

# thebigpicture

guideposts for the private investor

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## **Publishing and Subscription Information**

*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 BUYBACKS: SELL & WIN; STAY & LOSE?

Share buybacks are not what they were originally intended. Amidst the current share buyback fad, there might be as many benefits for a departing shareholder as one remaining.

A share buyback is a so-called capital management initiative to improve the economic performance of the corporation. In theory, the company should be able to buy back some of its shares at prevailing prices and make the remaining shareholders better off than they were before.

The benefit comes from two sources:

- fresh market demand for shares to help prop up the price in the short term; and,
- the economic value impact, in the longer term, from restructuring the balance sheet.

In the classic buyback model, remaining shareholders own the same income stream but it is now funded by more debt (with less equity) and split among fewer shareholders. The value proposition depends on a switch from relatively high cost equity to cheaper debt financing.

### The Corporate Buy-Back Sequence

- Buy back shares
- Reduce (relatively expensive) equity in balance sheet
- Fund the buyback using (relatively cheap) borrowings
- Leave total capital (debt + equity) unchanged
- Average cost of capital used is reduced
- Operating profit is unchanged
- Rate of return (profit on funds employed) is unchanged
- Spread between rate of return and cost of funds widens

*“...nothing is as certain as cash and taxes.... [h]owever, if the averages hold, there should be value for a shareholder in staying the course.”*

The selling shareholders, by definition, have decided to forego future value since the company would only be buying back shares as long as their market price is below their intrinsic value.

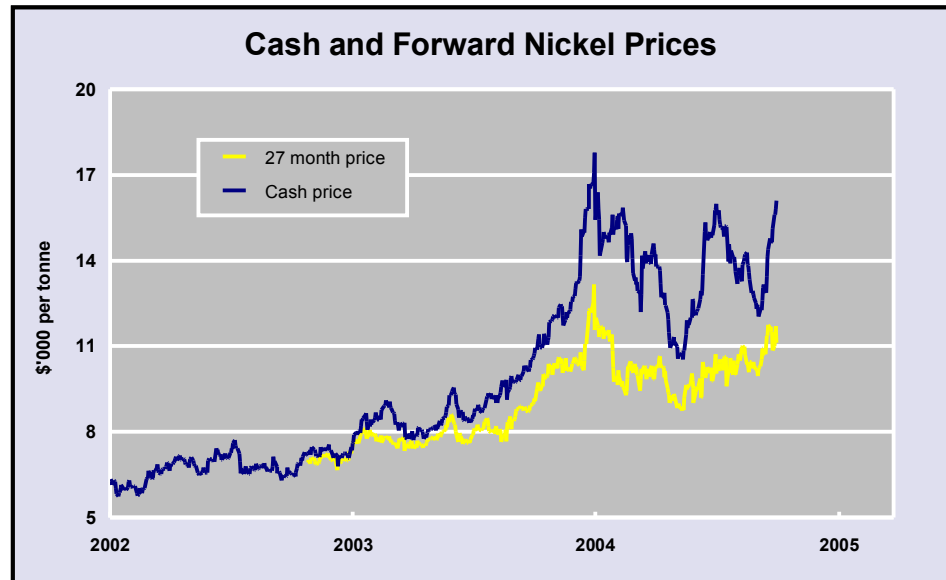
By participating, the former shareholder shows that company value is not his principle driver. Either that or he does not share the view of management and remaining shareholders about the prospects for the company.

More recently, the buyback has been dressed up to enhance its attractiveness to a seller. Companies like BHP Billiton, Telstra and Commonwealth Bank have structured an offering made up of a dividend and a capital component. With the dividend comes franking credits. Reducing the capital component of the receipt below the market price may also mean lowering potential capital gains tax payments.

In these versions of a buyback, the after tax return from accepting might be more attractive than selling the stock on the market at the prevailing price. Depending on one's tax circumstances, there might be benefits from buying shares in the short term solely to participate in the buyback. Typically, this strategy is more likely to suit a tax-

*(Continued on page 2)*

## THE WEEKLY CHART SPOT



Source: London Metal Exchange

Nickel prices have been among the most volatile of metal prices this year. Spot prices on the London Metal Exchange have been at a 40% premium to 27 month forward prices in the past week indicating that fears of metal shortages are intense.

This price differential flags one of the risks for equity investors at this stage of a cycle. When the spot price moves away from the longer term price like this, the former will generally not be subsumed into equity prices. Apparently buoyant metal markets (based on observations of spot prices) can be a trap for equity investors.

Even so, the average forward price so far in 2004 has been 32% higher than in the first half of 2003 indicating that longer term expectations have also been adjusted upward significantly to form the basis for a reappraisal of equity market value.

*“If managers are unable to come up with a business expansion opportunity they have little excuse for failing to build value by sitting on an unchanged balance sheet.”*

## SHARE BUYBACKS: SELL &amp; WIN; STAY &amp; LOSE CONT'D

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payer the lower his marginal rate of tax.

There has been some controversy in the press recently over whether these arrangements are contrary to the best interests of remaining shareholders since they use company resources in a discriminatory fashion by limiting access to a dividend to a narrow class of shareholder.

There is some merit in the argument. Remaining shareholders end up owning less value (by way of foregone franking credits) than they would have done if the simple on-market buyback model had been used.

However, there are two other matters for the investor to consider. In both cases, they relate to what happens afterwards.

In contemplating selling shares back to the issuing company, an investor needs to ask whether the characteristics of the company which prompted the investment in the first instance have changed.

For a start, having a buyback probably means that management thinks the company is worth more than the current market price. That is a signal to stay, not go.

Then, deciding to sell is only half the investment decision. The accepting investor, now with cash in hand, has to decide whether the cash should be reinvested and, if so, what should be bought.

Accepting a buyback only makes sense if there are alternative investments with prospective returns superior to the company being sold (adjusted for the net tax effects a buyback might be structured to provide).

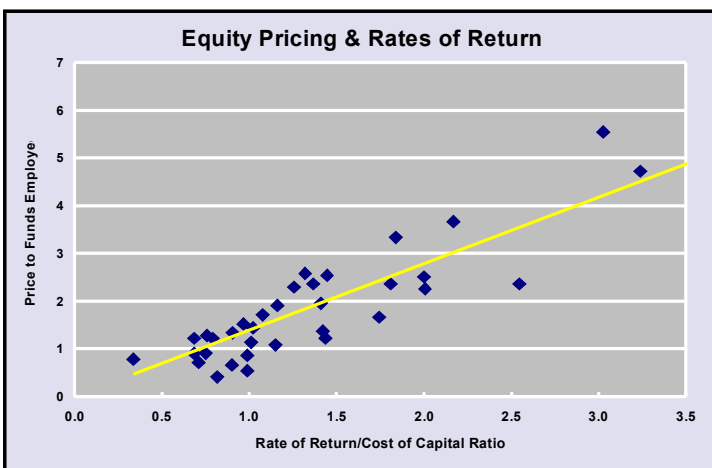
Since a buyback might deliver a larger return than the current market price, a shareholder has to also consider the market risk to his ongoing economic interest since there is a complex sequence between a company initiating a buyback and shareholders being able to realise the incremental value it is supposed to deliver. ■

## SHARE BUYBACKS: WHERE IS THE VALUE?

A company can raise its equity market value by widening the spread between its return on funds and its cost of capital. This is the underpinning for a share buyback.

The chart shows the relationship between the return spread (the ratio between return on funds and cost of funds) on the horizontal axis and the premium the market pays for a company (over the value of the equity and debt being used to run the business) on the vertical axis.

Casual observation suggests a positive correlation between the two measures



and statistical analysis confirms that the relationship is significant. As the spread ratio rises, the market premium expands.

On average, a 10% reduction in shareholder equity leads to a 6% rise in the market value of a company. This is the conclusion from an analysis based on the 35 largest industrial companies listed on the Australian stock exchange.

This group of companies was referred to in the last edition of *thebigpicture* which reported on the financial performance of the larger listed stocks in 2003/04.

These companies had average gearing (measured as debt/(debt + equity)) of 38% at the end of June 2004. To reduce equity by 10%, debt would have to rise by 16.3% to maintain an equivalent level of funding. In the process, the average cost of funds would fall from 8.6% to 8.2%. The return spread would increase, as a consequence, to 1.37 times the average cost of funds.

Among this group of companies, the equity market has been paying 2.04 times funds employed for a company with a re-

turn spread of this size. Before the capital restructuring it would have been paying less for the narrower spread – probably 1.93 times.

In this way, the reduction in the cost of capital could be thought of as adding 5.7% to the market value of the company.

It is doing this without effecting any change in operating performance, emphasising why managers are keen to pursue these opportunities if they are present.

If managers are unable to come up with a business expansion opportunity they have little excuse for failing to build value by sitting on an unchanged balance sheet.

In this example, boosting the return through operational measures to deliver an equivalent gain would require a 0.9% boost in operating profit. Of course, this is only illustrative to put the possibilities in some context. The two strategies are not mutually exclusive. A choice does not have to be made between them if each

initiative is individually feasible.

Confronted by a buyback proposal, the judgement to be made by an existing shareholder comes down to a choice between:

- the certain return from the share buyback less the opportunity foregone in no longer being invested in that company; versus,
- the market response to the reduction in shares on issue and the likelihood of a subsequent re-rating.

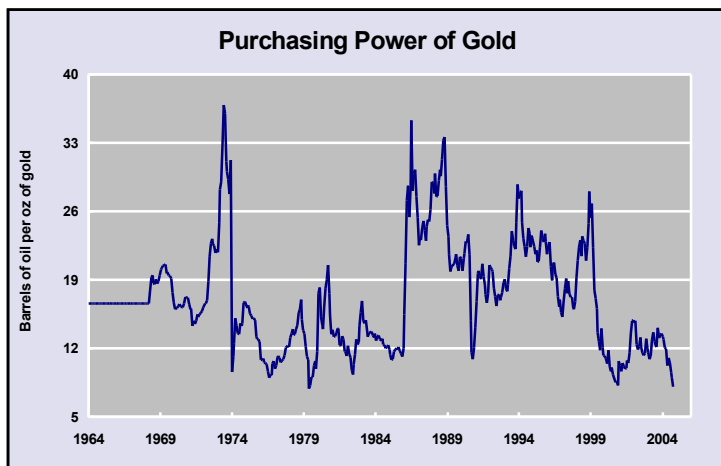
There are market vagaries which might affect whether the averages do hold. For example, a rise in bond yields or international political uncertainty might force a reduction in the premium the market is prepared to pay over the funds employed in the business. But these are the sort of risks faced by any equity market investment.

At the end of the day, nothing is as certain as cash and taxes (even when they are in the form of a rebate). However, if the averages hold, there should be value for a shareholder in staying the course. ■

*“There are market vagaries which might affect whether the averages do hold.... [b]ut these are the sort of risks faced by any equity market investment.”*

## IS GOLD TOO CHEAP?

With crude oil prices having topped \$50 a barrel, gold buys less oil than ever before – just eight barrels an ounce. Does that mean gold is too cheap?



The rapid rise in crude oil prices has prompted some commentators to enthuse about the prospects for gold prices in the aftermath. According to this hope, there is some link between the two commodities which should force gold a lot higher.

Unfortunately, there is little analytical connection between gold and oil. There is no reason why they cannot part company indefinitely or forever.

Gold is almost entirely irrelevant to the functioning of the global economy. Oil is critical. Virtually all the gold ever produced is still available for use. Global supplies of crude oil are being depleted. We can do without one but not the other. It makes sense for the price of one to rise as its relative scarcity takes effect.

The only tenuous link between gold and oil is through inflation expectations. Higher oil prices suggest that inflation pressures will be rising. This would certainly be so if people began to seek higher wages to compensate for higher oil prices and began to embed the oil price rises in the economic cost structure.

But, without this happening, higher oil prices are their own worst enemy. They lower purchasing power, drag down economic activity, create excess capacity and

eventually reduce oil usage sufficiently that the price is driven down to what the economy is better able to bear.

Traditionally, gold had a role as a protector of wealth. When currency was failing

to fulfil its role as a store of value, gold was an acceptable alternative. Hence, in periods of high inflation or when currencies lost credibility there was switching from currency to gold driving up its price and creating additional speculative interest along the way.

The key question: does gold still perform this role? *thebigpicture* is somewhat sceptical on

this point. Gold occupied its role as wealth protector when there were few other alternatives. From Treasuries to blue jeans, the alternatives now abound.

Today, barriers to alternative assets have largely been broken down. Capital has never been freer to move across political borders. There is hardly a place on the face of the earth where there is not a portfolio of choices for an individual losing confidence in the local currency. In this environment, the role of gold is reduced.

One thing going for it, however, is the relatively small size of the gold market compared with currency, financial instrument and equity markets, for example.

Its relative size means even seemingly modest movements in the value of one of these other asset prices can have a meaningful impact on the gold price as markets try to re-establish price equilibrium by adjusting asset portfolios to reflect changes in relative prices.

Even so, there is little doubt that the volatility within the gold market has reduced considerably. Despite abundant reasons for eschewing local currencies, the responsiveness of the gold price to a wide range of other prices, including crude oil, has diminished. ■

*“...there is little analytical connection between gold and oil. There is no reason why they cannot part company indefinitely or forever.”*