Feature Story

When To Do A Stock Buyback
by Al Ehrbar

Should your board pay dividends, repurchase shares, or just plain sit on the extra cash? Here’s 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 55%, to $257 billion, in 2004, and probably exceeded $400 billion last year. And it appears likely that public companies will shell out even more money for their own shares this year. In the early weeks of 2006, boards were authorizing repurchases at a rate of more than four a day, up from three per day at the same time a year ago, according to TrimTabs Investment Research, which tracks buybacks. Actual repurchases were beating the pace set in the first quarter of last year by 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 a good buy, they would simply sit on the cash, pay it out in dividends, or use it to draw down debt. But what’s really driving the current wave of repurchases? Why are so many companies spending so much to buy in their own shares? And how should you think about the issue when the management team proposes—or fails to propose—a share repurchase? (For the way this affects investors, see “What Buybacks Do to Stock Prices” on page 66.)

The principal motivation behind the huge increase has been the rather pedestrian one of returning excess cash to shareholders. That may not be exciting, but it is a testament to the fiscal health of corporate America. Many companies are awash in free cash flow, thanks to the current economic expansion, with far more money coming in than they need for reinvestment or new projects. So they have elected to distribute some of it to shareholders, with three 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 2003 to 2005, their dividend payments rose by just $83 billion, to $264 billion.

Although it may not be immediately obvious, dividends and share repurchases are equivalent 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 decline, because the company gets something—outstanding shares, or equity—cash. Divided among the remaining shares, the value of the shares bought in is equal to the dividend the remaining shares would otherwise have received.

Repurchases are sometimes pieces of much grander designs, of course, especially when the purpose is simply to get cash into the hands of shareholders. A repurchase is little different or special dividend. Many people argue, however, that taxes make repurchases a better deal for shareholders, even after the cut in dividend taxes to the same 15% as capital gains.
because repurchases allow shareholders to choose whether they want to pay at 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 regular dividends because repurchasing doesn’t force a decision on shareholders. We prefer regular dividends because repurchasing doesn’t force a decision on shareholders.

The biggest share repurchaser of all is Microsoft, which announced in July 2004.

Microsoft is the most notorious of the cash hoarders, even with last year’s $17 billion repurchase. Its portfolio of cash equivalents rose slightly, to $30.6 billion, leaving it with over $25.4 billion. But Microsoft is far from being the champion of negative leverage. 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 underlying risk of companies. Analysts and investors resist the temptation to acquire companies, including Charles Elson of the University of Delaware, take cash buildup. “Cash should be invested or returned to investors,” says Elson. “It shouldn’t maintain large cash balances that they don’t need.”

When your company distributes cash, you have plenty of reasons to prefer repurchases over dividends. One minor advantage is that open-market share repurchases are more efficient: It market share repurchases are more efficient: It cheaper to buy stock for a few pennies a share in commissions than it is to cut dividends 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 when business is good and ease off on repurchases when cash flows ebb, as in 2002 and 2003.

Dividends, on the other hand, are famously sticky. Boards are extremely reluctant to cut them, even during downturns. The market reacts so negatively precisely because generations of managers and boards have cut dividends only when they had no other choice. One consequence of this history is that companies are reluctant to raise dividends in good times beyond the level they are comfortably sustainable.

R. David Hoover, chairman and CEO of Ball Corp., has a keen appreciation of the flexibility. Ball has raised its dividend two times in the last three years but has left the 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 about $17 billion at Con 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 aero 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 fiscal periods ending 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 the two previous years.

Companies actually have the means to repurchase far more shares than they have been buying, even at the recent heady pace. Indeed, an increasingly frequent criticism of corporations has been the amount of cash, held in the form of marketable short-term securities, that they’ve become underleveraged. Some 25% of the companies in the 3000 stock index now have holdings of short-term securities that equal or exceed their total market value.

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GM would have made fewer headlines if it had eliminated repurchases instead of dividends. Trouble is, the company had to terminate its once-aggressive share-repurchaser some years ago to conserve cash. The real wonder is who GM thinks it’s fooling by paying 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. DX began last year intending to buy back about $150 million of the company’s shares before he and the board decided to repatriate $488 million of capital from abroad. 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 end the year without increasing debt. This year Ball again intended to do $150 million of repurchases, but reduced substantially after embarking on two acquisitions. “We want to keep everything in the business strategy,” 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 directors. Repurchases can also have a positive influence on management behavior. A 2004 survey of how finance executives view payout policies confirmed that those sticky dividends—both financial and operating strategies. The survey, titled “Payout Policy in the New Economy,” 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 Inter-Disciplinary Center and Cornell University. They found that many finance executives go to almost any lengths to maintain dividends. “Some executives,” they write, “sell assets, lay off a large number of employees, borrowing heavily, or by NPV [net present value] projects before slaying the sacred cow by cutting dividends. Some 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—are a way to distribute cash to investors, but many companies still prefer repurchases. One reason is that repurchases can be spread throughout the year, while special dividends are

Companies with a particularly sophisticated understanding of the role of buybacks as a sort of residual decision—something that is always subsidiary to operating 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-s in the context of our goal to double our business by 2010. Any excess cash goes 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 to pay out $1 a share in dividends when it is so strapped for cash.

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. In fiscal 2005, it 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 reached $132 million in fiscal 2005, and the board authorized another $150 million in January.

The procedure for authorizing repurchases is much the same at most companies. 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. In fiscal 2005, it 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 reached $132 million in fiscal 2005, and the board authorized another $150 million in January.

Yet share repurchases do warrant close scrutiny by the board. A frequent motive 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 buyback decisions. Share buybacks—unless they are buybacks that a company’s per-share earnings are higher as a percentage of the stock price than the after-tax income generated by those cash re

http://www.boardmember.com/issues/archive.pl?article_id=12472
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 is not likely to affect the value of the shares beyond a very modest gain from the tax savings on new debt. Everything else is just fiddling with the accounting arithmetic without altering the underlying performance that determines the value of the business. Evidence from recent academic studies says otherwise. It doesn’t work.

One such study was performed by Paul Hribar of Cornell, Nicole Thorne Jenkins of Washington University in 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-boosting repurchases when they would otherwise miss analysts’ earnings forecasts. The companies apparently believe that they can fool Wall Street into thinking that they made it. In fact, Hribar and company found that the market sees through the companies that meet or exceed earnings expectations solely because of repurchases. Everything else is just fiddling with the accounting arithmetic without altering the underlying performance that determines the value of the business.

Even though the increases in EPS and ROE that are driven by buybacks are what far as the stock market is concerned, 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 to rid them of “improvements” caused by repurchases.

Another reason managers like repurchases is that they believe they can tell when their shares are undervalued, and so can buy them at advantageous prices. Every company’s 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, Business and 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 managers 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,” Fried’s arguments raise one big question, however. If managers say that the stock is cheap, why not just buy shares themselves? That way they get instead of just a proportionate share from corporate buybacks.

Few others see repurchases as a significant governance issue. Nell Minow, editor of the Corporate Library watchdog outfit, says the subject has never come up on her radar screen. Charles Elson of the University of Delaware, who is a director of AutoZone, a regular share repurchaser, doesn’t see a problem either. “I have never viewed repurchasing z shares as a problem either,” 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 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 almost that repurchasers will be lousy market timers. Remember that repurchases drop in 2002, when stocks were in the tank, and didn’t recover until after market rebounded in 2003.