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Corporate Board Member May/June 2006

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. jumpe billion, in 2004, and probably exceeded $400 billion last year. And it appears lik companies will shell out even more money for their own shares this year. In th 2006, boards were authorizing repurchases at a rate of more than four a day, u per day at the same time a year ago, according to TrimTabs Investment Resea buybacks. Actual repurchases were beating the pace set in the first quarter of l about $300 million a day.

The buyback boom obviously indicates optimism on the part of CEOs and board about the shares of their own companies. If directors didn't believe their shares buy, they would simply sit on the cash, pay it out in dividends, or use it to draw what's really driving the current wave of repurchases? Why are so many compa so much to buy in their own shares? And how should you think about the issue 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 pedestri returning excess cash to shareholders. That may not be exciting, but it is a test fiscal health of corporate America. Many companies are awash in free cash flow current economic expansion, with far more money coming in than they need fo or new projects. So they have elected to distribute some of it to shareholders, w quarters of the increase in payouts taking the form of share repurchases rather While repurchases by the 1,000 largest companies increased by $241 billion fro 2005, their dividend payments rose by just $83 billion, to $264 billion.

Although it may not be immediately obvious, dividends and share repurchases ways of distributing cash to shareholders. Here's why: When companies pay div 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 pr decline, because the company gets something—outstanding shares, or equity— cash. Divided among the remaining shares, the value of the shares bought in is dividend the remaining shares would otherwise have received.

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

because repurchases allow shareholders to choose whether they want to pay ar
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 re
special dividends because repurchasing doesn’t force a decision on shareholders
disagrees is Charles M. Elson, director of the John L. Weinberg Center for Corpo
Governance at the University of Delaware. He believes the 2003 tax cut put div
even footing with repurchases.

The biggest share repurchaser of all is Microsoft, which announced in July 2004
buy in up to $30 billion of its shares over the following four years. The company
more than $17 billion of stock in 2005 and said in October that it would comple
purchases by the end of this year, 18 months ahead of schedule. Intel, a close s
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 b
repurchases by the end of 2007 and buyback authorizations of $5 billion at Con
at Marathon Oil, and $1 billion at Symantec. Plenty of others are spending simi
amounts relative to their market capitalizations. Ball Corp., a container and aer
company, repurchased $393.7 million of its stock last year, up from $85 million
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 fisca
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
million in the two previous years.

Companies actually have the means to repurchase far more shares than they ha
buying, even at the recent heady pace. Indeed, an increasingly frequent criticis
corporations have amassed so much cash, held in the form of marketable short
securities, that they’ve become underleveraged. Some 25% of the companies i
3000 stock index now have holdings of short-term securities that equal or exce
debt, including the capitalized value of off-balance-sheet leases. In other words
or negative net debt. That kind of balance sheet makes sense for a biotech star
a mature, comparatively stable company that has the significant tax advantage
deduct 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.
repurchase. Its portfolio of cash equivalents rose slightly, to $30.6 billion, leavi
at minus $25.4 billion. But Microsoft is far from being the champion of negative
the Russell 3000 companies, 270 have negative net debt that is even larger as
their total market value.

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

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

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

R. David Hoover, chairman and CEO of Ball Corp., has a keen appreciation of th
flexibility. Ball has raised its dividend two times in the last three years but has
comfortably sustainable level of about 1% of the current market price. The vast
shareholder distributions now take the form of buybacks. Last year it spent abo
repurchases for each dollar of dividends. “Dividends have an air of permanence
“I was CFO in the early 1990s when we had to radically cut the dividend. Those
days.”

GM would have made fewer headlines if it had eliminated repurchases instead c
dividend. Trouble is, the company had to terminate its once-aggressive share-r
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. Da
began last year intending to buy back about $150 million of the company's sha
was before he and the board decided to repatriate $488 million of capital from
repatriation set the stage for restructuring the company's liabilities, replacing o
debt with new debt and a larger revolving credit agreement. In the end, Hoover
boost Ball's repurchases to $328 million and still end the year without increasin
debt. This year Ball again intended to do $150 million of repurchases, but reduc
substantially after embarking on two acquisitions. "We want to keep everything
Hoover. "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
Repurchases can also have a positive influence on management behavior. A 20
how finance executives view payout policies confirmed that those sticky divider
both financial and operating strategies. The survey, titled "Payout Policy in the
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 Micha
Inter-Disciplinary Center and Cornell University. They found that many finance
go to almost any lengths to maintain dividends. "Some executives," they write,
selling assets, laying off a large number of employees, borrowing heavily, or by
NPV [net present value] projects before slaying the sacred cow by cutting divide
same executives say they will not pass up good investments or disrupt the busi
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 risks causing a company to make all kinds of mistakes, in bad times and
balance, the fear of raising the dividend too high will probably cow a dividends-
into paying out less cash to shareholders over the long run.

Special dividends—like Microsoft's $33 billion, $3-per-share payout in 2004—ar
way to distribute cash to investors, but many companies still prefer repurchase
that repurchases can be spread throughout the year, while special dividends ar

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

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 repu
Nowicki says. Herman Miller has been a serial share repurchaser for many year
reduced its shares outstanding from 99.2 million in fiscal 1995 to 80.5 million in
70.8 million in fiscal 2005. It has also been a flexible repurchaser. Buybacks rea
million in fiscal 2001 but tumbled to just $19 million in fiscal 2002, a dreadful y
Miller and its industry. With the recovery in the company's business, repurchase
$132 million in fiscal 2005, and the board authorized another $150 million in Ja

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

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

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

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

One such study was performed by Paul Hribar of Cornell, Nicole Thorne Jenkins University in St. Louis, and W. Bruce Johnson of the University of Iowa. They fo other things, that a disproportionately large number of companies do EPS-boos when they would otherwise marginally miss analysts' earnings forecasts. The co apparently believe that they can fool Wall Street into thinking that they made t numbers. In fact, Hribar and company found that the market sees through the companies that meet or exceed earnings expectations solely because of repurch a 60% lower valuation premium than companies that get there without a repur

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

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

Few others see repurchases as a significant governance issue. Nell Minow, edit Corporate Library watchdog outfit, says the subject has never come up on her Charles Elson of the University of Delaware, who is a director of AutoZone, a re repurchaser, doesn't see a problem either. "I have never viewed repurchasing a says. "It benefits all shareholders."Can managers really tell when their shares a too dear? Armed with all the inside information they're privy to, they certainly when their shares are dramatically undervalued, and the academic evidence cle that some managers can spot major mispricing. But if managers were really on traders, 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 almos that repurchasers will be lousy market timers. Remember that repurchases dro cash flows in 2002, when stocks were in the tank, and didn't recover until after market rebounded in 2003.

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May/June 2006

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