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IMPACT OF SHARE BUYBACK ON ECONOMIC VALUE ADDED: A STUDY OF SELECT INDIAN COMPANIES

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Abstract

Unlike most studies, concentrating on impact of share buyback on stock prices, here we examine the effect of companies share buyback on their operating performances through EVA. The study period extends from 1st April, 2009 to 31st March, 2017 i.e. post financial crisis period. So data base of all probable buyback announcement of BSE listed companies are considered from 1st April, 2011 to 31st March 2014 for pre and post buyback analysis.

[Keywords- Economic Value Added (EVA), Operating performance, Share buyback,]

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INTRODUCTION

Share buyback has become an immerging issue not only in business structure but also in academic researches. Times and now, companies tries to adopt corporate strategies to cope with the market scenarios or to maintain the market position. Financial restructuring practices through share buyback are increasing by leaps and bounds. So the volume of researches has also increased to decipher the impact. A major portion of these researches are concentrated to analyse the impact of share buyback on stock prices. Further, several theories have been developed to explain the motives behind the share buyback including information asymmetry hypothesis, leverage hypothesis, free cash flow hypothesis etc. The information asymmetry hypothesis states that there exist information asymmetries due to which companies' shares are undervalued. Thus the managers think that their operating performance is improving or will improve in near future. The leverage hypothesis explains that company can reach its target capital through share buyback thereby increasing financial leverage through lower cost of capital. This in turn will generate value. Similarly, free cash flow hypothesis curb the tendency of low return investment by paying out free cash flows. Thus, each of these motives underlies the value. Unlike these, our study concentrates on evaluating the operating performances by comparing the EVA of companies with (sample companies) and without (control companies) share buyback.

Economic Value Added

The term EVA is a registered trademark of Stern Stewart & Co. of New York City (USA). It is of the notion that earning profit is not the only consideration of the businesses, it emphasis on sufficient profit to cover its cost of capital and create surplus to grow. Traditional concept of profit fails to indicate clear surplus. These methods of measurement of corporate performance are many. Common bases used are: - Net Profit Margin (NPM), Operating Profit Margin (OPM), Return on Investment (ROI), Return on Net Worth (RONW) etc. Profit after Tax (PAT) is an indicator of profitability to the shareholder and Profit before Interest after Tax (PBIAT) is an indicator of the surplus generation capacity using total funds. ROI is still recognized as the most popular parameter of profitability measurement. However, these indicators are ineffective parameters in explaining whether the reported profit covers the cost of capital. The basic proposition is that the return on capital employed should be greater than Cost of Capital (i.e. ROCE >Ko.).

Capital Employed highlights long term capital and cost of capital represents weighted average cost of capital that includes opportunity cost of equity rather than dividend servicing cost.

Traditionally, Profit after Tax is shown in the Profit & Loss Account to indicate the profit available to the shareholders of both preference and equity shares. Ability to maintain dividend is not a test of profit adequacy. Ability to generate Economic Value Added is the only test of profit adequacy. Actually any surplus generated from operating activities over and above the cost of capital is termed as EVA.

LITERATURE REVIEW

Shoven and Simon (1987) reviewed the theories that were offered with the motive of no dividend payment in relevance to repurchase of share. Underlying motivation may include taxation advantage, adjustment towards optimal debt equity ratio, anti-takeover strategies, free cash flow consideration, signalling and habit formation or learning. Economically potential characteristics were derived and investigated by studying 2000 sample firm during 1976 and 1984. Ofer and Thakor (1987) developed a model for signalling true value either by dividend or stock repurchase or both. They used an integrated approach for explaining stock price response to dividend increase and stock repurchase. The study depicted that both dividend and repurchase can be used as signals and none dominates other under all circumstances. Dividends never leads to use of costly external funds for financing for payments on the other hand share repurchase resort to external financing in addition to internal available funds. Bagnoli, Gordon and Lipman (1989) developed a model in which share repurchase served as a defence mechanism and can be applied when the cost of repurchase was not too high. Inverse relation of cost and value of the firm was depicted, thereby a repurchase signals high stock values, blocking the takeover. Bagwell (1991) examined the use of share repurchase as a takeover deterrent. Mainly the study depicted that in the presence of positively sloped supply curve for share, takeover costs greater to the acquirer if the target firm distribute cash through share repurchase rather than cash dividend or doing nothing. This occurs due to the fact that shareholders willing to tender repurchase were those with lowest valuation which shifted the remaining shareholders towards more expensive pool. The study concluded that share repurchase appears as effective tool of deterrent when marginal shareholders are altered, Shareholders heterogeneity is large and benefit of control from takeover is low. Chowdhury and Nanda (1994) found that though management's motive was to restrict free cash flow rather than signalling yet undervalued firms are prone to share repurchase rather than dividend payment. Anderson and Dyl (2004) conducted the study to examine the determinants of offer premium of a fixed- price tender offer from 1970-99. The study exhibited negative relation between offer premium and tax variable i.e., lower premium when the investors tax liability is lower. Smaller firms offered high premium suggesting greater information asymmetry for smaller firm than the larger ones. Past offer appreciation in the firm's share were used as a measure of value of information signalling and was found to be positively related to the offer premium. Bonaime (2012) conducted the study with all open market share repurchase announcement between 1988 and 2007 to find out whether the stock market considers the past repurchase completion rate when evaluating new repurchase announcements. The Tobit regression used in the study suggests consistency in their repurchase completion or developing reputation. The announcement returns around are the open market repurchase were function of lagged completion rates that suggested credibility of open market operation was judged through firms reputation.

OBJECTIVE

The operating performance of a company is the major sustainable driver of future growth. So the basic objective of the study is to examine whether share buyback helps a company to create Value.

Hypothesis-

- Share buyback facilitates to increase Economic Value to the firm.

DATA BASE AND METHODOLOGY:

Our period of analysis for Buyback selection (considering pre and post buyback analysis) is from 1st April, 2009 to 31st March, 2017 covering relatively period of around eight years. So 68 share buyback announcement of BSE listed companies from 1st April, 2012 to 31st March, 2014 are analysed with 1 and 3 year pre and post buyback database. The effect of 1 year pre and post buyback is termed as 'immediate effect' and the effect of 3 year pre and post buyback is termed as 'sustainable impact'. The data base used in the study comprises two sets- i) data base for Buyback Company and data base for Control Company. The objective of choosing control sample is to make comparative analysis of performances. The final sample was arrived after complying with the following points- database of shares must be available in any of the two major stock exchanges of India i.e., BSE and NSE; data must be available for at least 1 year surrounding pre and post buyback year, shares with considerably low trade volumes are excluded, there should not be any other corporate announcement along with the share buyback.

As a new measure of corporate surplus EVA is defined as: - Profit of a Business after charging cost of capital. It is corporate surplus that should be shared by the employees, management and shareholders. EVA focuses on clear surplus in contradiction to the traditionally used profit available to the shareholders. It is used by companies as a performance indicator and also as a basis for executive compensation. Surplus should be derived by deducting cost of capital from profit before interest but after tax.

$EVA_t = NOPAT_t – WACC * Capital Employed.$

Where,

$NOPAT_t$= Net Operating Profit before interest and after tax during period t.

WACC = Weighted Average Cost of Capital.

Capital Employed = Net Block + Trading Investment + Net Current Assets at the end of period t.

It is free from subjective assumption that needs to be adopted while identifying profit and cost of capital. Capital Assets Pricing Model (CAPM) is used for deriving cost of equity.

RESULTS AND DISCUSSION:

The results are segregated in two sections namely Sustainable Impact i.e. the independence of three years' EVA pre and post buyback are considered, and Immediate Impact i.e. the independence one years' pre and post buyback are considered. The EVA obtained for 68 buyback announcements are analysed through the Paired t-test.

Table 1: Statistics of EVA, pre and post buyback

Change in EVA	**Buyback companies**		**Control Companies**	
	Number	**Percentage**	**Number**	**Percentage**
		Immediate Impact		
Increase in EVA	**31**	**45.59**	**24**	**35.29**
Decrease in EVA	**37**	**54.41**	**44**	**64.71**

Total	**68**	**100.00**	**68**	**100.00**
Sustainable Impact				
Increase in EVA	**33**	**48.53**	**33**	**48.53**
Decrease in EVA	**35**	**51.47**	**35**	**51.47**
Total	**68**	**100**	**68**	**100**

Table 2: Paired t-test Results

		Sustainable Impact		**Immidiate Impact**	
		t-values	**Sig. (2-tailed)**	**t-values**	**Sig. (2-tailed)**
Pair 1	Sample pre-post	1.906	.061	1.608	.113
Pair 2	Control pre-post	2.086	.041	2.269	.026

From the results obtained in Table 1 and Table 2 it is evident that 31(45.59%) sample buyback announcement out of 68 are found with average value addition in 1 years and 33 (48.53%) buyback announcement in case of sustainable value measurement in 3 years. The control companies revealed 35.29 % averages value addition of in 1 year and 48.53 % in 3 years. The paired t-test data of sample companies has been found insignificant at 5 % level of significance but the t-values of control companies are found significant at 5 % level of significance. So the sample companies failed to reflect positive impact on economic value whereas given in a normal situation the control companies reflected positive significant t-values depicting creation of economic value.

CONCLUSION:

The major objective of this study is to justify whether share buyback as a corporate strategy facilitates in value generation. From our empirical test results we conclude that the operating performance of the non buyback companies is better than the buyback companies with significant positive t values. The post buyback value on an average does not improve as compared to pre buyback EVA of the sample companies. Thus there is no proper evidence to justify that share buyback facilitates to increase the economic value of the firm.

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