Share Repurchase: To Buy or Not to Buy

Thinking share repurchase? Don't assume you need only buy back some stock, sit back and wait for your EPS numbers to jump off the charts.

By Swaminathan G. Badrinath and Nikhil P. Varaiya, with Rhona L. Ferling

In March 2000, *The Wall Street Journal* proclaimed: "Now stock buybacks have suddenly gotten even more popular. But to the frustration of corporate treasurers, many of the stocks aren't enjoying the expected price pops, despite the presumption that that is what a buyback would do."

Indeed, in nearly every year since 1994, stock buybacks have leap-frogged corporate stock issues by ever-increasing amounts. In fact, the $50 billion of buybacks set in motion in the early part of 2000 was the biggest burst of share-repurchase activity since late 1998. What's more, the total number of shares repurchased in the last six years has far outstripped the total number of new shares issued (see chart).

What's behind this growing surge of buybacks? And why aren't they always the adrenaline shot in the arm that companies expected them to be? In March 1999, an electronic poll of 155 FEI members was conducted during a teleconference on share repurchases that was moderated by FEI President Philip B. Livingston. These are among the key findings:

1) Thirty-nine percent of the respondents instituted a share repurchase program in order to improve their earnings per share numbers.

2) Twenty-eight percent said their companies were using buybacks as a way to distribute excess cash to shareholders.

3) Twenty-one percent reported that their companies were trying to reduce the cost of employee stock option plans.

4) Twelve percent noted that adjusting capital structure was the main reason for their stock buybacks.

To delve further into the tremendous popularity of stock buybacks, Financial Executives Research Foundation commissioned a research project to study the subject. The mission: to determine the long-term effects of stock buyback programs on a company's stock price and to assess which companies benefit most from these programs. The analysis of results and implications of 200 firms that announced, conducted and completed share purchase programs from 1991 to 1996 are published in the study, *The Share Repurchase Decision: Causes, Consequences and Implementation Guidelines*.

The research focused on what was defined as "completed repurchase plans," one in which the firm announced and later repurchased at least 50 percent of the shares authorized for the program. Completed plans were the focus since many firms announce buyback programs but actually repurchase very little stock; thus, completing a repurchase signals the level of commitment that the underlying firm has to the repurchase program.

Why repurchase shares?

The five most commonly cited reasons to set up a share repurchase program are:

1. *To increase share price*. This is often a strategy that management adopts when it believes the company's stock is undervalued by market analysts.

2. *To rationalize the company's capital structure*. In this case, a share repurchase program allows the company to sustain a higher debt-equity ratio.

3. *To substitute share repurchases for cash dividend payouts*. Since capital gains may be taxed at lower rates than dividend income, a share repurchase program offers long-term shareholders some major tax advantages.

4. *To prevent dilution of earnings*. Share repurchases can enhance a company's growth in earnings per share, or conversely, it can prevent an EPS de-

NET CORPORATE ISSUES vs. The S&P 500 INDEX

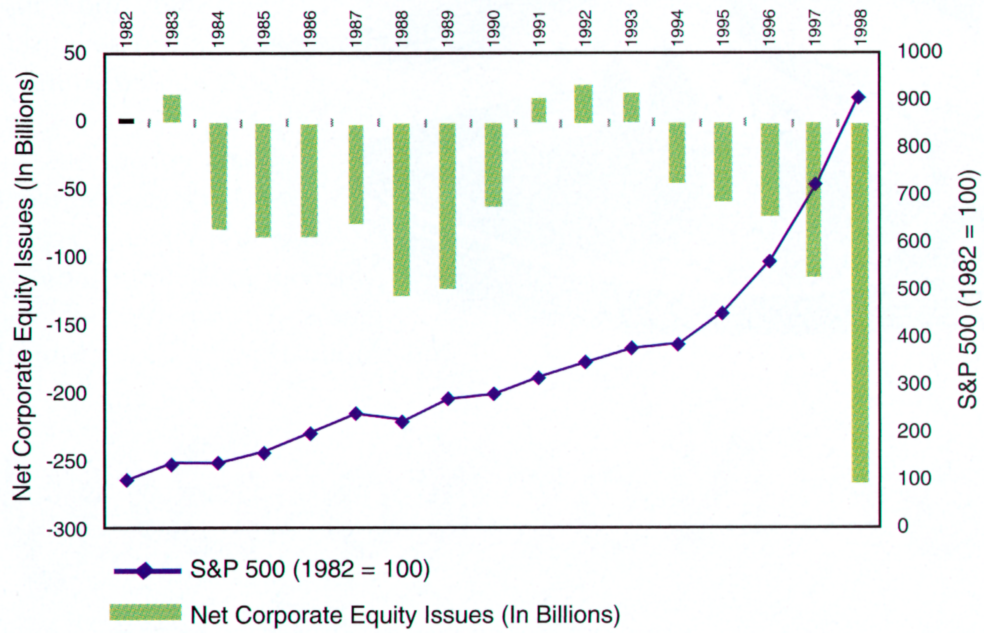

Chart 1 plots summary data on net equity issues by nonfarm, nonfinancial U.S. corporations over the period 1982-98. These data are from Flow of Funds Accounts compiled by the Federal Reserve System. These data indicate that except for the years 1982-83 and 1991-93, corporate share repurchases exceeded corporate equity issues. Moreover, over the 5-year period from1994-98, share repurchases exceeded share issues by increasing amounts each year.

crease that may be caused by exercises of stock option grants.

5. *To deploy excess cash flow*. Stock buybacks can be attractive alternative investments for any cash flow left over once the company has met its capital investment needs.

Companies that want to repurchase shares have several different options. They can conduct open market repurchases, tender offers (both fixed-price and Dutch auction) and privately negotiated repurchases. The scope of the study was restricted to the open-market method, which is by far the predominant avenue.

For the study sample, firms were chosen in a range of industries and market capitalizations. About 48 percent of the sample firms have market caps below $200 million; about 10 percent have market caps in excess of $10 billion; and the remainder range along a continuum. The study comprises 37 different industry sectors, including chemicals, electronics, machinery, appraisal, insurance, entertainment and health care. Repurchases by financial firms and utilities were excluded from the sample.

Four key findings

Among the key findings are those in the areas of shares outstanding, dividend payouts, effect on earnings per share and effect of debt.

1. *Shares Outstanding*: It was discovered that although most companies did repurchase the majority of shares for which they were authorized, these were still a small proportion of the total shares outstanding—about 5 percent. This proportion held true whether the repurchases were measured in terms of numbers of shares or in terms of dollar value.

2. *No substitute for dividend payouts*: The data revealed that companies don't seem to be using share repurchases as a substitute for dividend payments to shareholders. Although dividend payouts are generally smaller for repurchasing firms, as compared to their industry peers, the dividend payout ratios increase once the stock buyback program is over. This finding held true across the entire sample. In addition, both large-cap companies (market value of more than $500 million) and small-cap companies (market value of less than $500 million) reported the same increase in dividend payout ratios.

3. *Effect on earnings per share*: In the three-year period after the repurchase program, the sample companies showed significant increases in EPS growth. But this stepped-up growth rate is even more pronounced for companies in the same industry that don't conduct share repurchase programs. Together, these results imply that the repurchasing firms are effectively closing the gap between their EPS growth rates and those of industry peers that aren't buying back stock.

4. *Effect on debt*: Debt-equity ratios increased by a modest amount for the sample. But it should be pointed out that about 27 percent of the funds used to finance the stock repurchases actually

Considering a Share Repurchase?

Contemplating a buyback? Since decisions to repurchase shares have major consequences for a company's long term strategies, the management team (board of directors and senior management) needs to consider programs in the context of a firm's dividend, capital structure and investment policies. Use the following questions as a starting point for discussion to establish a structure for decision-making.

Dividend Policy

- Does your firm specify a target dividend payout ratio?
- Does your firm maintain a dividend 'pattern'—i.e. steadily rising dividends?

Capital Structure Policy and Investment Policy

- Does your firm maintain a target debt ratio?
- How is your firm's investment and capital expenditure policy specified?
- What's the degree of variation in net capital expenditures from year to year?
- Does maintaining your target payout ratio and/or maintaining your target debt ratio/interest coverage ratio impact your investment plans?

Share Repurchase Programs

- Does your firm have a share repurchase policy?
- What are the key reasons for initiating stock repurchases: (perceived undervaluation of stock; substitution of dividends; affecting leverage ratios, or deploying excess cash flow; enhancing earnings-per-share growth)?

Implementation of Repurchase Programs

- Which repurchase method should your company use?
- Did financial analysts, institutional holders or large block holders have any impact on the share repurchase decision?
- How will repurchases be financed?

Effects of Repurchase Programs

- What do you expect the program to accomplish—over the short (less than one year) and long (between 1 and 3 years) term?
- How would you compare the results of the repurchase program with the objectives?

Share Repurchase Programs and Options Grants

- Does your firm grant options to employees and management?
- Does your firm have an employee stock options program (ESOP)?
- Is your share repurchase program affected by your stock options program?
- How will you "fund" stock options that are exercised?

stem from excess operational cash flow. These are not funds that companies otherwise needed for investments or new product development.

Guidelines for getting going

If your company is considering a stock repurchase plan, you might be wondering whether the program really will rev up your earnings per share growth. According to the data from this study, companies that got the most *bang for their buck* from these plans are those that were under-performing their industry averages to begin with. In the study, these were mostly small-cap firms that also were under-leveraged and less profitable than their respective industry peers. As we all know, market analysts are always comparing companies to their peer group. Many of these companies are certainly solid but, for any number of reasons, simply not doing quite as well as their overall industry. A stock buyback program signals to the market that management won't be funneling any more money into markets or product lines that are dead ends. It also demonstrates that the company isn't hunting around for an acquisition, which analysts don't always view favorably.

As general guidelines, then, it's recommended that companies *repurchase equity* only under these two circumstances: 1) when they have excess debt capacity, and the supply of funds exceeds the demand, and 2) when they're under-performing, in terms of profitability and sales growth rates, relative to their industry's averages.

On the flip side, as you might expect, this means companies should *avoid stock buybacks* under these two circumstances: 1) when they're over-leveraged and sales growth rates exceed industry averages, and 2) when both their profitability and sales growth rates exceed industry averages.

But even companies that have sound reasons for conducting share repurchase programs should not undertake it lightly, nor should they jump on the bandwagon simply because other companies in their peer group are doing it. A share repurchase program must be conducted in strict accordance with federal securities laws to avoid liability for market manipulation or insider trading. Plus, a repurchase program must conform to the safe-harbor Rule 10b-18 of the Securities Exchange Act of 1934. This regulation imposes a volume limit on repurchases and contains a host of other procedural requirements.

For example, a company cannot conduct a share repurchase program at the same time it is engaging in a securities offering. In other words, it cannot buy back shares and issue more at the same time. The company's board of directors must determine that any proposed buy-back program is a sound course of action and that it's in the best interests of shareholders. And, once a company begins implementing a share repurchase plan, it cannot allow buybacks to exceed one quarter of the trading volume of the stock for the prior 30 days. Given the need to plot a careful course, it's strongly advised that a company's corporate legal counsel is consulted before embarking on any share repurchase program.

The value connection

One key to understanding the complex effects of a share repurchase program on a company's profitability is the Shareholder Value Based Management Framework. The SVBM Framework, a variation of the EVA™ model, developed by Stern Stewart & Co., clearly demonstrates that long-term shareholder value is created by the firm's growth and profitability prospects from its product market positions. From that standpoint, share repurchase programs can either create or destroy value, depending on how they affect investor perceptions about the firm's long-term prospects.

The study's findings imply, therefore, that a firm with excellent growth and profitability potential should clearly articulate its reasons for share repurchases because, arguably, the capital committed to the repurchase could be better employed elsewhere. Therefore, without a clearly expressed rationale, the company's decision to conduct a repurchase program could be misinterpreted by investors as a negative signal.

But the converse is also true—stock buyback programs by companies that are doing poorly are seen as a positive sign. That's because investors interpret the repurchases as a welcome return of capital and an indication that management is turning the business around.

The implications for chief financial officers are also profound. The decision to implement a share repurchase program has major implications for the remaining components of shareholder value creation—in fact, a ripple effect. Couching this decision in terms of the SVBM Framework, for example, it's clear that financial executives must start their decision-making by evaluating the demand for investment funds, as determined by the availability of investment opportunities. They also need to look at the supply of investable funds, which is determined primarily by the company's profitability.

When looking at the decision from this perspective, the model clearly shows that you can't think about the components of shareholder value creation separately; they are inextricably linked.

For the CFO, this means that developing and implementing a share repurchase program is no simple task. Conducting a successful stock buyback means that he or she must figure out how to bring the two major aspects of the job—strategy and finance—together in the most effective way possible. No one else has the skills to do this but the CFO, who must be the chief architect of this decision. For certain, share repurchase programs are not a one-size-fits-all proposition. In weighing the decision, CFOs must make certain all the factors that accompany a repurchase program—including the regulatory requirements—ensure the results and the resounding pop companies hope to achieve.

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