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 unchanged.

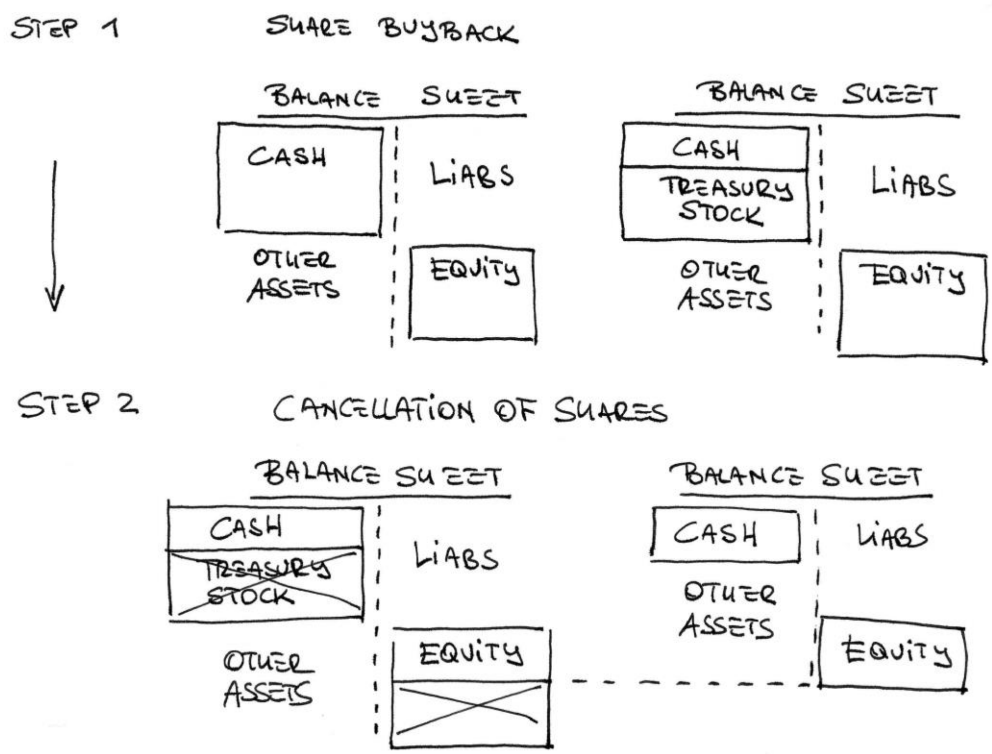
Corporates often pursue share buybacks for tactical reasons, such as when shares seem to be fundamentally undervalued and can be acquired “for cheap”. Hence, the announcement of a share buyback tends in a firm´s share price strengthening, as investors anticipate firm management to act rationally (not least, as executives implementing the transaction are de-facto insiders). - Once the share price has recovered, a firm may decide to sell previously acquired shares on the open market again. If implemented and timed right, then such transaction should make money for the firm.

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

Alternatively, a firm may decide to cancel shares held in the treasury stock position: A cancellation of shares not only reduces the free float of a company, but also 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. Frequently, this may have to do with the stage in the life cycle a firm has reached. Whilst, at the same time, shareholders rather seeking growth or yield momentum may now find more appealing alternatives to allocate their capital.

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 decreasing, leverage is increasing. Ideally, this may even result in a firm´s average cost of capital decreasing (with cost of debt lower than cost of equity). And, as share buybacks are either funded by cash readily available or 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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