# GRG Remuneration Insight 107

# Buybacks and Executive Incentives

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## Introduction

Over recent years, many ASX listed companies engaged in share buybacks, and yet little (if any) information has been provided in Remuneration Reports on the implications of such activities on executive incentive plans. This GRG Remuneration Insight discusses relevant aspects of share buybacks and raises some issues that may warrant consideration by Boards in relation to remuneration governance.

## What is a Buyback

A share buyback occurs when a company buys its own shares and, in Australia, cancels those shares. Buybacks are governed by the Corporations Act and the ASX Listing Rules.

## Illustrative Example

The following example is intended to show the expected impact of a buyback program in a company with reasonable debt and profit that distributes 50% of net profit after tax (NPAT) in dividends. It is intended to show what the expected impact of a buyback program may be, in a simple case, when a buyback occurs at the commencement of the second financial year:

| Position Prior to Buyback | | | | Position After the Buyback | | | | |
|---|---|---|---|---|---|---|---|---|
| Aspect | Borrowings | Interest Rate | Financials Pre Buyback | Retained Profit | Buyback No of Shares | Buyback Value | Borrowings | Financials Post Buyback |
| Revenue | | | $10,000,000 | | | | | $10,000,000 |
| Interest on Borrowed funds | $5,000,000 | 4.0% | $200,000 | $630,000 | | $1,890,000 | $6,260,000 | $250,400 |
| Other Exepenses | | | $8,000,000 | | | | | $8,000,000 |
| NPBT | | | $1,800,000 | | | | | $1,749,600 |
| Tax | | 30.0% | $540,000 | | | | | $524,880 |
| **NPAT** | | | **$1,260,000** | | | | | **$1,224,720** |
| Issued Shares | | | 1,000,000 | | 100,000 | | | 900,000 |
| Share Price | | | $18.90 | | | | | $20.41 |
| EPS | | | $1.260 | | | | | $1.361 |
| P/E | | | 15 | | | | | 15 |
| Market Capitalisation | | | $18,900,000 | | | | | $18,370,800 |
| | | | | | | | | |
| Dividend Per Share | 50% | | $0.630 | | | | | $0.680 |
| Dividend Yield | | | 3.3% | | | | | 3.3% |
| Total Dividends | | | $630,000 | | | | | $612,360 |

The borrowings/debt situation changes as retained NPAT reduces debt but both dividend payments and the share buyback costs increase debt ($5,000,000 - $1,260,000 + $630,000 + $1,890,000 = $6,260,000). The higher debt results in an increased interest cost (to ensure that changes relate only to the buyback; revenue, other expenses, company tax rate, dividends percentage of NPAT and P/E ratio have been assumed to remain unchanged).

The changes reflected in the foregoing illustrative example are discussed in the remainder of this GRG Remuneration Insight.

## Impact on Company

The impacts of buyback on the company include:

1. As cash is paid to acquire the shares being bought back, the company will have either:
    a. increased debt, or
    b. reduced assets, or
    c. a combination of a and b above,

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relative to the position it would have been in had the buyback not occurred.

2. Fewer shares will be on issue meaning that each remaining share will represent a larger percentage ownership of the company.
3. Both earnings per share and the share price may be expected to increase.
4. Less funds will be available for investment in new or improved business strategies which may undermine potential for future growth in shareholder value.
5. The company's risk profile may change if buybacks are funded with debt which grows to high levels (buybacks usually occur when companies take the view that the Share Price is under-valued and/or when there are no higher economic return opportunities available into which available cash may be deployed).

## Implications for Shareholders

The impacts on shareholders varies depending upon whether they sell shares into the buyback or not. However, in both cases they will be better off, at least in the short term, as follows:

- Shares sold into the buyback receive a more tax effective distribution from the company than a dividend (assuming CGT applies).
- Retained shares will have a higher value (share price) and their future income stream from dividends will be greater.

## Aspects to Consider in Relation to Executive Incentives

### Short Term Incentives (STIs)

In relation to STIs the important consideration is whether the buyback was factored into the business plans and budgets from which performance standards for key performance indicators were derived. If not, then it is possible for participants to receive windfall gains or losses depending upon KPIs being used. For example, if EPS were to be used then a buyback may increase the EPS achieved without any change in company performance, creating a windfall benefit. On the other had if NPBT or NPAT were to be used then the buyback may reduce performance, creating a windfall loss. While a reduction in return on capital performance may be expected (reduced NPAT with an increase to debt and a reduction to equity), the impact on return on equity may be more neutral (reducing NPAT and reducing equity).

Given that the timing of the buyback will also impact the outcomes consideration could be given to including Board discretion to make adjustments in the case of a buyback, as an explicit part of the STI plan rules, and then applying it if the buyback impacted STI performance outcomes.

### Long Term Incentives (LTIs)

Particularly for companies that use total shareholder return (TSR) or earnings per share (EPS) as LTI performance vesting metrics (which is the majority of companies), the impact of buybacks need to be considered.

The illustrative example indicates that buybacks will improve the performance of companies in relation to TSR and EPS and in turn improve possible LTI vesting. If the Board takes the view that buybacks are the result of management's initiatives and the Board is prepared to reward improvement irrespective of whether it is due to improved company performance or simply capital restructuring, then there may be no need to make any adjustment to LTI vesting in respect of buybacks. However, if the Board only wishes to reward improved company performance and the development of improved longer-term strategies which positively affect the share price, then consideration could be given to applying Board discretion when assessing LTI performance.

Such discretion may take into account the vesting scales, and the realisable benefits that flow from improved share price per vesting unit, though GRG would generally not recommend adjusting for the latter.

A key consideration for all incentives is whether or not the capital management was in the best long term interests of shareholders and in the case of a buyback, whether or not there could have been a better use for the capital involved in the buyback that may have produced a greater benefit over the long term.

## Conclusion

From the illustrative example it seems clear that both STI and LTI performance outcomes may be affected by share buybacks. It also seems unlikely that a simple formula can be adopted to negate the effects of buybacks on short-term and long-term performance.

Accordingly, it would seem to be appropriate for:

a) the rules of STI and LTI plans to include Board discretion to adjust performance outcomes and incentive awards specifically in the case of buybacks, and
b) Boards to consider the impact of buybacks when finalising STI awards and LTI vesting. Boards may wish to engage expert advice to consider what may be appropriate application of Board discretion, to support fairness and independence for all stakeholders involved.