ACCELERATED SHARE REPURCHASES PROVIDE FLEXIBILITY FOR BUYING BACK STOCK

By Don Carpenter, MSAcc/CPA

The corporate practice of repurchasing shares on the open market is nothing new. It has been used to return cash to shareholders for years. But with the recent windfalls from corporate tax reform, the magnitude of repurchases has skyrocketed, with 2018 repurchases exceeding $1 trillion, a considerable increase over the prior year.

Share repurchases allow companies to return extra cash to shareholders without setting expectations for future distributions that are implicit in increased dividend payouts. They also allow companies to selectively buy out large shareholders who may be at odds with management performance or strategy.

Share repurchases are beneficial for several reasons:

- Excess cash is a non-productive asset that reduces a company's return on assets and equity, both important measurements of management success; share repurchases reduce both assets and equity and improve these metrics;

- Share repurchases signal to the market that management and the board consider the stock to be undervalued and thus a good investment of the company's cash; but it may also indicate that relative to the company's valuation, there is a lack of attractive growth opportunities;

- Share repurchases shrink the outstanding capital stock of the company, improving earnings per share (EPS); companies in mature industries often see few alternatives for improving share price when earnings are relatively flat.

This final reason has drawn some criticism from Congress, which has requested that the Securities and Exchange Commission (SEC) consider new restrictions on repurchases, as executive bonuses and stock options are often contingent on EPS targets and market price. Congress is concerned that management may be using share repurchases to reach payout targets without a longer view of the impact of repurchases on the organization's financial well-being.

Regardless of the motivation for a repurchase, companies have traditionally been restricted regarding the timing of buying shares on the open market. Repurchases must operate within the trading windows and observe the same blackout periods that govern when corporate insiders may buy and sell shares.

These regulations generally allow for trading only for a short period after earnings are released to the investing public and before material additional information is available to insiders. Under these restrictions, a material share repurchase may take a considerable period of time to complete. Buying back large tranches of shares in a

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short trading window would artificially inflate demand and drive up the share price, reducing the number of shares the company could reacquire for a given investment.

Enter Accelerated Share Repurchases (ASRs). This "outsourced" repurchase program gives a company the opportunity to repurchase shares even during blackout periods and hype the EPS benefit of the repurchase when compared to traditional programs. To complete the repurchase, the company will rely on the services of one or more of its relationship banks. Although the structure of ASRs can vary, they typically include the following steps:

- Company A loans funds to the bank, which uses the funds to "borrow" shares of Company A from institutional investors (mutual funds, pension plans, etc.). The amount of this initial transaction is generally less than the total repurchase program announced by Company A.
- The bank returns the borrowed shares to Company A in consideration for the loan.
- The bank proceeds to opportunistically buy shares of Company A on the open market and uses the shares to "repay" the lenders of the borrowed shares in Step 1.
- At the conclusion of the program period (or earlier if the bank has completed all repurchases), Company A and the bank will settle any differences, with Company A either paying for additional shares or receiving a refund of proceeds for any repurchase shortfall.

The transaction is accounted for as a forward purchase contract. It offers several advantages over traditional repurchase structures. First, because the bank is not an "insider," it can continue to repurchase shares in a company during blackout periods, allowing for less volatility and the opportunity to exploit market dips. Just as importantly, the company can reduce its outstanding share count when shares are initially received from the bank. The tranche of shares that the bank borrows at the inception of the program would have had to be acquired over time by the company in a self-managed plan.

Since EPS is calculated on a weighted-average outstanding share count, the EPS benefit of the repurchase program is maximized by an ASR. It is this feature that makes an ASR particularly attractive, but is also the reason Congress is concerned. Because of the immediate EPS benefit, management can use ASRs to bump up share prices when stock options might otherwise expire or when bonus targets might not be met.

SINCE EPS IS CALCULATED ON A WEIGHTED-AVERAGE OUTSTANDING SHARE COUNT, THE EPS BENEFIT OF THE REPURCHASE PROGRAM IS MAXIMIZED BY AN ACCELERATED SHARE REPURCHASE.

The initial transaction is treated as a forward purchase, so the final settlement is usually structured to require an additional payment by the company and delivery of additional shares by the bank. Therefore, the initial loan may only include 75% - 80% of the total targeted repurchase. A refund of a portion of the initial funding, particularly if repeated on successive share repurchase programs, could call into question the integrity of the forward purchase.

It is unclear what action, if any, the SEC might take with regard to share repurchases, but until then, it appears that the appetite for these transactions is far from sated and we can expect to see companies continue to shrink their share base as the market demands ever-increasing EPS. ■