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How to Make Hay out of Buybacks

Companies can succeed by buying back shares when the price dips below its longer term trend and stop buying when the price rises above that trend.

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One of the most puzzling business conundrums today is the extreme propensity of public companies to buy back their own shares. From the start of 2008 through mid 2011, the S&P 500 deployed nearly $1 trillion to repurchase shares, and for the second quarter of 2011 these buybacks surged above $100 billion for the first time in 13 quarters. Those companies hold record cash of over $1.7 trillion, so we can expect increases in buybacks going forward. But are the buybacks effective for shareholders?

The appeal is obvious. With low interest rates and low valuation multiples, even companies that borrow to fund buybacks boost earnings per share (EPS). However, our research shows that companies deploying a higher percentage of cash flow to buy back shares deliver lower total shareholder returns (TSR).

A lesson can be learned from how private companies think about share buybacks. They rarely buy back shares since their distributions are typically uniform across all owners. From time to time, however, the owners of a private company must think about buying out a co-owner, and their typical thought processes are relevant for public companies.

Consider a restaurant with three owners, one of which seeks to leave the business. The other two huddle to decide whether to buy out the third partner and at what price. They consider the future of the business and are eager to buy out their partner if they perceive a bright outlook with strong profit growth within a reasonable timeframe. If their optimism turns out to be accurate, they will look back at an upside that is shared by two owners instead of three.

Conversely, if they fear the restaurant is in decline or if a successful restaurateur is rumored to be launching a new eatery across the street, they will not want to buy the third partner out at anything but a bargain- basement price. They will dread the thought of looking back in a few years to see their ownership worth a fraction of what they paid the third partner.

For public companies, a stock buyback should be considered in much the same way. If the share price rises within a reasonable time after a share repurchase, the remaining shareholders will be pleased shares were taken out at a lower price – one that leverages value growth across fewer shares. Conversely, shareholders will regret share buybacks if the value of the business later falls and is concentrated across fewer shares.

Measuring Buyback Effectiveness

To quantify the return, a “Buyback ROI," or return on investment for buybacks, can be estimated. Using public S&P 500 company data from 2008 through the mid 2011, we examined the cash outflows each quarter and estimated the number of shares repurchased at the average share price.

Avoided dividends were considered as a cash inflow and the Buyback ROI was calculated as an internal rate of return relative to what those shares would be worth at the September 30, 2011 share price – the end of the most recent quarter.

The companies with high TSR over this period, including priceline.com, F5 Networks, Edwards Lifesciences, and Amazon, tend to have high Buyback ROI. Just as in the case of the private company, a buyback strategy is likely to be successful in advance of a rise in value. For companies that executed a buyback before a share price decline, the downward share price pressure tends to be exacerbated as the loss of value is divided across fewer shares.

My business partner Steve Treadwell recently developed an innovative perspective on buybacks that we we call “Buyback Effectiveness,” which is based on the relationship between Buyback ROI and TSR. Companies that tend to buy shares when the price dips below the longer term trend and to stop buying shares when it rises above the trend can generate a Buyback ROI that is higher than their TSR over time.

For example, consider the repurchases of Biogen Idec. In late 2008, the biotech company’s share price dipped but then recovered for an annualized TSR over the period of 13.8%. By concentrating

70% of its buybacks when the share price was at its largest discount to the overall trend, Biogen Idec delivered a Buyback ROI of 31.0%.

While Biogen Idec's buyback program was very effective, over 60% of companies had negative buyback effectiveness over this period, since their Buyback ROI was lower than their TSR. Companies tend to buy too many shares when the price is high and not enough when it is low. There are two strategic steps companies should take to make their buybacks more effective.

First, consider whether the share price is likely to rise over time. If so, directing excess cash toward buybacks is likely to create value. Do such buybacks create more value than reinvesting the capital back into the business?

That depends. For companies with plenty of high sustainable-return investments, in which each dollar invested has a net present value of several times the investment, buybacks are unlikely to trump reinvestment unless management believes the intrinsic share value is several times higher than the actual price. Many managements believe their shares are undervalued, but few think the market is off by that much. Such companies should thus devote as much capital as they can to reinvestment, not buybacks.

On the other hand, consider a company that has a hard time earning returns above its cost of capital. Or another for which incremental returns are high but there are limits as to how much can be invested – limits stemming from high market share or fierce competition. In such cases, any perceived future upside in the shares should predispose companies toward more buybacks.

Second, if you decide to buy back shares, consider employing policies that discourage buying back more during peaks. Such policies should include either being very objective in valuing the company or maintaining steady buybacks.

Timing low points in the share price is ideal. In reality, however, it can be very hard to be truly objective, and most managements too often view their shares as undervalued. For most companies, a better approach is to simply buy a fairly constant dollar value of shares each quarter, which will lead to somewhat more shares being purchased when the price is low and a slightly positive Buyback Effectiveness.

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