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Advocates Overrating the Benefits of Buybacks

A 20% boost in share price from buying back stock may sound attractive, but over five years it's a below-average return.

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When companies consider capital-deployment alternatives, the benefits of buybacks are often overestimated. Too often, a company's earnings per share (EPS) is viewed in isolation without taking into account that investors tend to put more value on operating EPS growth over the long haul.

A 2010 academic study showed that the most common rationale given by companies for buying back their own shares was to maintain or achieve a certain level of EPS. One can imagine many executives and advisers arguing in the boardrooms that "with our current earnings and price-to-earnings multiple, a share buyback will decrease shares outstanding, increase EPS, and drive our share price higher."

The logic and math seem so compelling that buyback programs are often termed "shareholder value friendly."

OPINION

Unfortunately, the facts don't support this at all. Our capital-market research indicates that, over time, the market sees through this engineered EPS growth and typically drives down the P/E multiple for companies that rely heavily on buybacks. This mitigates much of the perceived benefit of buybacks.

Thus, for buyback-intensive companies, we estimate that the realized benefit of their repurchases is only about 50 cents on the dollar. That's because P/E multiples tend to decline when EPS increases are driven by buybacks.

Many say buybacks are more attractive for companies that have a low P/E since they can repurchase shares more cheaply. Unfortunately, these low-valuation companies tend to suffer

slightly larger percentage P/E declines when they buy back shares. This is truly “salt in the wound” for these companies, since many justify their share-repurchase programs as a signal of their low valuation and of management’s confidence in the future.

We analyzed more than 700 of the largest U.S. nonfinancial companies during seven rolling five-year periods spanning January 2001 through December 2011. For each five-year period, we calculated each company’s change in diluted shares outstanding and its corresponding change in P/E multiple. For all companies and periods, the companies were separated into low- , medium- , and high-buyback groups on a relative basis. Lastly, we calculated the median percent change in P/E multiple for each group over the corresponding five-year period.

The high-buyback group reduced its share count by a median of 3% per year compared with an increase of 4% for the low-buyback group (these were net share issuers) and 0% for the medium-buyback group (which maintained a flat share count).

The study showed the high-buyback group suffered a 20% reduction in its P/E multiple on average over five years. While this was a period when P/E multiples generally contracted, the high-buyback group suffered two and three times greater percent declines in multiple versus the medium and low groups, respectively.

To illustrate these findings, consider two typical companies from the high- and low-buyback groups. Each starts with the same EPS, P/E multiple, and number of shares outstanding, and each grows net income at the same rate over the period.

The high-buyback-group company reduces the share count to improve EPS 40% more than the low-buyback company, which had an increasing number of shares outstanding. Yet, its implied share price is only 20% higher because of the greater multiple compression. This reflects that on average, EPS growth from share-count reduction yields only 50 cents on the dollar (20%/40%) in terms of share price growth.

A 20% boost in share price may sound attractive, but over five years it's a below-average return.   And the low-buyback company has the opportunity to grow its net income by investing the 40% of its market capitalization it didn’t use to buy back shares into the business via research and development, capital expenditures, acquisitions, etc.

Such findings may prove uncomfortable for many that have become passionate about buybacks. After all, it would seem that buybacks help via the basic economic principle of supply and demand. A share buyback reduces supply by removing shares from the market and therefore with stable external demand the price should move higher. Right? Not really.

While it is true that a share buyback reduces supply, demand is not left untouched. A company's value (and future earnings) is largely dependent on its revenue growth, return on capital, and business investment, and a share repurchase does not improve any one of these three drivers. In fact, if taken too far, buybacks can crowd out investment and be detrimental to future earnings. This potentially causes the declining P/E multiple we observe since investors are less willing to ascribe value to the business's future.

And since compression of the P/E multiple offsets about half the buyback-driven EPS growth for a company, the threshold for other uses of cash should be lower. For example, consider a company that could spend $1 billion on share repurchases that would increase EPS by $0.06 or a $1 billion acquisition that would increase EPS by $0.04. Our research indicates that the acquisition is the more attractive use of capital.

Does this mean that all share repurchase programs are flawed? No. They can still remain a useful tool in a CFO's financial-strategy toolbox when used appropriately. Unlike investments that create value by driving revenue and cash-flow growth, buybacks should be viewed as a financial-policy implement much like capital structure, cash management, and the use of dividends.

It's important to remember that buybacks only create value if a gap exists between the company's public market value and its true, intrinsic value at the time of the buyback *and* that gap subsequently closes in the market. In reality, most share repurchases are done when prices are high rather than low, so they tend to destroy value instead of create it.

Executives considering repurchases should proceed with caution and ensure that their internal processes and decision-making criteria mitigate four critical value traps:

1. DON'T set thresholds for investment too high, as this will lead to less investment and more share repurchases.

2. DON’T overestimate the benefits financially engineered EPS growth will have on the share price.
3. DON’T allow internal optimism to exaggerate the potential gap between the company’s market price and its intrinsic value.
4. DON’T use an incentive-compensation measurement approach that rewards financially engineered EPS growth.

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