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Feature Story

When To Do A Stock Buyback

by [Al Ehrbar](#)

Should your board pay dividends, repurchase shares, or just plain sit on the ex how to make the smart choice.

Maybe Wall Street should think about replacing its famous 7,000-pound bronze boomerang. Stock buybacks by the 1,000 largest companies in the U.S. jumped to \$400 billion in 2004, and probably exceeded \$400 billion last year. And it appears like more companies will shell out even more money for their own shares this year. In the first quarter of 2006, boards were authorizing repurchases at a rate of more than four a day, up from one per day at the same time a year ago, according to TrimTabs Investment Research. Actual repurchases were beating the pace set in the first quarter of 2005, about \$300 million a day.

The buyback boom obviously indicates optimism on the part of CEOs and boards about the shares of their own companies. If directors didn't believe their shares were worth the price they buy, they would simply sit on the cash, pay it out in dividends, or use it to do what's really driving the current wave of repurchases? Why are so many companies so much to buy in their own shares? And how should you think about the issue the management team proposes—or fails to propose—a share repurchase? (For the investors, see "What Buybacks Do to Stock Prices" on page 66.)

The principal motivation behind the huge increase has been the rather pedestrian practice of returning excess cash to shareholders. That may not be exciting, but it is a test of the fiscal health of corporate America. Many companies are awash in free cash flow from current economic expansion, with far more money coming in than they need for operations or new projects. So they have elected to distribute some of it to shareholders, in the first quarters of the increase in payouts taking the form of share repurchases rather than dividends. While repurchases by the 1,000 largest companies increased by \$241 billion from 2005, their dividend payments rose by just \$83 billion, to \$264 billion.

Although it may not be immediately obvious, dividends and share repurchases are two different ways of distributing cash to shareholders. Here's why: When companies pay dividends, they distribute cash proportionately to all shareholders, and the stock price drops by the dividend per share on the ex-dividend date. With repurchases, the share price declines, because the company gets something—outstanding shares, or equity—back. Divided among the remaining shares, the value of the shares bought in is the same as if the dividend the remaining shares would otherwise have received.

Repurchases are sometimes pieces of much grander designs, of course, especially if it is part of a leveraged recapitalization or if a company is trying to send a strong message that its financial strategy has changed or its stock is woefully undervalued. But when it is simply to get cash into the hands of shareholders, a repurchase is little different from a special dividend. Many people argue, however, that taxes make repurchases less attractive for shareholders, even after the cut in dividend taxes to the same 15% as capital

because repurchases allow shareholders to choose whether they want to pay for them right now, by selling some of their shares, or whether they prefer to hang on. S Nowicki, treasurer of Herman Miller, an office-furniture company: "We prefer to pay special dividends because repurchasing doesn't force a decision on shareholders." A disagreeer is Charles M. Elson, director of the John L. Weinberg Center for Corporate Governance at the University of Delaware. He believes the 2003 tax cut put dividend repurchases on even footing with repurchases.

The biggest share repurchaser of all is Microsoft, which announced in July 2004 a buy in up to \$30 billion of its shares over the following four years. The company bought more than \$17 billion of stock in 2005 and said in October that it would complete purchases by the end of this year, 18 months ahead of schedule. Intel, a close competitor, announced in November that its board had authorized up to \$25 billion of repurchases. More announcements have included Time Warner's stated intention to do up to \$20 billion of repurchases by the end of 2007 and buyback authorizations of \$5 billion at Conoco at Marathon Oil, and \$1 billion at Symantec. Plenty of others are spending similar amounts relative to their market capitalizations. Ball Corp., a container and aerobics company, repurchased \$393.7 million of its stock last year, up from \$85 million in 2004. Electronics retailer Best Buy tripled its multiyear repurchase authorization from \$1.5 billion in April 2005 and spent \$434 million on its shares in the three fiscal quarters ended in late November, up from \$174 million in the same period a year before. Dickinson, a medical-supplies-and-technology company, spent \$550 million on repurchases in the fiscal year that ended last September, up from \$450 million in 2004 and \$450 million in the two previous years.

Companies actually have the means to repurchase far more shares than they are buying, even at the recent heady pace. Indeed, an increasingly frequent criticism of corporations is that they have amassed so much cash, held in the form of marketable short-term securities, that they've become underleveraged. Some 25% of the companies in the Russell 3000 stock index now have holdings of short-term securities that equal or exceed their net debt, including the capitalized value of off-balance-sheet leases. In other words, they have a negative net debt. That kind of balance sheet makes sense for a biotech start-up or a mature, comparatively stable company that has the significant tax advantage of deducting interest payments on debt (and pays punishing taxes on interest income).

Microsoft is the most notorious of the cash hoarders, even with last year's \$17.5 billion repurchase. Its portfolio of cash equivalents rose slightly, to \$30.6 billion, leaving it with a net debt of \$25.4 billion. But Microsoft is far from being the champion of negative net debt. Of the Russell 3000 companies, 270 have negative net debt that is even larger as a percentage of their total market value.

Some observers see all that cash as a huge positive, since it reduces the underpricing of stocks and is a strong indication that companies are resisting the temptation to make acquisitions. Others, including Charles Elson of the University of Delaware, take issue with cash buildup. "Cash should be invested or returned to investors," says Elson. "Companies shouldn't maintain large cash balances that they don't need."

When your company distributes cash, you have plenty of reasons to prefer repurchases to dividends. One minor advantage is that open-market share repurchases are much cheaper than dividends to buy stock for a few pennies a share in commissions than it is to cut a dividend and mail them to legions of shareholders. The major advantage, however, is that repurchases provide for paying out volatile cash flows. Companies can pump up repurchases when business is good and ease off on repurchases when cash flows ebb, as in 2004, or when they need cash for capital investments. As John Considine, executive vice president and CFO of Becton Dickinson, puts it, "We can turn off the buybacks if we need cash for acquisitions or other purposes."

Dividends, on the other hand, are famously sticky. Boards are extremely reluctant to cut dividends and with good reason—any reduction sends an awful message to the stock market. General Motors cut its dividend in half in early February, for instance, and its stock price fell over two days. The market reacts so negatively precisely because generations of investors have learned that boards have cut dividends only when they had no other choice. One consequence is that companies are reluctant to raise dividends in good times beyond the level they are confident they'll be able to maintain in the next downturn. As proponents of buybacks argue, companies get too little credit for raising dividends and too much blame for cutting them.

R. David Hoover, chairman and CEO of Ball Corp., has a keen appreciation of the value of dividend flexibility. Ball has raised its dividend two times in the last three years but has maintained a comfortably sustainable level of about 1% of the current market price. The vast majority of shareholder distributions now take the form of buybacks. Last year it spent about \$1 billion on repurchases for each dollar of dividends. "Dividends have an air of permanence that buybacks don't have. I was CFO in the early 1990s when we had to radically cut the dividend. Those were tough days."

GM would have made fewer headlines if it had eliminated repurchases instead of a dividend. Trouble is, the company had to terminate its once-aggressive share-repurchase program some years ago to conserve cash. The real wonder is who GM thinks it's fooling to pay out \$1 a share in dividends when it is so strapped for cash.

Ball Corp. provides an interesting case study in the flexibility of repurchases. Deere began last year intending to buy back about \$150 million of the company's shares, but when he and the board decided to repatriate \$488 million of capital from overseas operations, repatriation set the stage for restructuring the company's liabilities, replacing old debt with new debt and a larger revolving credit agreement. In the end, Hoover boosted Ball's repurchases to \$328 million and still ended the year without increasing debt. This year Ball again intended to do \$150 million of repurchases, but reduced them substantially after embarking on two acquisitions. "We want to keep everything simple," Hoover says. "They have a similar thought pattern at Energizer, where I'm a director of managing the capital structure."

Flexibility has a lot more to offer than the mere comfort it affords managers and investors. Repurchases can also have a positive influence on management behavior. A 2004 survey of how finance executives view payout policies confirmed that those sticky dividend policies are consistent with both financial and operating strategies. The survey, titled "Payout Policy in the 21st Century," was conducted by Alon Brav of Duke University, John R. Graham, also of Duke, Harvey of Duke and the National Bureau of Economic Research, and Roni Michaely of the Inter-Disciplinary Center and Cornell University. They found that many finance executives go to almost any lengths to maintain dividends. "Some executives," they write, "are willing to sell assets, lay off a large number of employees, borrow heavily, or by NPV [net present value] projects before slaying the sacred cow by cutting dividends." Other executives say they will not pass up good investments or disrupt the business to make repurchases.

The logical flip side of this behavior is that dividend payers can be tempted into investments or wealth-destroying acquisitions when cash is plentiful. A dividend policy that risks causing a company to make all kinds of mistakes, in bad times and in good, the fear of raising the dividend too high will probably result in a dividend policy that is paying out less cash to shareholders over the long run.

Special dividends—like Microsoft's \$33 billion, \$3-per-share payout in 2004—are one way to distribute cash to investors, but many companies still prefer repurchases because they can be spread throughout the year, while special dividends are one-time events.

Companies with a particularly sophisticated understanding of the role of buybacks view them as a sort of residual decision—something that is always subsidiary to overall financial strategy. Herman Miller is one of those. "We do an annual capital-strategy review with the board," says treasurer Joe Nowicki. "We first assess cash and capital-sources in the context of our goal to double our business by 2010. Any excess cash goes to business strategy. Two other factors are our pension-funding needs and maintaining a regular dividend. That is currently at about a 1% yield, which is where we want it."

After this—and an assessment of whether the business strategy calls for adding debt—"the preferred way to return excess cash to shareholders is through repurchases," Nowicki says. Herman Miller has been a serial share repurchaser for many years, having reduced its shares outstanding from 99.2 million in fiscal 1995 to 80.5 million in fiscal 2005. It has also been a flexible repurchaser. Buybacks rose to \$70.8 million in fiscal 2001 but tumbled to just \$19 million in fiscal 2002, a dreadful year for Miller and its industry. With the recovery in the company's business, repurchases rose to \$132 million in fiscal 2005, and the board authorized another \$150 million in January 2006.

The procedure for authorizing repurchases is much the same at most companies. The finance staff propose a repurchase authorization as part of the financial plan for the year or years ahead. The finance committee of the board reviews the entire plan and the repurchases—and may suggest modifications in any part of it. Then the plan goes to the board. Directors often ask about alternatives to the repurchase plan, such as increasing the regular dividend or issuing a special dividend, but they rarely overrule the decision of management and the finance committee.

Yet share repurchases do warrant close scrutiny by the board. A frequent motivation for repurchases—and one directors should be leery of—is to boost earnings per share on equity. Most finance executives say boosting (read: manipulating) earnings is an important factor in their repurchase decisions. Share buybacks will have that effect if the company's per-share earnings are higher as a percentage of the stock price than the cost of borrowing to finance the buyback (or, in the case of companies financing the buyback with cash rather than debt, the forgone after-tax income generated by those cash repurchases). After-tax borrowing costs for most corporations now at 5% or less, any company with an earnings yield above 5% will get an artificial lift to both EPS and ROE from a repurchase.

somewhat differently, EPS and ROE will both go up if the company's price-earnings ratio is below 20.

One wonders why managers would bother with this kind of manipulation, since it should not affect the value of the shares beyond a very modest gain from savings on new debt. Everything else is just fiddling with the accounting arithmetic by altering the underlying performance that determines the value of the business. The evidence from academic studies says they do try, and as expected, it doesn't work.

One such study was performed by Paul Hribar of Cornell University, Nicole Thorne Jenkins of the University of St. Louis, and W. Bruce Johnson of the University of Iowa. They found, among other things, that a disproportionately large number of companies do EPS-boos when they would otherwise marginally miss analysts' earnings forecasts. The companies apparently believe that they can fool Wall Street into thinking that they made better earnings numbers. In fact, Hribar and company found that the market sees through the companies that meet or exceed earnings expectations solely because of repurchases. They have a 60% lower valuation premium than companies that get there without a repurchase.

Even though the increases in EPS and ROE that are driven by buybacks are what the stock market is concerned with, they can have substantial payoffs for executives whose incentive compensation is based on one or both measures. As a result, compensation committees should make sure that they adjust the EPS and ROE targets used in their contracts to rid them of "improvements" caused by repurchases.

Another reason managers like repurchases is that they believe they can tell when a company is undervalued, and so can buy them in at advantageous prices. Every company with a repurchase program uses internal models to value the company and determine which it will and will not buy. Critics of repurchases (every corporate activity has its critics) see this as a major problem. One is Jesse M. Fried, co-director of the Center for Law and the Economy at the University of California at Berkeley. As he sees things, managers repurchase shares below their true value in order to transfer wealth to manager proportionate holdings in a company rise as the number of shares outstanding increases. "There is no reason that companies should be able to trade against their shareholders," Fried says. "There is no reason to treat corporate repurchases differently from the market. It's just insider trading." Fried's arguments raise one big question, however. If managers know that the stock is cheap, why not just buy shares themselves? That way they get the stock instead of just a proportionate share from corporate buybacks.

Few others see repurchases as a significant governance issue. Nell Minow, editor in chief of Corporate Library watchdog outfit, says the subject has never come up on her list. Charles Elson of the University of Delaware, who is a director of AutoZone, a repurchaser, doesn't see a problem either. "I have never viewed repurchasing as a problem," he says. "It benefits all shareholders." Can managers really tell when their shares are too dear? Armed with all the inside information they're privy to, they certainly can when their shares are dramatically undervalued, and the academic evidence clearly shows that some managers can spot major mispricing. But if managers were really on top of the market, the stocks of virtually all repurchasers ought to outperform the market. What's more, the use of buybacks as the means to distribute excess cash almost always means that repurchasers will be lousy market timers. Remember that repurchases dropped cash flows in 2002, when stocks were in the tank, and didn't recover until after the market rebounded in 2003.

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