INVESTOR'S GUIDE

A guide to the financial markets, investments and the economy

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NICO Asset Managers

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Topic 313: STOCK BUYBACK

Last week we started looking at stock buybacks and why companies do them. This week we conclude the topic by looking at the advantages and disadvantages of the buybacks to shareholders.

Advantages of Buybacks to Shareholders

There are several advantages of buybacks to investors and some of them are discussed below;

- **Lower price to earnings ratio (P/E ratio):** A Buyback reduces the total number of shares outstanding, but price per share may remain the same. This means that, all else being equal, buybacks reduce the P/E ratio, making the stock appear more appealing to investors.

- **Boost in share prices:** In the short term a buyback can increase the share price. The buyback means there are fewer shares trading on the public markets. This tends to strengthen the share price, so your shares may be worth more.

- **Rising dividends:** Sometimes in the short run the company will be able to increase dividend payment amounts per share after a buyback because there are fewer shares on which the company must pay dividend.

- **Positive psychology:** When a company buys back stock, investors usually see it as a sign the company believes the price should be higher and that investors are not realizing the company's true value. This can sometimes kick off an upward swing in stock price.

- **Tax Benefits**: Traditionally, buybacks are subject to capital gains tax whereas dividends are subject to ordinary income tax. If the stock has been held for more than one year, the gains would be subject to a lower capital gains rate or no capital gain tax at all as is the case in Malawi.

Disadvantages of Buybacks to Shareholders

Buybacks are not without their disadvantages to the investors and some of them are as follows:

- **Sinking dividends:** Sometimes companies spend a lot of money buying up shares and then cut their dividend as a result. After spending money buying back shares, the company has less cash to pay out as dividends. This can badly affect the income flow of an investor who relies on dividend cheques.

- **Buybacks can be a signal of the marketing topping out**: Many companies will repurchase stocks to artificially boost share prices. Typically, executive compensations are tied to earnings metrics and if earnings cannot be increased, buybacks can superficially boost earnings. Also, when buybacks are announced, any share price increase will typically benefit short-term investors rather than investors seeking long-term value. This creates a false signal to the market that earnings are improving and ultimately ends up hurting value.

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