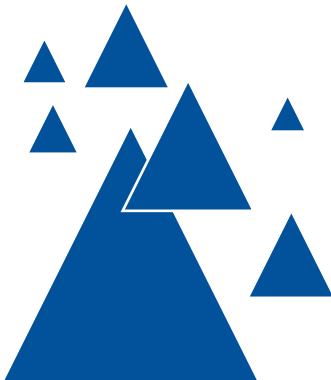




# Corporate Share Repurchases: The Perceptions and Practices of UK Financial Managers and Corporate Investors

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## Executive Summary



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# **E**XECUTIVE SUMMARY

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## **Introduction**

Share repurchase activity became a global phenomenon in the late twentieth century. Previously restricted largely to the US, repurchase programmes have been widely adopted in Europe and other countries such as Japan. In 2005, the global volume of share repurchase programmes was estimated at approximately US\$400 billion (Vermaelen, 2006). In the UK, where share repurchase programmes were legalised in 1981, activity grew extensively and by 2006, it is estimated that British companies spent a record £46 billion on buying back their shares compared with the annual spend of £10 billion during the late 1990s. Further, the UK exhibited a significant rise in the percentage of companies engaged in share repurchase programmes and at the start of the twenty first century, the volume of activity in companies listed on the London Stock Exchange and the Alternative Investment Market exceeded that of their counterparts listed on the US stock exchanges (Scholey, 2007).

Since 2007, however, market conditions in the UK and globally have changed markedly as a result of the global financial crisis: major western economies have moved into recession, and there has been an unprecedented number of companies that have issued profit warnings, and filed for bankruptcies. Finance for companies has been characterised by a paralysis in the money markets and as a consequence, the growth in share repurchase activity has rapidly reversed. In the US, for example, share repurchases by S&P 500 companies in the third quarter of 2008 were 44% down on the same period in 2007 (Prince, 2008) and a similar trend was experienced in the UK FTSE 100 companies, who for year ends between June 2008 and March 2009 reported a fall of some 43% compared to the same period the previous year.

Notwithstanding the reversal in growth, share repurchases continue to be an important financial management tool for companies. Indeed, despite the fall of nearly one half between 2007 and 2008 US share repurchases continue to far exceed dividend payments (Prince, 2008). The motivations underlying them and their impact on company value therefore remain of significant interest, and two key interrelated questions that have arisen as a result of the surge in share repurchase activity are: (i) in what capacity are share repurchase programmes used; and (ii) why did activity in the UK soar after legalisation up until the financial crisis, and throughout the world, more generally? Several motivations have been put forward to explain the use of share repurchase programmes by companies, including:

- substituting for regular or special dividends;
- signalling future performance and/or current undervaluation of shares to the markets;
- optimising the capital structure of companies;
- managing principal-agent problems;
- reallocating capital in the markets efficiently;
- influencing reported financial performance;
- protecting against potential takeovers; and
- influencing share prices and managing the market liquidity of companies' shares.

Prior empirical research has presented mixed and ambiguous results in relation to the usefulness and value of repurchase programmes, and the subject area remains relatively under-researched in comparison to other areas of financial management.

In this context, using a survey approach, this report seeks to examine UK managers' and investors' views in relation to the motivations underlying,

and factors influencing, the use of share repurchase programmes in UK listed companies. Specifically, it:

- captures the views of managers of both repurchasing and non-repurchasing companies on the general motivations underlying share repurchases and, where appropriate, the specific reasons for actual repurchases;
- distinguishes between the views of managers of share repurchasing and non-repurchasing companies to help explain the differences in practice, and why repurchase programmes are not adopted universally;
- examines the views of financial managers of both investment companies and non-investment companies separately in recognition of the different circumstances and characteristics of the respective organisations; and
- ascertains the views of the investor community to facilitate a comparison of the views and perspectives of investors with those of managers.

The results of the survey, based on usable responses from an individual from 97 non-investment companies, 53 investment companies and 57 investors are discussed below. For the purposes of this survey investment companies were defined as those which invest in a diversified portfolio of assets such as shares and securities of other companies; more specifically those included on the equity investment instruments and non-equity investment instruments sectors on the London Stock Exchange. To supplement the survey findings, interviews were undertaken with three individuals from the pension fund and investment fund sectors. The number of interviews undertaken was limited due to a reluctance amongst institutional investors to be interviewed during a period of significant market turbulence.

## **Motivations underlying the use of share repurchases: non-investment companies**

- Open market share repurchase programmes, generally financed by existing cash balances, dominate repurchase activity by non-investment companies in the UK.
- Repurchase programmes appear to be motivated by a desire to return excess cash flows to shareholders, and this perhaps serves to explain the fall in activity during the financial crisis when liquidity in the markets has become a major concern. Other factors that encourage repurchases include: a wish to influence reported earnings per share (EPS) levels; signal undervaluation to capital markets; optimise companies' gearing ratios; and management believe that the primary beneficiaries of such programmes are shareholders.
- Share repurchases, it is clear, are not used to replace regular dividend payments and appear to arise from a different set of circumstances and situations than dividend payments. Moreover, they are not used because they are considered to be fashionable, or an emerging trend in the markets. Just over one quarter of companies use them to influence their share prices.
- Overall, a select group of reasons listed above appear to drive UK repurchase activity, although in most companies, a multiplicity of factors, rather than a single reason, appear to be responsible.
- The views of managers of companies engaged in repurchasing activity are broadly in line with the general views of managers of both repurchasing and non-repurchasing companies. However, there are some differences in the opinions expressed; for example, although over half the companies generally agreed that signalling undervaluation and facilitating capital reallocation in the markets underlie repurchase programmes, only a small minority of repurchasers cited them as influencing their particular repurchases. Similarly, whilst repurchases are seen in general as a substitute for special, although not regular,

dividends only four repurchasers cited dividend substitution as motivating their particular repurchase activity.

- There appears to be little difference between the views of managers of repurchasing and non-repurchasing companies in relation to the general motivations underlying repurchases, suggesting that differences in perceptions between the two groups do not explain why this method of cash disbursement is used. Rather, the lack of funds to engage in repurchase activity and concern about adverse shareholder responses appear to explain the absence of participation by non-repurchasing companies in repurchase schemes.

### **Motivations underlying the use of share repurchases: Investment companies**

- Investment companies also rely heavily on open market share repurchases, although tender offers are also used.
- The main factors contributing to the use of share repurchase programmes among repurchasing investment companies appear to be the management of Net Asset Value per Share (NAV) and discount to NAV, both of which are specific to investment companies. Managing market liquidity is also an important factor for investment companies, in contrast to non-investment companies.
- Once again the specific motivations identified by repurchasing companies are consistent with the views expressed in general terms by both repurchasing and non-repurchasing investment companies.
- Further, the views of managers of repurchasing and non-repurchasing investment companies are very similar, and any differences generally relate to the strength with which the views are held. Repurchasing companies expressed stronger views: agreeing more strongly with statements that generated positive overall responses and disagreeing more strongly with statements that were unfavoured. As with non-investment companies above, these results indicate that decisions to

engage in/refrain from share repurchases are not a result of differences in perceptions of such programmes between repurchasing and non-repurchasing companies; rather, the absence of significant benefits from such programmes for the respective companies and/or the associated costs contribute to the lack of activity.

## **Motivations underlying the use of share repurchases: Investors**

- Comparing investor views with those of managers, a number of reasons for using share repurchase programmes attracted more managerial support than investor support, and equally there were a few that attracted more investor support than managerial support. Only one area, that relating to the impact of share repurchase programmes on corporate share price, generated closely synchronised views between management and investors. Specifically, both groups only marginally supported the views that share repurchases increase share price, and believed that changes to company value, if any, were likely to be gradual and over a long-term period.
- Reasons that attracted relatively more managerial support include: capital reallocation in which surplus funds are returned to investors in the absence of value enhancing projects; the flexibility of share repurchase programmes and their substitutability in relation to special dividends; the role of share repurchase programmes in influencing corporate gearing levels; and the signalling of both share price undervaluation and expectations of future income.
- Areas that attracted relatively more investor attention/support included: the notions that share repurchase announcements enable companies to generate publicity in the markets; that repurchase programmes may be used to influence total future dividend payout levels; and that repurchase programmes may be an emerging trend in the capital markets. Moreover, investors provided more support for the view that share repurchase programmes mitigate the principal-agent problem

by reducing opportunities for management to engage in behaviours which benefit themselves at the expense of investors. Nevertheless, the interviewees also highlighted the potential of such programmes to exaggerate principal-agent concerns by influencing EPS levels upon which managers are evaluated, and indeed investors in the survey identified managers, bankers and advisors as significant beneficiaries of such programmes, alongside shareholders.

- These differences in managerial and investor views above question: (i) whether managerial action through share repurchase programmes gives rise to the intended investor reaction; and (ii) whether investors approve the use of share repurchase programmes for the same reasons as management.

## **Perceptions in relation to regulation surrounding share repurchase activity in the UK**

- Investors and corporate managers alike believe that the current regulation under which share repurchase programmes in the UK are undertaken adds credibility to such programmes and also provides an opportunity to educate shareholders.
- Focusing on specific regulation, sub-groups of both investment companies and non-investment companies report that the listing requirements surrounding the volume, pricing and/or timing of repurchase programmes restrict the usefulness and value of share repurchase programmes, and this view is indeed shared by some of the investors. In relation to regulation concerning the reporting requirements to the Financial Services Authority and the opportunity to hold treasury shares, neither managers (from both investment companies and non-investment companies) nor investors consider such regulation to be restrictive.
- Addressing shareholder involvement in the approval process for share repurchase programmes, financial managers broadly believe

that this requirement does not curb corporate activity. At the same time investors, on average, appear to believe that they are playing a relevant role and that their current level of involvement is valuable. A small group nevertheless believe that share repurchase activity has spiralled out of control and that more regulation is required to protect shareholder wealth; unsurprisingly this view is not shared by corporate managers.

## **International comparisons**

On comparing the motivations that influence repurchase activity in UK companies, with those reported in prior Australian and US surveys, there are some notable differences. UK companies tend to emphasise the need to return surplus cash to investors and adjust gearing levels while their Australian and American counterparts emphasise the need to influence reported EPS levels, and purchase undervalued shares in order to effect share price changes. These differences may be a result of the stringent regulatory environment in the UK in which timing and volume restrictions limit the opportunity to signal undervaluation and directly influence share price. As such, regulation in the UK appears to be having the desired effect: to curb repurchase activity which seeks to influence company share price. However, management, in general, do not feel restricted by the regulation.

Other contributory factors for the differences in results, compared to Australian and US companies, may stem from the different time periods of the surveys in each country which reflect different market and operational conditions. For example, recent developments in corporate governance activities may be responsible for encouraging companies to return surplus cash to their shareholders.

## Implications

The policy implications arising from this study are:

- Managers and more importantly, non-executives with their fiduciary responsibilities, need to carefully assess recommendations from bankers and advisors in relation to share repurchase programmes because, as highlighted in the investor survey, they stand to gain from such programmes and thus their advice may lack objectivity.
- When managers use share repurchase programmes to capitalise on those characteristics which distinguish them from other distribution methods, they should emphasise the particular benefits such programmes generate which are, or may not be, provided by alternative distribution methods. A more extreme version of this, as suggested by the UK Shareholders' Association (UKSA) and supported by one of the interviewees in the study, is that regulation that requires companies to justify their use of share repurchase programmes over alternative distribution methods should be put in place.
- In addition, as suggested by one of the interviewees, to demonstrate good practice, management might report on the outcome of share repurchase transactions post-event to demonstrate the value of such programmes for investors. The UKSA once again holds a more stringent view and believes that regulation should be put in place to enforce such practice.
- Finally, from a shareholder perspective, while investors seek to discount the impact of share repurchase programmes on EPS levels to determine the 'true' level, managers may nevertheless be inclined to attempt to manipulate this ratio if their reward structures are tied to it. Indeed, as seen in the investor survey, managers are seen to be significant beneficiaries of such programmes and thus, where appropriate, investors should campaign for a change in such reward structures.



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