Local Authority
Pension Fund
Forum

SHARE BUYBACKS: SOLUTIONS OR ILLUSIONS

FOREWORD

In 2015, LAPFF issued a discussion paper on the subject of share buybacks. Since then the matter of share buybacks became a subject of attention in the government White Paper of August 2017, particularly in the context of the impact on executive remuneration, but also giving rise to other economic implications.

In 2017 LAPFF therefore decided to reissue the paper, and this is now published with the introduction from our late, highly respected and much missed Chair, Kieran Quinn.

Ian Greenwood
Co-Chair, LAPFF

Denise Le Gal
Co-Chair, LAPFF

The Local Authority Pension Fund Forum (LAPFF) is a voluntary association of 72 local government pension scheme fund members, based in the UK, with combined assets of approximately £200 billion. LAPFF exists to protect the long-term investment interests of its members and to maximise their influence as shareholders by promoting the highest standards of corporate governance and corporate responsibility amongst investee companies.

This report was compiled by Tim Bush of PIRC Ltd, LAPFF's research and engagement partner.

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INTRODUCTION

In 2015, LAPFF issued a discussion paper on the subject of share buybacks. Since then the matter of share buybacks is now a subject of attention in the government White Paper of August 2017, particularly the impact on executive remuneration, but also other economic implications.

Often, the reason given for buybacks is that the company believes the market has undervalued its shares. However, we question how often companies are in a position to make such an assessment accurately. We maintain that this practice can artificially inflate earning per share ("EPS"), create unfair advantage for executives in respect of their remuneration target, and lead to a lack of transparency on actual corporate performance.

In producing this paper it was been difficult to identify any advantages of buybacks over the traditional and transparent distribution of profits by way of dividends. For tax exempt pension fund investors, there should be no difference between income or capital returns.

Given that the subject matter is now the subject of government attention, and given that the issues that LAPFF raised in 2015 are unchanged, LAPFF has republished the paper, in order to participate and help drive the ongoing debate, from White Paper to legislation. The time is right. The government position is: *'the Government will .... commission an examination of the use of share buybacks to ensure that they cannot be used artificially to hit performance targets and inflate executive pay. The review will also consider concerns that share buybacks may be crowding out the allocation of surplus capital to productive investment. The Government will announce more details shortly.'*

The impact on EPS measures that feed into pay accords with the LAPFF analysis. On the matter of the diversion of productive investment, the wording of the White Paper leaves things open as to whether this is an argument against large distributions (i.e. special dividends) or whether it is concerned with buybacks as the method of doing it. The LAPFF analysis was not to deter distribution of surplus capital, but was concerned with buybacks as the method for doing it. As a member of an administering authority put it:

"Fundamentally, long-term investors wish to invest in companies based on the belief that their business models will deliver value for the long term. Investing in companies that are pursuing a model parallel to that, what amounts to little more than short-term speculation in their own shares, does not fit with that investor objective."

Kieran Quinn
Chair, LAPFF
December 2017

SUMMARY

A majority of UK listed companies are requesting general authority to buy their own shares as an alternative to paying dividends, or in order to return surplus capital other than by way of special dividend. This practice generally takes the form of filing a resolution at the company AGM requesting that shareholders approve an authority for companies to repurchase a maximum of 10% of the companies' issued share capital and that the authority expire at the following AGM.

In UK law dividends and buybacks can only be funded out of distributable profits. Collectively dividends and buybacks are called "distributions".

The benefits of share buybacks have been purveyed as a universal truth. However, a relatively simple analysis throws up enough issues and questions, and highlights additional direct costs, to raise doubt as to whether they are beneficial, or indeed, may have aspects that are positively harmful to the shareholder interest.

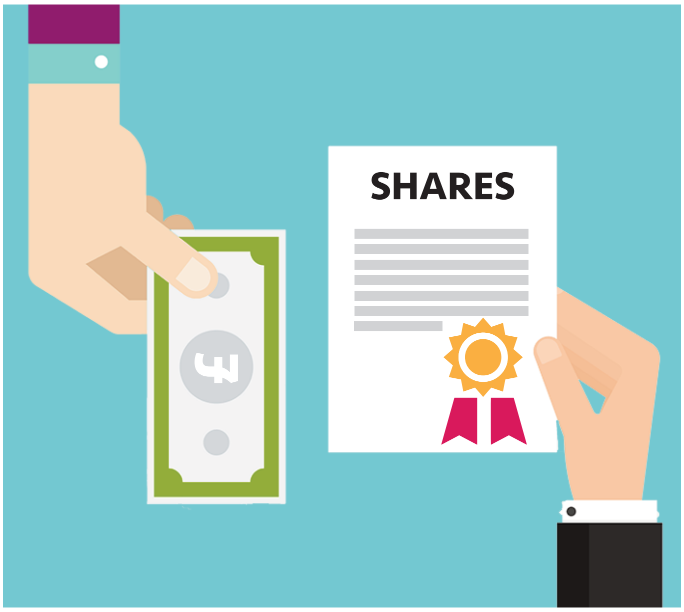
Terry Smith (of Fundsmith, and author of *'Accounting for Growth'*) for example has been openly critical of buybacks on the basis it creates an accounting illusion of EPS growth. LAPFF absolutely agrees with that, and covers this aspect in some detail, but there are many other problems too.

Buybacks have been promoted on the basis of various theoretical constructs, including that management are the best placed to identify when the company is undervalued, and hence buybacks result in an increase in shareholder value.

However, even were that presumed insight to exist, in practice there are many problems and conflicts associated with that premise. Such problems include distortion of performance, and the use of such distortion to justify the pay of executives, and inevitably prolong their tenure also.

In short it does seem that buybacks have been promoted by parties with a self-interest in having buybacks as opposed to simple, and transparent, dividends.

Fundamentally, long-term investors wish to invest in companies based on the belief that their business models will deliver value for the long term. Investing in companies that are pursuing a model parallel to that, what amounts to little more than short-term speculation in their own shares, does not fit with that investor objective.



This paper doesn't aim to set a policy for distributions by amount, merely to question whether buybacks are an appropriate method of returning profits (or surplus funds) to shareholders.

During July 2015, Andrew Haldane of the Bank of England raised the question of whether companies are under-investing due to distributing too much. One problem with buybacks is that it is a method of distribution that gives a false impression that the company is investing and growing share-price and EPS. Similar questions are also being raised in the USA.

Though this paper does not seek to enter into quantitative analysis, it has been observed that the period since 1997, when buybacks have been increasingly prevalent in the UK market, corresponds with FTSE 100 share index (which is ex-dividends) performance that has basically gone sideways. Whilst that poor investment return will have been supplemented by dividends, capital performance – as it is flat - has not actually been enhanced by the buyback activity in this period.

It is also interesting to observe that investment performance of the FTSE 250 index, where buybacks are very much less prevalent, is far superior in capital terms and total shareholder return than the corresponding measures in the FTSE 100.

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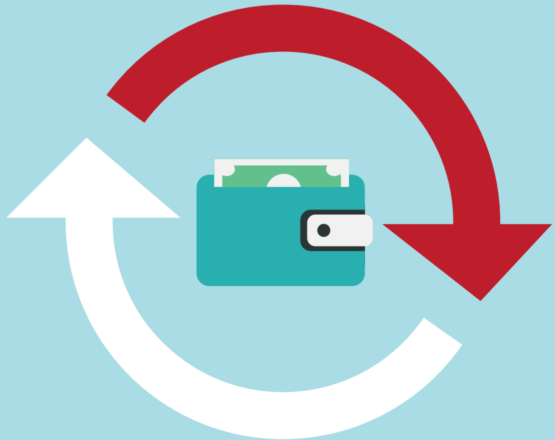
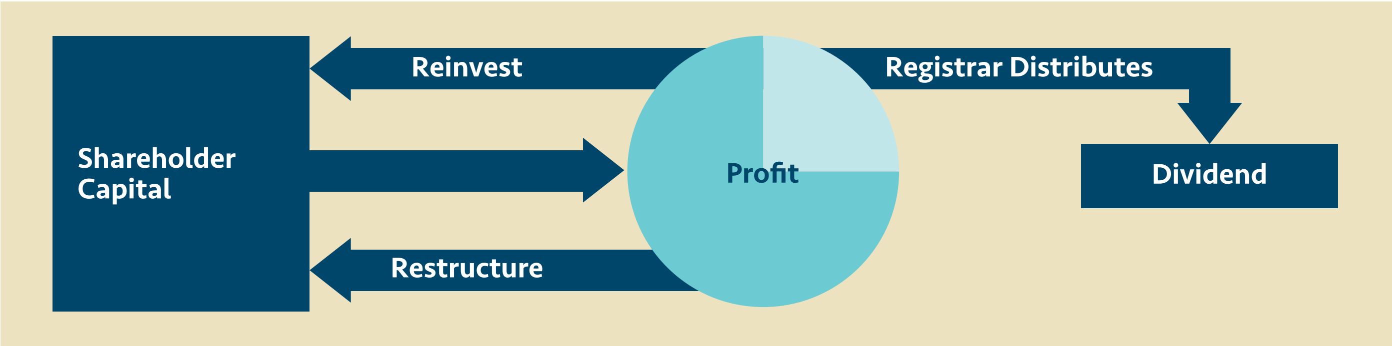
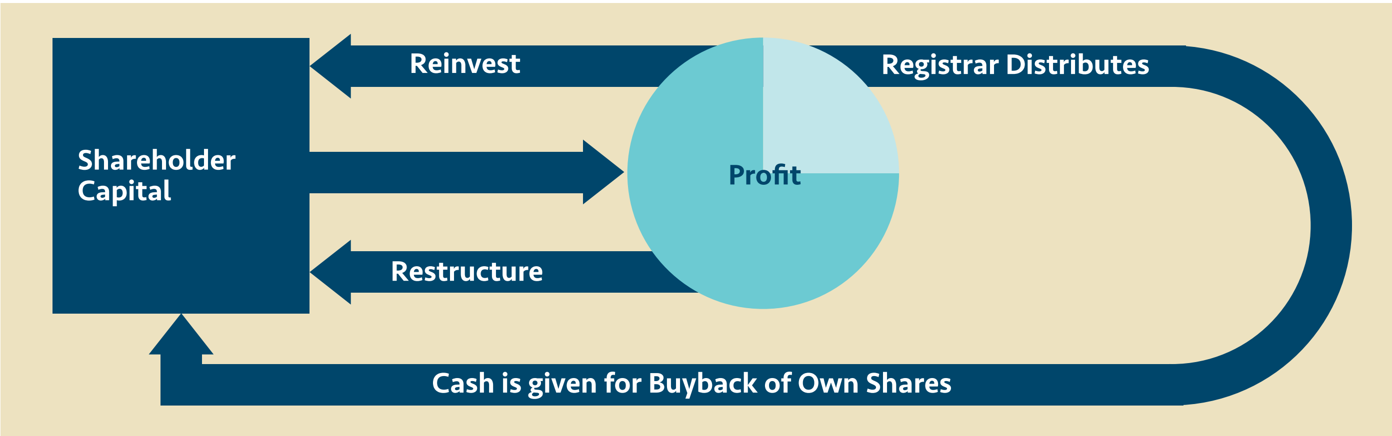


1) WHY DISTRIBUTION OF PROFIT MATTERS

The basic distribution model with dividends
When profit is generated by a company the following scheme shows the various things that a profit can be used for: distribution **as dividend** to shareholders, reinvestment, funding growth, increasing the capital base to allow more borrowing, or restructuring. The dividend yield of the FTSE All Share Index is typically in the range 3.0%-3.5%.



The distribution model with buybacks
When profit generated by a company to **fund share buybacks** the following applies. Rather than shareholders receiving a dividend, the cash is spent purchasing shares to buy out exiting shareholders. The net effect is that remaining shareholders instead of receiving a dividend own a larger share of the company instead.



Buyback and reissue
A further complication arises where shares bought back are later reissued.

Pre-year 2000 shares bought back had to be cancelled. However, the law was changed to allow shares to be held "in treasury", i.e. the company does not cancel them but holds them to release later, which may include their re-issue to executives and employees. When this occurs, then the purported benefit of public remaining shareholders owning more of the company as a result of buybacks is negated or at best diluted.

Treasury shares also complicate matters in terms of analysis and disclosure. The cumulative impact of buybacks is itself opaque as there are no disclosure requirements for recording the extent to which shares were bought back in prior periods. Put simply, there is no clear single figure trend as with a dividend. Treasury shares add further complication to this as there are various permutations and combinations in terms of what then happens to them. Some companies are holding treasury shares and do disclose this, but even those that do are then sometimes cancelling the treasury shares at a later date, or reissuing[1].

Does the long term shareholder benefit?
To answer this question requires weighing up several factors which includes; whether it distorts reported performance measures, including those used for director pay. The cost of undertaking buybacks also needs to be considered. There is then a more behavioral question as to whether management should be in the business of assessing whether their shares are underpriced. There is a related question of whether buybacks, in the short run, act to support the share price, due to the company itself being a large buyer in the market.

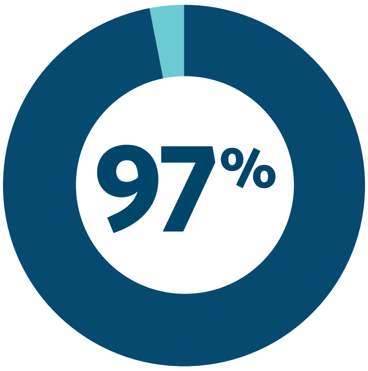
[1]The various combinations at play are: 1) Shares bought back and cancelled immediately, 2) Shares bought back and held in treasury and never reissued. 3) shares held in treasury and then reissued 4) shares held in treasury and then cancelled.

2) THE INCIDENCE OF BUYBACKS

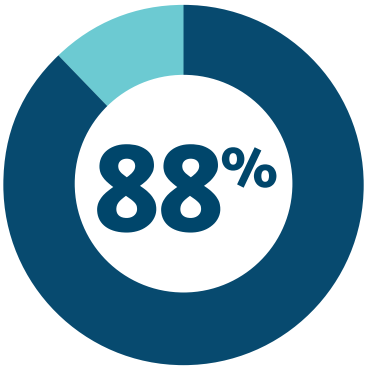
The following data was extracted from PIRC research.

Companies seeking authority to purchase shares 2014/15

FTSE 1-100

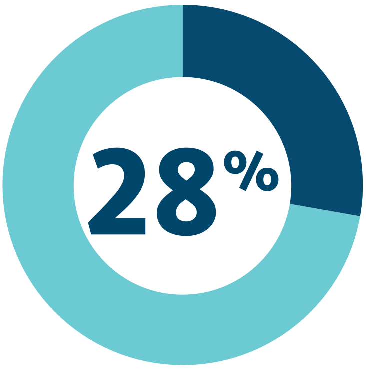


FTSE 101-350

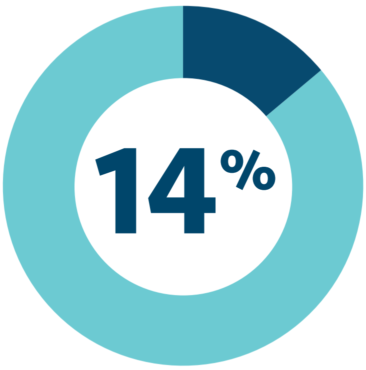


Companies actually purchasing shares 2014/15

FTSE 1-100



FTSE 101-350



Of note is that company secretaries are proposing buyback authorities at companies that are not actually conducting buybacks. Unless boards are collectively agreeing to seek the authority based on a proper understanding of the issues, it would appear that company secretaries may be unduly pressurised into a decision to undertake buybacks merely because everyone else is doing it. Put another way, buybacks have 'gone viral' with little basis for support, which suggests a herd-like mentality.

3) ADVANTAGES OF BUYBACKS? A DIRECT COST TO SHAREHOLDERS' FUNDS

On the basis of finance theory alone, the outcome of undertaking a buyback or dividend is financially neutral.

However, one factor in the UK in particular instantly changes that presumption.

Buybacks in the UK incur 0.5% Stamp Duty*, and also result in investment banking and broker fees which may be at least another 0.2%.

That compares to dividends where payment of dividend is a fixed cost irrespective of the amount, and therefore marginal increases to existing scheduled dividend payments should be zero. A 100p per share dividend costs the same to execute as a 5p per share dividend.

Long-term shareholders will not benefit from the funds used (cash) ending up in their pocket, but they will benefit to the extent that the value of the remaining shares rise. A consequence is that buybacks are inherently inequitable to long-term shareholders in those cases where the share price does not in fact increase.

***Note:** In preparing this document there has been some expression of disbelief that buybacks incurred 0.5% Stamp Duty (though investment banking fees were not disputed). To clarify the matter a copy of the filing of a BP plc share purchase with Companies House is shown below of £25.3m, with the requisite stamps attached for the £126,630 stamp duty payable affixed to the form required to reduce the number of shares in issue as recorded by Companies House.

2014 Q4 UK 10

LB11513

In accordance with Section 707 of the Companies Act 2006

SH03
Return of purchase of own shares

126689.

Companies House

✓ **What this form is for**
You may use this form to give notice of a purchase by a limited company of its own shares

✗ **What this form is NOT for**
You cannot use this form to g notice of a purchase by an ur company of its own shares

FRIDAY

A3ZNTSE0
A08 23/01/2015 #232
COMPANIES HOUSE

1 Company details

Company number: 1 0 2 4 9 8

Company name in full: BP p l c

→ **Filling in this form**
Please complete in typescript or in bold black capitals

All fields are mandatory unless specified or indicated by *

2 Shares purchased for cancellation

The section below should be completed by public limited companies (PLC) only

Class of shares (E g Ordinary/Preference etc)	Number of shares purchased	Nominal value of each share	Date that the shares were delivered to the company	Are these qualifying shares? ❶	Maximum price paid for each share	Minimum price paid for each share
Ordinary	1,475,000	$US 0 25	04 / 12 / 2014	☑ Yes	437 35	422 55
Ordinary	1,460,000	$US 0 25	05 / 12 / 2014	☑ Yes	439 70	429 75
Ordinary	1,475,000	$US 0 25	08 / 12 / 2014	☑ Yes	437 70	424 70
Ordinary	1,486,000	$US 0 25	09 / 12 / 2014	☑ Yes	429 30	422 50
			/ /	☐ Yes		

Please show the aggregate amount paid on shares purchased for cancellation

Total aggregate amount: £25,325,588

❶ **Qualifying shares**
Qualifying shares are shares eligible to be placed into treasury

For HM Revenue and Customs Stamp Office only

BIS Department for Business Innovation & Skills

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4) LACK OF TRANSPARENCY OF REAL PERFORMANCE

Buybacks result in a lack of transparency on financial performance generally.

All share related measures are changed, in a piecemeal way on too many separate occasions, making any meaningful financial analysis impossible.

For any company, the basic investment/return pattern follows a simple model, but it is subject to uncertainty of investment outcomes

Where the company does not do buybacks, then there is a perfect marriage in the numbers for financial return on capital employed (earnings yield) and earnings per share; and growth (year on one year change). This can be best explained by looking first at the basics of actual company investment returns, dividends and growth.

Mathematical relationship

$$\begin{tikzcd} \text{The return on investment} \arrow[r, "R"] & \text{profit for reinvestment or distribution} \arrow[r, "D"] \arrow[l, bend left, "G"] & \text{dividend} \end{tikzcd}$$

and the next year:

$$\begin{tikzcd} \text{The return on investment} \arrow[r, "R^1"] & \text{profit for reinvestment or distribution} \arrow[r, "D^1"] \arrow[l, bend left, "G"] & \text{dividend} \end{tikzcd}$$

This can be summarised as:

Return on Investment Percentage=Dividend Percentage+Growth Percentage
(=the Return Percentage-the Dividend Percentage)

If return on investment = 10% and dividend is 3.5%, then growth (in next year's earnings and next year's dividend) is 6.5%

Example Company A - does not undertake buybacks

	Year 1	Year 2	
Shares in issue	100m £200m mkt cap	100m £213m mkt cap	
Price per share ex div	£2	£2.13	6.5% growth in share price
Profit after tax	£20m (20p per share)	£21.3m (21.3p per share)	6.5% growth real earnings and earnings per share (EPS)
Annual dividend	£7m (7p per share)	£7.455m (7.455p per share)	3.5% dividend yield 6.5% dividend growth

On this model Earnings per Share (EPS) and Total Shareholder Return (TSR) should adequately explain what is going on in terms of fundamental financial performance. Indeed the validity of earnings per share as a useful measure in looking at performance and valuation is precisely due to the basic relationships above.

Example Company B - undertakes buybacks

	Year 1	Year 2	
Shares in issue	98.5m £200m mkt cap	96.926m £213m mkt cap	
Price per share ex div ex buyback	£2.03	£2.197	8.23% growth in share price[2]
Profit after tax	£20m (20.3p per share)	£21.3m (22.0p per share)	6.5% growth in real earnings 8.23% growth in EPS[3]
	Distributions		
Buybacks	£3m (1.5m shares @ £2 per share)	£3.195m (1.574m shares @ £2.03 per share)	Buybacks result in no cash return to holding shareholders
Annual dividend	£4m (4.06p per share)	£4.26m (4.395p per share)	6.5% growth in (smaller) dividend 2% dividend yield 8.23% growth in dividend per share
	Total distribution £7m	Total distribution £7.455m	

Items coloured in green are the fundamental things that remain the same

Items coloured in blue is the fundamental thing that has gone down – the amount paid as a dividend to remaining shareholders

Items coloured in red are the growth statistics inflated merely due to having less shares in issue

Investment and monitoring investment performance is difficult enough with natural uncertainty and variation in the real world. On top of that uncertainty and variation buybacks are a further distortion which make a considerable number of measures so complex as to be meaningless as well as misleading because it is impossible to strip back (to recalculate) the underlying numbers. It is a case of moving the goal-posts.

[2]This 'growth' is merely an amount replacing the amount that would have been paid as dividend
[3]This 'growth' is merely due to reducing the number of shares in issue

5) MANAGEMENT CONFLICT WITH THE SHAREHOLDER INTEREST

Buybacks, in the absence of solution to re-adjust the numbers, may inherently create a risk of misaligning management and shareholder interest in the following ways:

a) in the area of remuneration

b) lack of transparency

c) less accountability for actual business performance

Remuneration schemes
Buybacks give the impression of earnings growth by creating EPS growth.

The majority[4] of FTSE 100 pay schemes use EPS growth as a performance condition. This paper is not a critique of executive pay.

However, if EPS is used as a measure for executive pay, it becomes clear that payouts will not be linked accurately to company financial performance.

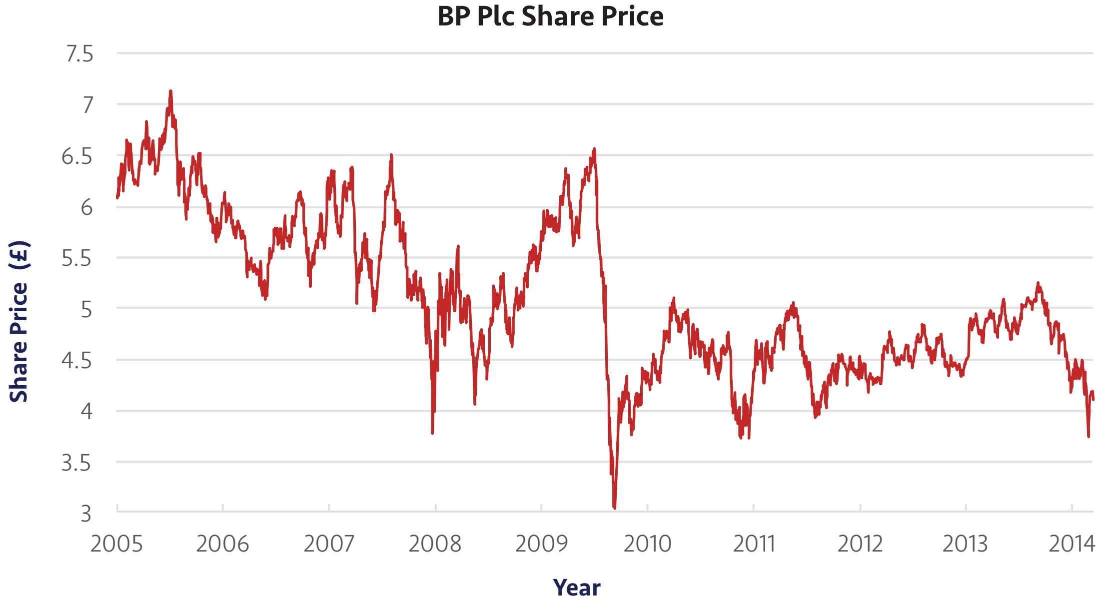
The link of pay to EPS growth, as a result of buybacks, as opposed to real earnings growth, may create an incentive to undertake buybacks due to the nature of the commonest remuneration schemes.

Running the company or gaming the market? Can management predict the long run share price?
The rational basis for investors forgoing dividends to accept buybacks in their place, rests on the assumption that instead of receiving income as a dividend the remaining shareholders will own a higher proportion of the company, for which the value goes up as a result of having less shares in issue, as well as the normal expected increase in value of a business over time, i.e. growth in the net assets and the expected return from those assets.

This proposition breaks down where, even post buy-back, the price per share actually goes down. When this occurs, the shareholders end up owning a higher proportion of something worth less.

However, inherent in equity having a risk premium attached is the fact that equity investment carries uncertainty and some investments will not perform at all. Therefore it does seem odd to establish buybacks as a policy decision for nearly all companies when inevitably not all of these will be winners.

This can easily be demonstrated in the case of BP.



The BP share price at 10 August 2015 was 372p, its lowest other than the period immediately following the Deepwater-Horizon spill in the Gulf of Mexico (when the company was neither paying dividends nor undertaking buybacks). Therefore on average over ten years the value of each share post buy-back is far lower than it was pre-buyback. Put another way BP rather than returning cash to all shareholders, or investing in appreciating assets, BP has invested in depreciating assets. Its own shares.

[4]Source, PIRC data.

Accounting for buybacks

If any company other than BP was buying BP shares over the period that BP has been conducting its purchases of its own shares, that company would show an investment in shares as:

Cost of aquiring shares – Current value of shares aquired
=Loss of shares acquired

In the case of the company acquiring its own shares, the cost of acquiring shares is not charged to the profit and loss account as a distribution. Any accountability, through the numbers, for the effectiveness of that repurchase is lost, as lower prevailing share prices are not reflected in the accounting, or, by way of note. There is nothing to stop companies showing this by way of a note somewhere, [indeed it is perfectly feasible for investors to log this information to remind companies of the effectiveness of their decision to buyback shares].

Market abuse or management optimism

The question of whether management can actually identify when shares are cheaper now than they will be in the future (which is the raison d'être for buybacks) is betrayed in the cases of, for example, Royal Bank of Scotland and Tesco, where there are issues of competence and honesty in play. Both have had aggressive buyback strategies and have not delivered value for shareholders in later years. Tesco to 2014 was running with accounting irregularities, RBS was actively writing unprofitable[5] business in the period prior to its collapse and rescue. There is then an additional question of whether in cases where management are able to identify that shares are cheap that dealing in the market, even if permitted by regulation, is appropriate, i.e. in substance does it still amount to insider dealing?

The investment proposition changes from:

The return on investment → profit for reinvestment or distribution → dividend
G

The return on investment → profit for reinvestment or distribution → dividend
G or buybacks → buybacks

Guinness/United Distillers

Buybacks, as a result of having a large buyer in the market, may raise/support the share price, leading to volatility, as well as overpayment.

The fact that relatively small purchases of a company's own shares can increase or "support" a share price, formed the basis of the criminal charges in the Guinness/United Distillers scandal in the late 1980's. The **incentive** was to "support" (i.e. increase, or stop the fall in) the Guinness share price in order to make the all-share offer by Guinness appear more valuable than the position of a rival bidder. However, the **process** was essentially the same as with buybacks (which were then illegal, but are no longer illegal under all circumstances), with the company's broker who went into the market to buy shares.

[5]Banks write long-term loans. The true result of a loan won't be known until all the interest and capital is paid off, or not. Any profit taking before the end of the contract is an estimate, and the more that profit is booked early on business that will in the long-run be unprofitable, the larger the sum that will that will be booked as a loss (i.e. the actual loss, plus the profit that was taken that needed to be written off).

6) UNCERTAINTY AND SANCTIONS FOR GETTING IT WRONG

Uncertain as to the amount
Dividends are by their nature a distribution of a known amount at a given time, with known effect. Directors in approving a dividend will be aware of all of the financial consequences. The only delegation is to the financial director to approve the payment to the Registrar who then divides this up to pay the individual amounts to each shareholder.

Buybacks are by their nature piecemeal purchases in the market over a period of time, pre-approved by general authority to conduct buybacks, and executed by an open ended process, hence the end result is not fully under the direct control of the directors. Transactions are executed by brokers as intermediary, and then settlement is made. The precise outcome (as it depends on prevailing share-prices) will not be known until after the event, therefore for a given sum of money, the directors won't actually be aware of how many shares will be bought back.

Criminal sanctions on directors
There are also legal quirks, the implications of which directors themselves may well not understand. Dividends that were unlawfully paid out of capital, or where the correct processes have not been followed, do not attract criminal sanctions, merely civil liability. For buybacks, the UK Companies Act is different. Wrongful buybacks, even where the process is wrong on technical grounds, create a criminal offence in the first instance[6].

[6]Section 658(2) CA 2006 provides that share purchases which are contrary to Part 18 CA 2006, which includes the provisions relating to relevant accounts under S712 CA2006, creates a criminal offence for which every officer of the company, not merely the directors, are accountable. A company secretary is an officer of the company.

7) PRE-EMPTION AND SUNDRY ISSUES

Circumventing pre-emption and treasury shares
It is a fundamental principle of company law that shares can only be issued by giving pre-emptive rights to existing shareholders equally, "first refusal" basically. This is subject to shareholder approval for waiving pre-emption rights up to an issue limit. Pre-emption rights are an essential protection for shareholders to prevent both economic dilution (from issuing shares cheaply to another party) and voting dilution.

Share repurchases can interfere with pre-emption rights by taking one of two routes: buybacks with immediate cancellation, or buybacks where the shares are not cancelled, but held in treasury. In the case of shares held in treasury there is the risk that:

- shares held in treasury, to be released in dribs and drabs outside of pre-emption, and on top of any other waiver of pre-emption rights in place,
- shares bought back may then be released for share schemes, masking the true dilution effect of schemes, and the extent to which pre-emption rights might be affected.

If a hazard of buybacks is management buying back their shares at too high a price, the converse is true if shares are being reissued out of treasury at too low a price. The lack of accounting for buybacks is even more marked when the buyback is only temporary due to reissue from treasury.

Buybacks may create problems of creeping control of already large individual shareholdings
It is a mathematical fact that if buybacks are occurring and large shareholders are not participating, they may acquire creeping control of the company. An example of this was Goldman Sachs. LAPFF identified in 2012/13 that Goldman (which had been solely employee owned as a partnership prior to flotation) was both undertaking buybacks and then re-issuing shares to employees. The result of this was the public shareholding in Goldman Sachs was falling. LAPFF engaged with the Chairman and shortly afterwards the company confirmed that it would reallocate more of its distribution from buybacks to dividends.

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Design by Stephen Levesley, West Midlands Pension Fund

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