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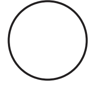

S.L. Mintz

U.S. Share Buybacks Rebound but Face Sharp Criticism

U.S. companies repurchased $144 billion in shares during the third quarter of 2014, according to our latest Buyback Scorecard, but the effectiveness of the strategy has been called into question.

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In late November, Yum Brands offered a twofer: The fast-food company said it would rev up stock buybacks by $1 billion through May 2016 and boost its dividend rate by double digits. Yum's moves are part of a corporate strategy that companies continue to pursue whether they're good at it or not.

Yum did get some instant gratification. Investors bought its stock, which had been down slightly for the year. Shares in the Louisville, Kentucky–based company, which operates KFC, Pizza Hut and Taco Bell restaurants, inched up after the announcement and continued higher for the next eight days.

Still, short-term stock gains won't alter a sluggish track record in buyback return on investment. In the latest ranking of our quarterly Corporate Buyback Scorecard, developed and calculated by Fortuna Advisors using Capital IQ data for the quarter ended September 30, 2014, Yum trailed the buyback return on investment of some 248 companies. Only 35 companies fared worse, among them two fast-food and casual-dining companies, Oak Brook, Illinois's McDonalds Corp. (No. 266) and Orlando, Florida's Darden Restaurants (No. 269), as well as companies in consumer services.

The Corporate Buyback Scorecard answers a straightforward question many investors have about companies that repurchase their stock: How do buybacks stack up against other investments companies make with shareholders' money? The two-year window the scorecard uses to judge buyback programs matches the time period that companies often employ to judge other major expenditures, such as capital investments or M&A. One quarterly scorecard is not sufficient to render a final verdict on the quality of management, notes Fortuna CEO Gregory Milano. But lackluster performance will stir debate about the merits of buybacks, strategic judgments and potential conflicts.

Buyback
Scorecard The S&P 500 as Stock Repurchasers Best & Worst ProgramsIndustry Comparisons

Robust buyback ROI stands out. At Stamford, Connecticut–based United Rentals (No. 4), which joined the top ten in the latest scorecard, timely buybacks chalked up a 79 percent ROI, albeit with a big lift from surging gains in the underlying stock. United chief financial officer William Plummer welcomes scrutiny. "It's perfectly legitimate to challenge the process," he says. "It's well worth asking, 'What's the thought process, why are you doing them, and why will it help the shareholders?'"

Adjusting the time frame can affect buyback ROI for better or worse, though four more quarters would not help Yum. Since the third quarter of 2013, the company has dropped 34 places on the scorecard, and its buyback ROI does not compare well against its peers and the S&P 500 median. Over 12 quarters Yum recorded 8 percent in buyback ROI, compared with a 29 percent median for its peers.

S&P 500 companies whose buybacks exceeded 4 percent of their market cap reported $144 billion in stock repurchases in the third quarter of 2014, beating the $115 billion in the second quarter and $128 billion in the third quarter of 2013. Median buyback ROI dipped for the third scorecard in a row as companies faced headwinds. Although stock prices mostly continued on an upward trek in 2014, spikes in market volatility made executing buybacks trickier.

Buybacks made before share prices fall hurt ROI. Buyback effectiveness measures that impact and compares buyback ROI with buyback strategy, a proxy for total shareholder return. Barely positive for the second quarter, buyback effectiveness went negative in the third-quarter scorecard.

Companies in the technology hardware and equipment sector posted the top buyback ROI: 38.1 percent. But with median buyback ROI below 7 percent, telecommunications services companies landed in the basement. Dallas-based Southwest Airlines Co. has long had an excellent record of buyback ROI effectiveness and led the pack with ROI just shy of 100 percent. New York luxury retailer Coach's negative 31 percent buyback ROI trailed that of every other company, hobbled by poor timing that exacerbated the impact of a sinking stock price.

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Huge investments that drag down performance ordinarily do not appeal to investors. But laggard companies such as Armonk, New York–based IBM Corp. (No. 261) and New York's Pfizer (No. 254) keep aggressively buying back shares anyway. The two companies retired 16 percent and 8 percent of shares outstanding, respectively, with subpar results in the latest scorecard, notes Fortuna analyst Joseph Theriault. Both companies unveiled more

buybacks after the third quarter ended: $11 billion by Pfizer and $5 billion by IBM. Like gamblers who regularly up the ante, companies that are down often sink more money into buybacks in hopes that their fortunes will revive.

Economics professor William Lazonick at the University of Massachusetts Lowell is critical of buybacks. "Buybacks are just a manipulation of the market," he charges. Ever since the Securities and Exchange Commission gave companies the green light to buy back stock in quantities large enough to affect stock prices, in the early '80s, Lazonick says, managers have used the strategy to inflate earnings per share and get rewarded for it at bonus time.

One of Lazonick's cases in point: San Jose, California–based Cisco Systems (No. 170). "It should be the world's leading technology company," he declares. "It's not even innovative anymore." Cisco, he says, has shoveled gains into buybacks rather than into investments that spawn innovation. Company officials might beg to differ with this assessment. In fiscal years 2013 and 2014, Cisco devoted $12.2 billion to R&D on networking products and services. In 2010 through 2012 only five companies in global computing and electronics spent more, notes *Strategy&*, a PriceWaterhouseCoopers publication. In the same period Cisco spent a nearly identical sum on buybacks.

Lazonick mounted an assault on buybacks in the September 2014 *Harvard Business Review*: "Profits Without Prosperity" marshals historical evidence that buybacks shift rewards to shareholders who contribute nothing other than a liquid market for shares rather than rewarding workers for increasing productivity. Lazonick includes buybacks in his larger critique of economic inequality and excessive corporate pay.

In his scenario wages stagnate, jobs disappear and managers forgo risk as higher earnings unlock stock-based compensation and buybacks and dividends keep rising. "While the top 0.1 percent of income recipients, which include most of the highest-ranking corporate executives, reap almost all the income gains," he writes, "good jobs keep disappearing, and new employment opportunities tend to be insecure and underpaid."

Lazonick, a Ph.D. graduate of the Harvard Economics Department, where he was on the faculty for nine years, criticizes three justifications for buybacks. Conceding "some sense" in the argument that buybacks may invest in undervalued shares and signal confidence in the future, he notes a persistently different reality over the past two decades. Companies ramp up buybacks in bull markets and reduce them in bear markets, a trend in evidence today as buybacks continue to occur.

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Lazonick rejects buybacks as a way to offset EPS dilution from stock options. He has calculated the impact of broad-based stock option programs at high-tech companies and sees no logical economic rationale for repurchases that offset dilution. “Options are meant to motivate employees to work harder now to produce higher future returns for the company,” he says. “Therefore, rather than using corporate cash to boost EPS immediately, executives should be willing to wait for the incentive to work.”

Last, Lazonick brushes off contentions by mature companies that in the absence of sound investment ideas, buybacks return excess cash to shareholders in a tax-efficient way. Not so, he says. In 2003, Congress equalized tax rates on long-term capital gains and dividends. Large, well-run companies enjoy competitive advantages over fledgling businesses. Using tax treatment to justify buybacks should sound an alarm, Lazonick says: “It raises the question of whether these executives are doing their jobs.”

The conventional wisdom about buybacks is that they are an efficient mechanism for shifting capital from companies that can’t invest it well to those that can. Reasonable observers may ask whether returning capital to shareholders serves the economy better than ill-fated investments. It might not, warns economist Dean Baker of the Washington-based Center for Economic Policy and Research. By putting money in workers’ pockets, investment spurs spending on consumer goods and services even if it doesn’t pan out. Buybacks create economic demand only when shareholders decide to spend. More often than not, they reinvest the money rather than spend it.

“If we were at full employment, then the impact on workers would be pretty much the same,” Baker says. Some demand would be pulled away to support either poor investments or shareholder consumption. “However,” Baker adds, “if we are below full employment, as is certainly the case now, we would much prefer the failed investment.”

Lazonick’s recommendation? Reform the system by ending open-market buybacks, reining in stock-based pay and transforming boards that set executive compensation. “If Americans want an economy in which corporate profits result in shared prosperity,” he says, “the buyback and executive compensation binges will have to end.”

One thing is clear: An end to open-market buybacks and compensation tied to EPS would eliminate conflicts that Lazonick contends are rife. To test the impact of stock buybacks on incentive compensation, consultant Jeff McCutcheon at Board Advisory, a firm that specializes in advising boards on incentive compensation, examined 21 companies at which buybacks reduced market capital by more than twice the median. These companies stand out because the magnitude of buybacks had the most pronounced impact on EPS, the most common incentive compensation trigger.

In the sample group that McCutcheon reviewed, buybacks appeared to release incentive compensation tied to EPS at five companies: Santa Clara, California’s Citrix Systems (No. 100); Corning, New York–based Corning (No. 61); Short Hills, New Jersey’s Dun & Bradstreet Corp. (No. 134); Ireland-based Ingersoll-Rand (No. 111); and New York’s L-3 Communications

(No. 108). The estimated effects on compensation weigh the present value of future earnings, free cash flow, pre- and postbuyback prices and cash used for buybacks.

The impact of buybacks on incentive compensation at Ingersoll-Rand and Corning could not be calculated using disclosed information. At software developer Citrix, which had retired 18 percent of its market cap, four additional cents of EPS resulted in a cash incentive award of $634,608 for CEO Mark Templeton. At D&B buybacks that retired 21 percent of market cap upped the compensation for former chair and CEO Sara Mathew and current CEO Robert Carrigan by $321,750 and $82,875, respectively.

After exceeding its 2013 EPS goals, thanks mostly to buybacks that trimmed market capital by more than one third, L-3 rewarded CEO Michael Strianese with substantial cash and stock payments. Based on the disclosed pay program, McCutcheon estimates EPS performance from the share buyback increased Strianese's cash bonus by roughly $800,000 and boosted shares earned by roughly $2 million. L-3, a prime contractor in aerospace systems and national security infrastructure, outperformed median buyback ROI in the latest ranking. On December 4, L-3 unveiled an additional $1.5 billion buyback program.

So long as corporate bylaws allow them, buybacks that increase executive compensation violate no laws or regulations. Executives at Citrix, D&B and L-3 would not comment beyond what their companies reported in SEC filings.

Pressure to return capital to shareholders has gained momentum, but companies such as Caterpillar (No. 107), based in Peoria, Illinois, insist that other needs be met first. "We want to increase the dividend, we want to fund growth, we want to keep the credit rating single A," Mike DeWalt, who heads financial services, told analysts at a recent conference sponsored by Credit Suisse. But, DeWalt says, cash remains: "If we found a good way to invest the money, whether it be organic or inorganic, we would do that. If we don't, the safety valve for cash, if you will, is a buyback." Last July, Caterpillar announced plans to spend $2.5 billion on buybacks, part of a $10 billion buyback authorization that is twice the cash the company devoted to equipment on operating leases and other capital expenditures during 2011, 2012 and 2013.

Critics who paint all buybacks as an assault on shareholders have it wrong, says Deutsche Bank analyst George Hill. Hill follows McKesson Corp. (No. 10), which has delivered solid buyback ROI since the scorecard's inception in the second quarter of 2012. The company's strategy, Hill says, centers on growing McKesson, not shrinking it. Provided buybacks are part of a prudent approach to capital deployment, any favorable impact on the stock price that helps managers also helps shareholders. Hill rebuts the charge that paying for stock when prices are high invites catastrophe. "The risk that McKesson goes down and repurchases look like a poor decision is a possibility," he says. However, he adds, San Francisco–based McKesson and other companies must make decisions about excess capital when circumstances may be beyond their control.

Buybacks rooted in EPS impact or market timing can be problematic, warns United Rentals'

Plummer. “Never do I ask if our stock price is up or down on a given day,” he says. “Neither do I ask if it will help our EPS or growth in EPS. In my view, those are specious reasons for doing share repurchases.”

As a company with revenue tied closely to construction cycles that doesn’t pay a dividend, United Rentals uses buybacks as a tool to manage its balance sheet and reward investors when cash allows.

Repurchasing United Rentals’ shares ahead of a surging stock price generated hedge-fund-like returns. When timely stock buybacks post whopping gains, shareholders and top executives can celebrate wins all around.

Filed Under: buyback scorecard , Yum Brands , McDonalds , Darden Restaurants , ROI

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