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Is Cash Still King?

Rather than buying back shares, most companies would be better off investing in their business or holding the cash.

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Shareholders, analysts, and pundits are up in arms about Corporate America's ballooning cash balances and are demanding share repurchases to disgorge the cash. The nonfinancial companies in the S&P 500 (including the 405 members of the current S&P that are not financial institutions and were public for the entire 2007-2010 period) held aggregate cash and equivalents representing 7.9% of their market capitalization at the end of Q3 of 2010. That is an 80% higher ratio than the same quarter in 2007. Indeed, CFOs sometimes get more investor questions about what they plan to do with those idle cash balances than they do about strategy and operating performance.

Should CFOs listen to their shareholders and distribute cash balances via share repurchases?

On the surface, it appears they should. With low interest rates, distributing excess cash usually reduces the share count far more than it reduces net income, so earnings per share rises. What's more, reducing the financial cushion can heighten the urgency and necessity for executives to pursue cost and asset efficiencies. Distributing cash reduces the perception of reinvestment risk, in which investors fear management will make potentially value-destroying investments because the money is too readily available. Indeed, reducing cash imposes the need for management to "go to the market" and raise capital for investments.

But is the beauty of a buyback only skin deep? My firm's research and client work have led us to conclude that repurchases are less attractive than they appear. Most companies would be better off investing more in their business or holding the cash to wait for potential future investment opportunities. And if they do want to distribute cash, ordinary and special dividends tend to be more effective over the business cycle.

Our research across the overall market shows conclusively that companies deploying a higher percentage of their available cash flow to buy back shares tend to deliver substantially lower total shareholder returns (TSR) over time in terms of dividends plus capital gains. Meanwhile, those that invest more into the business in the form of capital expenditures, working capital increases, and cash acquisitions tend to produce higher TSR.

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For example, our study of the 1,000 largest nonfinancial U.S. companies over the five years ending in 2009 shows the top quartile buyback companies distributed 57% of their cash flow through share repurchases and delivered a median TSR of minus 3%. In the same study, the top quartile reinvestment companies invested 115% of their cash flow back into the business and delivered a positive 34% TSR. We have replicated this work with similar results in numerous specific industries and over many different time periods representing bull and bear markets.

It is important to reconcile these findings with the countless studies showing there is typically a positive reaction to the announcement of a share repurchase. Investors value the reduction in reinvestment risk that comes with a distribution. They also like that the company will apply buying pressure, which can prop the share price up in the near term. But the share prices of high-buyback companies seem to stall over time, as the lack of reinvestment impedes the ability to create future shareholder value.

In aggregate, companies earn well above their cost of capital on their investments, so although it often takes time for the results to appear, a dollar invested will create greater than a dollar of market value more often than it doesn't. As Steve Chazen of Occidental Petroleum said at the company's investor day last year, "Our goal is to double your money. Every dollar we keep, [we aim to] give you back $2.00 in stock-market value. Share-repurchase programs simply will not do that."

To make matters worse, cash flow and market cycles often result in poor timing for share repurchases. Most of us learned to buy low and sell high when we were young, but the share-repurchase patterns of most companies seem at odds with that axiom. Many companies employ some form of pecking-order capital-deployment strategy in which they consider the deployment of capital first for organic investments, then for acquisitive investments, then for building cash and paying down debt, and finally for 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.

So what's a CFO to do?

Corporate financial policies for target leverage, cash balances, dividends, and share repurchases should not be the inadvertent outcome of a series of haphazard events. Instead, they should be deliberately and holistically designed to maximize value in the context of the chosen corporate business strategy and the desirability, size, and timing ambiguity of investment opportunities.

For a stable company with investment opportunities that are limited or appear with regularity, the value of financial flexibility is not high. So it is appropriate to institute more aggressive leverage and distribution policies. But too often, management puts its company in this category when in fact it has peers making successful large investments in their future. If a company has sizable growth investment opportunities with uncertain timing, more flexibility may be required. That justifies lower leverage and holding on to extra cash.

One thing is clear: companies need to fully integrate their capital allocation and financial policies with their corporate strategy. This holistic view of strategy, capital allocation, and financial policy should be clearly communicated with the market, and companies should target investors that value their strategy appropriately.

In the absence of a clearly defined corporate and financial strategy, investors will likely be skeptical and fearful that the company will misuse its cash at the expense of shareholders – and will demand their capital be returned so they can redeploy it elsewhere.

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