

Response to Senator O'Neill

Relating to the business model and whole existence being undermined by off-market share buy-backs.

Submitted by Gabriel Radzynski on behalf of Future Generation.

Effective and efficient capital markets require companies to have access to various means of managing their capital. This ultimately leads to a lower cost of capital. We believe off-market share buy-backs, that include the payment of franked distributions, are one such means.

The submission made by Future Generation did not allude to the entire existence of a charity being undermined by the changes being proposed to off-market share buy-backs. That is not a statement we are trying to make. Rather, we make the point that those charities who have investment portfolios and benefit from effective and efficient capital markets will be impacted by these changes.

More specifically, there are two simple ways of describing how a charity might benefit from off-market buy-backs. If a charity owns shares in a company that is undertaking an off-market share buy-back, it faces the choice of whether to participate or not. If it participates, it means selling some of those shares into the buy-back. The benefits of that decision will be, inter alia, the receipt of a fully franked dividend, and in turn the benefits of the attached imputation credit. All other things being equal, the charity will have reduced its exposure to that company. On the other hand, if the charity decides not to participate in the buy-back, the buy-back (which involves the buying back and cancelling of the shares that are tendered) increases value for the remaining shareholders. By way of a simple illustration, if a company with 100 shares is able to generate \$10 of after-tax income, its earnings per share is 10 cents per share. If it buys back and cancels 10 shares, assuming it can continue to earn \$10 of after-tax income, its earnings per share will increase to 11 cents per share (\$10 divided by 90 shares).

This last illustration also addresses some assertions made in earlier testimony which referred to “winners and losers” arising from off-market share buy-backs. Those who participate in the buy-backs are not the only “winners.” Remaining shareholders receive a benefit of the reduction in share count, which, all other things being equal, increases their share of continuing income.