Comprehensive study of Buy Back of Shares

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What is Buy Back of Shares? Why is it done?

The purchase of the shares of a Company by the Company itself (i.e. buys its own shares). Buy Back of equity shares is a mode of capital restructuring is used as a corporate financial strategy with the objective of increasing Earnings per Share, preventing hostile takeovers and changing the capital and shareholding structure. It is an alternative to Reduction of Capital.

Each equity share represents a small stake in the ownership of the company. If a business has a managing owner/promoter and one lakh shareholders, it actually has 1,00,001 owners. Companies generally issue shares to raise equity capital to fund expansion and growth; or for specific investments; but if there are no potential growth opportunities in sight, holding on to all that unused equity funding means sharing ownership for no good reason.

Unlike debenture holders, who get debenture interest on a fixed basis, equity shareholders do not have a fixed dividend every year; therefore, they have undertaken greater risk while contributing to the company and therefore demand greater returns on their investments in the form of dividends which is a cost of equity – so the business is essentially paying for the privilege of accessing funds it isn't using.

Buying back some or all of the outstanding shares can be a simple way to pay off investors and reduce the overall cost of capital. For this reason, Walt Disney (DIS) reduced its number of outstanding shares in the market by buying back 73.8 million shares valued at $7.5 billion in 2016

Buy-back used as a strategy to get more funds

Another subtle thing done by businesses is to buy-back shares that are undervalued, but on the verge of correcting itself. Stock can be undervalued for a number of reasons, often due to investors' inability to see past a business' short-term performance or sensationalist news items. If a stock is dramatically undervalued, the issuing company can repurchase some of its shares at this reduced price and then re-issue them once the market has corrected, thereby increasing its equity capital without issuing any additional shares.

Eg: A company issues 100,000 shares at Rs.25 per share, raising Rs.2.5 million in equity. An ill-timed news item questioning the company's leadership ethics causes panicked shareholders begin to sell, driving the price down to Rs.15 per share. The company decides to repurchase 50,000 shares at Rs.15 per share for a total outlay of Rs.750,000 and wait out the frenzy.

The business remains profitable and launches a new and exciting product line the following quarter, driving the price up past the issuing price to Rs.35 per share. After regaining its popularity, the company reissues the 50,000 shares at the new market price for a total capital influx of Rs.1.75 million. Because of the brief undervaluation of its stock, the company was able to turn Rs.2.5 million in equity into Rs.3.5 million without further diluting ownership by issuing additional shares

Companies Act:

The buy-back of shares is governed by Sec 68, 69 and 70 of the Companies Act, 2013; and further by the Companies (Share Capital and Debentures) Rules, 2014. For Listed Companies, the SEBI Regulations for Buy Back will also be applicable.

The following article is a thread-bare analysis of all the issues associated with the buy-back of shares.

Section 68- Power of Company to purchase its own securities:

Pre-requisites for buy back of shares (Sec 68)

Section 68 of the Companies Act governs the source of buy back of the company's own securities. It may only purchase own securities out of the following:

- Free reserves; or
- Securities premium account; or
- Proceeds of issue of shares or specified securities

However, buy-back of securities may not be made out of the proceeds of an earlier issue of the same kind of shares or same of other specified securities.

There are certain specified conditions which are required to be satisfied before the buy-back of shares. A Company can buy back its own shares only when:

a) It is authorised by its Articles of Association

b) A Special Resolution is passed at the General Meeting of the company authorising the buy-back of shares. However, this is not required when:

    a. The buy-back is 10% or less of the total paid-up equity capital and free reserves of the company; **and**

    b. such buy-back has been authorized by a Board Resolution passed in the Board Meeting of Directors;

c) The buy-back is **25% or less of the aggregate of paid-up capital and free reserves of the company**. If the buy back is only of Equity Shares, then the same shall be calculated as **25% of paid up equity capital only**. Additionally, the Debt equity ratio should be 2:1. Where:

a. Debt is aggregate of secured and unsecured debts owed by the after buy-back. Equity is aggregate of the paid-up capital and its free reserves;

d) All the shares or other specified securities for buy-back are fully paid-up;

e) If shares or securities are listed, buy back will be in accordance with the regulations made by the Securities and Exchange Board in this behalf; and

f) The buy-back in respect of unlisted shares or other specified securities is in accordance Share Capital and Debentures Rules, 2014.

g) No offer of buy-back shall be made within a period of **one year** from the date of the closure of the preceding offer of buy-back, if any

Time restraints:

1) The buy-back must be completed in full within a year from the date of the special resolution passed/board resolution passed.

2) No further issues of the securities bought back for a period of 6 months, other than in the form of:

   a. Bonus shares

   b. in the discharge of subsisting obligations such as conversion, stock options etc.

What shares can be bought back?

The buy-back can be from:

- Shares of existing shareholders or security holders on a proportionate basis;
- Buy back from the open market;
- Buying back the securities issued to employees of the company pursuant to a scheme of stock option or sweat equity

Default of Above Provisions

If a company makes any default in complying with the provisions of this section, the company shall be punishable with fine which shall **not be less than one lakh rupees but which may extend to three lakh rupees** and every officer of the company who is in default shall be punishable with **imprisonment** for a term which may extend to three years or with fine which shall not be less than one lakh rupees but which may extend to three lakh rupees, **or with both**.

Section 69-Transfer of certain sums to capital redemption reserve account:

Capital Redemption Reserve:

Where a company purchases its own shares out of free reserves or securities premium account, a sum equal to the nominal value of the shares so purchased shall be transferred to the capital redemption reserve account and details of such transfer shall be disclosed in the balance sheet.

Utilization of Capital Redemption Reserves:

The capital redemption reserve account may be applied by the company, in paying up unissued shares of the company to be issued to members of the company as fully paid bonus shares.

Section 70: Prohibition for Buy Back in certain circumstances:

Restriction on Buy Back:

No company shall directly or indirectly purchase its own shares or other specified securities—

a) through any subsidiary company including its own subsidiary companies;

b) through any investment company or group of investment companies; or

c) if a default, is made by the company, in the repayment of deposits accepted either before or after the commencement of this Act, interest payment thereon, redemption of debentures or preference shares or payment of dividend to any shareholder, or repayment of any term loan or interest payable thereon to any financial institution or banking company:

a. Provided that the buy-back is not prohibited, if the default is remedied and a period of three years has lapsed after such default ceased to subsist.

Important Compliances:

No company shall, directly or indirectly, purchase its own shares or other specified securities in case such company has not complied with the provisions of:

Sections 92: Annual Return

Section 123: Declaration and Payment of Dividend

Section 127: Failure to pay Dividend

Section 129: Failure to give True and Fair Statement

Thoughts or doubts? Let's discuss:

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