Pssst. Ford Motor–and Many Others–Have Found Something Better than Dividends

Companies increasingly are doing what finance professors have been urging for decades—but they're trying to keep it secret.

By S.L. MINTZ

Stock buybacks are giving dividends a run for the money at Ford Motor these days, and winning. In each of the past three years, Ford has used more of its earnings to repurchase common stock than to pay dividends. The company shelled out $2.5 billion to haul in 90 million of its shares between November 1984 and last December 17. Dividends over the period totaled just $1.8 billion.

That's $1.33 of repurchases for every dollar of dividends, and not because of a few isolated binges. Every week, even every day over long stretches, Ford has been buying in its shares. The heady days before the crash were no exception, and the results clearly have met expectations; Ford recently earmarked another $2 billion for enough repurchases to shrink outstanding shares by 11 percent.

Ford isn't alone. Allied-Signal, Firestone, Kroger, and Pepsico spent more on stock buybacks than on dividends in at least two of the past three years. SmithKline Beckman has spent $2 billion since 1984 to repurchase a grand total of 28 percent of its own shares, while distributing just $887 million as dividend payments to shareholders.

These companies are among the trend setters in a movement that is gaining considerable momentum. Increasingly, corporations are heeding what finance professors have been saying since the early Sixties and substituting stock repurchases for dividends as a way to distribute cash to shareholders. Corporate America has not forsaken dividends for stock repurchases, of course. But among the largest companies in the U.S., most of the increase in payouts in recent years has taken the form of buybacks.

Ford's Seneker: *Long-term buyback practitioner*

PHOTO BY DAVID KEYSZAK/BLACK STAR

In 1983 companies listed on the New York Stock Exchange spent $5.9 billion on open market purchases and tender offers for their own shares, according to research by Clifford Smith, Jr., and Michael Barclay of the University of Rochester's William E. Simon Graduate School of Business. That was just a blister on the $63.4 billion that NYSE companies paid in dividends. But by 1986 repurchases and self-tenders made up nearly one third of all payouts by NYSE companies. Dividends rose 13 percent, to $71.4 billion, over the three years. Repurchases and self-tenders jumped more than 500 percent, to $35.7 billion.

The trend was continuing last year before the dam burst on October 19. In the fourth quarter alone, 1,120 companies announced buybacks, according to Charles Plohn, Jr., a managing director who coordinates common stock repurchases at Merrill Lynch. Some of those buybacks haven't materialized, but the message is resoundingly clear: Top management is convinced that repurchases boost stock prices. So is Chairman David Ruder of the Securities and Exchange Commission, who has suggested that unfulfilled buyback pledges look a lot like market manipulation. The buyback pace has dropped off since January, but Plohn says it is ahead of where it was a year ago.

The issue of repurchases versus dividends provokes a clash of theory and reality that goes far beyond what to do when your stock takes a nosedive. Academics have been dumping on dividends ever since Merton Miller and Nobel laureate Franco Modigliani published a seminal paper on financial theory in 1961. M&M, as they quickly became known, maintained that share repurchases are superior to dividends because investors pay fewer taxes on them. Thus, companies should stop paying dividends altogether and simply buy in common stock on a regular basis. "Paying dividends is basically foolish. They are heavily disadvantaged because of the tax bite," declares Miller, now the Robert R. McCormick Distinguished Professor of Finance at the University of Chicago's Graduate School of Business.

The M&M argument soon became conventional wisdom in business schools across the country, but not in corporate offices. Financial executives preferred the safety of accepted practice to the uncertainty of untested theory. But students of M&M have now graduated to top positions at many companies, and it appears that theory is finally moving into the real world. Most of the CFOs doing buybacks insist that they remain committed to dividends, but they act as though they had Merton Miller on a consulting retainer.

The case for repurchases rests almost entirely on the tax advantages for investors. Simply put, companies should be indifferent to how they distribute cash, while taxpaying shareholders come out much better with buybacks than they do with dividends. A cash payout reduces shareholders' equity by the same amount whether it's a dividend or a buyback. But a shareholder who gets a dividend pays income tax on the full amount; one who sells an equal dollar amount of stock pays tax only on the realized capital gain. As John Shoven, a Stanford University economist, puts it, "An extra dividend and a buyback are absolutely equivalent—except for tax characteristics."

Consider the case of a hypothetical company with ten million shares outstanding that decides to make a distribution of $50 million, or $5 a share. Whether the money goes into shareholders' pockets as a dividend or a buyback doesn't alter the fact that the lower half of the liability side of the balance sheet will drop by $50 million and the top portion will be unchanged.

But the investor with, say, 10,000 shares is in a different situation. If he is in the 28 percent tax bracket, a dividend of $50,000 ($5 times 10,000 shares) leaves him with a $14,000 tax bill. If the shares are worth $100 each, selling 500 brings him the same proceeds as the dividend, but his tax bill will be lower. If his cost basis is, say, $75, he pays only $3,500 in taxes on a realized gain of $12,500.

Fuqua Industries' Fuqua: *Repurchased 75 percent*

PHOTO BY ROB NELSON/PICTURE GROUP

In both cases the shareholder still owns 0.1 percent of the stock, since the repurchase reduced the shares outstanding by the same percentage that the shareholder sold. And shareholders who reinvest their dividends get a double bonus from buybacks. Since they do not have to sell stock, they can effectively reinvest their portion of cash distributions without paying any taxes or commissions.

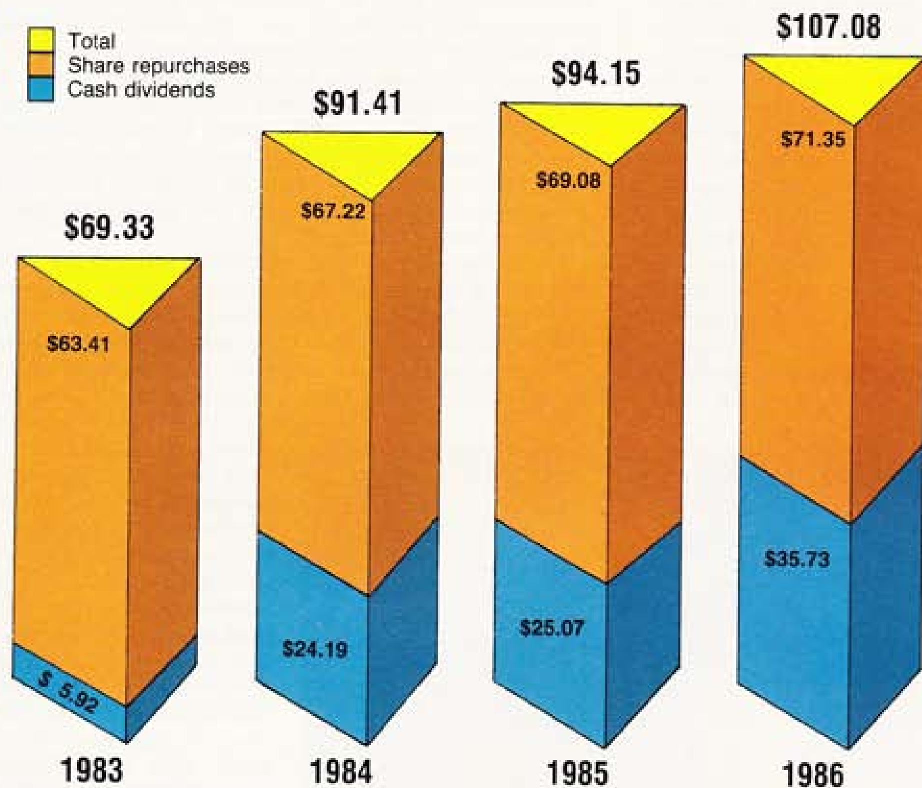
The crucial variable in this analysis is what happens to the stock price. Since the company is paying out the same amount of cash in each case, the aggregate value of the shares outstanding should drop by an identical amount after a dividend or a repurchase. With dividends, share prices normally fall by roughly the amount of the payout on the ex-dividend day. With repurchases, share prices should remain constant since the reduction in the aggregate market value is equal to the shares repurchased. In other words, the remaining shares should be worth more than they would be with a dividend because each has a larger claim on future earnings—a feature

that should appeal to managers with stock options.

A handful of companies openly acknowledge that they have embraced the M&M view of repurchases. Says Vince Hannity, director of investor relations at Boise Cascade: "We view buybacks as a form of dividend because they shrink the equity base and so the value of the remaining shares increases."

J.B. Fuqua, chairman of Fuqua Industries, puts the matter more strongly. "It's pretty clear under tax laws that there is a benefit to shareholders from buying in shares," he says. "I don't think there is much question about that." Fuqua Industries repurchased 75 percent of its shares in 1981, and in the next two years the value quadrupled, says Fuqua, who sees a direct link between the two events. He's no fan of dividends, either, though his company pays one to comply with "an old-fashioned rule" restricting many institutions to investments in dividend paying companies. "I'm one who says high dividends are generally an indication of poor management," he declares.

CPC International, a food processor, shares the progressive view of buybacks. "If you're just paying dividends you haven't given your shareholder the choice to reinvest and benefit through stock appreciation," says Konrad Schlatter, CPC's vice president for financial planning, reporting, and control. CPC has repurchased 17.8 million shares of its common stock for $737.5 million since November 1986. "The dividend certainly has its place," says Schlatter. "But so has stock repurchasing if you can show you are acquiring value." He adds that buying in stock, even at a relatively high multiple, underscores management's confidence that today's price is going to look cheap down the road.



Source: Michael Barclay and Clifford W. Smith, Jr., *University of Rochester*

Stock repurchases have been gaining fast on dividends as a way to distribute cash to shareholders. Just a trickle in 1983, by 1986 open-market repurchases and self-tenders accounted for more than one-third of all cash distributions by NYSE companies. Repurchases exceeded dividends at many companies.

Bowing to pressure from a shareholder group that knew what a tax difference repurchases make, Allegis recently retreated from its plans to distribute a large dividend. Instead, it tendered for 35.5 million shares using cash from the sales of its hotel and car rental subsidiaries (see previous story).

Some companies even believe it makes sense to pay a premium to buy in shares. In May 1984, for example, Teledyne offered $200 each for shares then selling for around $145. To some observers, the enormous premium seemed lunatic, even by comparison with ones routinely paid in acquisitions, leveraged buyouts, and recapitalizations. In Teledyne's case, the tender premium was $478 million, or 1.6 times the previous year's earnings.

Teledyne stock has since risen to more than $330 a share. "That's what is so fabulous about buying at a premium," says Joel Stern, managing partner of Stern Stewart & Co., a financial consulting firm. If management believes a premium accurately reflects the company's prospects, he says, it can move the stock price up with a tender offer. Stern argues that paying a premium serves shareholders better than simply buying stock at what management believes is an undervalued market price.

Other companies behave just like Boise and CPC, but have a very different view of the tradeoffs between dividends and repurchases. Allied-Signal's shareholders have

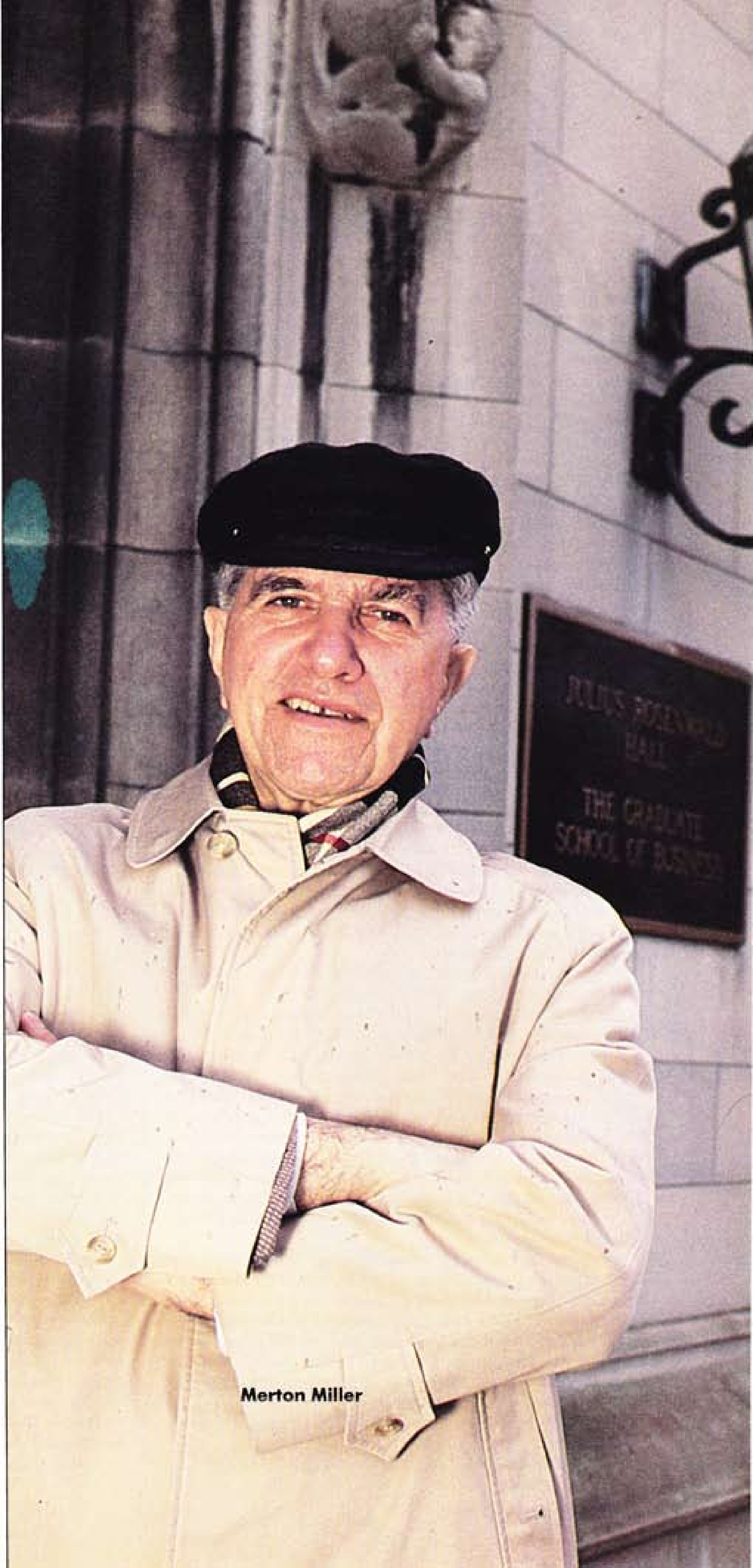
received more than twice as much cash lately from repurchases as they have from dividends, but CFO Donald Kayser isn't ready to endorse buybacks for all occasions. According to Kayser, repurchases serve shareholders better than dividends under certain conditions, but to entirely substitute buybacks for regular dividends would be a sure prescription for eroding shareholder value.

Calling the tax issue "a nice theoretical argument," Kayser contends that cutting dividends would clobber a company's stock price. "If [Allied chairman] Edward Hennessy were to go out tomorrow and cut the dividend from $1.80 to 60 cents a share and use the savings to buy back stock," he says, "I would wager 10 to 1 that our stock price would drop immediately." The drop would be deeper and more prolonged, according to Kayser, than the drop that usually occurs on the ex-dividend date. Perhaps, but it seems significant that when the crash came, companies rushed to announce buybacks, not dividend increases.

On the other hand, says Kayser, it is perfectly all right to use spare cash for repurchases. That's why Allied spent $1.7 billion over the last three years to buy in common stock, more than double what it paid in common dividends. Kayser says that Allied made the repurchases because it had too many shares outstanding and too much cash on its balance sheet.

The company issued shares worth $3.6 billion in 1985 to purchase Signal, which had $1 billion in cash when it was absorbed. And the disposition of one half of Allied's interest in its Union Texas Petroleum subsidiary brought in another $1.4 billion. "The simple solution," Kayser says, "was to buy back the stock until our capital structure was in the position that we feel is best for the company long-term." That meant lifting the ratio of debt to total capitalization from 24 percent to between 35 and 40 percent. Since embarking on the buyback program in the fourth quarter of 1985, Allied has reduced its shares outstanding by 25 million, or 14 percent. Last September the board authorized the repurchase of another 25 million shares.

Kayser says a special dividend would have accomplished the same adjustment to Allied's debt-to-capitalization ratio. But in fact, the company repur-



Merton Miller

PHOTO BY PHIL WALKER

Citizens' Utilities A shares pay only stock while B shares pay the same amount in cash. In April, A shares traded $5 higher than B.

chased stock for some of the reasons that get theorists excited. "We could pay [surplus cash] as a special, large dividend. That's great for people who happened to be shareholders on the record date, but after that point what does it do for the shareholders who decide not to sell?" He's talking about the increase in earnings per share. Buybacks provide shareholders the choice between taking a distribution or reinvesting. "By declaring a special dividend to all shareholders," Kayser says, "you presuppose they think that's best."

Flexibility is another motivation behind some buyback programs. Says Monsanto Treasurer Juanita Hinshaw: "You don't want to build unreal expectations by paying huge dividends one year that you cannot sustain the next." In 1985 Monsanto spent $91 million to buy back shares and $188 million on dividends. The company made no repurchases in 1986 because it needed funds for its $2.7 billion acquisition of pharmaceutical maker Searle, "a better use of our cash," Hinshaw says. But last year Monsanto spent $339 million to repurchase shares and paid only $212 million in dividends.

Some financial executives will never warm to buybacks. Potlatch CFO Penn Siegel, a former securities analyst, is one who doesn't buy the academic theories. "The logic isn't bad, frankly, but I don't believe decisionmakers in major corporations think that way," he says. "In general, buybacks are triggered by market events, not theories."

Unsurprisingly, most professional money managers are unmoved by the arguments for buybacks since their funds are largely tax-exempt. Says Stephen Timbers, chief investment officer at Kemper Financial Services: "How an academic tears price movement apart makes my eyes gloss over." To Timbers, dividends and buybacks are apples and oranges. He classifies dividends as bona fide distributions and buybacks as partial liquidations. Only a guarantee that buybacks would produce an equivalent increase would persuade him otherwise.

Peter Richardson, who oversees $4.6 billion in equity investments for Cigna, takes a strictly pragmatic view. "Do I care about the choice of buybacks or dividends?" he asks. "If it's sensible and intelligent, I don't. If it's dumb, I do." A dumb decision, by Richardson's lights, is buying back stock in a company that has a poor return.

Ford seems to have selected its course without dwelling on the tax aspects of buybacks. "We see it as a good return for shareholders," says CFO Stanley Seneker, stressing that the return extends both to those who sell stock and to those who don't. But those who hang on to it get the better part of the bargain. "When we buy back shares we're really emphasizing the value to our remaining stockholders," he explains.

By repurchasing stock, Seneker says, "inherently we're saying that it's undervalued." Ford arrives at that valuation by calculating what its stock should be worth several years from now. "We do internal forecasts [to predict] what our profit will be, then discount that back to the present and compare it with the market value of our stock," Seneker says. Since Ford saw fit to buy in its stock near the peak of $56.375 last year (it recently was selling around $47), it seems likely that the company's buyback program has a way to run.

Critics could argue that Ford would have served shareholders better by paying dividends instead of buying stock just before the crash. That's quite true, but even the crash failed to shake Seneker's faith in the value of an ongoing buyback program. "What the crash suggests is that we're not smart enough to time the market," he says. The average price for the 90 million shares Ford has repurchased was $27.78. "If we'd bought it all up front in a tender offer, we'd have been better off," Seneker says. "But that's hindsight. The best way is to buy over a long period of time on a steady and sustained basis and average out rather than try to time the market."

Ford's approach to buybacks typifies the attitude of many companies: They are an alternative to dividends that makes sense in some situations, but not a substitute. "We don't anticipate that we will be buying stock for the next 20 years," Seneker says. "Yet we hope to be paying dividends. People buy equities, he argues, "in anticipation of getting a steady stream of income."

Not all people, to judge by the unique case of Citizens Utilities, a Stamford, Connecticut, holding company. In 1956 the SEC granted Citizens the right to issue common stock that pays only stock dividends. These class A shares trade alongside class B, which pays an equal amount in cash dividends. Ever since, shareholders have been willing to pay more for Citizens A than Citizens B. In mid April, Citizens A fetched $33.125 a share while the price for B was $28.25. The unavoidable inference is that investors will pay more for a stock that reinvests its capital rather than paying it out as dividends.

The two bogeymen in the buyback picture are the Internal Revenue Service and credit rating agencies. The IRS has the power to treat periodic buybacks as "constructive" dividends. One tax expert sees this as a real possibility and one that would have awful results. "The bookkeeping would be absolutely nightmarish," warns Robert Willens, a Shearson Lehman Hutton senior vice president who spent 15 years with Peat Marwick.

Willens acknowledges, however, that the operative word is periodic, and that recurring buybacks aren't necessarily the same thing. Nor has the IRS announced plans to take action against large companies that have been repurchasing shares for an extended period. For his part, Seneker has never heard Ford's tax people raise an objection to regular repurchases.

The rating services may also be less averse to buybacks than is commonly feared. Samuel Gordon, director of Moody's Investors Services industrial ratings group, contends that open minds prevail. "To the extent that debt protection measures have worsened, sure, we'll change the rating," he warns. But he also says that a buyback doesn't affect a company's financial strength any more than a dividend: "If instead of $50 million in dividends, a company were to buy back $50 million in stock, the effect on net worth would be the same."

The evidence hasn't done much so far to alter the way most financial decisionmakers think about buybacks and dividends. They're not ready, by a long shot, to abandon regular dividends. But buyback proponents find much encouragement in the recent developments. As they see it, economic Darwinism is taking its course, and buybacks will prevail despite the skeptics, because buybacks are a better deal for shareholders. ■