

## **Share Buybacks and Shareholder Equity**

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In recent years, off-market share buybacks by Australian companies have been both popular and controversial. Most recently, the Coles buyback has attracted comment from Graham Sellars-Jones (AFR Letters, 14 June 2006) criticising this capital management technique on a number of grounds including shareholder equity.

The tax motivation behind off-market buybacks is clear and only low marginal tax rate entities, such as superannuation funds, find it worthwhile to participate. The buyback price, set below the current market price comprises a large franked dividend and small sale price component giving rise to a tax deductible capital loss for most participants.

But for high marginal tax rates the additional tax payable on the franked dividend component in the buyback, means that a better option is to sell on the open market for a concessionally taxed capital gain. Buyback information booklets generally explain this choice.

The issue of equity which arises, and creates so much angst, is that participants in the buy-back are receiving franking credits at the expense of non-participants. While governments might legitimately engage in redistributive actions from high to low income earners, company boards are expected to treat all shareholders equally.

But shareholders do have different characteristics, and maybe these actions create value for all, by targeting specific tax benefits to those best able to utilise them, at a cost to those recipients given by the buy-back discount?

One way to check might be to examine the stock market response when a buyback is announced. The accompanying figure, which effectively shows the average share price response on the announcement date, tells an interesting story.

On average, investors think that buybacks are a good idea. All shareholders are better off because of the higher share price. Unfortunately, this may reflect a view that some form of cash payout is good news, not that the method chosen is the best possible, or even desirable.

Luckily, an alternative (albeit still imperfect) approach is available. Some simple algebra (available on request from the authors) examines what happens to the share price controlling for announcement effects (the good news of a cash payout).

It assumes that the share price of a company incorporates the market's valuation of undistributed franking credits, and that this valuation is somewhere between 0 and 100 per cent. Many analysts have argued for a valuation ratio of around 50 per cent.

The algebra shows that the share price will be higher after a buyback if the aggregate value of the buyback discount exceeds the value of franking credits distributed. The intuition is straightforward. The value given up by remaining shareholders is less than the benefit received from repurchasing (and cancelling) shares at a below market price.

For example, if 1000 shares are bought back at a discount of \$1.00 per share and there are \$1,200 of franking credits distributed which the market values only at, say, \$600, the remaining shareholders are \$400 better off and the share price will increase.

The accompanying table provides calculations for a number of past buybacks by Australian companies. It can be seen that if undistributed franking credits are fully valued by the market, non-participating shareholders were in all cases worse off. If franking credit valuation were 50 per cent (thus dividing the last column by two) the story is somewhat more mixed, but non-participating shareholders are still worse off in the majority of cases.

Corporate decisions to pay-out funds by way of an off-market buyback, thus appear to have been more favourable to low marginal tax rate income investors. High tax rate investors do not reap as much of the benefit from the pay-out decision as they would if, for example, the buyback price were set lower.

Why the terms of buybacks appear to be set to provide greater benefits to one group of investors (primarily superannuation funds) than others is a question well worth asking. So also is the question of why the ATO permits such convoluted tax arrangements for buybacks.

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