IRA-International Journal of Management & Social Sciences
ISSN 2455-2267; Vol.04, Issue 02 (2016)
Pg. no. 447-454
Institute of Research Advances
http://research-advances.org/index.php/RAJMSS

A Study of Motivators of Tender Offer Repurchases in the Indian Environment

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Type of Review: Peer Reviewed.
DOI: http://dx.doi.org/10.21013/jmss.v4.n2.p14

How to cite this paper:
Varma, U., & Munjal, A. (2016). A Study of Motivators of Tender Offer Repurchases in the Indian Environment. *IRA-International Journal of Management & Social Sciences* (ISSN 2455-2267), 4(2), 447-454. doi:http://dx.doi.org/10.21013/jmss.v4.n2.p14

ABSTRACT

Share buybacks are a 15 year old process in India. In developed countries share buyback is a well-accepted practice but in India the concept has yet to gain popularity. The article tries to look at the tender offer repurchases in Indian between the periods 2004 to September 2013. There were 51 public announcements for share buyback through tender offer route. The other popular method is open market repurchase. The paper tries to identify the main drivers in the tender offer repurchase through regression analysis. The more significant drivers are reduction of earnings per share through buyback, correction in capital structure and improvement in return ratios like return on net worth . The paper also looks at identifying the impact on promoter's holding through tender offer buyback and identify if it is one of the drivers of share buyback.

Keywords: Share buyback, SEBI buyback regulations 1998, Tender offer**.**

JEL Classification: G35, G15

1. INTRODUCTION

Share repurchase refers to the process of a company buying back its shares from its existing shareholders (Damodaran, 2008).The buyback activity in India stared in 1998. In 1998, section 77A was introduced in The Companies Act 1956, which applies to all types of shares and other securities that may be bought back. With this amendment companies were allowed to buy back their shares, subject to statutory regulations. In India there have been 188 share buybacks announcements between years 2000 to 2011.[1] Company in Indian may buyback its own shares or other specified securities from the existing security holder on a proportionate basis through the tender offer or from the open market through either book building process or through stock exchange or from the odd-lot holders.

Share buyback in India is 15 year old process and has not been accepted in the magnitude as has been accepted by developed countries like US and UK. The reasons for lower acceptance needs to be investigated by looking at the regulations that govern share buyback .Along with it there is a need to identify drives of share buyback in India.

The present study focuses on identifying the drivers of tender offer share repurchase in the Indian set up. The study identifies through literature survey the prevalent drivers or motivators for share buyback and tries to investigate the key drivers in the Indian set up.

The impact of share buyback on a company is in terms of reduction in cash, reduction in outstanding shares, reduction in book value of equity and improvement in EPS(Damodaran,2008). Grullon and Ikenberry(2003) suggest that there is no single reason for buy back. They suggested that firms repurchase to boost their EPS. The study looks at improvement in EPS as one of the drivers of buyback. Ditter (2000) studies the relationship of share repurchase with excess cash, capital structure, and control and compensation policies. Medury, Bowyer and Srinivasan (1992) try to explain the stock repurchasing behaviour on the basis of leverage adjustment hypothesis; free cash flow hypothesis, the clientele hypothesis and anti-takeover hypothesis. Capital structure correction is again identified as one of the reasons for share buyback to be studied in the Indian context.

There are two schools of thought when we say dividends are substituted by repurchases. One suggesting that the dividends cannot be substituted by repurchases since both serve different signalling purpose. The study looks at investigating that is this phenomenon of substituting between buyback and dividends observable in tender offer share buyback in India.

Mishra (2005) observed companies going in for buyback were undervalued, have low promoter's stake, potential of takeover, and surplus cash in treasury, low debt equity ratio and high ROCE. He related that high ROCE signifies high free cash. The study tries to look into the aspect of profitability and promoters stake to identify if they act as drivers in the Indian context.

[1] www.sebi.gov.in

2. RESEARCH METHODOLOGY

The objective of the study is to determine the underlying drivers for tender offer share buyback in India. The study tries to identify if there is significant impact of drivers like capital structure correction, improvement in earnings per share, higher profitability and dividend pay-out as a substitute method for returning excess cash on the buyback through tender offer method. To find out the result 26 announcements have been analysed.

In between January 2004 to September 2013 there have been 51 public announcements for Tender offer share buyback[2]. The present sample consists of 26 companies which have repurchased between the periods January 2007 to September 2013. Mishra (2005) has also used a sample of 25 announcements in his study.

The median values have been used to identify the size of buyback in terms of numbers of shares repurchased, shares repurchased as a percentage of the fully paid up capital , shares bought back as a percentage of total number of shares, maximum buyback price , the buyback offer size in rupees, buyback share premium and maximum number of shares bought back.

The drivers identified for capital structure correction is debt equity ratio. Medury, Bowyer and Srinivasan (1992) have used debt to equity as measure of capital structure. The dividend policy is popularly measured dividend pay-out as stated by Damodaran(2008). Profitability ratio can be measured either in terms of capital employed or in terms of sales (Damodaran 2008). In this study profitability is measured by the returns on net worth.

Testing Tool : Model of the study

The survey on literature has been utilised to draw a model for testing the drivers of repurchase which has been given below :

$$N = \alpha + \beta_1 DE + \beta_2 EPS + \beta_3 RONW + \beta_4 DIV + €$$

N is the number of shares bought back.

DE is the debt equity ratio of the company before share buyback.

EPS is the earnings per share of the company before share buyback.

RONW is the return on net worth of the company before share buyback.

DIV is the dividend pay-out ratio of the company before share buyback.

Motivations for Share Buyback

Companies having excess cash and in dearth of profitable investments go in for buyback. They usually encounter agency conflict. The management acts in its own interest rather than the interest of the shareholders. It results in overinvestment in unprofitable investments and underinvestment in potentially profitable investments. To deter the improper utilization of this excess free cash companies go in for share buyback. Such companies benefit most from buyback and they do so to minimize excess cash. (Chan, Ikenberry and Lee, 2003)Buyback, by itself increases the leverage of the company by reducing the book value of equity. Hence it acts as a method for capital restructuring for the company. Share repurchase may be beneficial for companies that perceive its current leverage is below optimal target. So companies with low leverage benefit more from share repurchase (Chan, Ikenberry and Lee, 2003). Studies conducted previously have witnessed such capital structure correction more in overvalued companies than in undervalued companies, where the leverage ratio improves significantly post buy back (D'Mello and Shroff 2000).Takeover deterrence is also one of the popular reasons for share buyback. Companies which are potential targets for takeovers usually go

[2] Source : www.sebi.gov.in

in for share buyback to increase the share price of the company and hence making takeover difficult for the acquirer.This is more prevalent in firms which are overvalued and still go in for share repurchase. (D'Mello and Shroff 2000)

There are two schools of thought when we say dividends are substituted by repurchases . One suggesting that the dividends cannot be substituted by repurchases since both serve different signalling purpose. Dividends are used to signal a company's future prospects while repurchases signal undervaluation. The other school of thought suggests that both dividends and repurchases signal for undervaluation and agency conflicts and can be used as substitutes (Grullon and Michaely, 2002). In the present study we try to test this issue by considering dividend substitution as one of the hypotheses.Dividends and share buybacks serve the same purpose, of returning excess cash to the shareholders. The basic difference lies in the nature of customer we are dealing with. Dividends are paid to all the shareholders while buyback is made to the shareholders who are willing to surrender their shares and discontinue their association with the firm completely or partially. Such shareholders are referred as tendering shareholders. They tender their shares to the companies. The shareholders who do not wish to tender their shares are called non tendering shareholders. Distribution of excess cash through repurchase subjects the shareholders to capital gain tax. Dividend distribution is subject to dividend distribution tax[3] in the hands of the companies. It is seen that capital gain tax is preferred by high net worth tax payers. Hence due to their taxation impact, dividends and share repurchase act as substitutes.

3. **SAMPLE AND DATA**

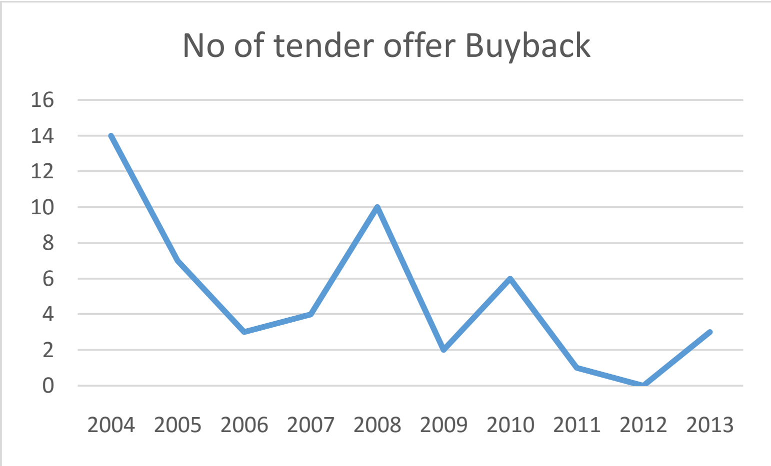
The sample of companies for the study is provided in the Table 3.1 and Graph 3.1 presents the trend of the number of tender offer in between period 2004 to 2013. There has been an observable decrease in the buyback through the tender offer over years and hence it becomes even more important to investigate the drivers for tender offer repurchase.

[3] Dividend income (as referred u/s 115-O of the I.Tax Act 1961) paid by Companies and Mutual Funds are exempt from tax. A 15% dividend distribution tax and surcharge of 3% is paid by companies before distribution.

TABLE 3.1 :SAMPLE OF COMPANIES			
Sr No	**Date of Announcement**	**Company**	**Maximum No of shares to be bought back**
1	Sep 20, 2013	Bayer CropScience Limited	28,79,746
2	Feb 15, 2013	Graviss Hospitality Limited	1,59,25,925
3	Jan 21, 2013	The Sandesh Limited	9,60,000
4	May 26, 2011	Amrutanjan Health Care Limited	1,06,937
5	Dec 10, 2010	Piramal Healthcare Limited	41,80,2,629
6	Nov 16, 2010	Navin Fluorine Buyback	3,38,792
7	Jun 21, 2010	Binanci Cement Limited	1,45,00,000
8	May 19, 2010	Geodesic Limited	20,46,919
9	Feb 26, 2010	Gujarat Petrosynthese Limited	12,11,762
10	Feb 22, 2010	Gee Cee Ventures Limited	40,50,000
11	Oct 16, 2009	Zensar Technologies Limited	24,24,000
12	Feb 06, 2009	Eicher Motors Ltd.	14,08,968
13	Dec 23, 2008	Binani Metals Ltd.	2350
14	Jul 29, 2008	Gateway Distriparks Ltd	58,18,181
15	Jun 11, 2008	SRF Ltd	43,75,000
16	Apr 29, 2008	Goldiam International Ltd	14,86,804
17	Apr 22, 2008	Sasken Communication Technologies Ltd.	15,38,461
18	Apr 17, 2008	Mastek Limited	8,66,666
19	Apr 17, 2008	Great Offshore Ltd	7,36,546
20	Apr 15, 2008	Patni Computer Systems Limited	72,92,308
21	Mar 12, 2008	Reliance Energy Limited	5,91,32,565
22	Feb 14, 2008	Madras Cements Ltd	1,53,506
23	Oct 05, 2007	Assam Carbon Limited	4,00,000
24	Sep 26, 2007	Hindustan Unilever Limited	2,20,67,76,097
25	Aug 13, 2007	GTL Limited	86,29,333
26	Apr 27, 2007	Ace Software Limited	4,42,346

Source: Compiled by authors using data from SEBI

Graph 3.1: Trend of the number of tender offer in between period 2004 to 2013.



Source: Compiled by authors using data from SEBI

Table 3.2: Median values for Tender offers between 2007 to 2013

Sr No	Data Descriptor	Median Values
1	Shares bought back as a percentage of fully paid equity	10%
2	Shares bought back as a percentage of total number of shares	5%
3	Maximum Buyback Price	Rs 230
4	Buyback Offer Size(in Rs)	55,24,00,000
5	Buyback Share premium	24% of share price
6	Maximum number of shares bought back	15,38,461

Source : Computed by authors using SPSS using Tender Offer Buyback data from SEBI website.

The data on tender offer buyback suggests that a median value of 10% of the shares are bought back as a percentage of the fully paid up equity and 5% of the shares are being bought back as a percentage of total number of shares. The shares have been repurchased at a premium.

4. ANALYSIS AND FINDINGS

The study has identified debt equity ratio as a measure of capital structure, return on net worth as a measure of profitability, dividend pay out as a measure of alternate mode to return cash to shareholder and earnings per share as a measure of value to shareholder. These variable selection have been found in prior studies of Damodaran (2008), Horn, Wachowicz and Bahaduri (2008) and Asquith and Mullins (1986)

Table 4.1 : Median Values of Financial Performance Indicator of Buyback Companies

Sr No	Financial Performance Indicator of Buyback Companies	Median Values
1	Debt equity ratio	0.160
2	Earnings per share	8.73
3	Return on net worth	14.92%
4	Dividend Pay out	28.62%

Source : Computed by authors using SPSS using Tender Offer Buyback data from Annual report of companies.

The median values of the drives have been found out. The debt equity ratio is moderately low for the repurchasing companies. The earnings per share also has a moderate value. We do not see a very high earnings per share value. The return on net worth is high for the buyback companies and dividend payout is also high.

Regression Results

Model fit is provided in Tables 4.2. The drivers of dividend substitution, low earnings per share, capital structure correction and profitability undertaken in the study explain the buyback activity in terms of number of shares bought back by 90%.

Table 4.2 : Model Fit

Model Summary				
Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.949[a]	.900	.881	148693025.18456
a. Predictors: (Constant), divpay, eps, de, ronw				

Table 4.3: ANNOVA

ANOVA[a]						
Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	4192658966390761500.000	4	1048164741597690370.000	47.408	.000[b]
	Residual	464301930509290240.000	21	22109615738537632.000		
	Total	4656960896900052000.000	25			
a. Dependent Variable: NumShare						
b. Predictors: (Constant), divpay, eps, de, ronw						

Table 4.4 : Coefficients and their significance

Coefficients[a]						
Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	-28708415.214	51516218.870		-.557	.583
	de	-224630665.977	47974900.401	-.336	-4.682	.000
	eps	-7667190.398	1626006.232	-.348	-4.715	.000
	ronw	14100338.231	1542685.288	.847	9.140	.000
	divpay	2836045.913	1230425.802	.203	2.305	.031
a. Dependent Variable: NumShare						

All the drivers have been found out to be significantly impacting the buyback activity. The signs of the coefficients explain the relationship. Debt to equity has an inverse relation with buyback. Earnings per share has an inverse relationship with buyback. RONW has positive relationship with buyback and Dividend pay-out has positive relationship with buyback. The comparison of the expected sign of the drivers of repurchase and the observed signs have been tabulated in Table 4.5.

Table 4.5 represents the comparison of the result with the theory on buy back

Sr No	Variables	Expected Sign	Observed Sign from study
1	Debt equity ratio	Negative	Negative
2	Earnings per share	Negative	Negative
3	Return on net worth	Positive	Positive
4	Dividend Pay out	Negative	Positive

Source : Compiled by the authors on the basis of results of the study using data from SEBI and annual report of companies.

5. CONCLUSION

The study concludes by finding that increasing the earnings per share is an important reason for companies to proceed for tender offer repurchase as has been stated by D'Mello and Shroff (2000) and Gustavo Grullon and David L. Ikenberry (2003). Capital structure correction is a significant driver for tender offer buyback in the study which is similar to study of Ditter (2000). Dividend payout has a positive relationship with buyback in the study hence the study finds out that dividend payout and share buyback are not substitutes to each other in the Indian environment supported by the study of Ditter (2000). Finally it has been observed that companies with higher profitability buyback through the tender offer route. A similar finding has been Mishra (2005).

6. LIMITATIONS AND SCOPE FOR FURTHER RESEARCH

The study is limited only to 26 companies and drivers of dividend substitution, low earnings per share, capital structure correction and profitability undertaken in the study. The study can further be conducted by adding more companies to the sample or by adding more drivers to the study like undervaluation. The study is also limited to only share buybacks through tender offer . The scope of the study can be increased by also considering buyback through open market repurchase.

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