corporate finance

DERIVATIVES IN BUYBACKS

A buyback option

THE USE OF DERIVATIVES IN THE EXECUTION OF SHARE REPURCHASES IS MUCH MORE POPULAR IN THE US AND CONTINENTAL EUROPE THAN IN THE UK. **CLARKE PITTS** EXPLORES WHEN AND WHY DERIVATIVES SHOULD BE CONSIDERED.

The use of share buybacks as a tool for returning capital and managing capital structure is well-established. In the past year over a quarter of FTSE companies have bought back shares.

LIMITATIONS OF CONVENTIONAL SHARE BUYBACKS A variety of external factors can impact a company's ability to access own share liquidity and to control the long-term completion of share buyback programmes. The dominant constraints to which UK corporates are subject fall into two categories:

- Share price sensitivity: A core consideration of the share buyback decision is value. Share price strengthening over the extended timeframe of buybacks can make repurchases less attractive, and cause the amount of capital returned to fall below expectations.
- Closed period constraints: Inability to purchase shares under the Model Code of the Listing Rules owing to material non-public information. These periods typically cover some of the most active trading days for the companies concerned.

As companies and their shareholders have become more aware of these constraints, they have looked to norms in other international markets to expand the array of buyback techniques available. The following have emerged to address precisely these constraints:

- Irrevocable Non-Discretionary Orders (INDOs): INDOs enable companies to access liquidity in their own shares during (predictable) closed periods. Repurchase instructions are delivered prior to a results-driven closed period conferring discretion to enter into on-market purchases to the company's agents (typically subject to certain price and volume limits). The principle is very similar to 10b5 programmes commonly used in the US.
- Option-based share repurchase tools: Writing (selling) put options enable corporates to purchase shares (during a closed period) for a predetermined target price. Shares are bought at a known price if the share price lies below a targeted level at maturity of the contract. The premium received for the put is guaranteed irrespective of subsequent share price behaviour (delivering value even if the share price rises above target levels). The first UK large-scale put selling programme was begun by Vodafone in August 2004 (see below, p20).

INDOs are well understood and intuitively clear. This article therefore focuses on the application of option-based share repurchase tools which uniquely address both of the above constraints.

Executive Summary

- The economic advantages of option-based share buyback techniques have led to considerable amounts of such activity. The tax, accounting and legal aspects of such transactions are clear.
- Companies looking to repurchase shares in large amounts, or who are constrained in their ability to access market liquidity by closed periods or other considerations, might benefit by selling puts or using similar techniques within their buyback programmes.

DESCRIPTION AND RATIONALE

Share price driven Let us consider a hypothetical company with a share price of £4.80. It decides that it has sufficient excess capital and that the share price is low enough that it should buy back equity. By the time the necessary approvals are sought and disclosures made, the price has risen to £5.40. The company hesitates while the market waits for them to buy. Rather than wait for the stock to fall back to its target of £5.00, it writes three month £5.20 puts for 20p. If the stock is below £5.20 at the end, it will have bought back at an average cost of £5.00 and saved some interest cost. If it is not, it has 20p cash more than it would have done if it had been intending to wait and hope for lower prices. Notice that the stock need never have traded as low at £5.00 yet it could achieve this level as an average cost.

Closed period A company has a large buyback programme to which it is committed but it has been locked out of the market for a significant proportion of the year (possibly the company makes many acquisitions, or it reports earnings four times a year). This company might sell out of the money puts (as per the previous example) to ensure that should the share price fall away for any reason, it will be able to capture the opportunity even if the drop occurs during a closed period.

There is an ancillary benefit that some consider positive, particularly around results dates. Selling short dated options on a stock tends to make the stock less volatile due to the nature of the hedging process. Put simply, if an investment bank owns puts on the shares, it is likely to buy the shares on weakness to deliver into the put writer. This buying will probably lessen the magnitude of falls, reducing volatility.

Another variant combines some of the concepts of the INDO and put writing. In this case, a company commits to buying 2-3 million shares at the average price (VWAP) over the closed period less a spread (e.g. 30 bps). The investment bank guarantees an execution of, at least, two million shares at that price and can deliver another million at the same average, if it so chooses, at the end. The last million shares is a put option where the strike price is the average price over the closed period and the value of the put

Box 1. Derivative Transactions: Pros and cons.

	Derivative Transactions	INDO
Application	• Purchase shares during (predictable) closed periods. • Guarantees some value even if shares are not purchased.	• Purchase shares during (predictable) closed periods.
Basis of purchases	• Shares purchased in closed period if price < strike.	• Shares purchased in closed period if price < agency instruction (limit).
Value creation	• Can lower average execution cost • Company rewarded for willingness to buy irrespective of execution • Taps liquidity of market during closed period.	• Taps liquidity of market during closed period.
Process	• Shareholder approvals alongside buyback authority.	• Within existing ABI template buyback authority.
Precedent	• Vodafone, Next[1]	• Widespread among FTSE companies.

option is paid to the company through the discount to the average price on the first two million shares on which execution has been guaranteed.

EXAMPLE OF UK PRECEDENT (VODAFONE)
Market activity Over the period of put sales, the company sold one put for every two shares bought directly.In the event of exercise, puts sold would have achieved a net purchase price between 2.5% and 6.5% below the closing price on the day the puts were sold. Vodafone sold puts maturing over a series of trading days during their closed period.

Communication and process At the Annual General Meeting (AGM) in July 2004, 97.5% of votes cast were in favour of granting the authorisation to enter into contingent purchase contracts (put options) to purchase own shares. (The parallel share buyback resolution received 98.0% approval.) The suite of documents pertaining to the resolution stipulated the potential counterparties, and set a minimum limit to the volatility level at which the company was permitted to enter into put transactions.

Source: Vodafone RNS disclosures & company website

Box 2. Put options over its ordinary shares

"Vodafone Group Plc ("Vodafone") announces today that, following approval of such transactions at its Annual General Meeting on 27 July 2004, it has sold a put option over its ordinary shares of U.S.$0.10 to J.P. Morgan Securities Ltd. (the "Counterparty") as follows:

Put Option over Ordinary Shares	
Trade date of the put option:	6 August 2004
Exercise date of the put option:	2 November 2004
Number of ordinary shares that are the subject of the put option:	10,000,000

If the put option is exercised by the Counterparty then the total consideration payable by Vodafone from existing cash reserves to the Counterparty (after deducting the premium it has received from the Counterparty) will be: £11,313,900."

Example of Vodafone's RNS disclosure of puts

Put sales were widespread in the US In the US, the sale of put options has for a long time formed a part of share repurchase programmes. US market practice typically involves the sale of a three month put over one share for every two to four shares repurchased directly in the market. This ratio is set so as to balance the desire for certainty of capital returns with scope to buy below the prevailing price, and to monetise a willingness to purchase at a predetermined price. This activity has slowed after US Generally Accepted Accounting Principles (GAAP) was modified to make such transactions mark-to-market so that profit and loss (P&L) from such trades could distort companies' earnings statement. International Financial Reporting Standards (IFRS) does not account for these trades in the same way (see Accounting notes below).

The Financial Policy Forum[2] research points to the past effectiveness of the put-based approach: "Dell saved itself about $1.6bn in two years, Microsoft $600m in three and a half years…"

Among others, Hewlett Packard, Pacific Gas & Electric, Yahoo, Adobe, TXU, Franklin Resources and Comcast have all been active in the last year using derivative or synthetic structures in their buyback programmes. Some of these are put sales and others are designed to accelerate Earnings Per Share (EPS) accretion.

While there are clear differences in the US disclosure environment (e.g. repurchase activity is aggregated and disclosed on a monthly basis), this does not explain the disparity between widespread put sales within the US and the historically low levels of UK usage. After all, about 15% of the UK stock market is held by US investors.

In Europe, BASF, Deutsche Bank, Telefonica, Vinci, EADS and Portugal Telecom have all done similar transactions (writing puts and sometimes buying calls too). It is not yet commonplace but the trend is clear.

ACCOUNTING ASPECTS The accounting implications have historically relied on UK GAAP which was not nearly as prescriptive with regard to capital instruments as IFRS. Uncertainty around accounting and tax consequences was a major impediment to some. Now, the accounting framework for transactions involving an entity's own equity has become clearer. In this context[3], the main categories of classification of own share transactions are either:

- Those that are treated as a direct deduction from equity: or
- Those that result in a deduction from equity and the corresponding recognition of a liability.

For example, a corporate writes a put option to buy back its own stock (physically settled). The entity records a deduction from equity for the present value of the strike of the put option and a corresponding liability for the present value of the strike of the put. Over the life of the contract a notional interest charge is taken to the income statement which is essentially the unwinding of the time value in the contract. At maturity the cash paid to settle the put results in de-recognition of the recorded liability. This broadly implies that the International Accounting Standards Board (IASB) sees a put to buy back stock as if the entity had physically borrowed cash today to buy the stock back and accordingly the accounting follows.

Therefore in the context of buybacks, buying call options would generally be deductions from equity for the premium paid. Written (sold) puts and forwards and swaps to buy back stock would both be deductions from equity with the recognition of a corresponding liability at the date at which the contract was entered into.

ADVANTAGES AND BENEFITS The economic advantages of option-based share buyback techniques have led to considerable activity. The tax, accounting and legal aspects of such transactions are clear.

Companies looking to repurchase shares in large amounts, or who are constrained in their ability to access market liquidity by closed periods or other considerations, might benefit by selling puts or using similar techniques within their buyback programmes.

1. Next PLC have executed contingent forwards on their own shares.
2. A US not-for-profit research centre, funded by the Ford Foundation.
3. ie. relating to buybacks, equity treatment is subject to some conditions such as physical settlement rather than cash.

Clarke Pitts is Managing Director in Equity Corporate Marketing at JPMorgan
clarke.pitts@jpmorgan.com
www.jpmorgan.com