

The BHP share buy-back

- Focusing on tax-effective strategies for our investors

Issued May 2011

By Warwick Cumming Deputy Head of Australian Equities



In April 2011, BHP Billiton Limited (BHP) conducted an off-market share buy-back for \$6 billion, representing 4.4% of its issued capital. While on the surface, off-market buy-backs may not be that appealing to some investors due to the discounted price offered, it's worth looking under the bonnet, as the tax benefits can be significant, depending on the structure of the buy-back, the individual investor's tax rate and the price they purchased their shares at.

Why did Tyndall Investments participate?

Tyndall participated in the buy-back as it offered significant tax benefits for many investors in our portfolios, including the Tyndall Australian Share Wholesale Portfolio and Tyndall Australian Share Income Fund, as well as institutional mandates. The timing of the buy-back worked well for Tyndall, as we had decided to reduce our position in BHP due to concerns on monetary tightening in China and the potential for short-term weakness in Chinese demand for raw materials.

How tax-effective was the buy-back?

Calculating the after-tax benefits of an off-market buy-back can be complicated and requires individual tax advice. However, below we have provided an example of the tax benefits that may apply from the BHP off-market buy-back to an investor who has a marginal tax rate of 15%.

BHP bought back 4.4% of its shares at \$40.85, which represented a 14% discount to its volume weighted average price (VWAP) over the previous five-day period (\$47.50). The investor was able to sell 21.7% of their holding (maximum allowable for all shareholders who participated in the buy-back) at the discounted price. This transaction detracted approximately 50 basis points in pre-tax 'headline' performance for the investor for the month of April.

However, the investor is substantially better off on an after-tax basis due to the income and capital component split. Of the \$40.85 buy-back price:

- \$40.57 comprised a fully franked dividend and
- 28 cents was a capital component.

The fully franked dividend of \$40.57 attracted significant tax benefits in the form of franking credits as illustrated in table 2 (assuming a marginal tax rate of 15% and a company tax rate of 30%).

In the example, the shares sold back to BHP by the investor had been purchased over many years at an average price of \$38 (which is the price that also applied to the Tyndall Australian Share Wholesale Portfolio). This, together with the 28 cent capital component and an Australian Tax Office (ATO) adjustment of \$6.65 resulted in a capital loss of \$31.07. This can be used to offset other capital gains the investor may have.

After taking into consideration the fully franked dividend of

Why does a company conduct share buy-backs?

When companies have excess capital they have three options: reinvest in a company; make acquisitions; or return cash to their shareholders (via share buy-backs and dividends).

Share buy-backs can be conducted 'on-market' whereby the company simply purchases its own shares on the stock exchange or 'off-market' whereby the company sends shareholders an offer document outlining the terms and conditions of the offer.

Off-market share buy-backs are generally offered to shareholders at a discounted price to the current market price, however depending on how the company structures the buy-back between capital and income, they can offer low tax-paying investors (ie on a marginal tax rate of 15% or less) such as retirees and superannuants, significant tax benefits. If the buy-back scheme has a heavy weighting to fully franked dividends, then the scheme can be likened to a special dividend. The BHP off-market share buy-back had a very high fully franked income component, making it a particularly tax-attractive option.

Table 1: The BHP buy-back facts

Buy-back:	\$6 billion
% of BHP's issued capital:	4.4%
% allocated to each participating shareholder:	21.7% of their request
Market share price on 8 April: (5-day volume weighted average price):	\$47.50
Discount:	14%
Buy-back price:	\$40.85
Comprising	
- Capital component:	\$0.28
- Fully franked dividend:	\$40.57

The BHP share buy-back

- Focusing on tax-effective strategies for our investors

\$40.57, the capital component of 28 cents and capital loss of \$31.07, the total after-tax proceeds for the investor was \$52.65. This equates to a return of 11% over the 14-day period from the close of the tender period to the receipt of payment. This is the equivalent of an annualised return of 283% (refer to table 2 for the calculations).

Table 2: An example of the after-tax benefits that may apply for an investor who participated in the BHP buy-back (illustrative purposes only)

Marginal tax rate	15%
CGT discount factor	100%
Income tax outcome:	
A: Volume weighted average price	\$47.50
B: Tender price discount	14%
C: Tender price (A – (A x B))	\$40.85
D: Capital component	\$0.28
E: Fully franked dividend (C – D)	\$40.57
F: Franking credits (E x 30/70)	\$17.39
G: Assessable income (E + F)	\$57.96
H: Tax @ 15% (G x 15%)	-\$8.69
I: Franking credit tax offset (F)	\$17.39
J: Net tax offset (H + I)	\$8.69
K: After-tax proceeds (E + J)	\$49.26
CGT outcome:	
L: Capital component	\$0.28
M: Excess tax value over buy-back price (A – C)	\$6.65
N: Cost base (average purchase price over 5-year period)	-\$38.00
O: Capital loss (L + M + N)	-\$31.07
P: Tax on capital loss (O x 10% CGT)	-\$3.11*
Q: After-tax proceeds (L – P)	\$3.39
R: Total after-tax proceeds (K + Q)	\$52.65
S: Return over the 14-day tender period ((R-A)/A x 100%)	11% (283% annualised)

* Discounted CGT applies - assumes the investor held the BHP shares for longer than 12 months and has capital gains to offset the capital loss.

Please note, this example is for illustrative purposes only, the tax benefits for each investor will depend on their individual circumstances, particularly when they purchased the BHP shares and their marginal tax rate. We recommend investors seek tax advice.

Conclusion

On the surface, participation in the BHP buy-back can hurt headline pre-tax performance numbers, as it did for the Tyndall Australian equity portfolios. However, Tyndall Investments has a fiduciary duty to look after the interests of the unitholders in the funds under our care, and as such participated in the buy-back to deliver the most tax-effective outcome for the majority of its investors and institutional clients.

Interestingly, BHP bought back 4.4% of its stock and those who participated in the buy-back at the final price had 21.7% of their stock accepted. To receive five times a shareholder's pro-rata allocation implies that nearly 80% of the eligible shares on issue didn't participate in the buy-back which suggests that the pre-tax performance loss of 14% may have been more important to some fund managers than the post-tax gain to the client.

Tyndall Investments has a strong focus on managing clients' investments on an after-tax basis and will continue to participate in off-market buy-backs where we believe it serves the best interests of the majority of our investors.

For more information on this paper visit www.tyndall.com.au or email warwick.cumming@tyndall.com.au

Disclaimer

This article was prepared and issued by Tyndall Investment Management Limited ABN 99 003 376 252 AFSL No: 237563 ("TIML"). The Tyndall Australian Share Income Fund ARSN 133 980 819 is issued by Tasman Asset Management Limited ABN 34 002 542 038 AFSL No: 229664 ("TAML"). The information contained in this document is of a general nature only and is not personal advice. It is for the use of researchers, licensed financial advisers and their authorised representatives. It does not take into account the objectives, financial situation or needs of any individual. Investors should consult a financial adviser before acting on the information contained in this document. To the extent permitted by law, no liability is accepted for any loss or damage as a result of reliance on this information. Investment decisions should be made on information contained in the current Tyndall Australian Equities Product Disclosure Statement ("PDS") and its Supplementary PDS ("SPDS") available at www.tyndall.com.au. Applications will only be accepted if made on an application form attached to the current SPDS. Past performance is no guarantee of future performance. TIML and TAML are subsidiaries of Nikko Asset Management Co., Limited ("Nikko AM").