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Equitile Investments

# While Stocks Last

## *Reflections on the share buyback debate*

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In US financial and political circles, the virtue of companies buying back their own shares is a subject of hot debate. Democratic presidential candidates Elizabeth Warren and Bernie Sanders, taking a lead from the influential Roosevelt Institute, have both said that curtailing them would be a crucial step in raising worker pay and reducing inequality. Some countries, India for example, have already levied new taxes to discourage them. Atlantic magazine recently wrote about the "Stock Buy-Back Swindle" and stock market pundits regularly put strong performance over recent years down to rapid growth in the use of buybacks.

The evidence, however, is not as clear cut as many suggest and, very often, problems associated with them are rooted in poor corporate governance rather than buybacks per se.

Concerns fall into three camps; financial, managerial and political.

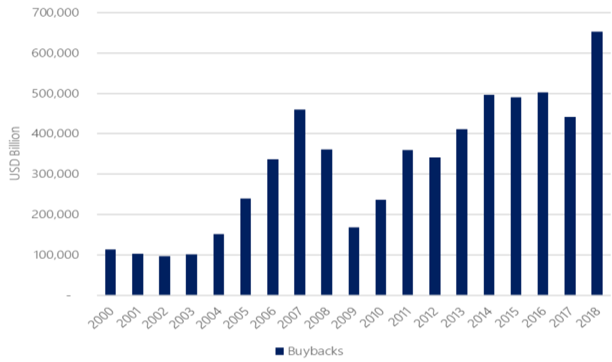
From a financial point of view, they are seen by some to ramp share prices while leaving corporations over-indebted. From a managerial perspective, executives have been accused of increasing earnings per share to justify bonuses without creating additional economic value. Moreover, they are often accused of doing this at the expense of investment and growth. Finally, in the eyes of some politicians, they accentuate wealth polarisation, not just through the enrichment of managers but also through the ensuing concentration of equity ownership.

### A modern phenomenon

The scale of share buybacks today is unprecedented. The volume of buybacks by US listed companies will be even higher this year than last – itself a record of $833 billion. In the twenty years since they took off as a tool for managing corporate balance sheets, over $10 trillion of equity has been bought from the market – close to a third of the current value of the whole US stock market today.

For the purposes of this paper we have primarily used the history of the 500 largest US corporations which we monitor as part of our investment process. *Figure 1.* shows the combined volume of buybacks from this universe since the turn of the century. This group accounts for more than 75% of all buybacks and, like the broader market, has seen a significant rise in buyback volumes since the Global Financial Crisis.

*Figure 1.* Buybacks for the 500 Largest US Companies




Source: Equitile, Bloomberg

Despite their wide use today, stock buybacks have not always been legal. Although there were attempts to repeal SEC rules (in place since 1934) governing buybacks in 1967, 1970 and 1973 they were thwarted on the grounds that they might engender market manipulation. The rules finally changed as part of Ronald Reagan's broader programme of deregulation in 1982. The SEC's Commissioner at the time, the first Wall Street insider to lead the Commission, argued that the few isolated cases of fraud related to the practice in the 1920s did not justify the onerous rules which effectively banned them.

As it happened, deregulation allowing their widespread use coincided with the emergence of "shareholder value" which put equity holders at the core of decision making, particularly with respect to remuneration policy.

### The Essence of Share Buybacks

On a basic level share buybacks are a useful tool for both companies and their investors.

It's reasonable to imagine how a Chief Financial Officer, faced with the choice of investing new capital with potentially poor returns or shrinking the capital base, might see sense in opting for the latter. Especially today, when the rise and demise of corporations occurs at an ever-increasing rate, it's logical for them to pro-actively grow and shrink their balance sheets accordingly.

For investors, in theory at least, reward through buybacks rather than dividends, shouldn't affect their ultimate financial outcome - although for many there are tax advantages to being rewarded through capital gains rather than income.

To illustrate, take the simple example of XYZ PLC which has no debt, has 100m of annual free cash flow and uses all of that to buy back shares. As an investor in XYZ PLC, assuming you don't sell into the buyback, your stake would increase over time which, even if the company's market value relative to its free cash flow remained constant, would increase the value of your investment.

In contrast, if Fiction PLC pays out all its free cash flow as dividends and (crucially) you reinvest your dividends, your stake in the company would also increase. In this case you would extract a return from dividends on your initial stake and the dividends on the newly acquired shares.

The total return to the investor, in both cases, remains the same.

So why is anyone concerned?

## Management incentives

One of the most common criticisms levelled at buybacks is that they are used to inflate C-Suite bonuses based on earnings per share. If a CEO can reduce the number of shares outstanding, they can grow EPS without growing the underlying business.

It's a genuine concern. In 2018, an SEC investigation revealed a tendency for executives to sell shares at a significantly higher rate in the days after a buyback announcement. Examples are not hard to come by. In 2018, for example, the CEO of Home Depot announced a $4 billion buyback and sold $18m worth of shares the following day. The day after that he was awarded a fresh $6m worth of stock, most of which he promptly sold straight away.

Beyond individual examples, however, it's not easy to find evidence that the perceived flawed incentive presents a systemic problem. One study found that the use of EPS related bonus and stock option plans do not impact long-term shareholder returns. Moreover, only around half of US companies have executive bonuses with EPS growth as a determinant. Even then, there is evidence that those with EPS based incentives tend to buy back shares to a lesser extent than those that don't have them[i].

A potentially more subtle abuse of share buybacks occurs when they are used to sterilise the dilution that comes when management share options are exercised - managers are reluctant to highlight the potential decline in EPS that comes from options related share issuance. It's arguably a clever way of capitalising on the exercise of share options without having to wait for the long-term strategy to overcome the impact of dilution in the short-term. Between 2007 and 2016, $4.2 trillion of equity was repurchased through buybacks but there was $3.3 trillion of new issuance – much of this share option related. About 50% of US equity issuance is to employees with around 85% of that being to employees outside of the C-Suite[ii].

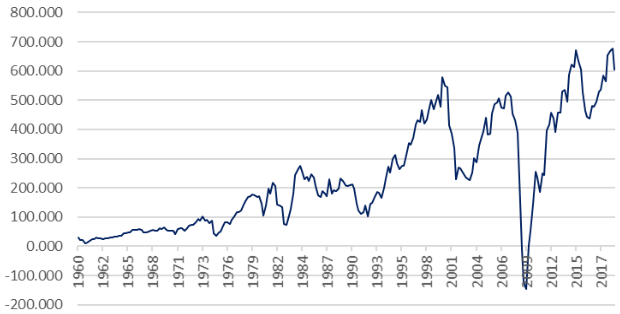
Although these issues are often raised during the buyback debate, the problem, we would argue, is one of corporate governance and sits with remuneration committees. It is for the board of any corporation to ensure that remuneration policies do not embed flawed incentives and it is the role of shareholders to engage with boards on this matter or sanction companies through the sale of shares.

## Underinvestment

Management incentives also play a role in investment decisions and so EPS related remuneration alongside buybacks could, in theory, incentivise under-investment in the underlying business. As well as potentially compromising shareholders' long-term interests, this has also become a political issue as it's often argued that they curtail investment across the whole economy.

The evidence on this, as a recent report from the Federal Reserve described, is "murky". It's not clear that companies are delaying investment and, if they are, whether it's because they simply want to buy back shares or because they can't find profitable investment opportunities. In the Federal Reserve study which looked across 26 OECD countries, they found some relationship between buybacks, dividends and investment levels but found it to be statistically insignificant[iii].

*Figure 2.* Net Business Investment ($bn)



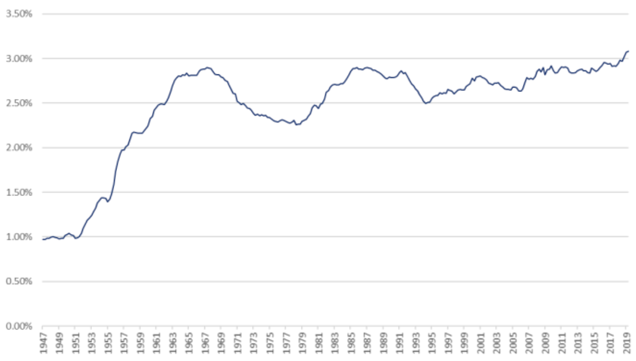

Source: Federal Reserve Bank of St.Louis

More importantly, the evidence doesn't point to a wider impact on investment. *Figure 2.* shows net business investment since 1960. Except for a sharp downturn during the 2008 crisis and after the dotcom bust, there has been no discernible slowdown in the pace of growth.

As NYU Stern School of Business' Professor Aswath Damodaran commented "Where did the $800 billion worth of cash used for buybacks in the US last year go? That money didn't just disappear; shareholders typically use their returns to invest elsewhere in the market. So, it's not that companies are investing less; it's that different companies are investing."[iv]

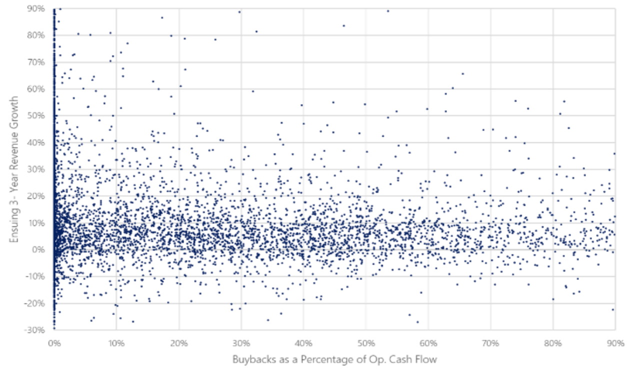
Similarly, the argument that buybacks negatively impact investment in research and development isn't supported by facts. *Figure 3.* shows R&D spending as a percentage of US GDP at its all-time high.

*Figure 3.* R&D/GDP %



Data Source: St Louis Federal Reserve

*Figure 5:* Impact of Buybacks on Future Growth

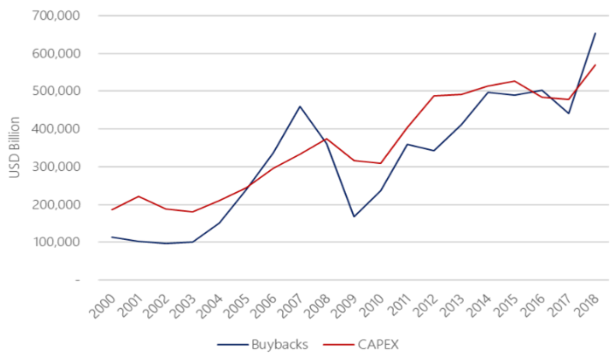



Source: Equitile Investments, Bloomberg

Looking at our own 500-stock universe, *Figure 4.* shows their aggregate capital expenditure and the volume of their combined buybacks. Although there is some evidence of stronger growth in buybacks than capex, congruous with the Federal Research global study, a statistician would be hard pressed to call this statistically significant.

In some respects, it's remarkable that capex has kept pace at all. As the industrial world becomes more "capital lite", investment requirements are no longer as onerous as they were – the price of investment relative to consumer goods has fallen by around 40% since 1990[v]. Moreover, in a digital world, the investment required to extract a dollar of revenue is simply less than it was.

*Figure 4.* Buybacks and Capital Expenditure




*For 500 of the largest US companies, based on market cap. Data Source: Bloomberg

In the end, companies reinvest cash flow to grow their revenue base. So, we looked for evidence that buying back shares hinders future revenue growth. Amongst our 500-stock universe. *Figure 5.* shows buybacks as a percentage of cash flow over 15 years and compares that with the ensuing three-year revenue growth. There is no discernible relationship between them suggesting that buy-backs in themselves have no impact on future growth.

Similarly, there is little evidence that buybacks impact total shareholder returns. One study looked at 5-year Total Shareholder Return for companies that had large share buybacks relative to those that had small ones and found no evidence that the magnitude of buybacks impacted ensuing shareholder returns negatively[vi].

## Leverage

Excessive leverage is a red flag in our own investment decision making and so we are always on our guard in this respect. Although share buybacks are often funded with debt and companies often over-leverage their balance sheet, one doesn't automatically flow from the other. If over-indebtedness does become a problem it is, once again, an issue of corporate governance rather than buybacks per se.

*Figure 6.*

| Total Years Conducting Buybacks Last 15 Years | Average Net Debt/ Operating Cash Flow* |
|---|---|
| 0 - 3 | 1.62 |
| 4 - 6 | 2.08 |
| 7 - 9 | 2.61 |
| 10 - 12 | 0.73 |
| 13 - 15 | 0.33 |

*as of 2018

Evidence from our 500-stock universe doesn't suggest a link between the two – in fact, it suggests the opposite. We broke down this group into quintiles by the number of years over the last fifteen in which each company has bought back shares. *Figure 6.* shows that those companies which have bought back shares the most times, on average, have much stronger balance sheets today than those which bought back shares on fewer occasions.

Companies that do buy back shares, most often, are doing so because they have a strong underlying business generating strong cash flow. Moreover, from a practical point of view, buybacks offer much greater flexibility than relatively fixed dividend policies when it comes to managing a balance sheet through time – not to be under-rated given the rapidly changing environment for all companies.

## Concentrating ownership

Left-leaning political thinkers argue that banning buybacks is a solution to low wages. As a recent study by the Roosevelt Institute and the National Employment Law Project pointed out "McDonald's could pay all of its 1.9 million workers almost $4,000 more a year if the company redirected the money it spends on buybacks to workers' pay checks instead". Starbucks' workers by the same logic would receive $7,000.

Beyond this somewhat crude analysis of capitalism, however, there's a more complex aspect of the political debate worthy of explanation - they are perceived to play a role in the concentration of ownership and hence wealth polarisation more broadly.

To be fair, equity ownership is much more concentrated than wealth overall. Whether it's owned directly or through pooled schemes such as pension funds and mutual funds, the Federal Reserve estimates that the top 10% by overall wealth own 84% of all equity, up from 77% in 2001. Once again, however, it's difficult to argue that this in any way is down to share buy backs.

Even though buybacks might concentrate ownership in the specific company, it doesn't follow that they concentrate ownership more broadly. In simple terms, the cash from the acquired shares is most likely invested elsewhere.

Counterintuitively, it's also possible that buybacks slow the process of ownership concentration that happens regardless. Owners of XYZ PLC, from our earlier illustration, were agnostic as to whether capital was returned through dividends or buybacks. For their rewards through dividends to keep up with buybacks, however, investors need to reinvest their dividend income. If the rate of dividend reinvestment was low for most shareholders, but few holders sell into the buyback, then actually it would be dividends that concentrate ownership at a faster rate than buybacks.

## Ramping the Market?

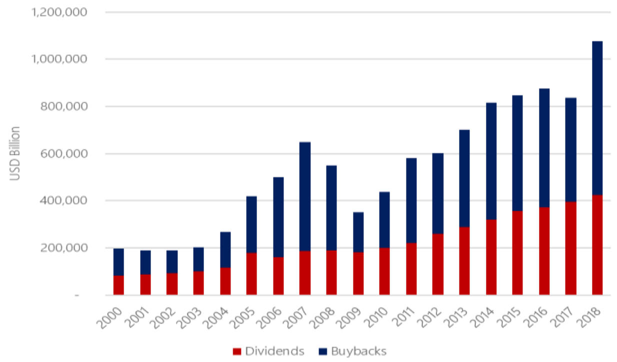
Stock market bears often point to the growth in buybacks as the main driver of stock market performance in recent years, claiming that they distort the market to the point when it no longer reflects fundamental value

Naturally, $1 trillion dollars of demand this year is far from trivial but neither is it as important as one might instinctively think. Firstly, as a percentage of the US stock market's total value, buybacks have been consistently between 2-3%. Moreover, less than 1% of stock market trading is buyback related.

More fundamentally, one shouldn't forget that buybacks are simply a mechanism for returning capital to shareholders, as a reward for the risk they take, and that they have replaced dividends to an increasing degree. The total pay-out ratio, including dividends and buybacks, is well within historic norms. Dividends and buybacks as a percentage of net income has averaged 73% since 1880 with most of that before the 1982 reform coming in dividends. In 2018 the combined pay-out was 88% of earnings, congruous with where it was between 1950 and 1970.

*Figure 7.* shows the mix between dividends and buybacks amongst our 500-stock universe. Although it's not been one-directional, there has been a growing shift towards distribution via buybacks and growth in dividend pay-outs has been relatively subdued in recent years.

*Figure 7.* Dividends & Buybacks for the 500 Largest US Companies

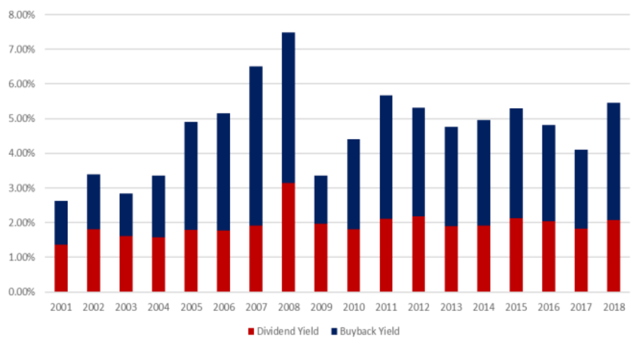



Source: Equitile, Bloomberg

Professor Aswath Damodaran looked at the history of the total "pay-out yield" (dividends and buybacks as a percentage of market capitalisation) and notes that this ratio has been relatively stable since the start of this century, *see Figure 8*.

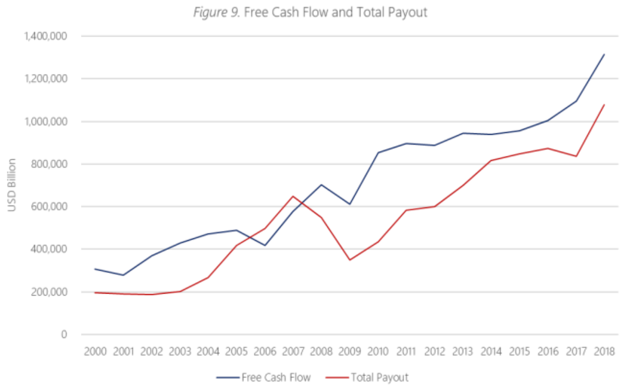
When it comes to buybacks and the overall market level, there's often inconsistency in the way the evidence is presented. If the dividend yield was, say, 3% then commentators might say the market is undervalued. When the buyback yield is 3%, they say the market's overvalued because it's being propped up by buybacks. This would be the same as arguing that the market is being propped up by dividends, which simply wouldn't make sense.

*Figure 8.* Payout yield for US market 2001-2018



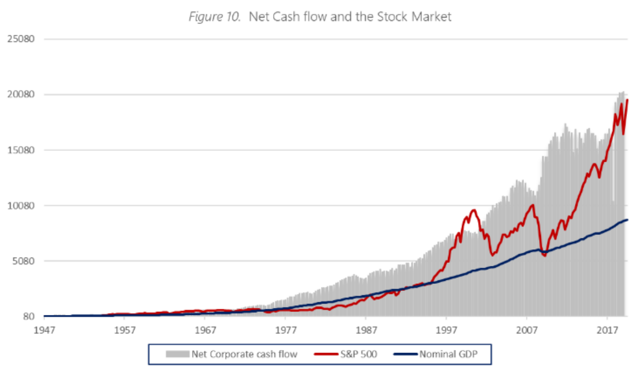

Data Source: Prof. Aswath Damodaran – Musings on Markets

As the volume of buybacks has increased, so has corporate cash flow. *Figure 9.* shows, for our 500-stock universe, the free cash flow (after capex) relative to the increase in buybacks and dividends combined. Amongst this universe at least, it seems that growth in overall pay-outs in recent years has been well supported by growth in cash flow.




*For 500 of the largest US companies, based on market cap – data source: Bloomberg

Finally, we looked at free cash flow growth for US corporations relative to stock market performance and US GDP going back to 1947 (*Figure 10)*. It's interesting to note that since then US aggregate corporate cash flow has grown at an annualised rate of 7.7% and the stock market has delivered an annualised return of 7.3%. One could argue that reinvestment rates and the mechanism for returning capital is not the key issue - what matters is that corporate USA continues to innovate and become more productive – the outcome of which is a growing ability to return cash to shareholders by any means.




Cash flow data source: Federal Reserve Bank of St.Louis

## De-equitisation

When it comes down to the pure investment decision, the increasing use of buybacks presents investors with a dilemma.

What has become known as de-equitisation, the process of removing equity contracts out of the financial system, has left fewer contracts representing a stake in the returns to the economy's productive assets. As this process continues, there's a growing argument that investing in the stock market is simply about hanging on to the equity contracts that are left in the system. De-equitisation has two main components; companies are relying less on equity to fund themselves and pension funds are relying less on equity ownership to fund their long-term liabilities. The outcome is a market much more sensitive to marginal buyers – if pension funds rebalanced their portfolios to equity, they'd find there is less equity to buy. Buybacks add to this challenge.

## Conclusion

Reflecting on the buyback debate we are left with several conclusions;

It is not clear that share buybacks are used to systematically inflate management rewards at the expense of productive investment. Neither is there evidence that large buybacks are the direct cause of over-leverage of corporate balance sheets.

Where there is a link between buybacks and poor management decisions, we would argue that this is a problem of corporate governance rather than buybacks per se. Used sensibly, buybacks are a valuable tool for right-sizing a company's balance sheet.

Politically, although the concentration of equity ownership is a crucial aspect of the broader wealth polarisation problem, it is not clear that the rise in share buybacks has accentuated this.

From an investment point of view, the switch from dividends to buybacks as a method for returning capital renders traditional dividend yield investing much less effective than it once was. More acutely, the free cash flow development of US corporations justifies recent stock market performance and current market levels.

In the long run buybacks are part of the de-equitisation process which leaves investors with a conundrum – at the current rate, logically speaking, the US stock market would have been fully privatised by 2050 leaving investors with no choice but to buy while stocks last.

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[i] Goldman Sachs. Buyback Realities, April 2019.

[ii] Are Share Buybacks Really Short-Changing Investment – Fried, Wang. Harvard Business Review,April 2018.

[iii] Corporate Buybacks and Capital Investment: An International Perspective. Federal Reserve April 2017.

[iv] Aswath Damodaran in "Top of the Mind, Buyback realities", Goldman Sachs Global Macro Research.

[v] The Price of Capital Goods and the Threat to Investment - IMFBlog July 1st 2019

[vi] Myths and Realities: Assessing the True Relationship Between Executive Pay, Share Buybacks and Managerial Short-Termism. Ira Kay, Blaine Martin, and Chris Brindisi. Pay Governance.