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COMPANY STOCK REPURCHASES AT FAIR MARKET VALUE MAY DELIVER VALUE ACCRETION FOR REMAINING SHAREHOLDERS

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When a company redeems its stock at fair market value, the value of the company's stock immediately afterward may increase. To some, this phenomenon is surprising, but the effects of stock redemptions and possible stock accretion may benefit the sellers, the remaining shareholders, or both.

Introduction

Whether publicly traded or privately held, companies from time to time might have to repurchase (or buy back) stock from their shareholders. These instances, among others, occur when (1) certain shareholders wish to be bought out, (2) certain shareholders require liquidity (i.e., for estate tax obligations, income tax obligations, life events, substantial purchases, or diversification desires), (3) the company seeks to consolidate ownership by reducing the number of shares outstanding, (4) the company seeks a reorganization where some shareholders would be ineligible shareholders (e.g., subchapter S elections), or (5) the company (a) seeks to maximize returns for its long-term shareholders and (b) has cash on hand, access to favorable financing, and/or other assets in exchange to fulfill the redemption price.

Public Company Stock Repurchases

When a public company's board of directors wishes to initiate a share repurchase, the board may start by looking at the current trading price of and the historical trading data for the stock. The board may decide that the public equity markets undervalued the company's stock price and may initiate a share repurchase. The "below market" (or discounted) share price could be attributed to overall poor market conditions, a subpar earnings report, or recent news and rumors involving the company.

Regardless of the reason, a company's repurchase of its publicly traded shares at the "discounted" current trading price (or similar) can be viewed as an effective use of dormant, unproductive cash and create a positive signal to investors.

Investors generally favor stock repurchases. That is because the repurchase of stock and the corresponding reduction of shares outstanding can improve certain financial metrics, such as (1) earnings per share ("EPS"), (2) return on assets ("ROA"), and (3) return on equity

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("ROE"). EPS would increase because the same amount of company earnings subsequently is spread across a smaller number of shares issued and outstanding. An improvement in ROA and ROE would occur from a stock redemption because assets and book value of equity (the denominator) decrease (reduced by the cash associated with the repurchase), and earnings (the numerator) stays the same, resulting in improved financial ratios. And over time, the growth in company earnings is enjoyed by a smaller number of shareholders.

Privately Held Company Stock Redemption

In the context of privately held companies, where no public marketplace exists, a stock repurchase often requires the approval of the board. The board has a fiduciary responsibility to its shareholders. To act prudently, a board may seek the opinion of an independent valuation professional. The independent valuation professional can provide an opinion of value of the privately held company stock, so the board's redemption solicitation (or offer) is at arm's length and a supported value. An independent valuation will inform the board of the contemporaneous "fair market value" of the company's stock and, along with other information, assist the board in reaching a price at which to redeem the stock (barring price negotiation).

IN THE CONTEXT OF PRIVATELY HELD COMPANIES, WHERE NO PUBLIC MARKETPLACE EXISTS, A STOCK REPURCHASE OFTEN REQUIRES THE APPROVAL OF THE BOARD.

Fair market value for a privately held company minority interest stock generally considers lack of control, lack of voting rights, and lack of marketability. When a privately held company repurchases a minority (i.e., noncontrolling) stock interest, the fair market value per share usually incorporates (or at least considers) a discount (or downward adjustment) for a lack of control, lack of voting rights, and lack of marketability, as applicable. When the company uses its accumulated cash (and/or access to favorable financing or other assets in exchange) to purchase the entirety or part of the stock owned by a selling shareholder in the business at fair market value, a peculiar phenomenon may occur. All else being equal, immediately after the stock redemption, the share price may increase, and the remaining shareholders may experience value accretion

Table 1
Repurchase of ABC Stock at Fair Market Value

	Before Stock Repurchase $	After Stock Repurchase $	Variance $	Variance %
Indicated Enterprise Value of ABC	10,000	10,000	-	0.0%
Plus: Cash and Cash Equivalents	1,000	120	(880)	-88.0%
Equals: Indicated Value of Total Equity	11,000	10,120	(880)	-8.0%
Divided by: Shares Issued and Outstanding	100	90	(10)	-10.0%
Equals: Indicated Value of Total Equity per Share	110.00	112.44	2.40	2.2%
Less: Discount for Marketability [rounded]	-20% (22.00)	-20% (22.50)	(0.50)	2.3%
Equals: Fair Market Value per Share [rounded]	88.00	90.00	2.00	2.3%
Multiplied by: Number of Shares held by Mr. Smith	10.00	NA	NA	NA
Equals: Amount Paid for the Repurchase of Mr. Smith's Stock	880.00	NA	NA	NA

NA = Not applicable

to their retained shares. This phenomenon occurs because stock repurchased at a discount increases the postredemption fair market value of equity for the remaining shareholders.

This phenomenon is driven by the privately held company purchasing its own shares for less than their pro rata enterprise value as though they were sold to a third party. Based on the valuation professional's analytical model, the redemption (a use of "cash") to acquire and retire stock (which decreases the number of shares outstanding) increases the share price immediately after the stock repurchase. Immediately after the repurchase, the remaining shareholders observe a value accretion of their shares held at that time. That is because although there is a decrease in cash and cash equivalents due to the repurchase, the indicated market value of equity is divided among fewer shares outstanding and, thus, increases the postredemption share price. An illustrative example follows.

Stock Repurchase

ABC Company, Inc. ("ABC") is a privately held company with 100 shares issued and outstanding. John Smith owns 10 shares of stock in ABC. Mr. Smith decides to sell his shares, and ABC agrees to redeem those shares to maintain the close shareholder nature of the business. ABC initiates the process of repurchasing Mr. Smith's 10 shares of stock in ABC by engaging an independent valuation professional to estimate the fair market value of the ABC stock held by Mr. Smith.

As of the repurchase date, ABC has $1,000 of cash and cash equivalents on hand to use for the share repurchase. In estimating the fair market value of the shares held by Mr. Smith, as summarized in Table 1, the independent valuation professional estimates the indicated enterprise value in ABC, on a noncontrolling, marketable ownership interest level of value basis, to be $10,000. To estimate the fair market value per share in ABC, the indicated enterprise value of $10,000 is added to the cash and cash equivalents of $1,000 to derive a total equity value of $11,000. The independent valuation professional then divides $11,000 by the number of shares issued and outstanding of 100 to conclude the indicated value of equity per share of $110.00.

BASED ON THE VALUATION PROFESSIONAL'S ANALYTICAL MODEL, THE REDEMPTION (A USE OF "CASH") TO ACQUIRE AND RETIRE STOCK (WHICH DECREASES THE NUMBER OF SHARES OUTSTANDING) INCREASES THE SHARE PRICE IMMEDIATELY AFTER THE STOCK REPURCHASE.

Table 2 Repurchase of ABC Stock Financial Data				
	Before Stock Repurchase	After Stock Repurchase	Variance	
Net Income	$ 1,500	$ 1,500	$ -	0.0%
Total Assets	$ 6,500	$ 5,620	$ (880)	-13.5%
Total Shareholders' Equity	$ 3,500	$ 2,620	$ (880)	-25.1%
Shares Outstanding	100	90	(10)	-10.0%
EPS	$ 15.00	$ 16.70	$ 1.70	11.3%
ROA	23.08%	26.69%	3.61%	15.7%
ROE	42.86%	57.25%	14.39%	33.6%

To estimate the "fair market value" of the ABC stock, the equity value per share then is discounted for the lack of marketability associated with the stock. In this case, because ABC is a privately held company, the shares of stock held by Mr. Smith cannot be sold on a public marketplace, and company bylaws and shareholder agreements include legal restrictions intended to deter an investor from selling their shares to third-party acquirers.

A DISCOUNTED STOCK REPURCHASE CAN BOOST FINANCIAL METRICS.

Because of these restrictions, the independent valuation professional estimates that a 20 percent discount for lack of marketability ("DLOM") applies to the indicated value of equity per share of $110.00. This applied DLOM results in the "fair market value" per share in ABC of $88.00, or $22.00 less per share.

We present in Table 1 (1) the value the moment before the repurchase of Mr. Smith's 10 shares, (2) the value the moment immediately after the repurchase, and (3) the resulting value accretion to the remaining shareholders in ABC.As presented in Table 1, although the cash and cash equivalents held by ABC decrease (because of the use of cash to repurchase Mr. Smith's stock), the fair market value per share for the remaining shareholders holding the other 90 shares increases. That is because (1) the shares were repurchased at a "discount" and (2) fewer shares now are outstanding.

As mentioned previously, a discounted stock repurchase can boost financial metrics, such as EPS, ROA, and ROE. In our example, ABC has a net income of $1,500, total assets of $8,000, and total shareholders' equity of $6,000. Table 2 presents the effects that a discounted stock repurchase has on ABC's financial metrics, all else being equal, immediately after the stock redemption.

Table 3 Repurchase of ABC Stock at Negotiated Fair Market Value						
		Before Stock Repurchase		After Stock Repurchase	Variance	
		$		$	$	%
Indicated Enterprise Value of ABC		10,000		10,000	-	0.0%
Plus: Cash and Cash Equivalents		1,000		120	(880)	-88.0%
Equals: Indicated Value of Total Equity		11,000		10,120	(880)	-8.0%
Divided by: Shares Issued and Outstanding		100		90	(10)	-10.0%
Equals: Indicated Value of Total Equity per Share		110.00		112.44	2.40	2.2%
Less: Discount for Marketability [rounded]	-20%	(22.00)	-20%	(22.50)	(0.50)	2.3%
Equals: Fair Market Value per Share [rounded]		88.00		90.00	2.00	2.3%
Multiplied by: Number of Shares held by Mr. Smith		10.00		NA	NA	NA
Equals: Amount Paid for the Repurchase of Mr. Smith's Stock		880.00		NA	NA	NA

NA = Not applicable

Regardless of the value accretion to the nonselling shareholders, a stock redemption transaction at fair market value is fair (and economically advantageous) for the remaining shareholders, but a stock redemption transaction also is fair for the selling shareholder.

To offset the one-sided nature of the value accretion effect, the seller may be aware of this posttransaction accretion and may be able to successfully negotiate with the board to have the value accretion be shared by the seller and the remaining shareholders. In other words, the transaction price to the seller may be negotiated higher given the economic posttransaction benefit that may inure to the remaining shareholders. This is also within the reasonable fairness of parties operating at arm's length and can be considered by all parties.

To accomplish that outcome, the parties may agree to split (or share) the economic stock value accretion. Some companies may consider this economic value accretion phenomenon slightly unfair to the selling shareholder—and the selling shareholder in the company may have that same feeling or resist the initial fair market value offer. Either way, the parties may mitigate the one-sided benefit by splitting the accretion to both the selling shareholder and the remaining shareholders. That is, in our example, as presented in Table 3, they might split the $2.00 per share benefit—an additional $1.00 per share to the redemption price (or $89.00 per share rather than $88.00 per share). That way, the transaction outcome is more equitable to each party, and no material accretion goes to either the seller or the remaining shareholders.

Conclusion

A peculiar value accretion phenomenon occurs when stock redemptions are made at a discount. Shareholders and boards of directors alike should understand this unique phenomenon and consider it within their stock redemption planning and execution. An experienced independent valuation professional can assist selling shareholders and redeeming boards of directors in understanding fair market value and the value accretion that may be available for negotiations.

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