CREDO
WEALTH

Mixed Signals

When a company generates profits, it then has a choice as to how to use the cash. Sometimes the company is able to re-deploy cash into organic growth opportunities, writing more insurance business, building a new factory or venue, purchasing new equipment or developing new products or technologies. On the other hand, sometimes it makes more sense to buy other businesses. This may take the form of buying a small business to plug into the existing larger network, creating a roll-up story or alternatively fewer larger acquisitions. Whether through acquisitions or organic growth, for companies with ample growth opportunities ahead of them, the increased profit generated by the larger business can also be reinvested and thus earnings are compounded. However, for either of these options to be an attractive choice there must exist the opportunity to reinvest these profits at attractive returns.

However, if a company is generating cash in excess of what is required to fund future growth or the returns available from re-investing are not sufficiently attractive, a further option is to return cash to shareholders. This can either be in the form of dividends or buying back its own stock. Historically dividends were the preferred method of distribution of cash. However, in the USA, since 1997 the total value of cash deployed into share buybacks has exceeded the total value of cash dividends paid. Furthermore, the proportion of companies with share buyback programmes increased from 28% to 53% between 1980 and 2018. There are multiple reasons why this is, including favourable tax treatment of capital gains vs. dividends for investors and greater financial flexibility for management. Investors have a history of generally reacting less badly to postponements or cancellations of buyback programs as compared to dividend cuts. In addition, share buybacks have long been considered a way for management to signal that they believe the company's shares to be undervalued and communicate confidence in the future prospects for the business.

From an investor's perspective, share buyback programs are an important factor to consider when calculating the potential return which can be achieved by owning shares in a company. When a company repurchases its own shares, the number of shares outstanding falls and therefore, the earnings per share increase as a result of the lower denominator in the equation. In some cases, this can provide a significant boost to earnings growth. Provided that investors still believe that the company should trade at the same valuation, the higher earnings per share number can then also translate into share price appreciation. In addition, reducing the number of shares in issue whilst also increasing demand can also be supportive of share prices in the short term.

An important nuance to this is that we should consider both share buyback programs and stock- based compensation in tandem since often the companies which are buying back the most stock, for example the Tech giants, are also those which issue the most stock to employees. Therefore, the net share count reduction is the number to consider.

The impact of share buybacks is also dependent on the price at which the stock is able to be purchased. High valuations mean that fewer shares can be bought with the same amount of cash and so for companies trading at low valuations, but which generate significant amounts of cash, the impact on earnings per share can be much greater. ▶▶

This year US companies have announced record levels of share buybacks. $870bn of repurchases have been authorised so far, which is $50bn higher than the previous highest record, set in 2018, and almost three times the value in 2020. As business confidence improves with the economy recovering from the pandemic, companies are starting to return some of the cash raised during the downturn last year. At the height of the pandemic, many companies raised significant amounts of cash to ensure they had sufficient funds to get through the economic shutdown. However, with the recovery now well underway, many have refinanced this debt at low rates and are thus choosing to return the cash to shareholders through buyback programmes.

Whilst perhaps not the most exciting part of investing, share buybacks have become an increasingly important element of equity returns. For stocks such as Wells Fargo, HCA Healthcare and Northrop Grumman, each trading at relatively low valuation multiples, they represent a substantial portion of the expected return, we as investors could receive.

It is worth questioning what management are telling us by authorising such vast amounts of share buybacks now. Are the expected returns of future growth projects so poor that buying their own stock is more attractive? Buybacks also accelerated significantly in 2006 and 2007. Alternatively, are management signalling their confidence and optimism about the future of their existing businesses? Food for thought. ■

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