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Hoosier Dispatch: The Skinny on Share Buybacks

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Picture the scene: You're scrolling through the latest corporate news blurbs on the Net and come across a headline announcing some kind of share buyback affecting one of your stocks. Intrigued, you double-click for more info only to be greeted with a page of legalese that might as well be written in Sanskrit.

After a valiant attempt to decipher the code, you realize that the company is actually spelling out terms of the repurchase deal (albeit with the eloquence of Bob Dole and the clarity of a welding helmet). Included in the description are references like Dutch auction, debt ratios and efficient capital structure, which mean about as much to most investors as a 50-page treatise on multivariate calculus.

Exasperated, you grip the arms of your chair and mutter a string of expletives. All you really want to know from these people is what effect, if any, the deal is going to have on your holdings. In other words, is this good, bad or immaterial for ME as an investor?

The answer is a resounding "it depends." Companies buy back shares for a variety of reasons, so you've got to understand the basics of the share repurchase game from the corporate angle to make an educated appraisal of each deal.

Remembering your basics, corporations have just two ways to raise investment money to fund their operations – issue either stocks or bonds. Each method has its own unique attributes for both the company and the investor.

Bondholders are creditors of the company who loan money to the firm for a particular period of time and collect interest along the way. These creditors get a fixed return for the life of their bond and don't participate in any growth of the company over time. In return, bondholders have a priority claim over stockholders for the firm's assets if the company founders.

Stockholders, on the other hand, are part-owners of the company and, as such, their fate is inexorably tied to the success or

failure of the business. If the firm grows, they'll get a piece. But if the firm hits an iceberg, they may end up going down with the ship while the bondholders flock to the lifeboats with all the loot they can carry.

In a laboratory setting, it shouldn't matter one iota what ratio of bond financing to stock financing (or "capital structure") the company uses; the value of the firm will always be the same. Step out of these sterile environs into the dirty world of reality, however, and the choice of capital structure can have a big impact on the firm.

The main reason for the difference is due to a quirk in the tax code that treats interest payments to bondholders as a tax-deductible expense of the corporation, while distributions to stock holders are taxed at the full corporate rate. By this logic, any rational CFO is going to strive for a 100% debt structure to take full-advantage of the favorable tax treatment, right? Well, not exactly.

A certain amount of equity from stockholders is a necessary item on the balance sheet of a company. Think of it like a down payment on a real estate loan. No banker in his or her right mind would loan a client 100% of a property's cost and bear all the risk of the deal. They want to know that the client has a vested interest in the success of the investment through the personal involvement of cold, hard cash from the client's own pocket.

Another reason companies don't use 100% bond financing is that as a firm goes deeper into debt, the cost of borrowing new money skyrockets. As a result, most companies strike a happy balance and try to keep the amount of debt on their books at a constant level (often between 30% to 70% of total capital from what I've seen depending on the industry).

Since bond values stay relatively stable over time, while stocks tend to appreciate (sometimes significantly like during our recent bull run), the firm's capital structure can get out of whack. Usually, the company ends up with a greater proportion of equity to debt than deemed "optimal." To correct the situation it will either sell more bonds, buy back its shares, or some combination of both to get the ratio back in line.

If the firm decides to repurchase stock, it will have to pay a premium over the market price to entice holders to sell, but it won't want to pay a dime more than it absolutely has to. How does the company figure out the right price to offer? It's simple. Most of the time it just lets the shareholders decide in a process called a "Dutch auction."

In a basic Dutch auction, shareholders communicate the price that they'd be willing to sell their shares (usually between a

certain range) to the corporation directly. When all offers have been collected, the company just lines up the prices in order and begins buying shares starting with the cheapest ones. The process continues as it moves up the list to higher-priced shares until it has purchased the desired amount of stock.

But what effect does this have on the market price of the stock? If the buyback is simply a minor adjustment to keep the firm's capital structure in line with stated policy, then the effect is likely to be minimal. Investors already expect the company to make these adjustments from time to time, so the announcement is usually no surprise.

If, on the other hand, a major policy change is under foot, the effect could be more pronounced. If a company decides to dramatically alter its capital structure by issuing a chunk of new debt to buy back shares, then the stock price might pop to reflect the added tax benefit associated with the new bonds.

In a third scenario, a company might buy back shares outright using its hoard of cash reserves. In this case, the Street might view it as a bullish signal. The argument is that the firm sees good things happening inside the company that aren't fully reflected in the market price of the stock, suggesting that the shares are a bargain.

Be careful, though. Companies buy back their shares for other reasons, too, like funding employee stock purchases and other incentive programs. Read the terms of the buyback carefully to determine the real impetus behind the repurchase.

In the final analysis, the terms of each stock buyback vary widely and can have dramatically different effects on share prices (or none at all). Just understanding the basics of these deals can help you make more informed decisions and give you the ability to analyze the facts and assess their likely outcome before jumping thoughtlessly into a friendly game of leapfrog with a unicorn.