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Understanding and Getting More out of Stock Buybacks

By Gregory Milano

Like any other use of corporate capital, stock buybacks can be good or bad.

I started corporate consulting in 1992 and over the ensuing three decades, I've worked with many companies that ended up overemphasizing buybacks and should have invested more in operations instead of just giving money back to investors. But I have also worked with many that squandered billions on worthless projects that ended up destroying both shareholder and stakeholder value.

The debate on buyback's impact on society has only intensified over the past decade, and recently this has led to government action. In February, U.S. Senators Sherrod Brown (D-OH) and

Ron Wyden (D-OR) authored the Stock Buyback Accountability Act of 2023, which seeks to reign in buybacks by quadrupling the tax rate applied to corporate share repurchases from the current 1% to 4%.

Buybacks Fuel a Growing Economy

A few years ago, when a different pair of senators aimed to restrict buybacks, my colleague Michael Chew and I published "Save the Buyback, Save Jobs" in the *Journal of Applied Corporate Finance*. We wrote about how people overlook the crucial economic function of recycling "excess capital" from large, mature enterprises and how such distributions boost capital productivity.

I still believe that this recycling of capital is an important driver of job creation since, according to the Small Business Administration's Office of Advocacy, "From 1995 to 2021, small businesses created 17.3 million net new jobs, accounting for 62.7% of net jobs created since 1995." I think it is important that these smaller businesses have access to funding freed up by mature companies distributing unneeded capital back to investors.

Assessing Buyback Success

In 2011, I created a buyback ROI framework to help corporate treasurers compare the benefits of buybacks to other uses of capital such as capital investments and acquisitions. It is calculated as an annualized return based on the amount of money spent on buybacks, the dividends avoided on the purchased shares and the value of the shares at the end of the period.

My company's *2023 Fortuna Advisors Buyback ROI Report* estimates that a 4% tax on net buybacks would have, over the five years ending in 2022, reduced buyback ROI by about 1.4%, which I believe is meaningful enough to constrain the recycling of capital to the growing companies of the future.

Another important insight buyback ROI provided was that most companies are pretty bad at timing their buybacks as they tend to repurchase more shares when the price is high, and less when it's low. This, of course, runs counter to the central maxim of investment to "buy low and sell high." The result of ill-timed buybacks is that more money is spent on the retired shares, and this can harm both shareholders and other stakeholders.

To quantify this timing element, my team and I developed a metric called buyback effectiveness, which is the compounded difference between buyback ROI and the company's underlying total shareholder return (TSR), including share price appreciation and dividends. When timing is good,

and shares are repurchased below a company's long-term share price trend, buyback effectiveness is positive.

Unfortunately, with the pullback in the markets last year, many previous buybacks now look like poor uses of capital, suggesting managements would have been better off waiting to buy back more shares at a lower price. The median company in this year's buyback ROI report had a buyback effectiveness of -1.1% over the last five years—much worse than 0.7% in last year's report. To boot, managements' often fail to realize how overpaying for their own stock, despite having an inside view on their business, doesn't usually inspire investor confidence the next time the company announces an acquisition.

What's more, many management teams overestimate the value of buybacks. In 2012, my colleague, John Cryan, and I published research showing that companies boosting EPS by buying back stock and reducing the shares outstanding tend to suffer declines in their price-to-earnings valuation multiple.

We estimated that increases in EPS resulting from share count reductions were worth only about half as much as EPS growth from the company's business activities. Obi Ezekoye, Tim Koller and Ankit Mittal of McKinsey & Co. found similar results in their article, "How share repurchases boost earnings without improving returns."

Getting More out of Buyback Capital

So how do managements improve their timing of buybacks? The reality is that it's hard to know with certainty when your own stock is cheap, and cognitive biases exacerbate this problem. This is why many corporate teams do ongoing discounted cash flow (DCF) analyses to assess their valuations.

While timing buybacks using valuation signals makes sense, this DCF approach relies on forecasts of the future—and in my experience, there is a tendency for insiders to overstate future growth and profitability and to understate the investments required along with the risks. And so the stock almost always ends up looking cheap.

Until about five years ago, Warren Buffett's Berkshire Hathaway had a rules-based approach, only repurchasing shares when the price-to-book ratio dropped below 1.2 times. This methodology proved overly simplistic, so the company abandoned it. But I still think objective signals can help management teams overcome the biases mentioned above.

I advocate for a more sophisticated approach called value inspired buyback execution (VIBE), which employs four fact-based buyback signals to help management better time their buybacks. Through this approach, the signals I urge others to prioritize include performance and valuation, the stock price versus consensus earnings (in the context of prior valuation multiples), intrinsic value estimate based on residual cash earnings and simulation models that help value your company. In each case, the signal is to repurchase shares when the price seems low.

Regardless of whether you employ the simpler or more sophisticated approach, rules-based signals are likely to reduce the price paid per share and the amount spent to retire the desired number of shares, which is always good for the remaining shareholders and other stakeholders.

Gregory Milano is founder and CEO of Fortuna Advisors LLC *and author of* Curing Corporate Short-Termism, Future Growth vs. Current Earnings*. Read Gregory Milano's full executive profile* here*.*