at different points of time; pre-buyback, closing prices on the opening day and on the closing day of the buyback offer. They found that, on the whole, share buyback exercised a positive pull on the share price and the buyback company's shares often moved upwards when the general market movement was downwards.

Dr. A.K. Mishra (2004) in his study analyzed the patterns of returns from the perspective of tendering (participating) and non-tendering (non-participating) shareholders. Return to tendering shareholders is the buyback premium while the returns to non-tendering shareholders are in the form of capital gains. He analyzed that buybacks are benefitting two groups within the shareholder universe: the promoters and the exiting share holders. Non-promoter shareholders not participating in the buyback pay the stiff price. In addition to this, he concluded that in most of the cases (out of the sample chosen), the individual shares of the companies have failed to record any price rise over the buyback price range and have rather fallen, missing the target of attaining superior share performance completely. The announcement of buyback did bring about an increase in the share prices but it was a short term phenomenon.

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Firms that are most likely to undertake Share Repurchases

As boards of directors must approve stock repurchase plans, the board may constrain management from engaging in earnings management. Prior studies suggest that firms repurchase shares for reasons such as distributing excess cash to investors, deterring takeover, and undoing dilutive effects of employee options, among other reasons. More recent studies show that firms may also utilize share repurchases as an earnings management tool to beat or meet analysts' EPS forecasts. As the firm reacts negatively to firm's news to failing to meet or beat analyst's EPS forecasts and positively to the news of meeting or beating earnings expectations, managers have strong incentives to manage upwards (e.g., Bartov, Givoly, & Hayn, 2002; Burgstahler & Eames, 2006). Consistent with the notion that growth firms have more investment opportunities and less free cash flows, it is found that the growth firms are less likely to engage in share repurchases for earnings management motives (e.g., Farrell, Yu and Zhang, 2013). They also examined the corporate governance of the repurchase firms; they found that firms with a more independent board and stronger shareholder rights are less likely to engage in earnings management through share repurchases.

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HYPOTHESIS OF THE STUDY

Hypothesis 1a: Are the shareholders better-off after the buyback of shares.

Hypothesis 1b: Shareholders are not better-off in the post-buyback period.

(The success of a buyback program from the shareholder's perspective depends upon the yield which the shareholders derive in the pre-buyback period and in the post-buyback period)

Hypothesis 2a: Share buyback increases the market price of the share.

Hypothesis 2b: Buyback of stocks does not increase the market price of the company's share.

(Share buybacks are generally done when the managers think that their shares are under-valued, therefore we can argue that buyback programs have an influence over the share price).

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AN OVERVIEW OF BUYBACK PRACTICES IN INDIA IN THE PAST 3 YEARS.

The first share buyback in India was announced in March 1999, since then India is an exploring market in this context. The table below shows the number of buyback offers made in the Indian market during the past three years. In 2011-12 the total no. of offers has increased by almost 35% but in the next year the decline has also been seen. Generally, it has been observed that buyback activity tends to rise when the market is depressed. In addition to this, it has been seen year on year, the companies prefer open market offer more as compare to tender offer, one reason can be tender offer involves high cost and legal formalities and another can be when markets are unstable, firms prefer the open market offer (Li & Nally, 1998).[1]

YEAR	OPEN MARKET OFFER	TENDER OFFER
2010-11	14	5
2011-12	28	1
2012-13	17	3

Table 1

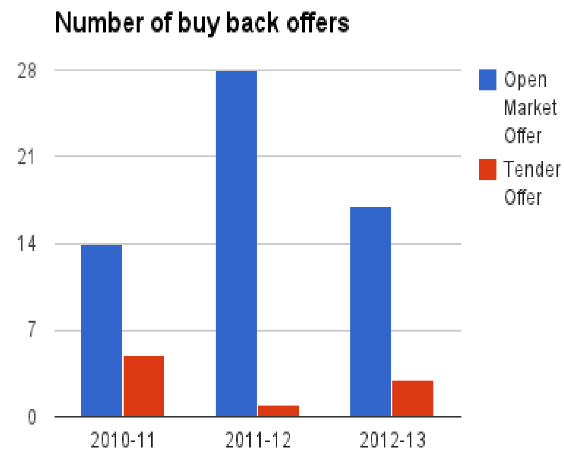

Fig. 1

The share buyback system has not achieved much popularity in India since its introduction as compare to other developed countries. The above chart shows that Share Buyback activity in India has remained low, much below the expectations at the time when share buyback was introduced.

EFFECTS OF SHARE BUYBACK ON SHAREHOLDER'S VALUE

This paper tries to examine the impact of buyback activity on the shareholder. It is of direct importance to understand the effect of share buybacks. The effect on the shareholder's wealth will be examined through two ways, viz. effects on **(a) share price**, and **(b) EPS**. Such effects have been measured by comparing the pre-buyback and post-buyback positions in regard to each of the above.

EFFECT ON SHARE PRICE

How buyback of shares by a company affects the market price of the share is a matter of concern and wide interest. Theoretically, the effect of share buyback on share prices is believed to be positive but this is not so in all the cases. This can be

[1] Adapted from Open market versus Tender offer share repurchases: A Conditional event study by Kai li & William McNally, March 1998.

measured by defining **the pre-buyback and post-buyback prices and comparing the two.**

For this purpose the whole of the analysis is differentiated between: **(i) announcement effect**, and **(ii) actual post buyback effect**. The announcement effect is the effect formed immediately after the buyback decision is made public. The actual post-buyback effect refers to the effect after the buyback program has been completed.[2]

ANNOUNCEMENT EFFECT

The comparison of the share prices at the following two points of time has been made: (a) the market price prevailing before the announcement regarding buyback is made (here price two months before is taken for analysis) and (b) the price immediately following the announcement of the share buyback offer.

For the purpose of measuring the effect, the buyback offers which opens and closed in the f.y. 2012-13 has been taken, in addition to this few offers which have their major span of buyback activity in this f.y. has also been considered. In total 13 offers are considered including 11 open market and 2 tender offers.

It has been examined, the majority (62%) of the cases, the buyback announcement effect was positive; but in 31% of cases, it was negative and it is also drawn out that somehow it may have no effect as well (as it was there in one case). So, it is noteworthy that a sizeable proportion of buyback announcements had a negative effect on share price, opposing the general belief that share buyback always have a positive effect on the share price.

Change in Share Price on the Opening day of the Buyback Offer vis-à-vis the price two months before	No. of Cases
Increase in Share Price (up to 10%)	2
Increase in Share Price (more than 10%)	6
Decrease in Share Price	4
No Change	1
TOTAL	**13**

Table 2

Therefore, broadly we can conclude that the positive effect is more common than the negative effect but not a universal fact that share buybacks always leads to increase in share prices.

OVERALL EFFECT OF SHARE BUYBACK

For measuring the overall effect of share buyback from shareholder's point of view, the paper looks at the change in share price at 3 different points of time.

(i) Pre-buyback price (2 months before the buyback announcement date)
(ii) Price on the opening day of the buyback offer
(iii) Price on the closing day of the offer.[3]

[2] In each case of share buyback, information has been collected about the relevant dates and the share prices on those specific dates.

[3] The price taken here is the closing price of the share on the respective dates.

PRICE CHANGE	ANNOUNCEMENT EFFECT	POST BUYBACK EFFECT	TOTAL BUYBACK EFFECT
	Change in share price on the opening day of the buyback offer vis-à-vis the price two months before	Change in share price on the closing day of the buyback offer vis-à-vis the price on the opening day	Change in share price on the closing day of the buyback offer vis-à-vis the price two months before
Increase in price	8 (61.53%)	12 (92.31 %)	12 (92.31%)
Decrease in price	4 (30.76%)	1 (7.69%)	1 (7.69%)
No Change	1 (7.71%)	0	0
Total No of Cases analyzed	13 (100%)	13 (100%)	13 (100%)

Table 3

During the period of buyback offer, i.e., from opening day of the offer to its closing day, the post-buyback effect is been analyzed and it has been noted that share price of more than 90% of the firms announcing buyback has gone up. The similar trend can also be noticed in the longer period from start to finish, i.e., on comparing share price on the closing day of the offer and the price before two months of announcement is made is also positive.

This shows that firms are able to achieve their goal; their stock's prices are increasing showing earlier they were undervalued.

EFFECT ON EPS (EPS for the financial year ending after completion of the share buyback program)

Notionally, earning per share (EPS) of a company going for buyback is expected to increase after buyback. The reason is simple; buyback reduces the number of shares outstanding, whereas the total earnings of the company are likely to be maintained. For this reason, the EPS is likely to go up after buyback.
The data of companies used here, shows that in approximately two-third of the cases (around 70%), such EPS have found to be increased. [4]

However, the situation becomes complex when the EPS of the non-buyback companies also increases, this may happen in the case when total earnings of the particular company had gone up. Hence, it is not always the case the EPS of companies

[4] The increase was in relation to the financial year before the buyback, i.e., 2011-12 in this case.

announcing buyback will raise; it can be other way round as well.

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