Motivations Of Share Buybacks In India

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ABSTRACT

Majority of the studies on share buybacks have been undertaken in the developed countries, especially the U.S. As the Indian capital market has unique features, it is desirable to examine the motivations of Indian share buybacks. A total of 119 events of share buybacks were analyzed over a period of 2003 - 2010. Public announcements provided by the companies were studied to identify the major reasons provided by the companies for undertaking share buybacks. The results reveal that the main motivations for announcing share buy backs in India are: Improving financial performance and returning of surplus cash. There is no shift in motivations across time and methods.
Keywords: Buyback, Motivation, Signaling, Undervaluation

SECTION - I

INTRODUCTION

Corporations primarily distribute cash to common shareholders through dividends and share repurchases. Dividends have historically been the preferred method, but share repurchases are growing in popularity. The U.S. companies can be regarded as the innovators of the share buyback system. The U.S. has the longest history for allowing share buybacks. Share buybacks had appeared in the U.S. in the late 1960s, and became very popular by mid-1980s. In Canada and U.K., buybacks were allowed in early 1980s. Share buybacks began to be permitted in the late 1990s in Asian countries. Buybacks were permitted in Japan in 1995, followed by Malaysia in 1997, Singapore and Hong Kong in 1998 and Taiwan in 2000. India recognized the usefulness of the share buyback system in late 1998. Until then, the Companies Act in India strictly prohibited companies from buying back their own shares (Gupta, 2005). Numerous theoretical and empirical studies have addressed the rationale of repurchases and have presented a mixed picture on the motivations behind share repurchases and the reasons for the market reaction to the repurchase announcements. Hypotheses have been tested in different markets and have found mixed results. Only a limited number of studies are available in India which have tested these hypotheses. The lack of studies on the issues in emerging markets and in the Indian context in particular, and the shortcomings of those that do exist provide strong justification for the current study.

The rest of the paper is organized as: Section II presents the literature review, Section III presents the data sources and methodology used, Section IV presents the results and discussions and Section V concludes the study.

SECTION - II

REVIEW OF LITERATURE

Surveys are a source of direct evidence of management intentions. The management has several reasons for initiating share buyback programs, as shown in the survey literature, and discussed in the following paragraphs. The Table 1 provides a summary of studies reviewed in this section.

Grullon and Ikenberry (2000) listed five hypotheses as to why firms initiate repurchases: signaling excess cash flow, capital market allocation, tax motivated substitution of buybacks for dividends and capital structure adjustments. Baker et al. (1981) found that the major reasons cited for repurchases were excess cash flow and option funding. The majority of the responding managers viewed share repurchases as an investment decision and not a dividend substitution or financing decision. Wansley et al. (1989) found that the reasons most often cited for repurchases were undervaluation of stocks and signaling to investors that managers are confident about the company's future. No support was found for substitution of repurchases for dividends. Tsetsekos et al. (1991) found that even though the most frequently expressed motivation was to change the capital structure, the majority of the responses supported the signaling hypothesis. Davidson and Garrison (1989) found that the market reacted : **1)** Negatively to the takeover

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defense motive (control) ; **2)** Substantially positively to undervalued stock motive (signaling) and; **3)** Neutrally to ESOP motivated repurchase (option funding).

Cudd et al. (1996) extended Wansley et al.'s (1989) findings and found a positive relationship between repurchase premium and takeover defense, while Davidson and Garrison's study did not find support for this relationship. Both studies found strong support for the signaling hypothesis. Mitchell et al. (2001) found that the motivations for share buybacks varied across the types of buybacks. Information signaling represented the major motivations for on-market share buybacks. Selective buybacks were effected primarily to remove shareholders or a subsidiary following a takeover. In relation to equal access buybacks, improved EPS, return of excess cash, optimal capital structure and removing a shareholder were considered as the dominant reasons for conducting employee buybacks. Finally, reducing the administrative burden of odd-lot share parcels was the main reason for odd-lot buy-backs. Baker et al. (2003) found that undervaluation of stocks and signaling to the market were the most cited motives, followed by adjusting the firm's capital structure and avoiding dividend taxes. The respondents did not consider substitution and option funding motives to be very important.

Table 1 : List of Survey Studies Showing The Motivations of Share Buybacks

Sr. No.	Study	Year of Study	Country/Stock Exchange, Sample size, Responses	Motivations for Buybacks
1.	Baker et al. (1981)	1970	USA-NYSE 150 repurchasing 150 non-repurchasing firms' CFOs	Investment of excess cash, option funding and substitution of repurchases for dividends.
2.	Wansley et al. (1989)	1986	USA 620 CFOs 98 repurchasing 42 non-repurchasing	Undervaluation of stock and signaling of future earnings.
3.	Tsetsekos et al. (1991)	N.A	USA-NYSE 1000 CFOs 183 responses	Undervaluation and signaling of future earnings supported.
4.	Cudd et al. (1996)	1986	USA 620 CFOs 77 responses	Takeover defense and signaling hypotheses supported.
5.	Mitchell et al. (1999)	1990-1995	Australia, ASX 67 buy back announcements	Signaling undervaluation, improving EPS, Removing a shareholder, Substitute for cash dividends
6.	Mitchell et al. (2001)	Nov 1989- June 1995	Australia, ASX 508 CFOs 80 responses	Information signaling, Excess cash, Optimal capital structure, Substitute for cash dividends, Removing a shareholder
7.	Baker et al. (2003)	Jan 1998- Sep 1999	NYSE, AMEX & NASDAQ 642 finance executives	218 responses devaluation of stock and signaling, adjustment of capital structure

Source: Compiled from various studies

Note: N.A: Not Available

All of the above-mentioned (Table 1) survey studies provided mixed results regarding the motivations provided by the managements of the companies announcing the share buybacks. The present study aims to extend the literature on share buybacks in the Indian market by investigating the motivations provided in the public announcements of companies announcing the share buybacks.

SECTION - III

DATA SOURCES AND METHODOLOGY

The major source of information used was public announcements by the companies announcing the share buybacks, where they cited the reasons for buybacks under the heading 'necessity for buybacks'. Public announcements were downloaded from SEBI website : www.sebi.gov.in. All the companies which announced buybacks from January 2003 - December 2010 have been included in the sample. A total of 119 events of buybacks were found, where public announcements are provided on the SEBI website. Some companies have announced buyback programs more than once. As companies mainly use open market method or tender method, analyses of motivations are further classified according to the method used for buybacks. Descriptive statistics like averages and percentages are used for the analysis.

SECTION - IV

RESULTS & ANALYSIS

On the basis of the methodology used by Mitchell and Robinson (1999), different statements provided as the necessity of the share buybacks in the public announcements were identified and are listed as the motivations for share buybacks. Based on the motivations identified by Gupta (2005) in the Indian context, the following Table 2 was prepared.

Table 2 : Description of Motivations

M	MOTIVATIONS	DESCRIPTION
M_1	Return of surplus capital	Returning to shareholders, the surplus cash is not required in the foreseeable future.
M_2	Improving Financial Performance	Enhancing the earning per share/ Increase in ROE/Overall enhancement of shareholder value.
M_3	Undervaluation	Conveying to investors, the management's view that the market is currently undervaluing the company's share in relation to its intrinsic value and that the proposed buyback will facilitate recognition of the true value.
M_4	Stabilizing Market Price	Stabilizing the market price of the company's share.
M_5	Illiquid (non-existent) Market	Providing an exit route to shareholders in case of illiquid shares.
M_6	Control	Raising the promoters' voting power.
M_7	Off-setting Equity Dilution caused by ESOPs	Off-setting the equity dilution caused by allotment of shares against employee stock option plans.
M_8	Defence Against Takeover	Warding off a takeover threat/speculative activity.
M_9	Capital Structure (Gearing)	Raising the debt-equity ratio of the company.
M_{10}	Accounting Effect	Make the balance sheet leaner.
M_{11}	Administrative Reasons	Reducing the cost of servicing.
M_{12}	Tax Effect	Dividend vs. capital gains (personal tax saving).

Source: Based on Gupta (2005)

Table 3 : Buy Back Frequency For The Calendar Year 2003 - 2010

Details and Years	2003	2004	2005	2006	2007	2008	2009	2010	Total
Open Market	0	8	6	6	4	32	33	10	99
Tender Offer	2	3	2	1	3	2	2	5	20
Number of Buyback Events	**2 (1.68%)**	**11 (9.24%)**	**8 (6.72%)**	**7 (5.88%)**	**7 (5.88%)**	**34 (28.57%)**	**35 (29.41%)**	**15 (12.60%)**	**119 (100%)**

Source: Primary Data

It was found that the main motivation behind share buybacks is not the same in the case of all the companies and at all times. It is very much related to a particular situation. Many of these are inter-related. Mainly, two methods of buybacks are used in India that are followed by different companies. A buyback offer is classified as a tender offer if the company commits itself to a buyback of a definite number of shares. Both fixed-price buyback offers and auction-based offers which use book building procedure for determining the buyback price are included. Both these are really

Table 4 : Analysis of Various Motivations		
M	MOTIVATIONS	No. of times provided (%)
M_1	Return of surplus capital	78 (65.54)
M_2	Improving Financial Performance	117 (98.31)
M_3	Undervaluation	13 (10.92)
M_4	Stabilising Market Price	4 (3.36)
M_5	Illiquid (non-existent Market)	42 (35.3)
M_6	Control	0 (0)
M_7	Off-setting Equity Dilution caused by ESOPs	0 (0)
M_8	Defence against Takeover	3 (2.52)
M_9	Capital Structure (Gearing)	4 (3.36)
M_{10}	Accounting Effect	7 (5.88)
M_{11}	Administrative	9 (7.56)
M_{12}	Tax Effect	4 (3.36)
Source: Primary Data		

the variants of the tender offer method. If there is no commitment about a number of shares to be bought back, it is classified as an open market offer.

In total, 119 events of buybacks were identified during the years 2003 - 2010, for which public announcements weare available. From the Table 3, it can be seen that a maximum number of announcements were made during the years 2008 and 2009, which accounted for 58% of the total events. Further, the open market method was more popular than the tender offer method, which accounts for only 16.80% of the total events.

Frequencies of the market released motivations as provided to the SEBI are noted in the Table 4. A total of 119 events of share buybacks are found for 104 companies. For companies that provided multiple motivations, no hierarchical preference is apparent, regardless of whether each motivation is given in conjunction with others or not, and all the reasons given are included in the motivational frequency count. Prominent motivations across all buybacks are :

a) To improve financial performance (EPS) or ROA (M_2) in 98.31 percent of the events ;

b) Return of surplus capital in 65.54 percent of the events (M_1) ;

c) Illiquid or non- existent market (M_5) in 35.3 percent of the events ;

d) To signal future expectations (undervaluation) (M_3) in 10.92 percent of the events.

Some interesting implications arise from these findings. First, the results show that the main motivation to improve the financial performance (EPS) and or financial position (ROA or ROE) by effecting share buyback reflects a functionally fixated view of the world. It assumes increases in book values, regardless of how achieved, will be viewed positively by the market. Consequently, an increase in firm value is presumed to occur with little regard for the

Table 5 : Buyback Method Used And Motivations												
	Frequency		Frequency of Individual Motivations									
Type of Buyback	**Companies**	**Buyback Events**	**M_1**	**M_2**	**M_3**	**M_4**	**M_5**	**M_8**	**M_9**	**M_{10}**	**M_{11}**	**M_{12}**
Open Market	86	99	65	97	12	4	30	3	1	5	6	1
Tender Offer	18	20	13	20	1	0	12	0	3	2	3	3
Total	**104**	**119 (100)**	**78 (65.54)**	**117 (98.31)**	**13 (10.92)**	**4 (3.36)**	**42 (35.3)**	**3 (2.52)**	**4 (3.36)**	**7 (5.88)**	**9 (7.56)**	**4 (3.36)**
Source: Primary Data												

economic and commercial fundamentals of the firm. Prima facie, increase in EPS achieved through a reduction in the number of issued shares will not necessarily be beneficial. If a buyback results in a reduction in cash (or near cash) reserves below that required to maintain the efficient operations of the firm; it could lead to an eventual decline in EPS. In this situation, despite an initial increase in EPS achieved through a share buyback, a firm's share price will be negatively affected (Mitchell and Robinson, 1999). But if the company has surplus cash as in case of M_1, (65.54% of the events), then improving financial performance through buybacks can be successfully achieved. Secondly, the companies which are traded infrequently on the stock exchanges, or where very thin markets are available, they provide an exit route to their shareholders. Thirdly, in case of 10.92% of the events, the management's belief that the share prices of the company are undervalued relative to the management's perception of value or intrinsic fundamentals, the restructuring is an attempt to signal to the market that the shares are incorrectly priced. So, buyback is an effort to signal information about the future expectations so as to influence the firm's share price.

The Table 5 shows a link between the various motivations and the type of buyback. It shows that for open market buybacks, improving financial performance or position, M_2, represents 97% of the events given in relation to that particular form of buyback. The second most stated motivation for an open market buyback was to return surplus cash, M_1, (65 per cent). In case of tender offer also, results show that the major motivation was improving financial performance i.e. M_2 (100 per cent). 65 per cent of the events provide returning of surplus cash, M_1, as the second major motivation. So, the method wise analysis of motivations of buy backs is not discriminative. These findings are in contrast to Mitchell and Robinson (1999), who found that on-market share (open market) buybacks are undertaken to signal future expectations and improving financial performance, while equal-access buybacks are undertaken as a substitute of dividends, which provide for personal tax-saving to shareholders.

Motivations across Time are provided in the Table 6. The number of buybacks change over time; hence, it is also examined whether the relative frequency with which each individual motivation is provided also changes over time or not. The Table 6 suggests that the relative frequency of individual motivations given by companies for carrying out a buyback is reasonably static over time. The two most popular motivations which were identified earlier namely, M_2 (improving financial performance) and M_1 (return of surplus cash) are provided in all the years from 2003 - 2010. Despite the increased buyback activity in later years, the relative frequency of individual motivations has not altered with the exception of the year 2004, where M_5 replaced M_1 as the second major motivation. However, due to a small sample, it is difficult to draw further inferences on the basis of these findings.

Table 6 : Motivations Across Time

M	2003	2004	2005	2006	2007	2008	2009	2010	Total
M_1	1	7	5	6	5	20	21	13	78
M_2	2	11	7	7	7	34	35	14	117
M_3	0	2	1	0	1	5	4	0	13
M_4	0	2	0	0	0	2	0	0	4
M_5	1	8	5	2	2	6	11	7	42
M_6	0	0	0	0	0	0	0	0	0
M_7	0	0	0	0	0	0	0	0	0
M_8	0	0	0	0	0	2	1	0	3
M_9	1	2	1	0	0	0	0	0	4
M_{10}	0	0	0	0	2	2	2	1	7
M_{11}	1	4	1	0	0	1	1	1	9
M_{12}	0	2	0	0	0	0	0	2	4
Total No. of Motivations	**6 (2.13%)**	**38 (13.52%)**	**20 (7.11%)**	**15 (5.33%)**	**17 (6.04%)**	**72 (25.62%)**	**75 (26.69%)**	**38 (13.52%)**	**281 (100%)**

Source: Primary Data

SECTION - V

SUMMARY AND CONCLUSION

Buyback activity is concentrated mainly in two years, i.e. 2008 and 2009, which together accounted for 58 percent of the total events. The relative frequency of individual motivations is consistent over time. Furthermore, there is no discrimination across the methods of buyback. In general, the numbers of motivations actually provided in the buyback announcements are relatively more concentrated relative to potential motivations provided in the literature. Two motivations dominate the Indian share buyback scenario i.e. improving financial performance (M_2) and returning of surplus cash (M_1). There is no shift across time and methods. Motivations for buybacks have been taken from the reasons stated in public announcements made by the companies. It may be argued that these motives may not properly reflect the true reasons held by corporate management for initiating buy back scheme. However, market forces compel the managers to disclose the true reasons in buyback announcements as :

a) There is an incentive to have the market react to the information about the motivations ;

b) The capital market will penalize directors for misinformation. An alternative means for identifying the motivations for share buybacks could be a survey of corporate managers, but there is no guarantee that the response will be any less noisy than the announcement approach (Mitchell and Robinson, 1999).

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