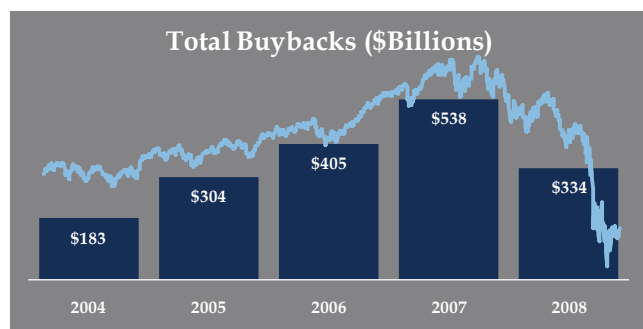


Are Buybacks The Best We Can Do?

Gregory V. Milano

What's going on? Has the Great American Economic Machine run out of ideas? Who would have thought buying back your own stock would have become such a big deal? In 2007, this use of capital reached a peak when large non-financial companies bought back \$538 billion in stock. During the 5 years ending in 2008, the group bought back shares worth \$1.8 trillion - nearly half the new seemingly very high US Government budget – to buy back stock.



The great irony of course is that the peak buyback year was also the year the S&P 500 index reached its all-time high of 1565. So much for buying low!

Why do so many companies buy back stock, especially if they need to increase leverage to do so?

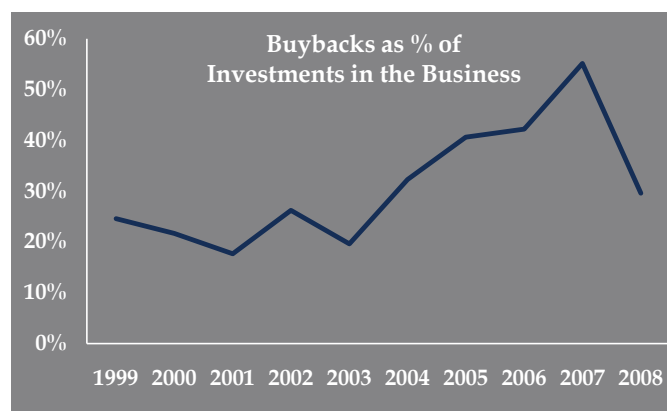
In years past, buybacks had better tax treatment than dividends for the combined company and investor. However, the Jobs and Growth Tax Relief Reconciliation Act of 2003 eliminated this tax difference. Oddly, buybacks accelerated, growing nearly fivefold from 2003 to 2007.

So what is it? Did executives view their own share price as being undervalued and therefore buying back shares was a great deal? Was the cost of debt so cheap that executives perceived a capital structure

arbitrage? Was it to fill the gap in EPS growth that top-line and efficiency gains couldn't provide? Was it a defensive maneuver to avoid activists or hostile bids from other companies or private equity firms? Or did companies simply have nothing better to do with the money?

We may never know all the motives. Some investors, advisors and academic researchers argue that a levered recapitalization reduces the cost of capital, thereby increasing the value of the firm. But is adequate attention given to the need to fuel growth and the need for financial flexibility? Do we boost the value of existing operations while at the same time reducing the value of the future?

It appears share repurchases are crowding out investments in the business such as capital expenditures (capex), R&D and Cash Acquisitions. From 1999-2003, buybacks hovered at 20-30% of investments in the business. In 2004, buybacks raced higher, crowding out growth investments and peaking at 55% at the top of the market in 2007.



So how have those that diverted more of their cash flow to buybacks fared? For the 5 years to 2008, the

companies were separated into two sets of quartiles based on propensity for deploying capital for buybacks and investing in the business. Those directing more cash flow to buybacks had lower median total shareholder return (TSR), and those investing in the business had higher TSR.

Quartile	Buybacks GCE	TSR	Quartile	Bus. Investment GCE	TSR
I	0%	28%	I	19%	(3%)
II	8%	21%	II	44%	12%
III	26%	12%	III	68%	25%
IV	57%	(3%)	IV	115%	34%

GCE = Gross Cash Earnings, or EBITDA before R&D and Rent

Does this imply buybacks are bad? Not necessarily. In some cases, companies with low TSR are more frustrated with their share price and buyback stock. Also, the very companies that have nothing better to do with the money than buy back their own stock endure weak market valuation due to a lack of growth options. Perhaps they would do even worse if they held the cash instead of buying back stock.

It is clear, though, that many companies should invest more in the business and less in repurchases - and more emphasis should be placed on buying back shares when cheap rather than when expensive.

When should a company buy back their own shares? This is one of several simultaneous considerations in an integrated framework for capital deployment. A company could invest organically or acquisitively, or it can consider capital distributions like reducing debt, paying dividends and yes, buying back stock.

Inconsistent methods are used to evaluate these different uses of capital. Many evaluate period expenses like R&D differently than capex due to the impact on EPS. Investments in capex and acquisi-

tions are often evaluated using discounted cash flow (DCF) while distributing capital is weighed on EPS accretion. We advocate a holistic view whereby alternatives are considered on the same economic basis.

Using DCF, most management forecasts suggest an 'intrinsic share price' above the current actual share price. While some of this gap may be management's natural tendency to be optimistic and to want subordinates to reach for stretch goals, a true information asymmetry between management and the markets may exist. Shares can be undervalued at times and this should affect the decision to buy back stock.

Let's say a company trades at \$20 and a conservative management plan is worth \$25. If management has conviction about their plan, buying back a share creates a \$5 NPV for the remaining shareholders, or 25% of the investment. In this case, management should only invest in the business if the NPV is expected to be at least 25% of the investment. This is but one example of integrated capital deployment.

More companies should embrace an integrated capital deployment framework with recognition of market peaks and valleys. We believe this would have provided the insights executives needed to avoid over-leveraging at the market peak, resulting in increased financial flexibility which could be used in the current markets to truly 'buy low'.

Gregory V. Milano is Co-Founder and Chief Executive Officer of Fortuna Advisors LLC

I thank Jeff Routh for his significant contribution to this research.

Study is based on the 1000 Largest Non-Financial US Companies as of 12/31/2009, excluding those not public for the entire 5-yr and 10-yr periods of the study, yielding 859 and 728 companies respectively.

Capital Deployment Fortuna Advisors Can Help

Are you concerned your share repurchases have not added value to your shares over time?

Do you have growth investment opportunities that raise questions of how much to distribute to owners?

Do you trade at a discount?

We are experts in value based strategic planning.

We collaborate on corporate development, capital deployment, business portfolio review and valuation to assist management in developing and implementing strategic plans to drive the share price higher!

Contact Fortuna Advisors

(212) 786-7363

info@fortuna-advisors.com