

# thebigpicture

guideposts for the private investor

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*thebigpicture* guideposts for the private investor is published by *thebigpicture* Economics (ABN 71 040 787 936). The author, John A Robertson, while working in Australia, London and New York, has over 20 years experience in international financial and commodity markets, corporate strategy, financial and business evaluation and government policy. He has been Chief Economist and a director of a leading Australian investment bank. He has been a top-rated institutional equity analyst and has marketed investment advice in all the major international financial centres.

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## SHARE REPURCHASES: THE SAFEST INVESTMENTS

**With lower share prices extending across the market, companies will begin to consider more actively the possibility of buying back their own shares.**

An investment in itself, the business it knows best, might offer a company superior returns to other forms of acquisition while economic conditions remain uncertain or there are only limited opportunities in a relatively small domestic market. If seen as a real alternative, buying back shares might help avert the need for offshore investments.

The share buyback is one of several ways of returning funds to shareholders, including:

- dividends (special or ordinary);
- a capital reduction and distribution; and,
- an in-specie share allocation.

The philosophical argument in favour of repurchasing shares rests on the idea that company equity belongs to shareholders. It is the responsibility of the company to invest the funds to obtain a return which at least matches the minimum standard required by the shareholders. If it is unable to do so, the equity should be returned because, in theory, participating shareholders would be able to get their required return elsewhere in the market.

*"...company equity belongs to shareholders. It is the responsibility of the company to invest the funds to obtain a return which at least matches the minimum standard required by the shareholders."*

Generally speaking, a share buyback has little impact on overall economic performance of a business (measured as the size of the operating profit relative to the total funds employed) since it is essentially a substitution of equity with debt.

A share buyback can, however, reduce the average cost of funds employed by replacing relatively expensive equity with relatively inexpensive debt. In doing so, the spread between the economic return generated by the business and its cost of capital is widened enhancing the value being added by the company. These higher economic profits should be valued by the market and reflected in the share price.

A buyback can also enhance earnings per share as long as the lower number of shares which remain on issue offset the added interest charges due to the higher debt. In this way, the share repurchase is able to supplement the earnings growth rate and improve the share price. Such a benefit is dependent, however, on there being some form of continuing and regular repurchase scheme so that the market is able to factor it into the future growth profile of the company and adjust the valuation accordingly.

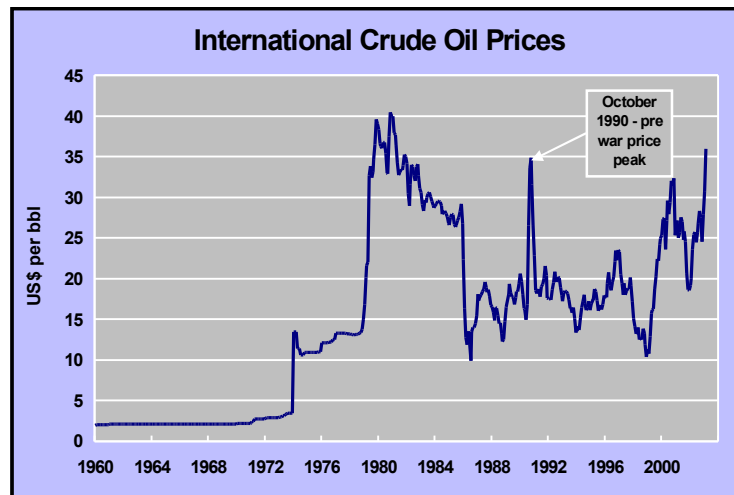
To the extent that a company regards a share buyback as one of its capital management tools, it is a signal that the management recognizes the interests of the shareholders and, in so doing, helps boost the standing of the company within the investment market.

There can also be negative messages from a share buyback. One is that the company has insufficient investment opportunities upon which to apply the equity funds. Such a signal can lead to questions about the sustainability of the company's growth profile and, depending on the growth which has already been factored into the share price, detrimentally affect the market performance.

The costs associated with raising capital are also a constraint on undertaking a buy-

*(Continued on page 2)*

## THE WEEKLY CHART SPOT



Source: International Monetary Fund & Energy Information Agency.

Crude oil prices have reached \$37 a barrel on international markets. Global conditions have not changed so greatly since the price was less than \$20 a barrel a year ago. However, market speculation in anticipation of a war in the Middle East and political strife in Venezuela have had an effect on market risk.

Previous experience says the price should revert to lower levels shortly after shooting commences in the Middle East and it becomes obvious that a US victory will be swift.

The danger now for investment markets is that the decision to commence shooting is continually postponed but always on the verge of being taken. In these circumstances, the higher price begins to influence economic decision-making.

The need to pay extra at the petrol pump for a prolonged or indefinite period will cause consumers to reappraise their spending priorities, lopping the more discretionary items of expenditure, probably affecting the retail sector in the first instance.

The cost impact of higher prices will also begin to have an effect. To the extent that the cost impost is expected to be prolonged, future profitability will be reappraised and investment spending and employment adjusted to accommodate the more pessimistic outcomes.

Reported measures of inflation will also begin to reflect the higher prices. While such impacts can be disregarded as long as the effects are expected to be temporary, this is harder the longer the effects linger. For example, there will be attempts to recoup the lost purchasing power through higher wages, further affecting corporate profitability.

Happening at a time when it is necessary for corporate profitability to catch up with some still inflated equity prices, the detrimental impact on profitability would jeopardize the ability of the market to hold near current, albeit depressed, levels. Also, tendencies toward higher inflationary expectations would limit the extent to which the Reserve Bank might be inclined to keep interest rates low to support higher rates of economic activity (and business profitability and equity markets).

## SHARE REPURCHASES: THE SAFEST INVESTMENTS CONT'D

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back. In the event that a company buys back shares and subsequently requires additional funds for an unanticipated investment, it will have incurred transaction costs for both the buyback and the subsequent capital raising. Also, market conditions might not be propitious for raising capital when it is needed. Conservative management would, therefore, be inclined

to retain access to existing capital, sometimes guarding it jealously.

There is also some uncertainty about the valuation impact of a buyback. A dividend or capital return delivers a fixed amount of cash and, therefore, definite value, to a shareholder. A buyback, on the other hand, only adds value for the remaining

(Continued on page 3)

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## SHARE REPURCHASES: THE SAFEST INVESTMENTS CONT'D

(Continued from page 2)

shareholders and, even then, this might not occur if growth expectations are disappointed by the buyback and are revised down by the market.

Moreover, shareholders who elect to participate in the buyback may fail to gain any particular advantage. There are constraints on how a share repurchase plan

is implemented. It is possible that shares are bought back at a price not significantly different from the level at which they would have otherwise traded in the market without intervention.

For reasons such as these, companies are often reluctant to embrace a share buyback as readily as the theoretical arguments might indicate they should.

## Debt Levels Highlight Buyback Capacity

**One sign of the capacity of a company to undertake a share repurchase is its existing balance sheet gearing.**

Many of the larger listed companies are in a position to increase their balance sheet gearing. Their capacity to do so reflects the emphasis in recent years on achieving better returns by disposing of underperforming businesses and the absence, in many cases, of substitute investments into which the excess funds can be deployed.

Nonetheless, company circumstances do vary.

Some companies such as Cochlear, Flight Centre and CSL, for example, are on relatively early stage developmental growth paths and might prefer to conserve their financial resources to ensure that they have the capacity to fulfill their plans. Others, such as Lend Lease and Leighton, have historically been conservative in their financial management and, with their shareholders accepting this approach, use their balance sheets to back their entry into large developmental projects.

Yet others, such as Woolworths, Mayne Group, Southcorp and Wesfarmers, are in a more mature phase of their corporate lifecycles and are candidates for the more aggressive financial management which a share repurchase signifies. However, they have created expectations of growth which can only be delivered through external investment initiatives. Failing to use their balance sheets for this purpose would flag to investors that they might not be able to deliver the growth to which they aspire and on which their share prices are at least partly based.

Some others, such as resource companies MIM Holdings and Rio Tinto, could be regarded as already having excessively leveraged balance sheets.

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Company	Gearing <sup>1</sup>	Interest cover <sup>2</sup>
Flight Centre Limited	-109.7	6.4
Leighton Holdings	-66.4	35.2
Amcor Limited	-6.3	3.0
Lend Lease	8.9	3.5
Woolworths Limited	13.1	10.1
Mayne Group Limited	15.0	4.1
Stockland Trust Group	15.4	10.8
Macquarie Infrastructure	16.6	5.5
Cochlear Limited	17.3	34.1
Patrick Corporation	21.8	9.0
General Property Trust	25.9	8.2
Coles Myer Limited	26.7	4.1
Southcorp Limited	31.2	4.8
Harvey Norman Holdings	36.3	6.1
Origin Energy Limited	39.8	3.6
Wesfarmers Limited	40.5	5.1
CSL Limited	42.0	4.4
CSR Limited	43.2	5.9
Westfield Trust	43.4	3.8
John Fairfax Holdings	43.6	2.2
Mirvac Group	44.4	5.7
Boral Limited	45.2	3.7
Santos Limited	46.1	7.6
Goodman Fielder Ltd	49.1	2.7
Orica Limited	49.6	1.6
Coca-Cola Amatil	49.7	2.2
PBL	50.7	2.8
Tabcorp Holdings	50.9	5.4
BHP Billiton Limited	52.1	8.5
Woodside Petroleum	54.9	9.5
M.I.M. Holdings Limited	63.2	1.2
Lion Nathan Limited	64.0	1.9
Coal & Allied Industries	64.0	3.9
Transurban Group	72.3	0.3
Aristocrat Leisure	73.6	9.1
Foster's Group Limited	74.7	3.8
Rio Tinto Limited	77.1	5.0
Westfield Holdings	77.1	4.2
The News Corporation	77.2	0.8
Toll Holdings Limited	81.6	5.6
Telstra Corporation	87.0	4.7
Qantas Airways Limited	96.2	9.6
AGL	118.8	1.8
Brambles Industries	127.9	2.5
Westfield America Trust	152.0	1.2

1. Net debt to shareholders funds.

2. After tax operating profit as a multiple of interest expense.

## THE BUYBACK DECISION: HOW IT WORKS

The interplay between existing levels of debt, interest rates and the size of a share buyback will determine whether it can make sense for shareholders.

	Initial position	After 20% buyback
Shares on issue	1,000	800
Issue price (\$)	2.00	2.00
Equity (\$)	2,000	1,600
Debt (\$)	-	400
Gearing (%)	na	25
PBIT (\$)	200	200
Interest (\$)	0	24
Tax (\$)	60	52.8
Net profit (\$)	140	123.2
Earnings (cents per share)	14.0	15.4

The example in the table shows a company which has issued 1,000 shares at \$2 each (making total shareholders funds of \$2,000). It is generating profit before interest and tax of \$200. The balance sheet is ungeared.

Subsequently, the company repurchases 20% of its outstanding stock. Although net profit is reduced from \$140 to \$123.2, the reduction in the number of shares on issue more than offsets the fall and earnings per share are increased by 10% to 15.4 cents. On the assumption that the market continues to accord the company the same rating (which had been a price/earnings ratio of 14.3), the share price would rise by 10% from \$2.00 to \$2.20.

Conceptually, earnings can keep rising as long as the equity is being replaced by cheaper debt. However, debt cannot rise indefinitely without some effect on borrowing costs. The second table shows how the theoretical share price would vary with changes in the size of the share buyback (in the left hand column) and movements in interest rates (on the top

row of the table).

Following the example, assume that the size of the share repurchase was boosted to, say, 30% and the applicable interest rate rose to 8%. The implied share price, if this happened, would be reduced to \$2.17.

A company seeking to optimize value for shareholders must make some judgements about the desirable size of a prospective share repurchase based on its borrowing capacity and the reaction of debt markets to the increased borrowing.

The reaction of the markets to higher levels of debt will depend on the cash flow and cyclicity of the underlying business. A consumer goods company, for example, which is regarded as having relatively secure and stable cash flows, will be able to sustain a relatively high level of debt. Some would say that gearing (debt/equity) in excess of 100% could be acceptable and represent an effective (albeit aggressive) use of shareholder equity.

On the other hand, a resources company which is subject to significant cycles needs the cushion afforded by lower gearing. For such a company, gearing around 30% might be more appropriate so that it can weather sustained downturns in commodity prices or be able to take advantage of depressed conditions by being able to buy assets from distressed sellers at the bottom of the cycle.

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		Interest Rate on Borrowings						
		6	7	8	9	10	11	12
Size of Share Repurchase (%)	0	2.00	2.00	2.00	2.00	2.00	2.00	2.00
	5	2.04	2.03	2.02	2.01	2.00	1.99	1.98
	10	2.09	2.07	2.04	2.02	2.00	1.98	1.96
	15	2.14	2.11	2.07	2.04	2.00	1.96	1.93
	20	2.20	2.15	2.10	2.05	2.00	1.95	1.90
	25	2.27	2.20	2.13	2.07	2.00	1.93	1.87
	30	2.34	2.26	2.17	2.09	2.00	1.91	1.83
	35	2.43	2.32	2.22	2.11	2.00	1.89	1.78
	40	2.53	2.40	2.27	2.13	2.00	1.87	1.73