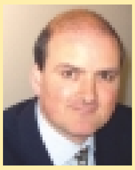

FROM 1 DECEMBER, COMPANIES WILL BE ABLE TO BUY BACK THEIR OWN SHARES. BUT WHAT ARE THE IMPLICATIONS OF THIS CHANGE TO UK LAW? **PETER ELWIN** OF CAZENOVE FINDS OUT.

BENEFITING FROM BUYBACKS

Far left **Duncan Hunter, Managing Director, Corporate Finance at Cazenove & Co Ltd** Left (from l-r) **Roger Lomax, Michael McKersie and Huw Jones**

From 1 December 2003, listed UK companies will be able to buy back their own shares and hold them 'in treasury' rather than cancelling them. At a recent Association of Corporate Treasurers (ACT) conference sponsored by Cazenove, a panel of speakers from all sides of the debate discussed the implications of this change, and debated the merits of the rules as currently proposed. Here, we review the discussion and highlight the enhanced opportunities for efficient capital management.

RETURNING EQUITY CAPITAL TO MAXIMISE SHAREHOLDER VALUE. Modern portfolio theory suggests that if a company can no longer earn returns on new investments in excess of the returns required by its investors, it should stop investing and return any excess capital to shareholders. This enables them to invest the capital elsewhere and achieve a higher return than that achievable by the company from the opportunities currently available to it.

This theory has been followed with enthusiasm by UK companies. As *Figure 1* shows, they have consistently returned more capital to investors than they have raised by way of rights issues since 1997.

Choosing the appropriate method for returning capital involves considering a number of factors that will vary depending on the company, the reason for the excess capital and the shareholder base.

Where the excess capital results from strong operating cashflows, as opposed to one-off events such as the disposal of a business, many companies have found it beneficial to establish a rolling repurchase programme to return capital to shareholders.

BUYBACKS REDUCE DISTRIBUTABLE PROFITS. Under UK law, buying back shares reduces distributable profits unless it is done through a court-approved restructuring. If the company subsequently discovers new opportunities that have the potential to earn attractive returns, and issues new shares to fund these projects, the original impact on distributable profits is not reversed, with the result that a rolling repurchase programme can end up restricting a company's ability to pay dividends.

Treasury shares can avoid this problem, since the new law provides that distributable profits which are eliminated on a share repurchase can be reinstated when the treasury shares are re-issued.

In theory, this means that using treasury shares to fund a new loss-making project could help to counter the impact on profits arising from the project losses, so reducing the pressure on the company's dividend policy, but it remains to be seen how such an approach would be received by investors!

THE PROBLEM OF GEARING. In addition to the doctrine that excess capital should be returned to shareholders, the theories put forward by Modigliani and Miller in the 1960s have long been used to support the idea that companies should seek to achieve the lowest weighted average cost of capital (WACC) by balancing the relative levels of debt and equity. Tax relief on interest payments means that debt finance is usually cheaper than equity finance, supporting the view that increasing the gearing of a company can be a sensible way to reduce its WACC and thereby increase the value of the company.

Modigliani's and Miller's theories go beyond simply suggesting that companies should return excess capital to shareholders. They imply they should aim for high levels of debt, since this will result in a lower cost of capital than that achieved by an equivalent ungeared firm. This has led a number of companies to restructure their balance sheets and take on more debt. However, the reality is that debt and equity investors start to grow nervous if a company takes this policy beyond an optimal level, pushing up the costs of equity and debt, and leading to the 'WACC curve' illustrated in *Figure 2*.

This issue is complicated by the fact that the level of debt considered acceptable by the market will vary depending on a number of factors outside the company's control. In the extreme, a company that has pursued a path of balance sheet efficiency could find it is suddenly regarded as too highly geared by both the debt and equity markets, driving down its value. The obvious solution – issuing equity to replace debt – will be difficult if the equity market is reluctant to provide finance to such a highly-geared company, and the formalities associated with issuing new shares mean that the company cannot react quickly to a changing market so as to avoid this problem.

TREASURY SHARES ALLOW COMPANIES TO ADJUST GEARING MORE EASILY. In theory, treasury shares will reduce this problem by making it possible for companies to adjust their gearing levels in line with market sentiment (on a daily basis if necessary), without many of the formalities associated with issuing shares.

The fact that reversing the process will be marginally easier may make companies less nervous about gearing up in the first place and therefore enable them to maintain greater capital efficiency than is the case at present. However, several conference participants highlighted the practical difficulties of identifying the optimal level of gearing, and the fact that the restrictions placed on treasury shares will limit their potential for making significant changes to gearing. Both points imply that treasury shares are

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FIGURE 1
CAPITAL RAISED BY WAY OF RIGHTS ISSUES VS CAPITAL RETURNED BY UK COMPANIES

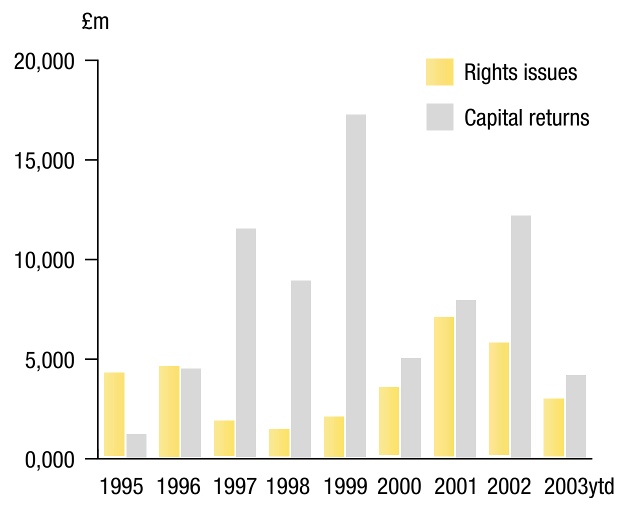
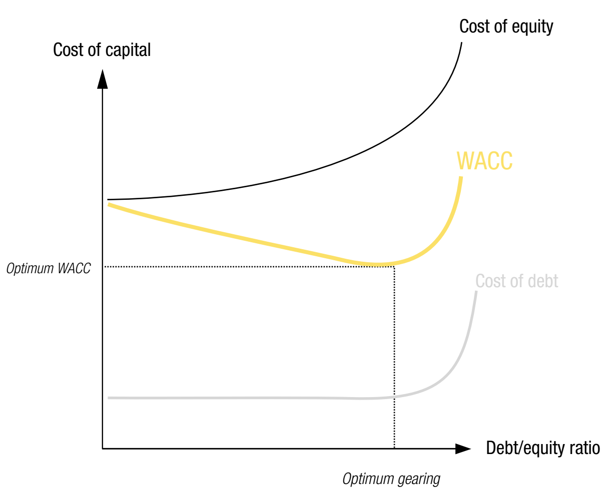


FIGURE 2
RELATIONSHIP BETWEEN GEARING AND WACC



unlikely to encourage companies to raise gearing levels significantly.

TREASURY SHARES CAN BE USED TO COVER EMPLOYEE SHARE SCHEMES. There was a general consensus at the conference that being able to cover employee shares schemes using treasury shares was a welcome development but that the restrictions on companies imposed by the Model Code when dealing in their own shares (for example, not dealing during close periods) meant that employee share trusts would remain an essential component of any scheme.

An obvious advantage treasury shares will provide, compared with an employee share trust, is that shares that fail to be passed on to employees (for example, as a result of failure to satisfy performance criteria) can easily be sold again. In addition to this, the company will immediately recover cash and distributable profits as a result of the sale.

RESTRICTIONS REGARDING THE ISSUE OF SHARES FROM TREASURY. The new treasury shares regulation will prevent firms from holding more than 10% of their issued share capital in treasury, and when the shares are re-issued they will be subject to pre-emption rights.

Current Association of British Insurers (ABI) and National Association of Pension Funds (NAPF) guidelines state that shareholders should agree to resolutions proposing a waiver of pre-emption rights, provided that such issues do not exceed 5% of the issued share capital in any one year, and not more than 7.5% over any three-year period. Discussions at the conference indicated that the 7.5% limit will not be applied to treasury share issues, but that the 5% limit is likely to remain in place for the moment (although companies will always be able to ask shareholders to waive it in particular circumstances). The ACT website at www.treasurers.org will carry full details of this.

The contrast between the restrictions placed upon treasury shares in the UK and the relatively relaxed regime in the US was highlighted – particularly the fact that US companies can use treasury shares to make small acquisitions, whereas UK companies will not be able to do this. Several delegates remarked that treasury shares would be more attractive if this restriction was lifted, but investors remain to be convinced that this is desirable.

IMPACT ON VALUATION. There was some debate as to whether a sizeable holding of treasury shares would depress the share price, since the firm would be seen as a potential seller. No consensus was reached on this point. It is clear each case will be treated individually, but the credit rating agencies routinely treat treasury shares as if they had been cancelled.

SLOW PROGRESS. The consensus at the conference was that treasury shares will provide a useful capital management tool but that we are unlikely to see a flurry of activity on 1 December. Companies will need authorisation from shareholders before holding shares in treasury, the shares themselves must be purchased, and investors remain to be convinced of the advantages.

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