Impact of buyback on EPS
An empirical analysis

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Buyback is expected to increase earnings per share (EPS) as a result of favourable impact of financial and operating leaverages. This paper, thus, makes an attempt to examine the impact of buyback on EPS through empirical evidences during 1998-99 to 2000-01.

Buyback of shares, i.e., buying of own shares by a company having substantial cash reserves, has been permitted in India with effect from 31st October, 1998. Till then, an Indian company could buy its own shares only in consequence of reduction of capital under Sections 100 to 104 of the Companies Act, 1956 or, if so ordered by the Company Law Board under Section 402, to give relief in a petition of oppression / mismanagement.

The Government of India in consensus with the captains of industry and stock market fraternity decided to introduce buyback in company legislation in order to give the necessary fillip to the stock market. Earnings per share (EPS) is one of the performance indicators of a firm and it boosts the market sentiments. The literature also suggests that increase in EPS is one of the benefits of buyback.

The remainder of the paper is organised as follows. Section 2 narrates the objective of the case study in Indian context. Section 3 deals with sample selection and research methodology. The findings of the case study are discussed in Section 4. Finally, summary and conclusion are given in Section 5.

Objective of the case study

The performance of listed companies is commonly assessed by reference to its EPS, that is, the profits which are attributable to equity shareholders divided by the number of equity shares in issue, primarily because an increasing trend in EPS enhances global competitiveness and improves stock price performance of firms. Buying back shares is expected to improve this financial parameter even after neutralising the effect of reducing the floating stock via buyback because the operating efficiency of the company is likely to be enhanced after buyback. There is, thus, a hidden assumption in the application of the buyback tool.

Since buyback permits companies to return surplus cash to its shareholders when there are no proper investment opportunities to maintain the rate of return on capital, it effectively assumes that a company should experience increases in future earnings and cash flows. At least, they should remain unchanged after buyback so that the company does not find it difficult to finance its future asset needs. Moreover, reduction of share capital due to buyback automatically increases the proportion of debt in the capital structure and consequently enhances the financial risk of the company. As a result, the company's operating profit should rise after buyback in order to be able to meet the increased expectations of the existing shareholders for a higher return on their investment.

Therefore, the basic objective of the case study is to examine the effect of buyback on EPS of the selected companies in India and to analyse the change in their operating profit during the period surrounding buyback so as to offer an explanation to the observed change in EPS of the sample companies as a result of buyback.

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Sample selection and research methodology

In order to empirically examine the effect of buyback on EPS, a sample comprising those listed public limited Indian companies in the private sector that have effected buyback between the period 1998-1999 to 2000-2001 is formed after searching for a public advertisement of the buyback offer and the details of the outcome of such offers in leading newspapers in India - The Economic Times, Business Standard and The Financial Express. It may be noted that since buyback legislation originated in India in the year 1998, the selection of three consecutive financial years (i.e., 1998-'99 to 2000-2001) as the period of study helps to determine the impact of buyback on EPS of those Indian companies that were the first ones to go for buyback. Table 1 gives the profile of the five companies that constitute the sample and the details of the outcome of their buyback offers. (See in Table 1)

In selecting the sample, the following rule has been observed: all such buyback offers which commenced during the period 1998-'99 to 2000-2001 are included irrespective of whether such programs were actually completed within the said period. As for example, Raymond Ltd. completed its buyback beyond the financial year 2000-2001, yet it has been included in the sample on the ground that its offer commenced within the period of study.

The effect of buyback on EPS and operating profit of the sample companies is studied by examining the change over a three year period - year preceding buyback, year of buyback and year following buyback. Relevant data are obtained from the Annual Reports of the companies for the analysis.

Table 1
Profile of sample companies and other particulars re. buyback offer

Particulars	Cases				
@Names of the Companies	I Bajaj Auto Ltd	II Indian Rayon Ltd.	III Motor Industries Company Ltd. (MICO)	IV Raymond Ltd.	V Tezpore Tea Company Ltd.
Industry group	Automobiles (Two & Three Wheelers)	Diversified	Auto Ancillary (Engine Parts)	Diversified	Tea
Month(s) and Year of buyback	Sept.–Oct., 2000	Sept.–Oct., 1999	Dec., 2000	Mar.–Apr., 2001	Nov., 1999
# Target fraction (as % of paid-up equity capital)	15.08%	25%	5.55%	25%	12.44%
Fraction repurchased (as % of paid-up equity capital)	15.25%	11.3%	5.55%	18.26%	4.56%
Buyback price (Rs. per share)	400 (offer price)	85 (upper limit of the offer price range)	3800 (offer price)	160 (maximum offer price)	75 (offer price)

@ arranged alphabetically
\# fraction sought for buyback

Findings of the study

Based on EPS information gathered from the 'Financial Highlights' segment of the Annual Reports of the sample companies, it could be observed from Table 2 that the percentage change in EPS as on the year of buyback indicates that buyback has a negative impact on EPS in case of three out of five companies contrary to what the theory claims. Of the remaining two companies, EPS has shown a remarkable increase-in case of Raymond Ltd. 1162.79% while it has risen by only 9.71 % in case of MICO. On comparing the percentage rise in EPS with the percentage of shares repurchased, it may be observed that EPS rises in case of MICO and Raymond Ltd. after offsetting the benefit arising out of reduced number of shares post buyback. The decrease in EPS post buyback in case of Bajaj Auto, Indian Rayon and Tezpore Tea Company Ltd. may well be due to a fall in operating profit out weighing the positive effect of lesser number of shares on EPS as a result of buyback.

Over a longer time frame, i.e., one year after the year of buyback, EPS has increased in case of Bajaj Auto and Indian Rayon Ltd. but has

Table 2

Effect of buyback on EPS of the sample companies

Cases	% of shares reduced by Buyback	Before Buyback (Rs..)	EPS As On Year			
			Of Buyback		After Buyback	
			Amount (Rs.)	% change @	Amount (Rs.)	% change #
I. Bajaj Auto Ltd.	15.25	53	22	(–)58.49	51	131.82
II. Indian Rayon Ltd.	11.3	15.71	9.62	(–) 38.77	11.44	18.92
III. MICO	5.55	278	305	9.71	240	(–)21.31
IV. Raymond Ltd.	18.26	4.3	54.3	1162.79	14.36	(–)73.55
V. Tezpore Tea Co. Ltd.	4.56	22.73	10.60	(–)53.37	3.07	(–)71.04

$$@ \ \frac{\text{(EPS as on year of buyback – EPS as on year before buyback)}}{\text{EPS as on year before buyback}} \times 100$$

$$\# \ \frac{\text{(EPS as on year after buyback – EPS as on year of buyback)}}{\text{EPS as on year of buyback}} \times 100$$

Table 3

Effect of buyback on Operating Profit of the sample companies

Cases	Operating Profit As On Year				
	Before Buyback (Rs. in million)	Of Buyback		After Buyback	
		Amount (Rs. in million)	% change @	Amount (Rs. in million)	% change #
I. Bajaj Auto Ltd.	5847	3052	(–) 47.8	6205	103.3
II. Indian Rayon Ltd.	3226	2058	(–) 36.21	2302	11.86
III. MICO	+NA	3157.1	—	2518.1	(–) 20.24
IV. Raymond Ltd.	2311.5	5257	127.43	1880.8	(–) 64.22
V. Tezpore Tea Co. Ltd.	82.802	38.265	(–) 53.79	26.436	(–) 30.91

+ NA - Not Available

$$@ \ \frac{\text{(Operating Profit as on year of buyback – Operating Profit as on year before buyback)}}{\text{Operating Profit as on year before buyback}} \times 100$$

$$\# \ \frac{\text{(Operating Profit as on year after buyback – Operating Profit as on year of buyback)}}{\text{Operating Profit as on year of buyback}} \times 100$$

decreased in case of MICO, Raymond and Tezpore Tea Company Ltd. The impact of buyback on future operating profits of these companies might explain the observed changes in EPS. Accordingly, we analyse the movement of operating profit over a three-year period as stated earlier.

Operating profit figures are obtained from 'Management Discussion and Analysis'segment of the Annual Reports in case of Bajaj Auto, Indian Rayon and MICO, 'Financial Highlights'segment of Annual Report in case of Raymond Ltd. and 'Cash Flow Statement' annexed to the Annual Report in case of Tezpore Tea Company Ltd. The change in operating profit is measured in Table 3 to explain why EPS of the sample companies has not improved as a result of buyback.

It may be observed from the percentage change in operating profit as on the year of buyback that there is a post buyback decrease in operating profit in case of Bajaj Auto, Indian Rayon and Tezpore Tea Company Ltd. while operating profit of Raymond Ltd. has increased after buyback. The post buyback change in operating profit could not be calculated in case of MICO because the data for the year preceding buyback is not available.

Since three out of four companies have shown a post buyback decline in operating profit, the analysis does not quite uphold the theory that operating efficiency increases as a result of buyback. This also explains that the decline in operating profit of Bajaj Auto, Indian Rayon and Tezpore Tea Company Ltd. has more than offset the benefit of reduced number of shares arising out of buyback and has consequently resulted in a decrease in EPS of these companies post buyback (Table 2). Similarly, the remarkable increase in EPS in case of Raymond Ltd. may, to some extent, have been accounted for by the significant jump in its operating profit as observed in Table 3.

One year after buyback, operating profit rises in case of Bajaj Auto and Indian Rayon Ltd. which probably explains why EPS shows a positive change in these two companies during this period (Tables 3 and 2 respectively). On the contrary, operating profit falls in case of MICO, Raymond and Tezpore Tea Company Ltd. during this period and hence their EPS also declines in this period.

Thus, it is clear from the above observations that, contrary to expectations, EPS and operating profit do not quite improve as a result of buyback.

5. Summary and conclusion

The theory says that buyback can improve EPS provided it does not jeopardize the firm's ability to fund promising investment opportunities that might arise in the future. That is, it is expected that the firm's future earnings and cash flows would increase or, atleast, remain same after buyback. But the findings of the case study in Section 4, though carried out on a limited number of companies, show that EPS rises in two out of five companies in the sample (i.e., MICO and Raymond Ltd.) immediately after buyback. Bajaj Auto and Indian Rayon Ltd. have shown signs of improvement in EPS one year after buyback while the remaining three sample companies have experienced a decrease in EPS during the same period. A simultaneous analysis of the change in operating profit of the sample companies suggests that the operating profit changes in a near similar pattern as that of EPS.

Thus, it may be reasoned that as the empirical evidence does not quite uphold the basic assumption in 'EPS bump' hypothesis that future earnings should atleast remain unchanged, a fall in EPS has been noticed among majority of the sample companies after buyback. If the same findings do emerge from a large number of buyback cases in the future, then the earnings boost hypothesis needs to be re-examined.

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