INTUITION

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What is a BuyBack and How Does it Impact an Income-Driven Investment Philosophy?

In major markets, particularly the United States, share buybacks are increasingly being used to 'return' excess income to investors, but what are they and how do they work? Why do companies choose this route? Importantly, do they favour an investor who requires dividends to live on? Is it possible for a company to buy itself out completely, and can it do so?

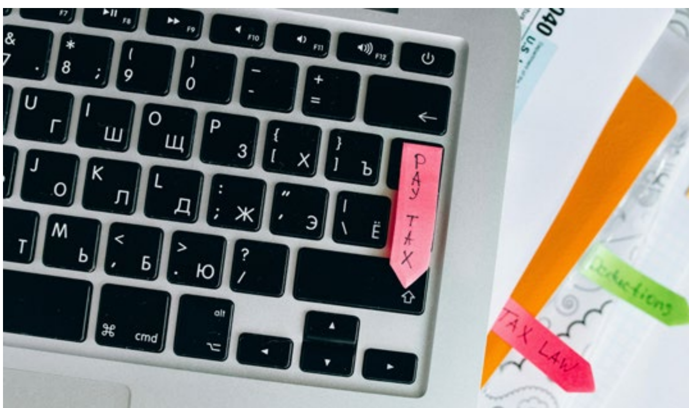
Robin Gibson

Share buybacks have been prevalent in overseas markets for a long time. They are increasingly being used by JSE companies as well. But what is a buyback and what is the point?

A share buyback is when a company uses its cash, or occasionally borrowings, to buy its shares on the open market. These shares are either cancelled entirely or held as treasury shares which are not included for earnings per share calculations, but can be sold and "re-issued" to raise cash in the future. So why would a company do this?

1. **Tax efficiency.** In most parts of the world dividends are taxed. In South Africa, there is a Dividends Withholding Tax (DWT) of 20%. This means that cash paid to shareholders via dividends is automatically taxed before the shareholder gets the opportunity to reinvest. With a buyback that same value is theoretically gained in capital appreciation as the shares are purchased by the company and then either cancelled or held in treasury. This spreads the earnings of the company across fewer shares and in theory results in an immediate appreciation in share value that is only taxable if the investor sells, and possibly at a lower rate of tax.

2. **Share schemes.** Most big companies have employee share schemes where remuneration is a combination of cash and shares. To issue new shares to employees without them paying for those shares would dilute existing investors. A buyback into treasury shares



Tax considerations are a large part of the decision to favour stock buybacks for a management team.

SPEED READ

- **Share Buybacks are a mechanism whereby a company uses excess cash, or on occasion borrowings, to purchase its own shares. These shares are then either cancelled or held in treasury to issue later to either raise capital or reward employees through share incentives.**
- **The rationale behind share buybacks is largely tax-driven as a buyback has no implications for investors whereas, in most cases, a dividend results in a deduction of withholding tax.**
- **Share buybacks result in future earnings being distributed among fewer shares. This implies a higher level of earnings per share, which when multiplied by the price-earnings (PE) ratio, results in a theoretically instant capital increase per share. Capital gains are only taxed on the sale of the asset whereas dividends are taxed on payment.**
- **Share buybacks offer a return of capital to existing investors without punitive tax deductions, allowing the investor to passively increase his interest in that company efficiently.**

allows a company to have a stockpile of shares to use for these share incentive schemes without creating the perception of diluting the existing investors.

3. **Strategic cash management**. If a company has large cash reserves it can do one of two things - return it to investors or hold it pending future investment initiatives. Paying a dividend implies that the cash is gone, spent by the shareholder who may not necessarily wish to give it back. Furthermore, raising capital in the future can be tedious and expensive. But holding the cash can also cause problems, especially in a low interest rate environment. It dilutes the earnings and negatively impacts key investment ratios such as Earnings Per Share (EPS) and Return on Equity (ROE). The neat alternative then becomes the share buyback. It either buys and cancels shares which enhances both the EPS and ROE (this is a strategy used extensively by Apple management, for example) or it buys the shares and holds them in treasury to use later in business deals or to easily raise cash for capital projects without being a drain on the ratios in the meantime. (Tesla has used both these strategies - acquiring SolarCity by paying with Tesla shares and financing its Gigafactories out of treasury shares).

How then should a particularly income-focused investor view companies who regularly use buybacks as a strategy to return capital to investors? This is a tricky question as while in theory a company should see equivalent share price appreciation from dividends or buybacks (if not more so), it is not always the case. This means that it is very important for us to consider and monitor the total value returned to investors through both dividends and share buybacks. A company which cannot create decent compounding earnings growth out of operations and buyback enhancements provides a red flag of potential trouble.

"Companies that grow earnings per share strongly while undertaking share buybacks give income investors like Harvard House the opportunity to raise income more tax efficiently than dividends."

Companies that grow earnings per share strongly while undertaking share buybacks give income investors like Harvard House the opportunity to raise income more tax efficiently than dividends. An individual investor who sells an investment pays 18% Capital Gains Tax at worst, versus the 20% DWT. This income is generated by a share sale but because the increased value came from excess company cash, this is effectively not impacting the investors' capital or relying on the capital appreciation of the underlying business.

Harvard House's research team constantly analyses our preferred companies in all these aspects. Share buybacks are here to stay, but require a dedicated and focused understanding to ensure that management isn't trying to get one over the sanguine investor who has not tracked the metrics accurately.

Tesla is a firm that has used share buybacks and treasury shares for effective management of its of cash resources.

Having examined the case for SA in our last seminar, our next presentation will focus on the prognosis for offshore investments.

Topic:	Re-examining the case for offshore
Natal Midlands	
Date:	13 March 2025
Venue:	Christ Church Howick, 23 Mare Street, Howick
Morning Time:	10am for 10.30am
Evening Time:	5.30pm for 6pm

Johannesburg	
Date:	11 March 2025
Venue:	Rosebank Union Church, Cnr Winne Mandela Drive and St Andrews Road, Hurlingham
Time:	7am for 7.30am

Cape Town	
Date:	n/a
Venue:	SSISA Conference Centre, Boundary Road, Newlands, Classroom 1, 3rd Floor
Time:	7.30am
Venue:	ABRU Motor Studio, Lourensford Wine Estate, Somerset West
Time:	5.30pm for 6pm

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CONTACT DETAILS:

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HARVARD HOUSE GROUP

3 Harvard Street, Howick, 3290, South Africa

P.O. Box 235, Howick, 3290, South Africa

+27 (0) 33 330 2164

+27 (0) 33 330 2617

admin@hhgroup.co.za

www.hhgroup.co.za

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