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Corporate Buybacks – Part II

Shorting the Buyback Contradiction

"To arrive at a contradiction is to confess an error in one's thinking; to maintain a contradiction is to abdicate one's mind and to evict oneself from the realm of reality" - Ayn Rand

The positive short-term price action of buybacks lures unsuspecting investors on the promise that such a shell game is sustainable. Many on Wall Street support such activities as it promotes rising stock prices, ultimately bolstering their wallets. However, clear-headed reason would argue that unless one is an executive whose compensation is tied to metrics influenced by the effects of share buybacks, there are few instances that support this use of corporate resources.

Those who promote buybacks base their support on the fact that fewer shares outstanding, a by-product of the share repurchases, produces more earnings per share (EPS) as the numerator in the EPS equation is unchanged while the denominator is smaller. In "Corporate Buybacks; Connecting Dots to the F-word" we point out that most investors fail to consider the use of assets required to execute the buyback and the current valuation of those companies. Even more worrisome they fail to fully understand the implications of spending corporate capital to repurchase (often expensive) shares instead of investing it in the future growth of companies. **The obscured shortcomings of share repurchases actually highlight a blatant contradiction. Share repurchases boost EPS, making valuations appear cheaper, however at the same time they reduce the ability of companies conducting such buybacks to grow future earnings. Recognition of this circumstance presents significant opportunities for those willing to embrace the "realm of reality".** This article uses logic and mathematical analysis to demonstrate the serious price distortions share buybacks are creating and offers specific trade recommendations to capitalize on those distortions.

Distortion

Buybacks distort financial ratios that many investors rely upon to evaluate stock prices. This is most evident in the widely used price to earnings ratio (P/E). This straightforward ratio simply divides the price per share of a company by its earnings per share. The resulting multiple tells an investor the price one must pay for each dollar of earnings. Investors calculating P/E can use

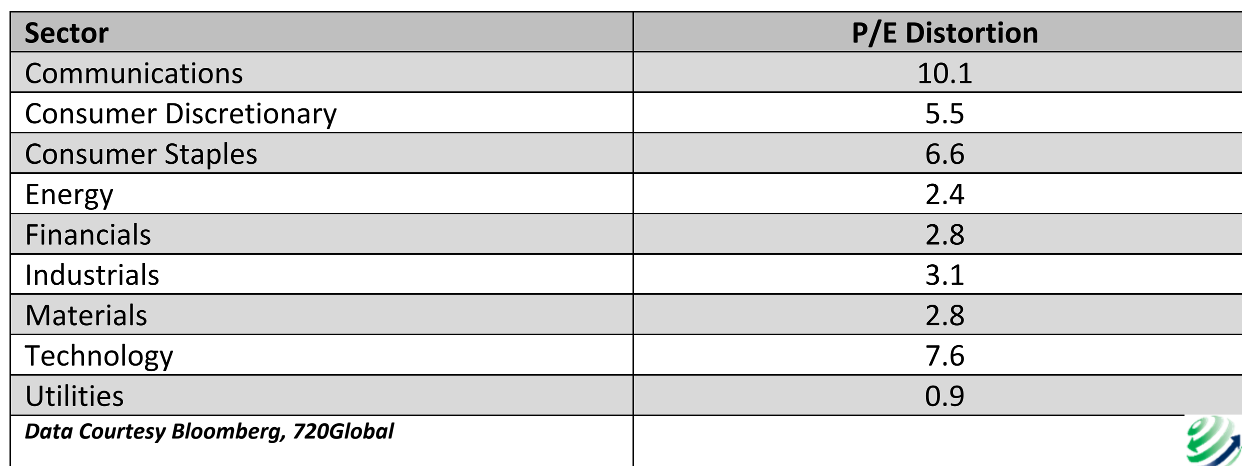
a wide variety of historic, current or estimated future data for the denominator, earnings per share. On the other hand the numerator, price, is a known number – the current equity price of the company in question. Therefore, when using P/E as a valuation technique, the validity of the earnings per share input should be given careful consideration.

The reality is that stock buybacks distort EPS data and produce lower P/E ratios, thus making the shares optically cheaper. As an example, consider a company with a $20 price per share, $1 EPS and plans to buyback half of their outstanding shares. Upon completion of the buyback, the company's P/E will drop from 20 to 10 as the price remains at $20 but EPS will double to $2, due to the reduced share count. This P/E distortion (an investor now only needs $10 to claim $1 of earnings instead of $20 prior to the buyback) will likely lead investors to conclude that the equity is cheap. However, investors have failed to consider the use of cash to purchase the stock and the now impaired ability of the company to fund and produce future growth.

Analysis

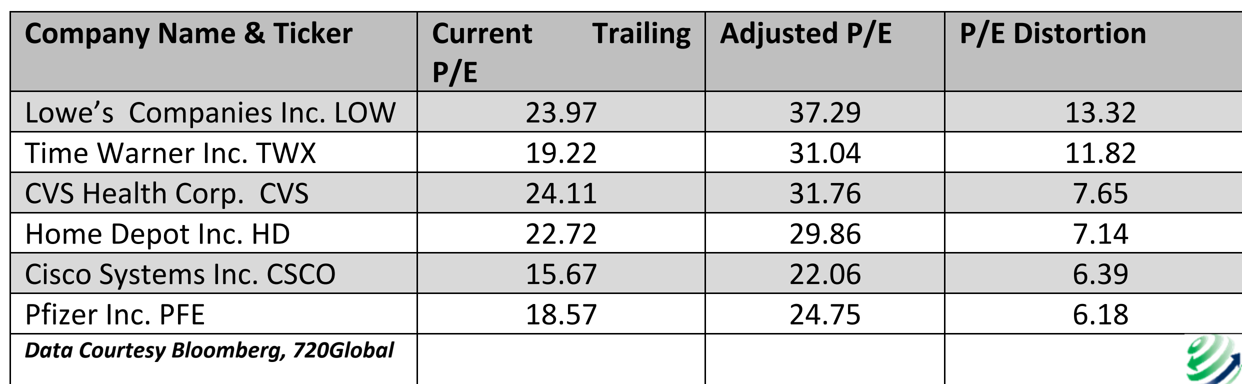
For this analysis, we considered publicly traded companies listed on U.S. stock exchanges with a market capitalization greater than $5 billion. To quantify the distortions to P/E created by share repurchases, a buyback "adjusted" P/E is calculated. This adjusted P/E ratio normalizes EPS, the denominator, by assuming NO shares were repurchased since 2011. Normalizing EPS in this way reduces the denominator and therefore increases the P/E ratio. Comparing the current P/E to the adjusted P/E gives one some sense for just how much buybacks may be distorting values. To illustrate, the adjusted P/E of the company used in the example above would be 20, instead of the post buyback P/E of 10. The distortion of P/E highlights how buybacks may lead investors to misinterpret value and then misallocate investment capital.

Of the over 600 companies analyzed, including 99 which did not conduct buybacks, the average adjusted P/E was 3.99 higher than the average non-adjusted P/E. Based on the trailing 12 month S&P 500 P/E of 18.25 currently present in the market, investors are unknowingly invested in an adjusted market P/E which is over 20% higher than they assumed. Buyback distortions are larger than ever and not limited to any one industry grouping. The table below shows the average distortion to P/E by industry.

Sector	P/E Distortion
Communications	10.1
Consumer Discretionary	5.5
Consumer Staples	6.6
Energy	2.4
Financials	2.8
Industrials	3.1
Materials	2.8
Technology	7.6
Utilities	0.9
Data Courtesy Bloomberg, 720Global	

The following tables expand the analysis by detailing the P/E distortion for individual companies. Company specific analysis was limited to the S&P 100 to ensure we highlight widely held companies that can be easily traded from the short side and have liquid option offerings. Please contact us if you would like to receive analysis on the companies not included in this table.

Within the S&P 100 six companies were selected based upon a combination of large P/E distortions and the magnitude of recent share buybacks versus total outstanding shares.

Company Name & Ticker	Current Trailing P/E	Adjusted P/E	P/E Distortion
Lowe's Companies Inc. LOW	23.97	37.29	13.32
Time Warner Inc. TWX	19.22	31.04	11.82
CVS Health Corp. CVS	24.11	31.76	7.65
Home Depot Inc. HD	22.72	29.86	7.14
Cisco Systems Inc. CSCO	15.67	22.06	6.39
Pfizer Inc. PFE	18.57	24.75	6.18
Data Courtesy Bloomberg, 720Global			

The Contradiction

When investors pay an above-market P/E for shares they are frequently betting that the company will deliver higher future earnings growth than the market. The table below uses the adjusted P/E of the six companies to calculate the annualized required EPS growth. The required EPS growth is the pace at which earnings must rise in order to align the adjusted P/E with the current market price to earnings ratio without requiring a discounting of current share prices. In other words, how much does EPS have to grow to reduce the company's P/E to

equate it with a market average P/E? Revenue growth is a sound proxy for earnings growth as a company cannot grow earnings more than sales in the long run. In the table below, annualized revenue growth is also included for the last 3 and 5 years.

Company Name & Ticker	3 Yr. Required EPS Growth	Historical 3 Yr. Revenue Growth	5 Yr. Required EPS Growth	Historical 5 Yr. Revenue Growth
Lowe's Companies Inc. LOW	29.02%	2.69%	20.19%	2.67%
Time Warner Inc. TWX	21.50%	-1.61%	16.04%	0.35%
CVS Health Corp. CVS	22.41%	4.21%	16.55%	7.72%
Home Depot Inc. HD	19.97%	4.05%	15.18%	3.91%
Cisco Systems Inc. CSCO	8.67%	4.41%	8.69%	2.52%
Pfizer Inc. PFE	12.83%	-3.78%	11.11%	-5.85%
Data Courtesy Bloomberg, 720Global				

Based on S&P 500 5 yr. revenue growth of 4.83% and 3 yr. revenue growth of 2.13yr

Consider the large gap between the required EPS growth rates and historical revenue growth rates. The transparency of the adjusted P/E reveals that the required EPS growth hurdle has risen to seemingly unachievable levels. Given these large differences, investors should be alarmed that these companies have limited and continue to constrain their ability to grow by using cash for buybacks. Using these resources for the purposes of buybacks makes them unavailable for projects that might generate those earnings! Those that believe buybacks are a vote of confidence by management in the company should carefully reconsider that opinion and the inherent conflicts buybacks create.

Trade Recommendation and Conclusion

Aggressive investors can take advantage of this analysis by shorting the six highlighted companies on a market neutral basis and countering the short positions with long positions in companies offering fair valuations. Conservative investors may want to sell holdings in these firms or shy away from future purchases in them.

P/E ratios calculated with past, present and future EPS along with many other valuation techniques currently register in the extreme upper tiers of historical readings (click here to reference "Courage" in which we illustrate the currently rich valuations). Investors in companies or indices containing a significant number of companies conducting buybacks should carefully consider the effects, distortions and long term ramifications of share buybacks.

The contradiction of buybacks is apparent; a company should not have a higher P/E multiple resulting from buyback actions when those actions at the same time reduce the company's ability to achieve the additional growth required to justify the higher P/E multiple.

The best way to avoid the permanent impairment of capital is to never overpay for an asset.

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