Understanding Stock Repurchases

What are stock repurchases and how and when do they return value to shareholders.

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5 minutes

What Are Stock Repurchases

Stock repurchases, also known as "stock buybacks," occur when a company decides to acquire its own shares. By reducing the number of shares in circulation, they increase the ownership stake of the remaining shareholders in the company.

How It Works

Take, for example, the following company named "XYZ":

Example 1:

XYZ is valued at $10,000, with 100 shares outstanding, and an intrinsic value of $100 pesos per share.

XYZ buys back 10 shares, at $80 pesos per share.

XYZ's cash decreases by $800 pesos.

The value of XYZ drops to $9,200 pesos and the circulating shares to 90.

The value per share increases to $102 (102 = 9,200 / 90).

We observe that by repurchasing shares when a company is undervalued, the company can directly return value to shareholders. The value of the company divided by the remaining shares ends up being higher than before.

It's crucial to mention that if XYZ had repurchased shares at a price equal to or higher than its intrinsic value, it would not provide value to shareholders. In fact, if the price of the repurchased share is higher than its real value, the company destroys value.

Example 2:

XYZ is valued at $10,000 pesos, with 100 shares outstanding, and an intrinsic value of 100 pesos per share.

XYZ buys back 10 shares, at $110 pesos per share.

XYZ's cash decreases by $1,100 pesos.

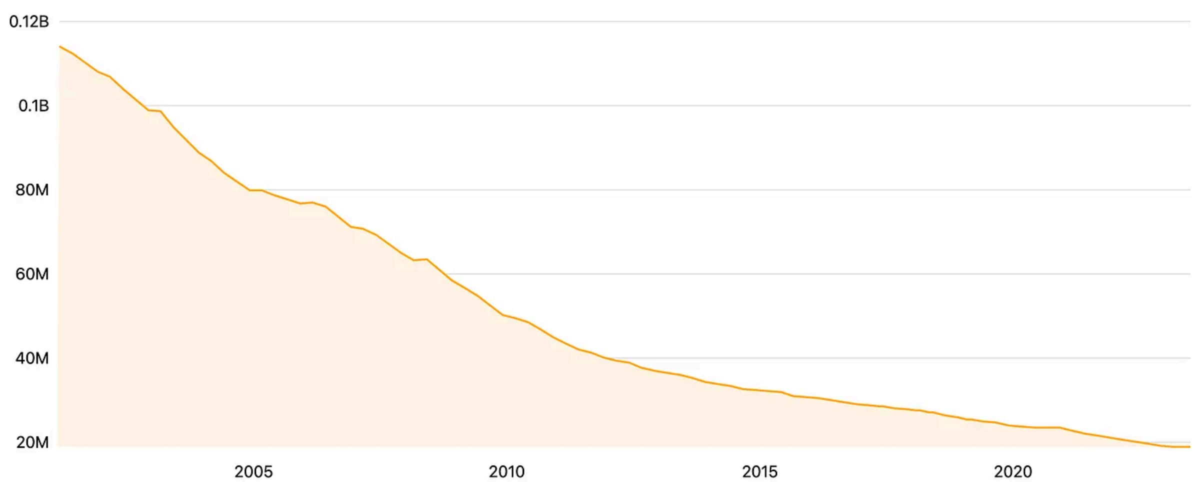
The value of XYZ drops to $8,900 pesos and the circulating shares to 90.

The value per share decreases to $98 (98 = 8,900 / 90).

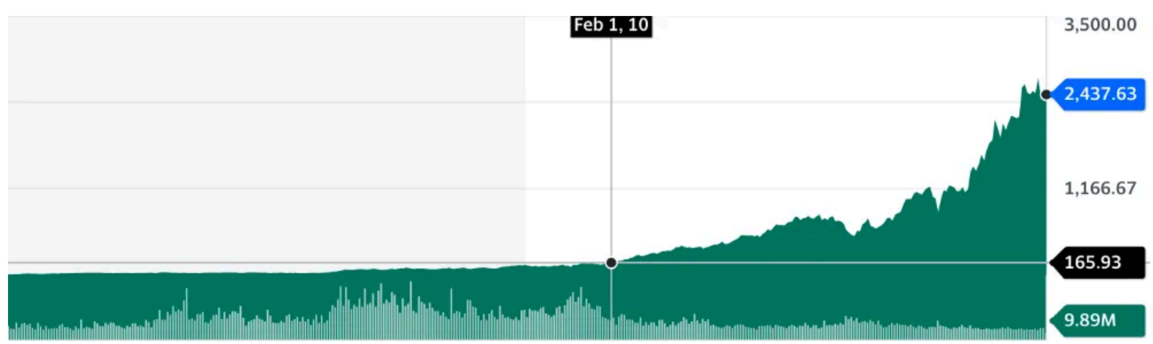
Case Study

When done right, it's an excellent way to return value to shareholders; and unlike dividends, there are no taxes to be paid. Companies like Autozone have used this 'capital allocation' strategy to reduce the number of circulating shares and increase the value of its shares.

Shares Outstanding of Autozone



Stock Price of Autozone



Conclusion

If a company can continue growing or if it is undervalued, then a stock buyback program can benefit shareholders.

However, the risks of this strategy are notable: capitalism is brutal, and only a small number of companies may be able to grow their profits over a long period. Moreover, if the executives implement this strategy and the stock price is higher than the company's real value, then the company destroys value.

Comments