Candor

A Curable Cancer in the Heart of Our Equity Capital Markets

Introduction

Across Europe our equity capital markets are at a crossroads. Regulators and industry leaders are driving reforms to address perceived shortcomings, as a fundamental question emerges: Who are we designing our capital markets to truly serve?

At their core, the equity market represents a bargain between issuers and long-term investors. Companies receive permanent capital to fuel growth, create jobs, and drive economic prosperity. In exchange, investors receive a share of ownership with the expectation of fair returns, robust governance and high transparency standards.

While the individual owners of these shares may change over time, the underlying issuers equity capital remains constant. When issuers accumulate surplus capital, they frequently choose to return some to their shareholders through dividends and/or buybacks. The efficiency of the transmission of this capital back to investor is critical to their returns. This is the virtuous circle at the heart of our market. The greater the returns from our current market, the more attractive our future market is to new issuers and investors.

Share buybacks have gained significant traction in recent years, accounting for approximately 40%[1] of capital returned by UK companies in 2022 and 2023, and nearly 50% in the EU. While dividend payments incur minimal frictional costs[2], a hidden and potentially substantial expense lurks within the execution process of share buybacks.

This article highlights an important issue that threatens the integrity of our capital markets: the excessive and overlooked execution costs associated with most share buybacks. However, there are also straightforward solutions to this growing problem. The benefit of immediate attention from regulators, corporate leaders, and investors, will be an instant improvement to the overall returns for our current investors.

Scale of Buybacks: A Stark Contrast

The scale of share buybacks across Europe dwarfs the IPO market. In 2022 and 2023, while IPOs raised a modest €25.5bn (with the UK contributing £2.5bn), European issuers repurchased a staggering €410bn of equity capital, including £105bn from UK issuers. This trend shows no signs of slowing. As of May 2024, Morgan Stanley reported that 230 European (inc. UK) issuers have already repurchased about €70bn YTD, with over €9bn in just the final two weeks of May. They estimate that there is an additional €220bn of

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[1] AJ Bell's Dividend Dashboard Q1 2024 & Janus Henderson

[2] We do not have a precise value for the frictional costs of dividends. These costs will be largely the admin and bank transfer charges, however as a % of the capital we expect that this cost is measured in fractions of a bp.

approved buyback programmes remaining to be executed. At this current pace, the cumulative value of UK and EU share buybacks is projected to reach approximately €700bn over the three calendar years 2022 through 2024.

Modelling Buyback Transaction Costs: The Hidden Burden

To understand the true cost of executing buybacks, we need to consider both explicit costs (commissions and taxes) and implicit costs (impact and slippage). Using Morgan Stanley's aggregate data as a baseline, we estimate that the average European share buyback is €1bn, is executed at an average of 4.75% of daily volume, over a three-month period.

Standard market impact models[3] suggest that the implicit transaction cost to implement a buyback such as this would be around 4.5%. This cost aligns with Morgan Stanley's 3-month return estimate of 5.5% for their basket of buyback stocks[4].

If we combine this 450-basis point implicit cost with a further 20[5] basis points of explicit costs, we arrive at a total transaction cost of approximately 4.7%. This translates to a market wide total cost of about €35bn over this three-year period, or €11bn annually. The purpose of estimating the total transaction costs is to give an idea of the scale of buyback execution costs vs those of dividends. The point we are trying to highlight, is that each additional 1% of inefficiency has been a €7bn drag on total returns over this 3-year period. These return drags compound as future earnings are spread over a greater share count.

Who Bears the Burden of Buyback Execution Costs?

While selling shareholders receive the proceeds of their sales minus explicit costs[6], it is the holding shareholders who bear the brunt of implicit costs, which is over 95% of the total transaction costs in our model. This disproportionate burden on long-term shareholders raises critical questions about the actual efficiency of the buyback execution practices employed.

The Cancer: Inefficiency in Buyback Executions

Despite their prevalence, the execution of share buybacks in UK and EU markets often falls short of optimal efficiency. Case studies reveal two troubling trends:

1. Outsized fee extraction (e.g., [Royal Mail's 8.5% fee to BoAML in 2021/2022])

[3] Using a square-root model adjusted for cumulative costs: Impact = $\sigma * \sqrt{Q/ADV} * \sqrt{T} * \gamma$. σ (daily volatility) = $25\% / \sqrt{252} \approx 1.57\%$, Q/ADV = 3 (300% of ADV), T = 63 (trading days), $\gamma = 0.2$ (revised constant based on literature)
[4] Morgan Stanley estimates an 11% annualised return of their buyback basket vs a suitable hedge. This equates to 5.5% ($11/\sqrt{4}$) over a 3-month period.
[5] Assume 10bp commission and 10bp the weighted average stamp tax across Europe inc. UK
[6] In the example of a €1bn programme, the issuers buyback provides liquidity for the sellers to sell their shares, for which they receive all €1bn net of explicit costs charged to the issuer. 20bps in our example.

2. Clear breaches of market abuse exemption laws (e.g., [Diageo's execution strategy in 2023/2024] and [ING's disclosures in 2023])

These inefficiencies represent a significant leakage to the capital that was intended to be returned to investors, undermining the very value of these buybacks.

Protecting the Holding Shareholders Interests

As we mentioned in the introduction, we need to pay particular attention to the value transmitted of the buyback to the holding shareholder. Through the narrow lens of the execution of a share buyback, the interests of the holding shareholder are directly proportional to the number of shares repurchased. The higher the share price moves prior to, and while the shares are being repurchased, the less shares will be repurchased. The value of a buyback to these shareholders diminishes as the number of repurchased decreases.

The Hidden Conflicts

The execution of share buybacks presents a unique set of conflicts that often go unnoticed. Drawing from Milton Friedman's concept of spending money, we can see how buybacks represent a scenario where people are spending others' money on something that doesn't directly benefit or harm them.

For long-term shareholders, the ideal outcome is maximizing the number of shares purchased. However, this often only occurs when the share price is also lower, which displeases both existing shareholders and corporate management. Conversely, a rising share price reduces the number of shares bought back but temporarily satisfies management and shareholders.

This conflict is exacerbated by the opaque nature of buyback executions. The responsible party within the issuer typically lacks expertise in equity transactions, future share price movements are uncertain, and the capital involved is substantial, i.e. these individuals have very little upside, and potentially a significant downside. In this context, execution products that guarantee outperformance of a recognized benchmark, ensure completion within a specified timeframe, and mitigate regulatory risks become highly attractive.

On the other side, investment banks' derivatives desks excel at designing and selling these appealing products. Their track record shows a remarkable ability to extract significant value by exploiting complex, opaque situations through sophisticated financial strategies.

This combination of conflicting interests, lack of transparency, and the allure of seemingly beneficial financial products creates an environment ripe for inefficiencies and potential exploitation in the buyback process.

Improving Buyback Execution Efficiency

The majority of transaction costs stem from implicit factors which policymakers and regulators can quickly and simply influence:

1. Information leakage
2. Market impact
3. Delay costs

Information Leakage

Information leakage relating to the execution of buybacks increase the chances of the share price rising prior to the issuer repurchasing. The granular details that our European disclosure laws require, enable intermediaries to accurately predict the quantities, time and venue where the issuer will repurchase shares. This enables brokers, hedge funds and proprietary trading firms to position themselves in front of the issuer's buybacks. This behaviour extracts a portion of the value of buyback, at the direct expense of the holding shareholders.

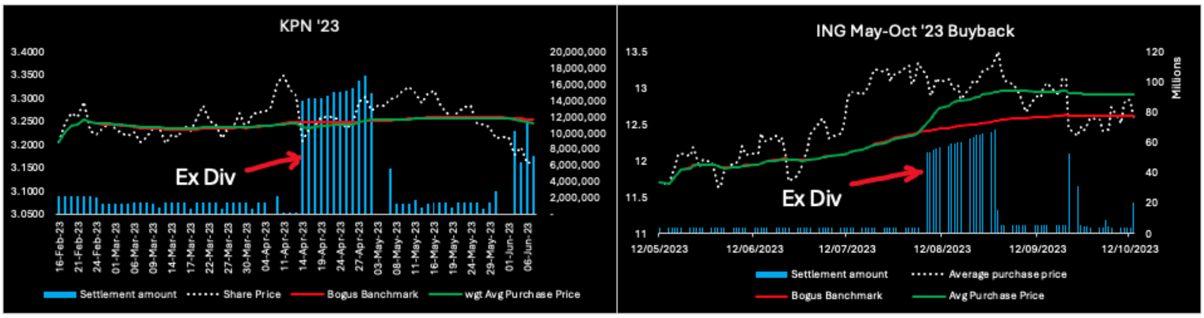
The demonstration of this extraction process can be shown through the presence of a thriving share buyback basket[7] trading business as well as the sale of specific daily buyback trading data directly to trading firms. These two businesses do not have an equivalence in the US because the buyback disclosure details are very different. This topic has been highlighted in an article "Dimon is no Buyback Fool", which references comments made by the JP Morgan CEO. Jamie Dimon was asked to reveal additional details regarding further JP Morgan share buybacks. He suggested that he would not give details as that would enable hedge funds and other market participants to position themselves ahead of JP Morgan's shareholders.

Market Impact

Buying shares inevitably results in price impact. The scale of the price impact is influenced by the size of the buyback, the availability of liquidity and the speed of buying. There are two very controllable aspects worth looking at. The first is the accessibility of available liquidity to the issuer. Most issuers and brokers, when implementing a buyback, endeavour to remain within the "conditions for trading" of our Market Abuse Regulations. This results in many programmes being capped at 25% of the liquidity on the lit continuous venues. This is equivalent to approximately 5%[8] of the total available liquidity to a normal investor. Trading on the lit continuous venues is one of the least preferable liquidity sources by the market. This opinion is corroborated by the FCA's Occasional Paper 60, which concludes that investors can reduce their execution cost by selecting venues with less pre-trade transparency than lit venues.

[7] Example Bloomberg symbols: MSSTBFW (Morgan Stan.), BCEUBUYB (Barc.)
[8] The volume on the lit continuous venues is approx. 20% of accessible liquidity. The MAR buyback volume cap is 25% of the volume on the venues being used... 25% of 20% = 5%.

The second aspect worth addressing are the execution products themselves. We have written extensively on the use of a very popular suite of execution products which we call the "problem products". The market nick names for these products are names like "VWAP-discount", "VWAP-minus", and "Optimised VWAP[9]". Through these products the brokers guarantee issuers an outcome, in return for an incentive fee based off the relative execution price compared to an average share price. Simply put, these products are not suitable. Their execution strategy is suboptimal in general, including from the perspective of their contribution to market impact. These simple charts exemplify part of this problem.



The blue bars represent the value of the reported shares purchased each day, the white dotted line is the daily share price. The broker dramatically increases the rate of repurchasing immediately post the share price going ex-dividend[10]. Would you want someone to buy shares on your behalf in this manner?

Delay Costs

There is a potentially enormous opportunity cost in the execution of share buybacks. The issuer, by the definition of allocating capital to a buyback, has decided that they are willing to purchase shares at the current market price at the initiation of the programme. If this is not true, then the issuer should either put a lower share price limit on the programme or should not proceed at all. There are very well researched trade-offs between the speed of execution and the cost of impact. Any artificial constraint on the execution strategy's ability to speed up has a potential opportunity cost. The access to liquidity and enforced time aspects of these "problem products" already mentioned adds unnecessary risk of delay. Time has a cost in equity execution, just like time has a cost in most aspects of finance.

Conclusion

By implementing these straightforward solutions, regulators, corporate leaders, and investors can significantly improve the overall returns for investors.

1. Enforce the existing market abuse exemption regulations
2. Revise the access to liquidity available to issuers within the MAR safe-harbour
3. Revise and introduce delays to the disclosure laws

[9] VWAP stands for Volume Weighted Average Price – the version of this benchmark used for Share Buybacks differs substantially from the benchmark of the same name used in by the broader market

[10] For more details "Where does opportunism stop and fraud start?" and the series of posts called the "Craziest buyback footprint ever?"

Through the continual re-alignment of the mechanics of our capital markets with the interests of our issuers and investors, we will help to restore confidence in the equity capital markets. Which, in turn, will make them more attractive to both potential new issuers and investors alike.

Candor Partners Limited, offers a consultancy service to help corporates execute share buybacks (and other share transaction) in an efficient and regulatory compliant manner. This service is designed to also help boards discharge their governance responsibilities throughout the implementation phase of these large capital allocations. We help marry objectives with outcomes, help estimate costs, and then measure and evaluate the results. Ultimately the goal is to enable the efficient transfer of capital from issuers back to their investors improving total returns.