Share Buybacks

In the course of a share buyback program, a company buys its own shares for strategic or tactical reasons in the open market. The intentions behind such transactions can differ.

Own shares acquired by a firm are parked in the treasury stock position on the active side of the balance sheet. Whilst a buyback transaction reduces the number of shares in free float, the number of shares outstanding remains the same.

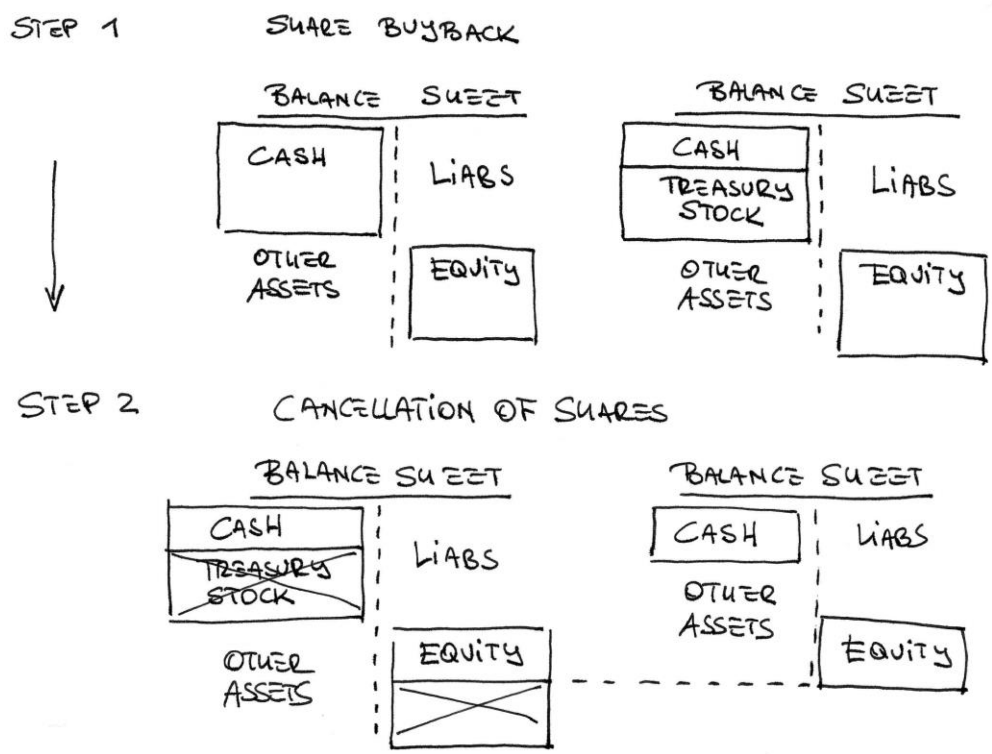
Corporates often pursue share buybacks for tactical reasons, when a firm´s shares seem fundamentally undervalued and can be acquired "for cheap". Hence, the announcement of a share buyback usually results in a firm´s share price increasing, as investors anticipate firm management to act rationally (not least, as executives implementing the transaction assume the role of an insider). - Once the share price having recovered, a firm may decide to sell previously acquired shares on the open market again. If implemented and timed right, then such a transaction should make money for the firm.

Sometimes, though, a firm may decide to use the treasury stock position for other purposes than simply re-floating own shares again, such as: Meeting obligations from share option schemes offered to senior management, meeting obligations originating from convertible bonds if investors decided to convert such instruments into shares, or pursuing acquisitions for shares, instead of paying in cash (stock-for-stock deals).

Alternatively, a firm may also decide to cancel shares held in the treasury stock position: A cancellation of shares not only reduces the free float of the company, but now also reduces the number of shares outstanding. As a result, the price for shares that remain outstanding will increase following the transaction, with the value of the firm now distributed among a reduced number of shares (an effect known as accretion).

The rationale of a share buyback with a subsequent cancellation of shares is that the firm does not require as much equity any longer. This may have to do with the stage in life cycle a firm has reached. Shareholders seeking growth or yield momentum may now find more appropriate alternatives to allocate their capital.

At the same time and from a firm´s perspective, a share cancellation provides an opportunity to amend a balance sheet´s funding structure: With the equity position and therefore also the length of the balance sheet having decreased, leverage has increased. Ideally, such may also result in a reduction of a firm´s average cost of capital (with cost of debt lower than cost of equity). And, as share buybacks are either funded through cash readily available or through newly assumed debt, in latter case, a firm´s balance sheet would be (re)-levered even further.


STEP 1
SHARE BUYBACK
BALANCE SHEET
CASH
LIABS
OTHER ASSETS
EQUITY
BALANCE SHEET
CASH
TREASURY STOCK
LIABS
OTHER ASSETS
EQUITY
STEP 2
CANCELLATION OF SHARES
BALANCE SHEET
CASH
TREASURY STOCK
LIABS
OTHER ASSETS
EQUITY
BALANCE SHEET
CASH
LIABS
OTHER ASSETS
EQUITY

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