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Share Buybacks: The Good, the Bad and the Ugly

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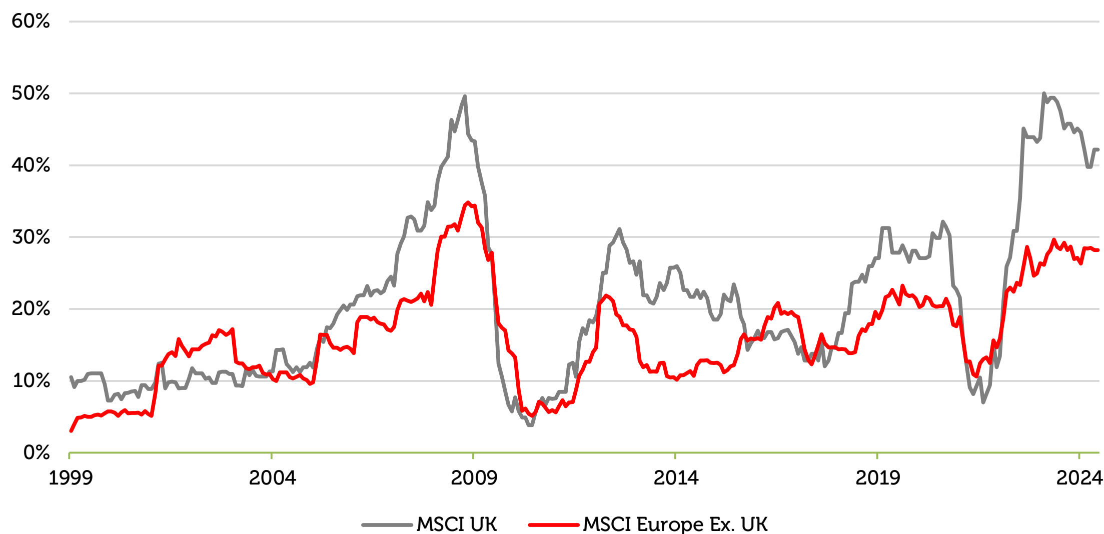
3 October 2024

Introduction

Earlier in the year, we produced a paper entitled 'The Return of the Total Return Kings' in which we identified two catalysts which we felt could realise the value available in UK equities; corporate takeovers and share buybacks. So far this has proved to be prescient since corporate takeovers have continued apace whilst share buybacks have also been a significant feature of 2024.

Number of companies with buybacks over 1% of total market cap/ total number of companies



Source: Morgan Stanley, 'The Land of Equity Yield', 28 June 2024. Percentage of companies within the MSCI UK and MCSI Europe Ex. UK indices that have bought back a minimum of 1% of shares outstanding over the previous 12 months. The information shown above is for illustrative purposes.

Some of the companies which we argued would be big beneficiaries of a total return approach (dividends plus share buybacks) have subsequently produced strong returns such as NatWest Group and Barclays which are up 56% and 46% year to date, respectively.[1]

In our latest note, we wanted to delve deeper into the subject of share buybacks in order to make it clear that we do not view all share buybacks as positive. Just as in the spaghetti western starring Clint Eastwood, Lee Van Cleef and Eli Wallach (and which in our opinion is vastly superior to the Magnificent Seven), share buybacks can be good, bad, or downright ugly!

The Importance of Capital Allocation

Probably the most important function of a company CEO is allocating capital, since it is this which will largely determine future returns of the business. His or her menu of options includes organic investment, acquisitions

[1] Bloomberg, 25 September 2024

and debt repayment. Any capital deemed surplus to this can be distributed to shareholders via ordinary dividends, special dividends and share buybacks. Historically, the payment of a dividend was the conventional way to return capital to shareholders but over the last thirty years buybacks have become more prevalent.

So why would a company want to buy back their own shares rather than pay a dividend?

That's a good question because from the company's perspective, the aggregate effect is the same; cash leaves the company and gets paid to the shareholders. There are, however, some important differences between a dividend and a share buyback:

- Dividends are sticky as companies are loath to cut them, whereas buybacks are not.
- Dividends return cash to all shareholders, buybacks only to those who choose to sell.
- Dividends and buybacks may have different tax consequences since they are treated as income and capital gains, respectively.
- Buybacks affect the share count, dividends do not.

So if buybacks reduce the share count, that must mean earnings per share (EPS) go up?

This is usually the case, although it depends on the relative costs of debt and equity. The potential EPS uplift can be calculated using a formula which we provide in the Appendix.

We can use this formula in the example below to demonstrate the impact of a buyback. Here we assume a company buys in 10% of its shares using debt to finance it with the result that EPS is increased by 3.4% in year one and 11% in year two.

Impact of buyback on EPS

Net income, 2024 (£m)	3.0
Net income, 2025 (£m)	3.8
Number of shares (m)	10
EPS 2024 (£)	0.3
EPS 2025 (£)	0.38
EPS growth	27%
Market capitalisation (£m)	45
Share price (£)	4.5
2024 P/E pre buyback	15
2025 P/E pre buyback	12
Buyback	
% of shares repurchased	10%
Share bought (m)	1
Price of buyback (£)	4.5
Total cost of buyback (£m)	4.5
New share price (£)	4.65

Cost of debt (Kd)	6.2%
Corporate tax rate (t)	25%
Implied P/E of debt = 1/(Kd(1-t)	22
Interest cost post tax (£m)	0.21
EPS Impact	
Pro forma 2024 Net Income (£m)	2.79
Pro forma 2024 EPS (£)	0.31
Uplift to 2024 EPS	3.4%
Proforma 2025 Net income (£m)	3.59
Proforma 2025 EPS (£)	0.42
Uplift to 2025 EPS	11%

The information shown above is for illustrative purposes.

So, the more expensive the shares, the less a buyback works?

That's exactly right. Buying back stock can be earnings enhancing but only when the cost of debt is lower than the cost of equity. This can be shown in the table below which holds the cost of debt constant but varies the valuation of the equity and the size of the buyback. Note that when the PE of equity is the same as PE of debt there is no earnings enhancement.

	P/E Equity (x)	15	20	25	30
	P/E Debt (x)	25	25	25	25
	2%	0.8%	0.4%	0.0%	-0.4%
	4%	1.6%	0.8%	0.0%	-0.9%
Proportion	6%	2.5%	1.2%	0.0%	-1.3%
of shares	8%	3.4%	1.7%	0.0%	-1.8%
repurchased	10%	4.4%	2.2%	0.0%	-2.3%

The information shown above is for illustrative purposes.

This explains why share buybacks increased in popularity in the last decade since very low interest rates meant that some companies were able to issue debt very cheaply. Issuing a 10-year bond at 2.5% (1.9% post tax) equates to a P/E on debt of 52x, which means that any share bought up to 52x earnings will be earnings enhancing.

So, if earnings are enhanced, does that actually increase the value of the whole business?

Some, particularly on the sell side, seem to believe that earnings enhancement always equates to value creation. In our example above we could say that EPS has increased by 3.4% and if we apply the same price-to-earnings multiple of 15x then the value of each share has gone from 4.50 to 4.70. However, this assumes that the multiple applied to the earnings should be unchanged regardless of the fact that the business is now carrying more debt which should make the equity riskier. This doesn't strike us as a particularly plausible assumption.

The counter argument is that a share buyback merely changes the capital structure of a company with equity being reduced and either cash being decreased, or debt being increased. If the flows of cash that the business generates and the riskiness of them are unchanged then arguably the value of the business is unchanged.

This latter view was formulated in 1958 by two US-based economics professors, Franco Modigliani and Merton Miller, who developed the 'capital-structure irrelevance' proposition. Essentially, they hypothesized that in perfect markets, it does not matter what capital structure a company uses to finance its operations. They theorized that the market value of a firm is determined by its earning power and by the risk of its underlying assets, and that its value is independent of the way it chooses to finance its investments or distribute dividends. The basic Modigliani-Miller (M&M) proposition was based on the following key assumptions:

- No taxes.
- No transaction costs.
- No bankruptcy costs.
- Equivalence in borrowing costs for both companies and investors.
- Symmetry of market information, meaning companies and investors have the same information.
- No effect of debt on a company's earnings before interest and taxes.

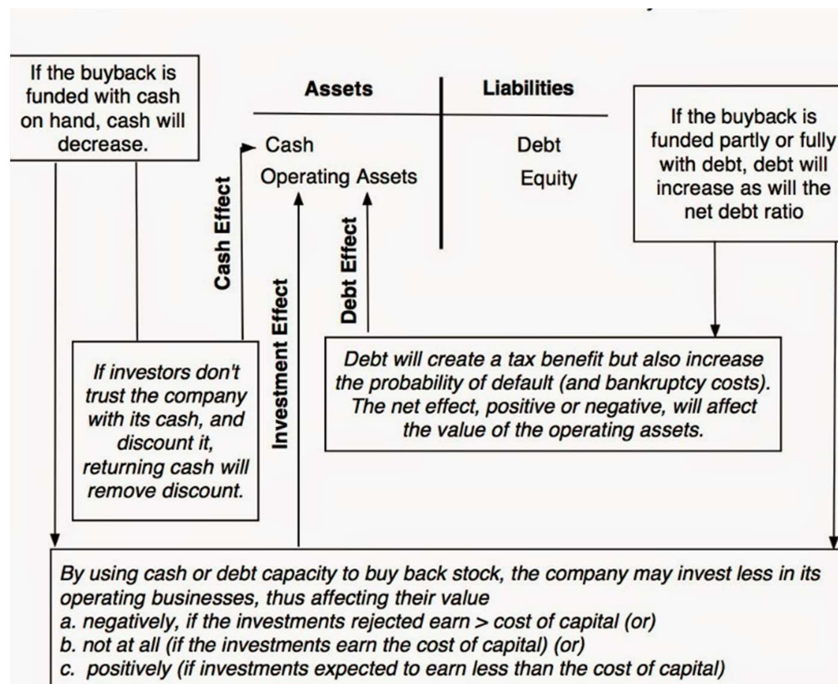
However, as time passed some of the assumptions above began to look unrealistic, particularly that with regards to the tax deductibility of interest, and so Modigliani and Miller amended their original hypothesis to recognise the value of the tax shield in their 'Proposition II' formula, which we provide in full in the Appendix.

It asserts that, although the cost of equity again rises with leverage, (because the risk to equity rises) this can be more than offset by a reduction in the tax payment which results from the tax deductibility of interest payments. In this case, the value of the firm could therefore increase because the cash flows to the shareholder have increased (essentially a transfer of value has occurred from the taxpayer to the shareholder).

Shouldn't you also consider what else the company might have done with the cash (or debt?)

Yes, you absolutely should. The following chart from Aswath Damodaran, Professor of Finance at Stern School of Business in New York, helps to frame the debate as to when share buybacks create value by considering the alternative uses of that cash or debt.

Financial balance sheet: the value effects of a buyback



*Source: '*Stock Buybacks: They are big, they are back and they scare some people!', *Aswath Damodaran, Sept 2014. The information shown above is for illustrative purposes.*

Damodaran argues that there are three ways that a buyback can have a positive effect on value:

1. If the company has a significant cash balance and investors don't trust the company to spend this wisely, then reducing the cash is a positive.

2. If a firm finances its buyback with debt, it will end up with a lower cost of capital if the tax benefits of the debt are larger than the increase in costs associated with higher default risk. This will usually occur if the firm has debt capacity to begin with, but the lower cost of capital adds to the value of the operating assets.

3. If a firm has been actively investing in bad businesses, then redirecting cash towards buybacks is a positive

Negative scenarios are as follows:

1. A firm is correctly or over leveraged and finances its buyback through more debt because the increase in the cost of debt eventually outweighs the tax shelter of the additional debt.

2. If the firm redirects cash that would have otherwise been invested in superior investment opportunities and instead buys back stock.

So does all this mean that increasing debt always makes sense if it is cheaper than equity?

Under efficient market assumptions, it often does because Weighted Average Cost of Capital is lowered by increasing debt relative to equity. In the real world, however, it does not make sense when the shares that are being repurchased are trading significantly above their intrinsic value. In fact, it makes no more sense to buy your own overvalued shares than somebody else's overvalued shares.

In his 1984 Letter to shareholders, Warren Buffett said:

*'When companies with outstanding business and comfortable financial positions find their shares selling **far below intrinsic value** in the marketplace, no alternative action can benefit shareholders as surely as repurchases.'*

At the height of the dot-com bubble, however, Buffett warned in his 1999 letter that companies were now overpaying for their own stock.

"Nevertheless, it appears to us that many companies now making repurchases are overpaying departing shareholders at the expense of those who stay. In defense of those companies, I would say that it is natural for CEOs to be more optimistic about their own businesses. They also know a whole lot more about them than I do. However, I can't help but feel that too often today's repurchases are dictated by management's desire to 'show confidence' or be in fashion rather than by a desire to enhance per-share value."

It strikes us that, with the valuation of the S&P500 at one of the highest levels ever[2], many companies are currently repeating the error that Buffett warned about in 1999. Within the S&P500, we view technology companies as some of the biggest repurchasers of shares at a time when they are arguably very over-valued. To take one example, the share price of Nvidia has risen by c.782% since 1 January 2023 and trades on 31x sales[3]. Many investors were surprised, therefore, when it announced that it was going to repurchase $25bn of stock in August 2023, after the stock had trebled in the year. Interestingly, its hugely influential CEO, Jensen Huang, is actually selling his own shares whilst at the same time the company is buying shares. In July alone Huang offloaded approximately $323 million in Nvidia stock—and near $361 million if one counts the first week of August.[4]

The idea that executives could buy back shares but only when they are trading below intrinsic value is fine in theory but more complicated in practice as it relies first on CEOs knowing how much their business is worth, and second on them being able to control their emotions. Historical precedent suggests this is harder in reality; in the six months to May 2008, as Lehman Brothers faced a cash crunch that would end in bankruptcy, it repurchased $1bn of its own stock. In all, America's financial sector repurchased $207bn of shares between 2006 and 2008 and by 2009, taxpayers had injected $250bn into many of the same banks to save them. This suggests that CEOs have little idea of the true value of their businesses and that they are overconfident in their ability to predict the future.[5]

[2] Hussman Strategic Advisors, 21 July 2024

[3] Bloomberg, 27 September 2024

[4] Bloomberg, 25 September 2024

[5] FT Advisor, 'Fund Selector: Indulging in a buyback binge', 201

So which groups of people like share buybacks?

i. Activist investors like them. We are seeing a new generation of investor giving shareholder activism a bad name. This type of investor has little patience for working with management and other stakeholders to improve the fortunes of the business but instead look for quick, low risk gains. They do this by taking small stakes in companies and broadcasting their investment on social media. They then typically try to bully management into loading the company with debt in order to buy back stock. This usually produces an instant pop in the share price which they exploit by unloading their own shares at a profit. This sort of behaviour is unfortunately not new and in his 1984 letter to shareholders, Warren Buffett criticised this practice.

"Our endorsement of repurchases is limited to those dictated by price/value relationships and does not extend to the "greenmail" repurchase—a practice we find odious and repugnant. In these transactions, two parties achieve their personal ends by exploitation of an innocent and unconsulted third party. The players are: (1) the "shareholder" extortionist who, even before the ink on his stock certificate dries, delivers his "your-money-or-your-life" message to managers; (2) the corporate insiders who quickly seek peace at any price—as long as the price is paid by someone else; and (3) the shareholders whose money is used by (2) to make (1) go away. As the dust settles, the mugging, transient shareholder gives his speech on "free enterprise", the muggee management gives its speech on "the best interests of the company", and the innocent shareholder standing by mutely funds the payoff."

ii. Sell side analysts like them, citing the potential for an EPS boost, a floor under the share price and a sign of confidence. In the 2005-2007 run up to the financial crisis, strategists at one global investment bank even coined the term 'de-equitisation' to describe the process by which they encouraged companies to lever up. Although the fallout for many during the financial crisis was catastrophic, the same group of strategists continued to urge companies to take on more debt after the financial crisis[6].

iii. CEOs like them. For many, stock and options "constitute a large and increasing share of total compensation,"[7] which is the result of the shareholder value maximisation movement of the last two decades that sought to align management's interests with those of their shareholders. One unintended consequence of this seems to be that some CEOs have been incentivised to increase EPS and the stock price in the short term, and share buybacks are one of the easiest ways to meet these twin objectives. As previously stated, an increase in EPS is often not the same as value accretion, but this could be easily overlooked by executives judged on EPS and remunerated on share price.

Another reason some CEOs like share buybacks is that it enables them to pay employees in stock and then use share buybacks to avoid dilution. This is something that is particularly prevalent amongst the large US technology companies. According to Pavilion Global Markets, Alphabet bought back $156 billion of stock on a cumulative basis, 1.88 billion shares, over the 10 years ended in September 2022. However, the internet giant issued 1.69 billion shares to employees over that time, so the overall count only decreased by just under 200 million shares. Over that 10-year period, the number of shares outstanding fell just 1.2%, which is not much to show for $156bn of share buybacks.

Meta Platforms has been unimpressive in the buyback category. It bought back 378 million shares in the 10 years ended in September, but it issued 431 million shares to employees, so its share count increased about 12%. From its initial public offering in 2012 to September, its market cap rose by a multiple of about 7 times, but the stock price rose less than 5 times, according to FactSet.[8]

[6] 'De-equitisation is one of the key global investment themes for the next 12-18 months' Citi Global Buyback Screen, June 2015
[7] "CEO pay has skyrocketed 1,460% since 1978", Economic Policy Institute, October 2022
[8] "Apple and Meta Stock Buybacks Haven't Been Equal. Here's Why." Jacob Sonenshine, March 2023

Conclusion

We continue to believe that most UK companies are doing the right thing by buying back their own very undervalued stock using excess cashflow at a time when their balance sheets are in rude health. As we have made clear in this note, however, share buybacks must be judged as part of a hierarchy of capital allocation and therefore cannot always be assumed to be positive.

The Good

- A buyback that is part of a sensible capital allocation hierarchy (pay down debt if too high, invest in the business if returns are attractive, return surplus cash to shareholders via dividends and share buybacks).
- Financed from free cash flow rather than debt.
- Buying back stock which is demonstrably very undervalued.

The Bad

- Buying back expensive stock.
- Buying back stock whilst at the same time issuing stock to employees.

The Ugly

- Using debt to buy back expensive stock when the company is already financially vulnerable.

APPENDIX

Earnings uplift formula:

EPS uplift= $\frac{\%B}{(1-\%B)}$ x [1-PER x r (1-t)]

where %B is the proportion of the market capitalisation being repurchased and r(1-t) the after-tax interest rate on the borrowing which finances the repurchase.

M&M Proposition II formula:

$$r_E = r_0 + \frac{D}{E}(r_0 - r_D)(1 - T_C)$$

where:

r_E is the required rate of return on equity, or cost of levered equity = unlevered equity + financing premium.

r_0 is the company cost of equity capital with no leverage (unlevered cost of equity, or return on assets with D/E = 0).

r_D is the required rate of return on borrowings, or cost of debt.

D/E is the debt-to-equity ratio.

T_c is the tax rate.

Key Information

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