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What's Your Return on Buybacks?

Managements may be biased in favor of their own companies' valuation.

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During informal discussions after a recent presentation to a company's investors and analysts, I stood with the CFO and watched in dismay as he was barraged with questions about buybacks. He and his CEO had presented a strong growth strategy and were commended for it. Yet the questions were disproportionately about share repurchases and not the company's organic and acquisitive investments. Sometimes investors seem to overly fixate on what they perceive to be the benefits of buybacks.

In other cases, senior executives seem to overemphasize share repurchases, often because they boost earnings per share (EPS). Interest rates are so low that cash in the bank contributes zilch to net income. By distributing excess cash via repurchases, EPS increases because net income is divided by fewer shares. I've heard one CFO say that over half of his company's EPS growth in recent years came from buybacks - but is that as valuable as EPS improvements from revenue growth and margin improvements?

Do buybacks help improve a company's total return to shareholders? What sort of return do investors get from buybacks?

Those are critical questions, since after a lull during the financial crisis corporate buybacks are on the rise again in a big way. During the previous buyback wave from 2004 through 2008, the members of the current S&P 500 repurchased over $1.80 trillion worth of their own shares, which represents $90 billion per quarter.

In 2009, buybacks declined 63% from that five-year average. In the first quarter of 2011, however, buybacks are back up to $85 billion. The recent torrent of buyback announcements indicates that we're in the midst of another wave of heavy share repurchases.

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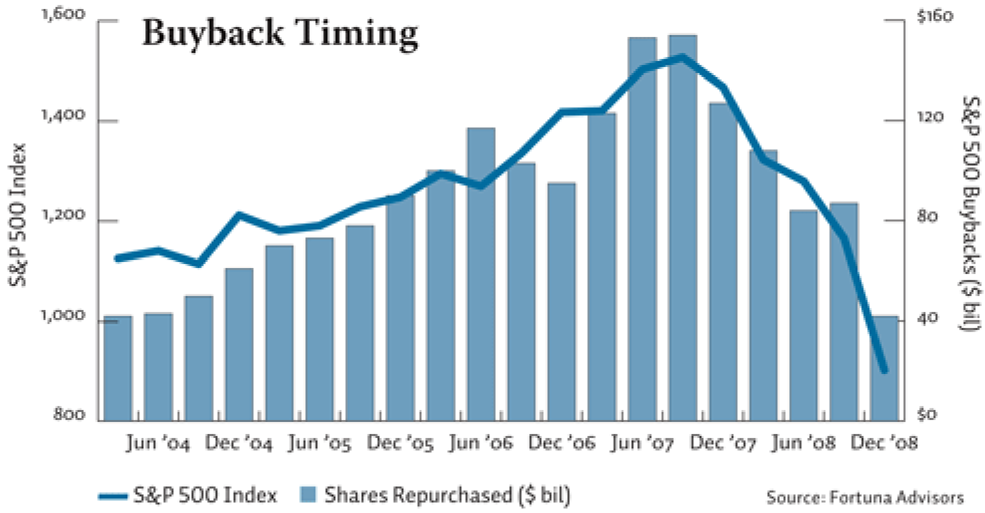
So how do buybacks affect share price performance? Our research on the buyback habits of 461 of the current S&P 500 during the five-year buyback wave from 2004 through 2008 and the after-effects on share prices demonstrates, for one thing, that investing in them may not yield as much value as investing in a company's business.

One observation based on the research is that the 29 companies that did not repurchase any stock during this period delivered median total shareholder return (TSR) of positive 40% while the overall S&P 500 index was down 19%. That is likely caused by differences in the investment opportunity set.

Those companies with great investment opportunities don't buy back shares, yet they have strong TSR. It may not mean that the presence or lack of buybacks caused the difference, but the result certainly reinforces the notion that investing in the business is a better way to drive the share price than buybacks. CFOs must be careful not to allow buybacks to keep the company from making good investments in the business.

A second observation is that buyback timing doesn't seem to follow the "buy low and sell high" paradigm. Indeed, as shown in the graph below, buyback timing seems to follow a "buy high" rather than a "buy low" course. That is critical, since many companies explain their buyback programs by claiming their shares appear undervalued. Perhaps managements are prejudiced in their assessment of their own company's valuation.



We also tested the return on investment (ROI) of buyback programs by using both a straight gain-or-loss methodology and an internal rate of return (IRR) approach.

Overall, these companies repurchased $1.80 trillion worth of their shares from 2004 through 2008, and the shares would have a market value of $1.96 trillion as of April 2011, resulting in a gain of $160 billion. The top gains were registered by IBM, Exxon, and Oracle, with the top ten accounting for 90% of the gains.

The bottom ten buyback companies repurchased $230 billion worth of shares at prices that averaged 94% higher than their prices are today. Not surprisingly, this group includes many financial institutions, with the top losses registered by Bank of America, Citigroup, and GE.

Do such results represent a desirable use of capital? We applied an IRR approach to examine the average annualized ROI on these "investments." We examined the cash outflows each quarter from 2004 through 2008 and estimated the number of shares repurchased at the average share price of the quarter. We then calculated an ROI relative to what those shares would be worth at the April 2011 share price. The top ROI was Netflix, with $300 million in repurchases now worth nearly $2.7 billion, for an ROI of 94%.

The median buyback company delivered an ROI of 3%, and three out of every four companies delivered a buyback ROI of less than 10%, a common hurdle rate for capital investment. For companies with rising share prices, buybacks amplified the increase. But for those with declining share prices, buybacks exacerbated the decline. In many cases the only happy shareholders are the ones who sold shares back to the company when the share price was higher.

Given common buyback strategies, such poor results are almost inevitable. Many companies employ a pecking order capital deployment strategy in which cash in excess of reinvestment needs is distributed via share repurchases. While this strategy seems sensible, it leads to buying back more shares when the market value has increased significantly in response to stronger cash flows. This capital deployment strategy seems flawed.

What are better buyback strategies? There are two reasonable choices. The first is to stop distributing capital based on availability and shift to a steady buyback program that distributes a consistent sum of cash every quarter. In effect, it means buying back more shares when prices are low than when they are high. That may be hard to stomach in a financial crisis, and may attract activist investors who abhor rising cash balances during good times.

The second is to continue with the pecking order strategy but shift the variable portion of the distributions to a changeable special dividend. That way leverage and cash balances can be maintained while avoiding the typical propensity to buy back more shares when they are expensive. Either way, the shareholder will be better off.

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