Digging deeper: Investment Trusts

6. Share buybacks

Key takeaways:

- Know the regulatory backdrop to share buybacks
- Understand the workings of a share buyback
- Know the advantages and disadvantages to a company (and shareholders) of buying back shares

Category: Investment insights

What is a share buyback?

An investment trust uses cash on its balance sheet to buy its own shares at the market price.

The shares bought back are then cancelled.

The rules

Chapter four (ss690–708) of Part 18 of the Companies Act 2006 allows a company to buy back its (fully paid) shares, subject to any restrictions in its articles, **unless** the buyback would result in the company no longer having an issued share capital, or having an issued share capital made up solely of redeemable or treasury shares.

When a company buys back its own shares, it must do so out of distributable profits or the proceeds of a fresh share issue made to finance the purchase (s692). This section also allows a private limited company to buy back its shares out of capital, as set out in Chapter five of Part 18.

How does a buyback work?

The board of directors can create programmes of investment trust share buybacks. This would usually be done in trusts where the shares trade at a large discount to net asset value (NAV).

The board must be granted permission by shareholders before the buyback can begin. This is normally a long procedure, since the resolution would need to be agreed by a shareholder vote. This vote would usually take place at the annual general meeting, meaning that information about the proposal would need to have been submitted with the trust's annual report. In other words, it might be six months (or more) from the time the board of directors first discusses the matter until an approval by shareholders is granted.

Often, though not always, a company's desire to buy its own shares would suggest that there is an oversupply of the trust's shares in the market. Buying back shares – in effect cancelling them – can boost performance all round.

Why the discount matters

When the discount of an investment trust falls too far (above 15%, and perhaps as far as 30% in extreme cases) predators will start to circle the fund, smelling money in the air.

Finding ways to narrow the discount between the share price and the NAV then becomes very important to the fund manager. The narrower the discount becomes, the less instant profit there is to be made by any predator fund or organisation that may attempt some form of hostile takeover.

Why have share repurchases become more popular?

The popularity of share repurchases by investment trusts increased dramatically after Advance Corporation Tax (ACT) was abolished in April 1999. Before that, any trusts buying back shares at a price greater than their issue price had to pay ACT on the difference. This was a major disincentive for those trusts whose share prices were far higher than their issue price, and in particular affected all the long-established international general trusts.

The guidelines for an investment trust share buyback:

- a trust must not pay more than 5% above the market price to purchase its own stock
- the board can seek approval to purchase no more than 14.99% of trust shares at any one time
- the money for purchase must come from the capital of the investment trust – this must be the same money that would otherwise be used to purchase an investment

An example

Let's consider the following example, where an investment trust owns investments that are worth £20 million in total. If the trust has one million shares in issue, the net asset value per share is £20.

However, the quoted market price on the stock exchange might be only, say, £18 per share. In this situation, we would say that the shares stand at a 10% discount to net asset value.

Workings

(£20-£18) / £20 = 10%

Let's assume that the company offers in the market to buy back up to 100,000 shares at a price of £18.50 per share, at an aggregate cost of £1,850,000. The selling shareholders should be happy. Before the investment trust started the buyback, these shareholders could only sell at the market price of £18.00 per share. Instead, they have been able to sell their shares at £18.50 each.

The share buyback will change the net assets per share, since both the net assets and the number of shares in issue decrease. Before the buyback, net assets per share were £20.00 each (£20 million net assets / one million shares in issue). Now the net assets per share are: (£20m – £1.85m) / (1,000,000 – 100,000) = £18.15m / 900,000 = £20.17.

The shares may be cancelled or held by the trust in treasury (i.e. they will still exist and are not immediately cancelled). If they are held in treasury and the price subsequently rises, so too will the NAV of the trust and shareholders will benefit.

Advantages

The advantages of share buy-backs to shareholders:

- Increases the NAV per share if the price per share subsequently rises
- Reduces discount volatility
- Allows shareholders wishing to exit the trust to do so without putting undue pressure on the balance of supply and demand
- May narrow the discount
- The dividend yield may also be enhanced

Disadvantages

Share buybacks can shrink the size of investment trusts, which can have a knock-on effect on their liquidity in the medium to long-term. It might also be detrimental to the investment manager if the fees are charged on the net assets. However, it is in the management group's best interests to be managing investment trusts where performance is good, discounts are stable and the shareholder base is satisfied.

Finally

New shares may also be issued by the investment trust when there is significant demand for them. Please refer to our factsheet 5 "Issuing new shares".

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