Institutional Investor

Share Buybacks Are the Apple of Carl Icahn's Eye

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Dinner plans with Apple CEO Tim Cook rocketed around the investment world on August 22 via the magic of Twitter. The source was none other than activist investor Carl Icahn, who had tweeted: "Spoke to Tim. Planning dinner in September. Tim believes in buyback and is doing one. What will be discussed is magnitude."

A commitment earlier this year to earmark $60 billion for share buybacks over the next three years, aimed at placating Apple shareholders, fixated on the company's $150 billion mountain of idle cash. Icahn, in particular, has been implacable about urging Apple to accelerate buybacks and reignite Apple's sluggish stock price. A year ago the stock closed above $700 a share. In early August shares changed hands well below $500.

BUYBACK SCORECARD

THE MOST AND LEAST EFFECTIVE STOCK BUYBACK PROGRAMS

THE S&P 500 AS STOCK REPURCHASERS

BEST AND WORST PROGRAMS

INDUSTRY COMPARISONS

Icahn sniffed opportunity and bought Apple stock worth $1 billion. His postbuyback target: $625 a share. A recent convert to the power of social media, the septuagenarian billionaire began strategically tweeting the virtues of Apple buybacks.

Shareholder conventional wisdom suggests that buybacks have no obvious downsides beyond ratcheting up leverage, usually by relatively small amounts. It's nice to get the cash, of course, and buybacks increase earnings per share, as long as earnings and cash flow remain constant or grow. Buybacks can also boost overall demand for shares.

But can buybacks be measured, judged and ranked? That's the goal of the latest quarterly version of *Institutional Investor*'s Corporate Buyback Scorecard. Designed and calculated by Fortuna Advisors, a New York–based corporate strategy consulting firm, the ranking submits buybacks to a rigorous return-on-investment analysis. The scorecard quantifies the total return on cash expended in buybacks by 268 companies in the two years ended June 28, 2013, taking into account total dividends avoided and the average value of shares at the end of each quarter during that period.

The ranking includes S&P 500 companies where buybacks over two years exceeded $1 billion or at least 4 percent of their market cap at the start of the period. The group made a median repurchase of shares worth $1.4 billion. The results reflect a rising stock market, with median two-year buyback return on investment growing 470 basis points since the last quarter, to 24.1 percent. The latest Corporate Buyback Scorecard reflects a small rise in buyback activity over the past two years, to $819 billion, from $804 billion.

Some buyback programs appear more favorable if you extend the time frame."The longer the period, the less responsible you hold managers for the purchases they make," says Edward Swanson, the Nelson D. Durst Chair of Accounting at Texas A&M's Mays Business School and a co-author of research analyzing share repurchases. "Two years strikes me as a reasonable period."

Historically, buybacks have seldom attracted much attention. A good track record on buybacks may cast a benign glow over a company, if the program is visible at all. Poor execution may hint at deeper problems. If managers can't judge the market for their own stock correctly, can they effectively evaluate outside investments that may provide even less information?

Corporate cultures can dim buyback prospects, warns Zacks Investment Research chief equity strategist John Blank. That might occur if a CFO can't pull the trigger when buybacks make the most sense. Buybacks, notes Blank, cater to boards, shareholders and analysts eager to see share prices rise. But management opposition to a buyback may spawn doubts. Says Blank, "Only the strong and really savvy CFOs play the game properly."

Blank likens buyback ROI to an oil gauge in a car. “You know you need oil, but you don’t know why,” he warns.

Apple, which spent $17.9 billion on buybacks, fell well below the market median, trailing only Cleveland-based iron ore and coal miner Cliffs Natural Resources. The market views Apple as lacking the creativity and drive that the late Steve Jobs provided. If new management can’t recharge the iconic maker of iPhones and iPads, then it’s just another mammoth high-tech company past its prime whose buybacks destroy shareholder value.

As a soaring S&P 500 rewarded investors in most sectors, Apple’s buyback ROI skidded 43.1 percent, and Cliffs thudded 54.3 percent. Both severely underperformed their respective sectors. The Technology, Hardware and Equipment sector logged a median buyback ROI of 18.2 percent. The Materials sector saw a median 19.6 percent buyback return on investment.

Other companies fared far better. Victor, New York–based Constellation Brands, a distributor of wines and spirits, took the top prize, returning almost $2 for every $1 invested in share repurchases, for a buyback ROI of 99.4 percent, nearly double the 52.3 percent increase in its stock price.

Outstanding buyback ROI appears to reflect timing and prescience. Constellation accelerated share repurchases at $20 a share shortly before an event that was beyond its control, though one that it anticipated. “They were the solution to an antitrust problem for Anheuser Busch,” says Tim Ramey, who covers Constellation for D.A. Davidson & Co.

Opportunity arose from Constellation’s joint venture with Grupo Modelo, a Mexican beer distributor half owned by Anheuser Busch Inbev, which controls about half the U.S. beer market. The venture was set to expire in 2017, and most analysts reckoned Modelo would not renew it, keeping the business for itself. The Street valued the venture closer to $500 million than a more customary ten times earnings before interest, taxes, depreciation and amortization, or $2.3 billion.

Ramey says CEO Rob Sands had argued that there was no way the Justice Department would ever allow Anheuser to control 100 percent of Modelo in the U.S. “Add 7 share points to 50; it just wasn’t going to happen,” Ramey says.

Wall Street refused to buy any story other than an end to the joint venture. The valuation gap, he says, invited Sands to buy back stock. When Anheuser announced its intention to acquire the half of Modelo it didn’t own, Justice imposed restrictions. Constellation swooped in and bought Modelo’s U.S. beer business, including a manufacturing facility in Mexico, for $4.7 billion. The market saw that as a bargain, and the stock price climbed to $50 a share.

“That was smart. That was intentional. I give them full credit,” says Ramey.

No. 2 on the Corporate Buyback Scorecard is Gilead Sciences, a Foster City, California–based biopharmaceutical company, which recorded 81.3 percent buyback ROI in the second quarter. Analyst Mark Schoenebaum at ISI Group credits good timing. Gilead shut down a buyback program after it paid $11 billion in cash to acquire biotech Pharmasset in late 2011 despite the target’s $9 million loss in fiscal 2011. Gilead’s stock price then tripled, partly because of promising clinical trials for a Pharmasset drug candidate.

Tenet set the pace for companies in the Health Care Equipment and Services group by rewarding shareholders with 72.9 percent in buyback ROI. The Dow Jones U.S. Healthcare Sector had risen 28.8 percent for the year by September 4. But share repurchases added almost 32 percent to buyback ROI over market gains.

Execution is pivotal in the buyback ROI sweepstakes. San Antonio oil refiner and gas station operator Tesoro defied a propensity to reinvest at the wrong time that plagues companies in its sector, says analyst Doug Terreson, at ISI Group. Although surplus cash was scarce until 2012, Tesoro launched buybacks in the third quarter. Since then it has boosted repurchases each quarter, leading to a 78.5 percent buyback ROI at the end of the second quarter, 16.7 percentage points above its stock performance.

Technlogy Insight Research analyst Nehal Chokshi credits Western Digital Corp.'s execution for its showing. Close to half its repurchases in the past two years happened in the quarter after the Irvine, California, maker of digital storage devices closed its purchase of Hitachi Global Storage. Before that the stock traded near $30, hurt by a flood at a Thai factory that hobbled production and left investors unsure whether Western Digital would regain market share lost to rival Seagate. Western Digital not only won back share but increased it. And a residual effect of supply interruption and consolidation was higher disk drive prices. "They were able to move to a 50 percent-higher operating margin in six months," says Chokshi.

For Western Digital, repurchasing shares as its stock price rose enabled it to deliver a 74.5 percent buyback ROI, almost 38 points higher than the stock price gain, a larger margin than three companies that posted higher buyback ROI.

Other companies have few reasons to boast, not that a poor track record necessarily alters decisions to repurchase stock. Edwards Lifesciences Corp., Teradata Corp. and F5 Networks slid 56, 28 and 23 places in the buyback ROI rankings, respectively.

On August 28, San Jose, California, semiconductor maker Altera Corp. embraced the adage "If at first buybacks don't succeed, try, try again." It expanded its repurchase authorization by 30 million shares. All told, the board has approved the repurchase of 41 million shares, roughly 13 percent of shares. Any other investment that lost 6.7 percent since July 2011 might have met board skepticism. Instead, buybacks that lagged peers were fully endorsed. The Semiconductor sector trailed 23 industries but still recorded buyback ROI over 10 percent.

Altera has zigzagged in its buyback program. The biggest buyback used to calculate its current rank occurred in the third quarter of 2011. But as its stock slid, Altera tapped the brakes. With an uptick in the stock, the company began buying back more than $100 million a few quarters later, only to hit another slowdown. After limiting buybacks in the first quarter, they crept back to over $50 million in the second quarter. The latest announcement promises more to follow.

To illustrate how companies achieved their ROI, Fortuna examined two other measures: buyback strategy and buyback effectiveness.

The effectiveness measure shows how successful — or unsuccessful — companies were in timing stock repurchases. It bridges the difference between buyback ROI and buyback strategy, which is a measure of total shareholder return for the stock over the two years of the study.

Companies record positive buyback effectiveness if they repurchase shares below the stock price trend and negative effectiveness if they buy back shares above the trend line. Repurchasing shares below the line cushioned Altera's 14.2 percent stock price slide. The current buyback effectiveness median for the S&P 500 adds 8.2 percentage points to the underlying gain, an improvement of 3.2 percentage points since the first-quarter ranking.

Poor strategy and execution drove Cliffs Natural Resources over the edge in the latest Corporate Buyback Scorecard. "I'm not surprised that they rank very low," says security analyst Garrett Nelson, who follows diversified mining for BB&T Capital Markets. Confident that iron ore prices would hold up despite declining steel prices, Cliffs launched $290 million in buybacks in the second half of 2011. The gamble failed. Iron ore prices slid, global steel production slowed, and seaborne ore from Western Australia found its way to more global markets.

All this was bad news for buyback ROI, but the minus 3.9 percent in buyback effectiveness put the company in an even deeper hole. Late in 2012, Cliffs slashed its dividend to 60 cents a share, from $2.60. Soon after, CEO Joseph Carrabba announced plans to step down.

Companies contemplating buybacks might draw one lesson from the Corporate Buyback Scorecard: Bigger seems to be better. Despite Apple's bumpy ride, buybacks over $18 billion have produced higher median buyback ROI and sturdier gains since the first quarter, up 6.4 percentage points, to 26.2 percent median buyback ROI. Companies in the lowest dollar threshold added only 2.3 percentage points, ending with 20.9 percent buyback ROI. Buybacks representing the largest percentage of market capital outperformed the least ambitious. • •