THOUGHT LEADERSHIP:
BREAD AND CIRCUSES - THE US BUYBACK REVEAL

MAY 2019
It is a stately process, and one that approaches the level of a ritual: one by one, large companies announce their intentions to buy back shares using some of their excess cash. They mail out explanatory notices to their shareholders and invite them to participate in the buyback. Everyone gets something: the company gets to repurchasing securities at a discount to the market price.

For some investors, off-market buybacks can be attractive despite the shares being sold at a discount to market (although this depends on the terms of each buyback and the tax treatment of the investor). Off-market buybacks make-up a significant portion (but not the majority) of shares repurchased by Australian companies.\(^1\) And corporate share buybacks overall have consistently been 1-2% of overall market capitalisation in Australia over the past 20 years.

In the US however, a different process unfolds. With low taxes on dividends but no dividend imputation, off-market buybacks are relatively unknown. But on-market buybacks have surged in the past 20 years — up to 3% of US market capitalisation — and a greater share of profits on average have been used to buy back shares than to pay shareholder dividends.

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\(^1\) Over the three years to end 2018, we estimate off-market buybacks have accounted for approximately 44% of the shares bought back in the Australian equity market. The majority of shares bought back are conventional on-market share repurchases, that bear some similarities to the buybacks of countries that do not have dividend imputation systems, such as the US.
Instead of everyone getting something, some get a lot: current shareholders get a boost to earnings growth from a lower share count; and company executives (whose compensation is frequently based on earnings growth accompanied by share price targets) often see the value of their compensation rise significantly. Dividend focused investors get little, and those looking for increased corporate investment — investment that offers the prospect of boosting employment — can also be disappointed. Instead of the cooperative capitalism that characterises off-market buybacks, this is a capitalism that favours management and shareholders, each of whose focus has appeared increasingly short-term in recent years. And though it is a technical area that is usually lost on the investing public, excessive corporate buybacks may ultimately come back to bite US companies — and their investors.

Chart 1: US Corporation Dividend Yield and Buyback Yield

Traditional corporate finance theory – and until very recently traditional equity analysis – split corporate profits into earnings to be retained, and those to be distributed to shareholders as dividends. During the 1980s, however, this model was revised – at least in the US – by deregulation, the hostile takeover movement, and a new ideology of maximizing shareholder value. By the end of the millennium, US corporate executives became focused on using repurchases, as well as dividends, as an important way of distributing corporate profits to shareholders. Chart 1 shows the increase of buybacks relative to dividends by US companies over time.

In Australia, by contrast, the large-scale privatisations of government-held corporations did not occur until the mid-1990s. Dividend imputation – the process by which shareholders receive the benefits of a company’s tax payments to government - has remained firmly entrenched in the market’s perception of shareholder value.
The two systems therefore evolved differently over time, and even subsequent tax cuts that have reduced the tax on US dividends have not managed to change the US trajectory.

Buybacks by US companies now constitute the single largest use of corporate profits, accounting for more than half of the US$1.8 trillion in corporate savings from a 2017 US corporate tax cut.

Roman emperors distracted their increasingly disgruntled, somewhat lazy citizens by making food cheap and circuses plentiful. In the United States post GFC, stock buybacks have made earnings growth cheap and more consistent by reducing the amount of company stock. Corporate executives have grown increasingly rich from such buybacks as executive compensation schemes reward earnings per share growth – a fact not easily understood by ordinary citizens and residents.

As for the circuses, in the economic arena at least, they have been provided by a continuous central banker show, offering discounted bond issue tickets to many of the world’s companies. These two together have made the spectacle of companies swapping equity for debt a profitable activity for many. This feature article details how we got here, and what is likely to happen next.
Understanding Stock Buybacks

In theory, corporate stock buybacks are a healthy financial activity. Their underlying rationale is that a company without significant profitable investments to be made is better returning profits to shareholders, either through buybacks or dividends.

The two modes of distribution, however, are fundamentally different. Payouts through dividends increase the income return of shareholders. Buybacks increase the price return per share, since a holding investor’s share of the company through the buyback is increased on a per share basis. They do so in two ways: in the short term, by providing a price return through the increased demand created by the buyback, and in the medium term by providing increased earnings per share, since the number of shares are reduced going forward. The two effects together can be combined into a single expression of buyback yield which is merely the change in a company’s aggregate shares outstanding. That figure is also shown in Chart 1.

US companies bought back an estimated 2.8% of their shares in 2018, as shown in Chart 3. This compares to 1.1% in Australia (which has a greater focus on dividends, as discussed earlier).

Key US Buyback Regulations (Rule 10b-18, SEC) – implemented in 1982
1. A company’s board can authorise a share repurchase program of up to a specific dollar amount over a specified or open-ended period. The company must publicly announce the program.
2. The company will not be charged with stock price manipulation if its buyback of stock on any single day is less than 25% of previous 4 weeks’ average daily trading volume.
3. The company must report total quarterly purchases, but beyond announcing the program does not need to report daily purchases.

Key Australian Buyback Regulations (ASIC rules covering buybacks)
1. Stock bought back within 10% of the total shares and purchased within a 12-month limit must be announced to ASX; exceeding the 10/12 limit requires shareholder approval.
2. The ASX notice expires after two months if the buyback is not activated by the company.
3. A company can only buy-back securities at a price which is not more than 5% above the average of the market price.
Buybacks are particularly beneficial if a company’s stock price is lower than it should be. From the 1980s onwards, the idea of shareholder value as the ultimate determinant of corporate behaviour became the dominant paradigm for understanding how a corporation should best allocate capital. Certainly, a corporation that wastes capital through unprofitable expansion or acquisition is pursuing an inferior path to one that returns capital; similarly, the idea that a corporation should buy back stock when its price is low also appeals to shareholders concerned with value.

However, the idea of using stock buybacks to improve shareholder returns has become less defensible over time. The pace of buybacks, as shown in Chart 3, has risen or remained stable in every year since 2009. This is despite a US stock market that has risen by 400% since 2009, and has outstripped growth in dividends. Most large US companies that have positive cash earnings have some form of announced stock buyback program. So much for buying back stock when management believes that it is cheap relative to intrinsic value.
However, the multi-year boost to earnings growth from US stock buybacks has been too much of a good thing for US companies. Without it, actual company earnings growth would have been significantly lower. Investors seeing lower earnings growth could arguably discount companies’ future earnings potential. On the other hand, the amount not being used to buy back company stock could be used to either pay larger dividends or be re-invested in existing or new company businesses.

However, evidence for stock buybacks crowding out capital expenditures is slim. By some counts, 2018 was the first year that US stock buybacks exceeded capital expenditures, for example, but aggregate average capital expenditure has continued to grow year on year.

Increased capital expenditure can be linked with increased employment, since a company building or researching to reinvest in its business ordinarily needs to hire more staff to manage this. Alternatively, a company may increase capital expenditure in a bid to increase productivity.

But US unemployment is at a multi-decade low, even with stock buybacks occurring at the pace that they are. The 2018 estimated increase in buybacks relative to capital expenditure was likely caused by a one-time effect from the US corporate tax rate reduction. Prior to this, the last time buybacks exceeded capital expenditures was in 2007, just before the 2008 financial crisis.

Positive and Negative Side Effects

Stock buybacks have unequivocally improved corporate earnings growth – mathematically, they must – but another collateral benefit has been company management compensation.

From 2000 through 2019, S&P 500 companies used more than half their earnings to buy back their own stock, almost all through open-market repurchases. By contrast, the aggregate dividend payout ratio for US companies has averaged no more than 20-30% of earnings.

Since large-scale, open-market repurchases give a boost to a company’s stock price, some of the prime beneficiaries of stock-price increases are the same corporate executives who decide the timing and size of the buybacks.
In addition, until the regulation was changed in 2017, performance-based executive compensation – much of it tied to buybacks – also received favourable corporate tax treatment. In other words, until 2017, a company’s board could authorise a large-scale buyback program, and a company’s management could decide when to exercise stock repurchases. Management would often then be compensated based on the resulting share price increase.

Management compensation related to the increase was generally tax deductible for corporations, and compensated management also were (and still can be) subject to favourable tax treatment for stock-based performance compensation. US managers are ordinarily quick to point out that their compensation is entirely discretionary and aligned with company performance, but the rules of the current game seem to favour them: for example, it would be rare to find a performance agreement in which a company’s managers had to disgorge previous discretionary compensation received, even if a company’s stock price declined subsequent to the award.

In the face of this enormous wave of stock buybacks by US companies, most investors have remained silent. It is difficult to argue with the concept of returning excess cash to shareholders, even if it has been arguably distorted in favour of company management.

Despite some criticism, initial attempts to reduce the amount of US company stock buybacks have been few and faltering. In early 2019, US Senators Bernie Sanders and Charles Schumer tried to introduce regulation that would limit stock buybacks if they were not tied to corporate business reinvestment. But their proposed measure was immediately criticised across the business establishment. It was deemed that the US had more pressing national problems, and that the relative complexity of buybacks may make it difficult to maintain a sustained public focus.
While buybacks are arguably a cause of inequality, they are certainly not the only one. It is as if Margaret Thatcher’s famous statement at the beginning of the current era of capitalism — ‘There is no such thing as society; there are individual men and women, and there are families’ — should be extended to ‘individuals, families, shareholders and management’ under current practice. These latter two groups have done very well from stock buybacks over time.

We have so far demonstrated that stock buybacks have been a large source of earnings growth, and by extension, corporate stock returns, for indices such as the S&P 500. We have also shown that, under current US regulation, they are enormously valuable to company management as a source of wealth. We have restated some of the criticisms of stock buybacks: that they are not always undertaken when a company’s stock price is low, and that they may crowd out reinvestment in a company’s business. These are all arguments against stock buybacks, at least as they practiced among US companies. However, buybacks have increased in most years since the 2008 financial crisis without significant public comment until the last few years.

But it is fair to say that stock buybacks are a relatively polarising topic among those who study the practice. One key recent proponent is Roger Ibbotson, whose 2017 article on US stock buybacks sought to cement the practice as both a legitimate and key component of long-run shareholder returns, as equally measurable and forecastable as dividends.

At a company level, to consider buybacks as a source of return equivalent to dividends makes sense. If a company is spending more to buy back shares than it is paying in dividends, then to primarily consider dividends in the ultimate valuation of such a company (i.e. in a dividend discount model) leaves out most of the return implicitly available from stock buybacks. This is as long as they are expected to be a consistent management practice and useful allocation of capital (although to a shareholder, a dividend is a present receipt of capital; a buyback is a way of potentially increasing future receipt of capital). Many equity investment managers both consider stock buybacks a legitimate source of equity return and include it in their expected returns.

The S&P Buyback Index, an index consisting of the 100 companies with the highest stock buyback ratios, has significantly outperformed even the S&P 500 index in its four fold price rise since 2012.

Net issuance has become more negative over time for US stocks; as of year-end 2018, net issuance was approximately negative US$500 billion. At an aggregate stock market level, however, the picture is not nearly as clear. While stock buybacks have increased in markets such as the US (to the extent that net equity outstanding has fallen), in markets without such high buybacks, net equity outstanding has continued to increase (that is, buybacks and buyback yield are negative). This is due primarily to the dilutive effect of new stock issues within a market — at any one time, different companies may be buying back stock or issuing new stock; the aggregate net issuance is the sum of the two.
Table 1: Historical Dividend Yield and Net Buyback Yield for Selected World Markets

<table>
<thead>
<tr>
<th>Equity Market</th>
<th>Dividend Yield (%)</th>
<th>Net Buyback Yield (%)</th>
<th>Total (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Euro Area</td>
<td>3.7</td>
<td>-0.5</td>
<td>3.2</td>
</tr>
<tr>
<td>Japan</td>
<td>2.6</td>
<td>0.1</td>
<td>2.7</td>
</tr>
<tr>
<td>U.K.</td>
<td>5.0</td>
<td>-0.3</td>
<td>4.7</td>
</tr>
<tr>
<td>Australia</td>
<td>4.9</td>
<td>-0.9</td>
<td>4.0</td>
</tr>
<tr>
<td>Canada</td>
<td>3.5</td>
<td>-1.4</td>
<td>2.1</td>
</tr>
</tbody>
</table>

Source: AQR. Estimates based on data from 1988-2018

Most stock markets worldwide continue to expand through net issuance; for example, as Table 1 shows, Australia and Canada each have negative net buyback yield due to positive aggregate net issuance. And this is the case in most emerging markets as well. So, while the shareholders and management of an individual company may benefit from stock buybacks in terms of current stock price, earnings growth and future earnings and dividends per share, another company’s shareholders may be diluted by new equity issuance.

Dividends have continued to be the primary source of yield for investors at an aggregate stock market level across most markets outside the US. And this means the estimated net stock buyback yield is more moderate for aggregate equity markets.

Still, the importance of stock buybacks to stock market behaviour should not be underemphasized. Buybacks provide an important price support for an individual company’s stock — whether in a specific buyback period (as for Australian companies) or as part of an open-ended buyback program that can buy back stock whenever the company decides to do so (as in the US).

They provide both current and future earnings per share growth. In economies that seem to have more corporate capital than they know what to do with, they provide a way for companies to release that capital back — albeit indirectly — to shareholders. And so it is reasonable to ask whether, if there was not such a direct link between management compensation and stock buybacks, buybacks themselves would have been undertaken in such consistently large amounts, at least for US companies.
The Aggregate Effects of Stock Buybacks

Right now, however, the most relevant question is whether a practice that appears to have contributed to large growth in market capitalisation is a stable one at an aggregate level.

Most criticisms of, and initial attempts to regulate, buybacks have focused on limiting buybacks themselves, or at least the circumstances under which they can be done. But buybacks may at times serve legitimate purposes.

The use of debt to fund stock buybacks however, probably deserves greater scrutiny. A company can continue to buy back stock until almost none is left, as long as it does so with cash flow. But the use of debt changes this equation. Creditors must fund more debt; equity holders benefit from increased cash to be distributed to them as dividends, or used to buy back stock. Buybacks funded from debt clearly can’t go on forever.

A significant percentage of US stock buybacks over the past ten years have been funded by debt. In 2017, for example, roughly one-third of all US stock buybacks were debt-funded. Global large-cap companies with intangible assets in their brand and franchises, including franchise brand companies such as McDonald’s, YUM! Brands, and Domino’s Pizza Inc., have bought back so much stock and issued so much debt to do so, that they have negative balance sheet equity – that is, the book value of their assets is less than their liabilities.

Negative book value is a traditional guardrail for equity analysis, and would disqualify these companies from many traditional, accounting-based value strategies. But, so far, they have sailed past the negative book value barrier without any adverse sentiment, either from debt or equity investors. McDonald’s, for example, issued Australian dollar denominated 7-10 year debt in March 2019 at 3.0-3.8%, evidence that these traditionally risk-averse debt investors were bothered by the negative US$6 billion in equity (which compared to US$3 billion the previous year).
US corporate debt has increased by around 100% since 2009 — and debt-financed stock buybacks have contributed to this growth. At the same time (and because of this additional debt), the amount of lower-rated corporate debt has also increased, as shown in Chart 6. On average, a non-financial corporation — whether public or private — has far more leverage now than it did before the global financial crisis.

Corporate treasurers tend to do what is rational at the time. For most, the overarching lesson of the 2008 financial crisis was to not be caught with too much short-term debt. Long-term debt, however, has escaped this scrutiny. For the past ten years, corporate bond yields for high-rated companies have been significantly below equity earnings yields, as shown in Chart 7.

If McDonald’s can issue ten-year debt at 3.8% and expect earnings yield to be higher than this, then issuing debt is the rational choice to make, even if it increases leverage and negative book equity. Interestingly, based on its May 2019 share price, McDonald’s earnings yield from its 37,000 franchise restaurants is precisely 3.8% — and this is after years of serial debt-funded share buybacks.
There is a 2% gap between US high-grade debt funding costs and earnings yield, as shown in Chart 7. If this gap were to close, we would expect the debt-for-buybacks trend to stop and shift into reverse.

More companies would default on their bond or loan payments, and this would cause credit spreads to widen beyond equity yields. We would then see companies issue equity to pay down debt, in place companies issuing debt issuance to pay down equity — that is, debt-funded buybacks. Such an unwinding can be painful for shareholders and creditors alike, as was evidenced during and in the aftermath of the 2008 financial crisis.

Equity earnings yields would likely fall as a result, despite stock price falls. But this relies on one of two things occurring: either global central bank quantitative easing suddenly ends debt market distortion, or the marginal buyers of corporate debt balk at the idea of buying bonds collateralised primarily by future revenues from a company with negative equity.

With central banks still providing ample credit and liquidity to financial markets, buybacks look set to continue over the short-term. US corporate share buybacks are so far setting a record pace this year, even higher than their record 2018 levels. For both corporate management and shareholders, earnings growth is cheap — to generate it, all management needs to do is keep buying back shares. It’s hard to see an end to this trend, unless government regulation or tax treatment changes.

However, debt-funded stock buybacks are likely to result in financial instability over the longer term, if they are overused. And markets seem to sense this: in 2018, the buyback amount funded by debt issuance fell to 15% — significantly below the 20-35% average for the eight years prior to this.

But only significant regulation is likely to stop US stock buybacks from continuing over the short term. And so, while this looks unlikely, the pace of buybacks means investors should exercise caution.

The US stock market, which makes up 63% of the MSCI World index, continues to be at a 33% premium to the rest of the world (in aggregate, on a trailing price/earnings multiple basis). If even a third of the 9% annual earnings growth from stock buybacks over the past five years were to disappear over the next five years, the cumulative loss of earnings would push the price/earnings multiple to 23.5x. This would compare to the rest of the world’s whose trailing price/earnings multiple is 15x.

The discrepancy in valuations between markets alone — even if buybacks are considered real uses of cash that grow current and future earnings per share — should give an investor allocating between regions pause. If stock buybacks in the US stop for any reason, both management and investors alike will have to shift earnings per share expectations downwards. Based on comparable recent history, it wouldn’t be pretty.

Note that some of this article refers to the tax strategies that are employed by domestic investors and Australian corporations in buying back shares. Please note that this article is not intended to provide tax advice; any readers with interest in such strategies should consult their tax adviser.
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