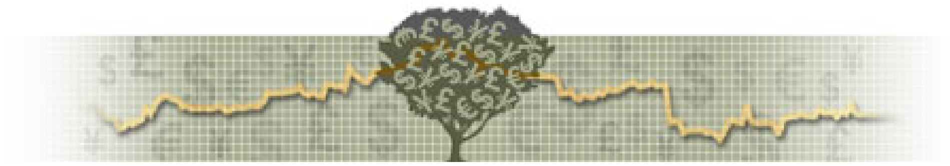
Buttonwood

A valuable alternative to empire-building

Apr 19th 2005
From The Economist Global Agenda

Companies are buying back their own shares in record quantities. In many cases, their shareholders should thank them for it



COMPANIES are reeling in their shares hand over fist these days. First-quarter corporate results have brought a new batch of buyback programmes—and much food for thought. In the past week alone, BASF, a German chemicals group, has announced a new €1.5 billion share buyback, on top of the €1 billion programme it has just completed. Citigroup and Merrill Lynch, two giants of American finance, have unveiled repurchase plans worth $15 billion and $4 billion respectively. Kerr-McGee, an American oil company, said it would buy back up to $4 billion-worth of its shares. BP, a British oil giant, Franco-Belgian bank Dexia and Germany's Deutsche Börse are also buying back shares.

The specifics are slightly different in each case. Citigroup's shares have seriously lagged those of other banks and it has recently sold off its Travelers insurance operation, while Kerr-McGee is fighting off a boardroom attack by that inveterate corporate raider, Carl Icahn. But they have one thing in common: more cash (or unused debt capacity) than they know what to do with.

In all, S&P 500 firms were sitting on $619 billion in cash at the end of 2004, as corporate profitability rose and earnings outstripped investment. Two revealing statements indicate the problem, for such in fact it is. In July 2004, Microsoft said it would hand back about $32 billion to shareholders in the form of a special dividend. On February 28th, Warren Buffett lamented that a $43 billion wodge of cash on Berkshire Hathaway's balance sheet had caused the investment firm to underperform the S&P 500.

Share buybacks are growing fast (see chart below). In 2004, repurchases by S&P 500 firms totalled $197 billion—51% higher than in 2003—according to Standard & Poor's. Howard Silverblatt, an equity-market analyst at the firm, reckons total repurchases could be higher this year; others suspect that capital expenditure and other pressures may reduce the figure. Regardless of detail, these are record levels for the S&P 500. And it's not just American firms that are buying back shares, as it would have been ten years ago before regulatory and tax changes made buybacks more popular elsewhere.

Have corporate bosses run out of more productive things to do with their money? With the world in its third year of solid, if slowing, growth, are buybacks a sad reflection on threadbare late-cycle capitalism? Is there perhaps skulduggery afoot, with bosses trying to jack up earnings per share and share prices so that their own stock-based compensation schemes are worth more? Or do buybacks in fact create more value for shareholders than letting bosses keep the money to squander on misguided acquisitions?

Companies buy back their shares for three main reasons: they think their firm is undervalued and want to tell the market so; they want to have enough shares in hand to satisfy employees exercising their stock options without having to "dilute" current owners or see their balance sheet become too skewed towards equity; or they don't see any more profitable investment opportunities and want to hand back the unusable cash to shareholders. This last is particularly persuasive when interest rates are low and cash represents a dead weight on the balance sheet.

When a company chooses to buy back its shares, this spreads earnings over a smaller equity base and raises earnings per share. If there is no investment in sight with greater long-term returns, if the shares' price is less than the cost of the cash to buy them, and if the level of earnings is maintained (a big if), the buyback adds value and a higher share price should result.

Is this in fact what is happening?

There are lots of studies based on data from the 1980s and 1990s showing that share prices rise when a buyback is announced—by a lot, if the repurchase is at a substantial premium to market value, by a small percentage if it is at the market price. The longer-term boost is greater, according to studies of American and Canadian buybacks by finance professors David Ikenberry, Josef Lakonishok and Theo Vermaelen, especially for firms that were trading previously on humble market-to-book multiples.

Updating these studies to incorporate more recent repurchase announcements, Mr Vermaelen and Urs Peyer of INSEAD conclude that these trends still broadly apply. They also show that companies which say publicly that they are buying back their shares because they think them undervalued tend to get a warmer welcome from the market than those that mention dilution or increasing earnings per share.

Just last week, Bloomberg reported that of 1,500 companies which had announced share buybacks in America between 2002 and April 2004, two-thirds were trading above the S&P 500 after 12 months. So it seems that, on average, companies are able to time the market by taking advantage of an undervalued share price. And if they think that their stock is no longer undervalued, or if they come across a better investment prospect, they simply won't complete the repurchase. Mr Ikenberry, who runs the finance department at the University of Illinois, reckons buyback programmes often represent "good stewardship".

There is another benefit for companies that buy back shares: they are likely to be able to raise equity finance later more cheaply, say Matthew Billett and Hui Xue from the University of Iowa. This is so not only because repurchasing shares is likely to raise their price; their shares also resist better the normal downdraft that accompanies a new share issue.

The structure of ownership matters too. In Britain, Steve Young of Lancaster University and Dennis Oswald of the London Business School found an unusual concentration of external shareholders (ie, fewer insiders, more institutions) among firms announcing buybacks, and also spotted a link to better corporate governance. A group of European academics, published by the Centre for Economic Policy Research, suggest that companies where short-term institutions are heavily represented tend towards paying out through buybacks, while those where long-term investors predominate are more inclined to rely on dividends.

So are share buybacks, however wimpy they make management look, the best way to create value at the moment? Yes, in many cases. Will they continue at present levels? All things being equal, yes again. The fall in employee stock-option plans in America is reducing one pressure for buybacks, but the trend towards shorter-term investment horizons is perhaps increasing pressure from another quarter. Share prices are unlikely to rise to the sort of heady level that would make repurchases uneconomical. And chief executives are sadly reduced figures these days, where capital allocation is concerned. If even Mr Buffett can't find anything to buy, who can?

Send comments on this article to Buttonwood (Please state whether you are happy for your comments to be published)

Read more Buttonwood columns at www.economist.com/buttonwood