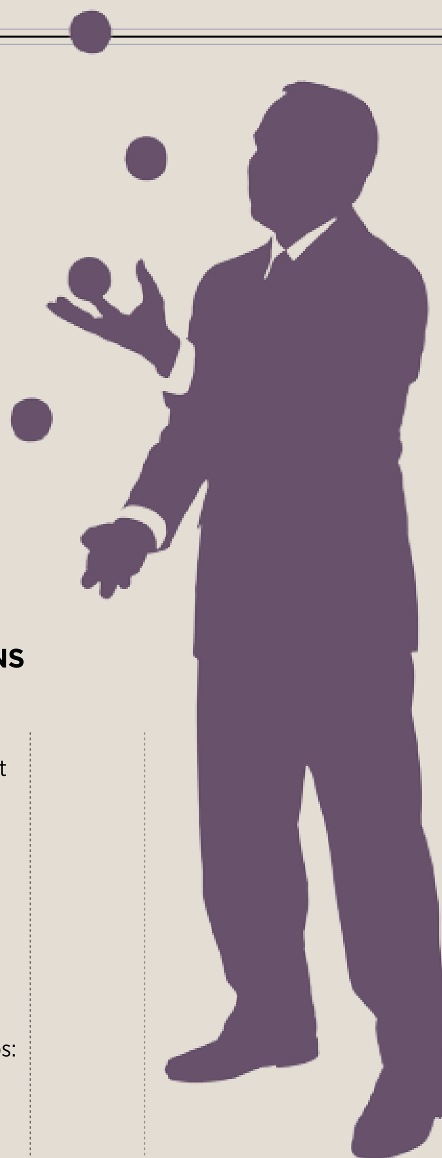

# KNOW YOUR OPTIONS

**TREASURERS LOOKING TO MINIMISE THE COST OF SHARE BUYBACK PROGRAMMES HAVE A CHOICE OF STRATEGIES. MARK DALTON EXPLAINS**

In an era where the majority of share trading is done through the use of algorithmic tools to achieve best execution, I find it interesting that many companies, both in the UK and abroad, continue to execute their own share repurchases in a relatively hands-on fashion, relying on a good dose of human intuition, rather than using the tools that most of the market employs.

Typically, execution is benchmarked against the volume-weighted average price (VWAP) of shares traded during the same period as the repurchase is undertaken.

It strikes me that these companies are more concerned with the day-to-day execution of the buyback than with an overall strategy that minimises the cost.

Why is it important to minimise the cost of a buyback in absolute terms? Unlike a dividend, which benefits all shareholders equally, a share repurchase programme benefits the continuing shareholders. The shareholders selling to the company almost certainly do not know that it is the company buying their shares, and so they see a direct benefit only in so far as the repurchase programme allows them to sell at a higher price than they might otherwise, or in volumes that might otherwise be difficult to achieve. For most mid- to large-cap companies, a share repurchase programme will be designed and executed so as to avoid either of those situations, as they don't want to create an unsustainable situation in the trading of the shares that is likely to be detrimental to continuing shareholders.

For a company that executes its buyback continuously throughout the year (handing over execution to a broker during closed periods), it is implied that the company does not have a view on whether its shares are over- or undervalued, and as such it should simply minimise the impact on the market of any repurchases.

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But is that the right way to look at it? Management almost invariably has a view on the valuation of its shares. So, if this is the case, shouldn't that view be reflected (or at least considered) in the company's approach to share buybacks?

### Designing a buyback programme

Let's think about four scenarios:

- A company feels that its shares are undervalued today. In this case, arguably, it should buy as many shares as possible, as soon as possible, to maximise the value for its continuing shareholders.
- Conversely, if the company feels that its shares are overvalued, share repurchases should either not be used at all and only executed once the share price has fallen, or only executed if they can be done below market.

As an example, UK retailer Next uses an interesting strategy to achieve below-market repurchases in the form of its contingent forward purchase contract programme, whereby it is able to buy shares at a fixed price that is a significant discount to the market price at the time of entering into the contract. In these contracts, Next commits to buying a fixed number of shares each week for a set duration, whether or not the share price rises or falls. But if the share price rises significantly, above a pre-agreed threshold, the contract terminates early.

- Perhaps neither of these is the case, and the company feels that its shares are fairly valued at present, but wishes to execute its buyback over a longer period of time. If the company is worried that the share price might increase before it can execute its repurchases, it should consider tools for capping the share price at which it buys those shares. Buying call options (explicitly or implicitly in a repurchase contract) could make sense. For a company that does not wish to pay the option premium that such a strategy would require, selling a put (or embedding

## EXAMPLES OF DIFFERENT SHARE REPURCHASE STRATEGIES

| STRATEGY | EXPECTED PERFORMANCE | IMPLIED GOAL OR VIEW |
|---|---|---|
| **Type 1: No options component** | | |
| Buy a fixed number of shares every day | Match average of daily VWAPs | Purchase a fixed number of shares – no view on share price |
| Buy a fixed value worth of shares every day | Slightly beat average of daily VWAPs | Return a fixed amount of cash – no view on share price |
| Actively managed share repurchase | Approximate or beat VWAP | Company expects to beat VWAP through active management |
| **Type 2: 'Vanilla' options-based strategies** | | |
| Capped share repurchase (buying a call) | Buy fixed number (or value) of shares over a period of time, subject to a maximum price | Minimise cost of buyback if stock price increases – pay for the protection |
| Collared share repurchase (buying a call, selling a put) | Buy fixed number (or value) of shares over a period of time, subject to a maximum and a minimum price | Minimise cost of buyback if stock price increases – take risk of buying above market if stock price falls |
| Put option sales | Buy fixed number of shares if the stock price drops | Earn money through sale of options, only buy shares if stock becomes 'cheap' |
| **Type 3: 'Exotic' options-based strategies** | | |
| Contingent forward purchase contracts | Buy shares below market price | Purchase shares below market – most effective if shares are range-bound |
| Guaranteed discount to VWAP over a term | Beat average of daily VWAPs over a (variable) period of time | No view on share price – desire to outperform VWAP |
| Guaranteed discount to VWAP each day | Beat VWAP each day purchases are made | No view on share price – desire to outperform VWAP |

a minimum purchase price in the repurchase contract) could be an effective way to reduce that cost.

In the US, many companies have used these strategies in the form of capped and/or collared accelerated share repurchase programmes.

Alternatively, a company could sell put options on its shares, generating option premium (cash in hand for the company) upfront, and agreeing to buy the shares if the stock price falls (and presumably becomes cheap).

A frequently cited example in the UK is Vodafone's put sale programme from 2004, although this strategy has also been used in the US market by several issuers.

◆ A fourth possibility is that the company truly does not have a view on its share price, or does not wish to imply a view in the construction of its share repurchase programme. In this case, it should consider a buyback programme that minimises the expected purchase price in relation to the VWAP over a reasonable period of time.

To that end, most large investment banks can offer a range of strategies (some widely used, others very bespoke) in which they will guarantee to match (or beat) VWAP, subject to the company providing some flexibility to the bank.

For example, if a company is indifferent as to the exact period of time during which it will execute a share buyback, but wants the buyback to be completed by no later than three months' time, and has a fixed number of shares that it wishes to buy (or a fixed amount of money it wishes to spend), a bank could guarantee to deliver those shares at a guaranteed discount to VWAP during the execution period, subject to having flexibility over the exact timing. For instance, it could offer a 0.5% discount to the VWAP, with the obligation to terminate the execution period no sooner than two months and no later than three months after the start date. Regardless of the exact date of termination, the company would be able to show that it had achieved a discount to VWAP during the period it was undertaking the buyback.

An alternative structure could allow the company to buy the shares at a discount to VWAP on any given day, but give flexibility to the bank over volumes on each day (subject to a minimum and maximum). By providing such volume-based flexibility, the bank can buy more on down days and fewer on up days, and, in exchange, guarantee to beat VWAP on every day for the company.

Of course, there are jurisdiction-specific rules that companies must follow in the execution of any share buybacks. The examples in the table are designed to demonstrate the points, but the inherent logic should still hold when designing a programme within those regulatory constraints.

Success of a buyback programme relative to its benchmark is typically measured in basis points. Perhaps it is time for more companies to embrace strategies that can outperform those benchmarks by a significantly wider margin.

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