Commentary

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Share Buybacks: A Good Use of Capital?

- A share buyback is a return of capital to investors and occurs when a company purchases its own shares.
- Buybacks among U.S. corporations are currently at historically high levels, providing support to equities.
- The level of activity has raised questions regarding whether buybacks are a good use of capital.

In our view, U.S. stock prices are currently benefitting from a buyback induced tailwind. Investors often have concerns about the sustainability of share buyback programs and if they are a good use of capital. With less buyback activity outside of the U.S., there may be opportunities for programs to expand in other countries.

Mechanics of a Buyback

A share buyback is a return of capital to investors and occurs when a company either makes a tender offer to shareholders that it will buy a set number of shares at a given price, or more commonly in today's investment environment, purchase shares in the open market over time. Share buybacks tend to increase in bull markets, as companies are often flush with cash, and fall in bear markets, as companies often struggle with falling profits.

Are Share Buybacks a Good Thing?

"There is only one combination of facts that makes it advisable for a company to repurchase its shares: First, the company has available funds -- cash plus sensible borrowing capacity -- beyond the near-term needs of the business and, second, finds its stock selling in the market below its intrinsic value, conservatively calculated."-- Warren Buffett, 2000

Academic research suggests share buybacks can provide support to share prices (although some research suggests this may be short-term in nature), while also improving data such as earnings per share (EPS). Price support is simply often a matter of increased demand (as the company buys shares in the market) and reduced supply (as the company simultaneously removes those same shares from the market). Meanwhile, EPS will improve as earnings remain constant while the number of shares outstanding decline.

Since share buybacks often increase during bull markets, companies end up buying back stock at a premium price, which can be counterproductive. This can also cause concern among investors that rather than signaling that management's view on a company's future is positive, a buyback program is simply a way for CEOs to manipulate the stock price by raising the value of stock options and thus their pay, however, our view is that CEOs are simply managing company earnings. Additionally, for companies with low internal growth rates buybacks can represent a better return on equity for shareholders even if stock prices are relatively high.

Conversely, when the stock is undervalued buybacks there is an argument to be made that buybacks are a good use of shareholder capital. The picture becomes less clear when factoring value destroying merger and acquisition activity (which also tends to increase during bull markets) into the mix. When faced with the choice between overpriced acquisitions and buybacks, investors naturally prefer the latter.

A Few Words About Dividends

Dividend payments are another way to return capital to investors. Companies often choose buybacks over dividends because investors generally don't have the same expectations for buybacks that they do for dividends. If buyback amounts vary from year to year, investors generally have very little reaction. Dividends on the other hand tend to be stickier, with companies loathe to cut them for fear of shareholder backlash.

How Long Can the Cycle Go?

In 2014, Bloomberg estimated U.S. companies used about 95% of their earnings on share buybacks and dividends. Other uses of earnings include acquisitions, capital spending, research and development, or simply holding cash on the company balance sheet. Of course companies can engage in all of these activities in amounts that exceed earnings by borrowing money or issuing more stock. Intuitively, new stock issuance is generally low in periods of increased stock buybacks. Debt financing however is a readily available option today with mostly relaxed borrowing criteria and historically low interest rates.

Aside from the company economics of buybacks, there are also activist shareholders to consider. Activists typically accumulate large minority stakes in publicly traded companies. They use these stakes to urge company management to engage in activities that they deem value creating. Often, companies with large cash stakes will eventually have activist investors seeking a buyback program or increased dividends.

The following paragraph contains references to publically traded companies. We selected these companies to illustrate the buyback situations discussed in this paper and because they're familiar to many investors. These references are for ILLUSTRATIVE PURPOSES ONLY. The references are NOT RECCOMENDATIONS to transact in any securities issued by these companies.

In fact, Apple, a company flush with cash (although a majority of it is offshore and largely inaccessible without paying hefty corporate taxes) has engaged in several low-cost debt issuances for the purposes of funding a share buyback program. Apple is also the subject of notable activist investor Carl Icahn, who has advocated for the company to expand its buyback program and increase dividends. However, we have also witnessed some companies going the other route and ending share buybacks. This is most notable in the energy sector where many companies are struggling with dramatically lower crude oil prices. The highest profile company to do this was Chevron, which ended its share buyback program due to receding profits and an unwillingness to borrow at this time.

SEI's View

Return of capital programs (buybacks and dividends) are bumping up against the natural limit of 100% of corporate earnings. However, the borrowing environment and previously accumulated cash piles (which are currently at historically high levels) have served to soften that limit and even extend the length and amount of the buyback programs as companies have access to cheap debt.

In the wake of the 2008 financial crisis, companies were cautious with their borrowing. Economic growth was uncertain, monetary policy unconventional and the U.S. Congress paralyzed in its policy making. Uncertainty will often lead to corporate cash hoarding. Today, at least on the economic front, there are more reasons for optimism. In our view, companies are simply catching up with what they should have been doing for the last six years; optimizing their cost of capital by financing with historically low cost debt and canceling out equity which carries much higher required rate of return. The activity is natural, spurred by subsiding fears and continuing low rate environment.

We could see some sectors, especially energy, have to cut back on buybacks as profits decline, but we don't see a rapid market-wide scale back at this point. However, we believe the programs will eventually be scaled back, especially if the U.S. Federal Reserve (Fed) raises rates as expected; but momentum in stocks remains strong so that won't necessarily signal a significant selloff.

In our opinion, the event risk of an interest rate hike is overly exaggerated by most investors and media outlets. A 25 basis point (0.25%) increase by the Fed will not change the fact that borrowing is extraordinarily cheap. Only when corporate bond yields approach earnings yield, should we start expecting a reversal in the dynamic. This would require more than a single hike. Admittedly, corporates are surely issuing excess debt to lock in today's low rates. SEI expects a slow down after the first hike, but then an eventual recovery.

Additionally, share buybacks have largely been a U.S. phenomenon, with Europe focused more on dividends. The primary reasons for this distinction are the level of stock option compensation and differing tax codes. In Europe, the use of stock option compensation is not as widespread as in the U.S., thus removing some additional incentive for company management to buy back shares. In the U.S., capital gains receive preferential tax treatment, so buybacks represent a more efficient distribution of capital. In general, this is not the case outside of the U.S., as most countries treat capital gains and dividends equally for tax purposes. Given this, there is likely room for buybacks to increase in Europe; especially with the European Central Bank's commitment to its asset purchase program. However, European companies are sitting on cash hoards for the same reason U.S. companies did in 2008—uncertainty. For European companies, it's important that the ECB follows through with its plan.

SEI's current positioning (primarily found in global equity funds) is to favor European equity over U.S. equity. Conversely, currency positioning is to favor the U.S. dollar over the euro. This positioning is mostly due to more favorable valuations in Europe, with the share buyback environment a secondary factor.

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