CRISIL RATINGS
The Most Reliable Opinion on Risk

Implications of a Share Buyback on the Credit Rating

Buyback is a method adopted by companies to reduce their equity capital by purchasing their own shares either from the market or through a direct offer to shareholders. Following the promulgation of the Securities Exchange Board of India (SEBI) Regulations on Buyback of Securities in 1998, public listed companies in India have an option to buy back their equity shares. CRISIL studies in detail the impact of a company's buyback programme on its creditor protection levels to understand its implications on the company's credit rating.

Highlights of the buyback ordinance

The key highlights of the ordinance, which are important from a creditor's point of view, are:

- The buyback ordinance only covers listed securities of public limited companies. Any buyback programme is subject to the approval of its shareholders in a general body meeting.
- The ordinance allows companies to go in for a buyback programme through one of the following routes: tender / proportionate buyback, open offer through stock exchanges, reverse book building (Dutch auction), odd lot purchases and purchase of employee stock options. The ordinance explicitly prohibits private or negotiated deals for buyback of shares.
- According to SEBI's regulations, extensive disclosure requirements have to be fulfilled including a rationale for the buyback, funding proposed for it, its quantum and the price suggested, the promoter holding before and after the buyback, a confirmation from the management that there has been no default on repayment of deposits, debentures, term loans and the like.
- Once a buyback is completed, the company cannot issue the same type of security for a cool-off period of 12 months.
- A limit of 25% of total equity capital is imposed on the total buyback and the funds used for the buyback are limited to 25% of the networth.

Key reasons for buyback

The main reason that drives any buyback programme is enhancing shareholder value since a buyback increases the company's earnings per share (EPS) by reducing its share capital. This enhanced EPS is likely to result in a better share price in the market, provided the company's price-earning (PE) multiple remains constant. This increase in share price results in enhanced shareholder value for all post-buyback shareholders.

So a buyback is used to send strong signals that a stock is undervalued in the marketplace. By making an open offer at a price higher than the prevailing market price, the company moves its share price closer to the offer price. Companies that have a bloated equity base due to historical reasons also resort to a buyback in order to reduce their future equity servicing requirements.

Implications of a buyback on the credit rating

A buyback programme essentially involves a reduction in the equity capital / free reserves. To this extent, the company's gearing would definitely increase although the extent of the increase would depend on whether the company funds the buyback through a reduction in its current assets (such as cash balance and marketable securities) or through incremental borrowings.

Any increase in leveraging reduces the protection level available to creditors and hence, any buyback programme has a negative implication on the company's creditor protection levels. The extent of the negative impact depends on several factors such as the extent of the reduction in networth, nature of funding for the buyback programme, the strike price for the buyback and post-buyback financial ratios. The impact is most significant when the buyback is to the maximum extent possible, that is 25% of the paid-up capital, and when it is funded entirely out of fresh borrowings.

A buyback programme has a negative impact on other financial ratios such as the company's profitability and its financial flexibility as well. Profitability would reduce because of the increase in the interest outgo if the buyback is funded through borrowings (or reduction in non-operating income if funded out of liquid investments). Similarly, the increase in gearing or the debt-equity ratio would negatively impact the company's financial flexibility to raise additional debt for its operations. Moreover, the company will be prohibited from issuing fresh equity for one year, which again limits its financial flexibility.

On the positive side, the company's share price would improve on account of the buyback programme. This improved share price, if sustained over a period of time, would open an opportunity to mobilise equity funds at a future date. Another positive implication is the reduction in the company's equity servicing obligations (dividend outflow), which would partly offset the shortfall in cash accruals due to the higher interest outgo.

CRISIL would evaluate the adverse impact of a buyback programme on a company's financial ratios, especially on its gearing and profitability. The outstanding credit rating on any debt instrument issued by the company would be reviewed taking into account all these parameters to reflect the company's current risk levels.