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Why to Choose Growth Over Buybacks

Business-services companies should be cautious of share repurchases until they have exhausted all acquisition opportunities first.

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The next time the leadership and board of a business-services company convene to discuss the merits of a share-repurchase program, they need to realize they would better serve their shareholders by dusting off their acquisition-strategy playbook.

Our capital-market research has found that those business-services companies that have historically invested more cash into acquisitions created more value for shareholders than those that distributed cash by repurchasing shares.

To evaluate the merits of capital-deployment alternatives, we studied the policies and share-price performance of 53 business-services companies ranging from environmental-services powerhouse Waste Management to office-service supplier Pitney Bowes and human-resources consultancy Korn/Ferry International.

The companies in our study had a market capitalization of more than $500 million. We examined two adjacent periods, 2002 through 2006 and 2007 through 2011, where we compared results in both a bull and bear market.

From 2002 through 2006, this industry was “rockin’ and rollin,’” with 46 of the 53 companies delivering total shareholder return (TSR), including share-price appreciation and dividends, in excess of the 35% return of the S&P 500 index. In fact, median TSR for all 53 companies was 101%, nearly three times the index.

During this industry bull market, these service companies delivered median revenue growth of 8% per year and generated median cash-on-cash returns on capital of 17%.

Most important, share repurchases did not enhance shareholder returns during this period. To determine this, the companies were sorted into two groups based on the percentage of their cash earnings distributed via net share repurchases.

The high repurchase group used 22% of its cash earnings for net repurchases versus negative 2% for the low repurchase group (net share issuers on median). The high repurchase group delivered a median TSR nearly 20% lower than the low repurchase group (93% TSR versus 112%).

For the high repurchase group, the distributions may have squeezed out growth investments; this group grew its revenue nearly 4% slower per year than the low repurchase group (8% versus 12%).

Conversely, by sorting the companies based on how much of their cash earnings they invested in net cash acquisitions, we found the more acquisitive companies generated better TSR. And the difference in acquisition strategies is stark. The high acquisition group deployed 42% of its cash earnings into cash acquisitions, versus only 4% for the low acquisition group, and it delivered a 21% better TSR (112% versus 91%).

ANALYSIS

These different capital-deployment strategies have big implications for each company's value drivers — in essence, it all comes down to the growth-versus-return trade-off. Thelow acquisition group, for example, increased its cash-on-cash return on capital including goodwill and intangibles by nearly 4% while growing revenue by 7% per year. On the other hand, the high acquisition group improved returns by only 1%, but grew its revenue by 11% per year. In this case, as in many other industries, investors welcomed the additional revenue growth enough that they were willing to endure less improvement in return on capital.

The results are even more eye-opening in the much more difficult macro business environment from 2007 through 2011. The industry delivered lower TSR, as did most industries. But though many would think this was a good time to hunker down and limit the amount of investment, the data shows that even in this tough environment it was better to invest in acquisitions than it was to distribute cash via share repurchases.

The high repurchase group distributed 30% of cash earnings by repurchasing shares versus 2% for the low repurchase group, yet the high repurchase group delivered 22% worse TSR. In contrast, the high acquisition group invested 40% of cash earnings in net cash acquisitions versus 10% for the low acquisition group, and the high acquisition group delivered 24% better TSR. Once again, the more acquisitive companies grew their revenue faster while expanding returns slower.

While it takes company-specific analysis to determine the right capital deployment strategy at any given point in time, there are several structural issues unique to the business-services industry that help to explain the benefits of acquisitions relative to repurchases.

First, the industry overall generates very strong cash-on-cash returns, even if goodwill and intangibles are included in the asset base. With such high returns, revenue growth is tremendously valuable to shareholders.

Second, most of the business-services industry requires little capital to grow revenue internally. While lower capital intensity may be desirable from an efficiency standpoint, it does not provide many opportunities for a company to organically redeploy its cash flow.

Finally, share repurchases divert the cash flow generated from a company's current activities out of the company, rather than keeping the cash in the company to be invested in generating new sources of growth and/or replacing the current activities when they come to an end. By contrast, acquisitions not only keep the cash invested in the company, but the investment typically generates additional cash flow over time that can also be reinvested in the future (organically or acquisitively). This creates a valuable option to reinvest that the companies in the high repurchase group forgo.

Overall, it is not surprising that investing in these high return on capital businesses, even through acquisition, is better than simply giving the money back to shareholders in a buyback.

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