ADVISOR PERSPECTIVES

The Shocking Truth About Share Buybacks

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of F.A.S.T. Graphs

The value and benefits, or lack thereof, of share buybacks to the future fortunes of a company and their shareholders is one of the most hotly debated subjects on popular financial blogs such as Seeking Alpha. Unfortunately, at least based on my own personal experience, most of the arguments are predicated on opinions and beliefs in lieu of the facts.

Consequently, the primary thesis behind this article is to provide a more fact-based discussion regarding the desirability of share buybacks devoid of emotional or opinionated arguments. Stated more directly, my objective will be to answer the question posed in the title of this article: to buy back shares, or to not buy back shares, that is the question.

My Inspiration Was Not Positively Instigated

My inspiration for penning this article, which I feel was long overdue, came as a result of a loyal reader of my work sharing a rather one-sided, prejudicial and opinionated article on share buybacks that he/she read on MorningStarAdvisor. The article was authored by Rex Nutting of MarketWatch on April 24, 2015 with the provocative title "Update: How the Stock Market Destroyed the Middle Class." From my perspective, this article represents a classic example of an opinionated and prejudiced argument lacking a factual representation as evidenced by the following provoking excerpt:

"But one under-appreciated factor is a pervasive business model that encourages top managers of American corporations to loot their company for short-term gains, depriving those companies of the funds they need to build and enlarge, and invest in their workers for the long haul.

How do they loot their company? By using large stock buybacks to manage the short-term objectives that trigger higher compensation for themselves. By using those stock buybacks to manipulate the share price, which allows them to use inside information to time their own stock sales. By using buybacks to funnel most of the company's profits back to shareholders (including themselves). They use the stock market to loot their companies."

In my opinion (pun intended) this article clearly expressed the author's negative and prejudiced opinion and view of share buybacks while simultaneously alleging that they are destructive to the economy and the middle class. There were facts presented, and I'm going to accept that they were accurate; however, I do not accept the fact that they supported his economic destruction thesis. The reader can form their own opinions by following this link to the entire article found here.

The truth is that share buybacks are neither good nor bad in their own right. Under certain circumstances and in certain instances, share buybacks can be a very bad or poor use of corporate capital. Under other circumstances and instances, share buybacks can be the most prudent and beneficial use of corporate capital. Therefore, prejudging all share buybacks as bad or destructive is just as wrong as holding prejudiced views or judgment about people based on race, creed or color.

When Share Buybacks Are Good and When They Are Bad

In his 2011 letter to shareholders of Berkshire Hathaway, renowned investor Warren Buffett wrote extensively on his and partner Charlie Munger's position on share buybacks. Here is a link to the full letter, but what follows are a few important excerpts that relate to the subject of this article:

"Charlie and I favor repurchases when two conditions are met: first, a company has ample funds to take care of the operational and liquidity needs of its business; second, its stock is selling at a material discount to the company's intrinsic business value, conservatively calculated."

Personally, I believe that Warren Buffett succinctly hit the nail on the head with this one sentence. However, the first condition can be very difficult to accurately assess, and admittedly open to some debate. On the other hand, that is not to say that it cannot be properly evaluated, it just takes a little work and digging under the hood of a company, the competitive landscape of its industry and its business model to correctly ascertain.

The second condition is easier to determine and evaluate, and represents the primary financial subject that I have dedicated my professional life to-sound valuation. It is a prudent, sound and long-term profitable tactic when a company can repurchase shares at sound and attractive valuations. In contrast, share repurchases can represent a very unsatisfactory and destructive use of capital when valuations are unsound or high. In the same letter, Warren Buffett had this to add on the subject:

"We have witnessed many bouts of repurchasing that failed our second test. Sometimes, of course, infractions – even serious ones – are innocent; many CEOs never stop believing their stock is cheap. In other instances, a less benign conclusion seems warranted. It doesn't suffice to say that repurchases are being made to offset the dilution from stock issuances or simply because a company has excess cash. Continuing shareholders are *hurt* unless shares are purchased below intrinsic value. The first law of capital allocation – whether the money is slated for acquisitions or share repurchases – is that what is smart at one price is dumb at another. (One CEO who always stresses the price/value factor in repurchase decisions is Jamie Dimon at J.P. Morgan; I recommend that you read his annual letter.)"

Interestingly, Warren Buffett then went on to use one of his large holdings, International Business Machine (IBM), as his example to illustrate his points more comprehensively. I found this interesting for a couple of reasons. First of all, because I am also long IBM, and because I authored two articles on the company found here and here that created quite a stir and large and lively comment threads.

The second reason I found this interesting, is based on the date in which Warren Buffett made the comments (his 2011 letter) and the subsequent corresponding share buyback behavior of IBM's management team. Next I will share Warren Buffett's comments on IBM and its management relative to their share repurchases behavior, and then I will provide factual evidence utilizing the F.A.S.T. Graphs™ fundamentals analyzer software tool to provide supporting evidence of the veracity of his words.

"Let's use IBM as an example. As all business observers know, CEOs Lou Gerstner and Sam Palmisano did a superb job in moving IBM from near-bankruptcy twenty years ago to its prominence today. Their operational accomplishments were truly extraordinary. But their financial management was equally brilliant, particularly in recent years as the company's financial flexibility improved. Indeed, I can think of no major company that has had better financial management, a skill that has materially increased the gains enjoyed by IBM shareholders. The company has used debt wisely, made value-adding acquisitions almost exclusively for cash and aggressively repurchased its own stock.

Today, IBM has 1.16 billion shares outstanding, of which we own about 63.9 million or 5.5%. Naturally, what happens to the company's earnings over the next five years is of enormous importance to us. Beyond that, the company will likely spend $50 billion or so in those years to repurchase shares. Our quiz for the day: What should a long-term shareholder, such as Berkshire, cheer for during that period?

I won't keep you in suspense. We should wish for IBM's stock price to*languish* throughout the five years.

Let's do the math. If IBM's stock price averages, say, $200 during the period, the company will acquire 250 million shares for its $50 billion. There would consequently be 910 million shares outstanding, and we would own about 7% of the company. If the stock conversely sells for an average of $300 during the five-year period, IBM will acquire only 167 million shares. That would leave about 990 million shares outstanding after five years, of which we would own 6.5%.

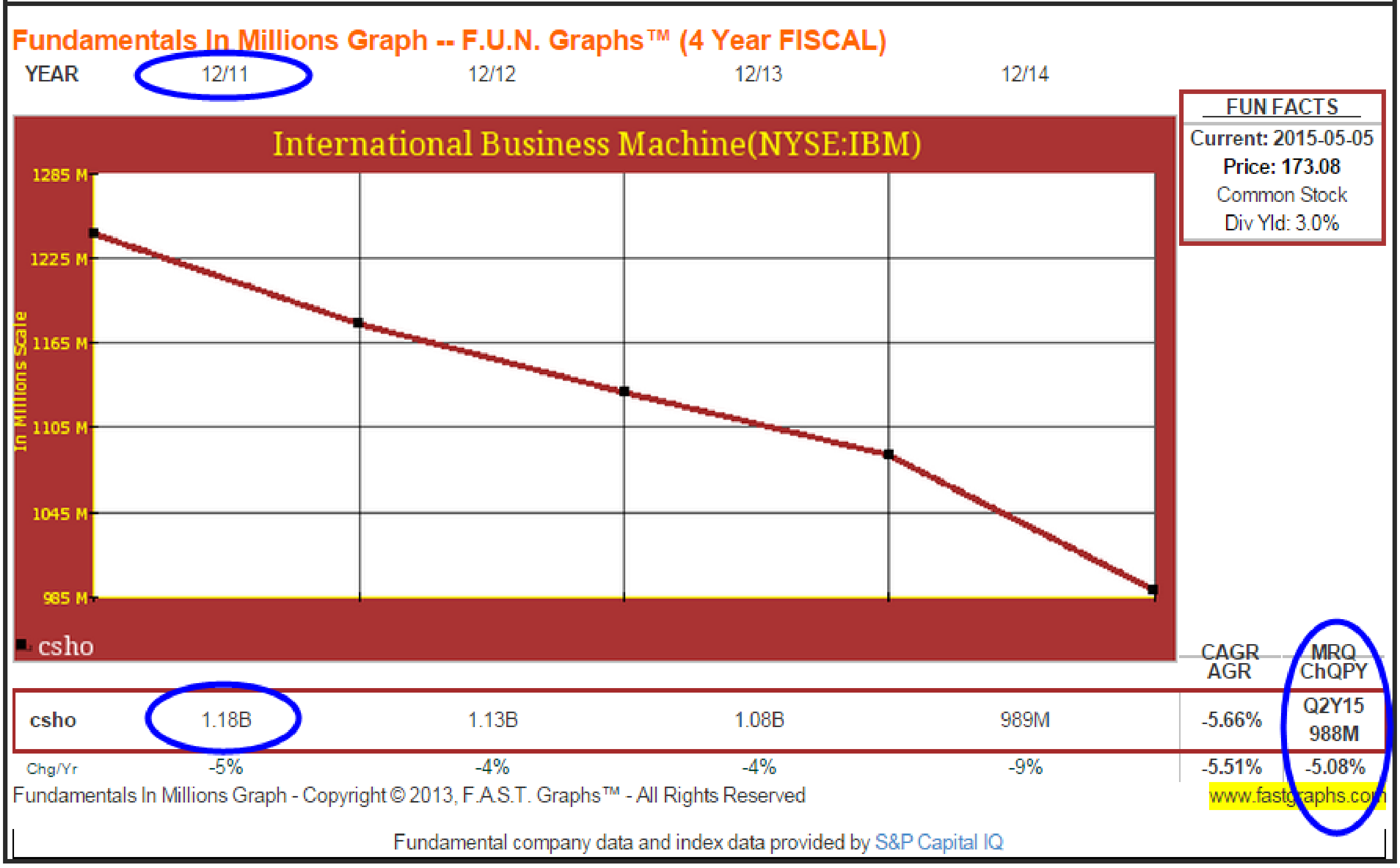
If IBM were to earn, say, $20 billion in the fifth year, our share of those earnings would be a full $100 million greater under the "disappointing" scenario of a lower stock price than they would have been at the higher price. At some later point our shares would be worth perhaps $1 1⁄2 billion more (1 ½ billion dollars) than if the "high-price" repurchase scenario had taken place.

The logic is simple: If you are going to be a net buyer of stocks in the future, either directly with your own money or indirectly (through your ownership of a company that is repurchasing shares), you are *hurt* when stocks rise. You benefit when stocks swoon. *Emotions*, however, too often complicate the matter: Most people, including those who will be net buyers in the future, take comfort in seeing stock prices advance. These shareholders resemble a commuter who rejoices after the price of gas increases, simply because his tank contains a day's supply."

Warren Buffett's Math Was Correct

I find it fascinating, but not surprising, that Warren Buffett's math in 2011 was prophetic and almost precisely correct. As it turns out, his statement that it would leave about 990 shares outstanding after five years came out almost exactly as he prophesies. As the following FUN Graph (fundamental underlying numbers) illustrates, IBM had 988 million shares outstanding at the end of its second fiscal quarter 2015.

Common Shares Outstanding (csho)

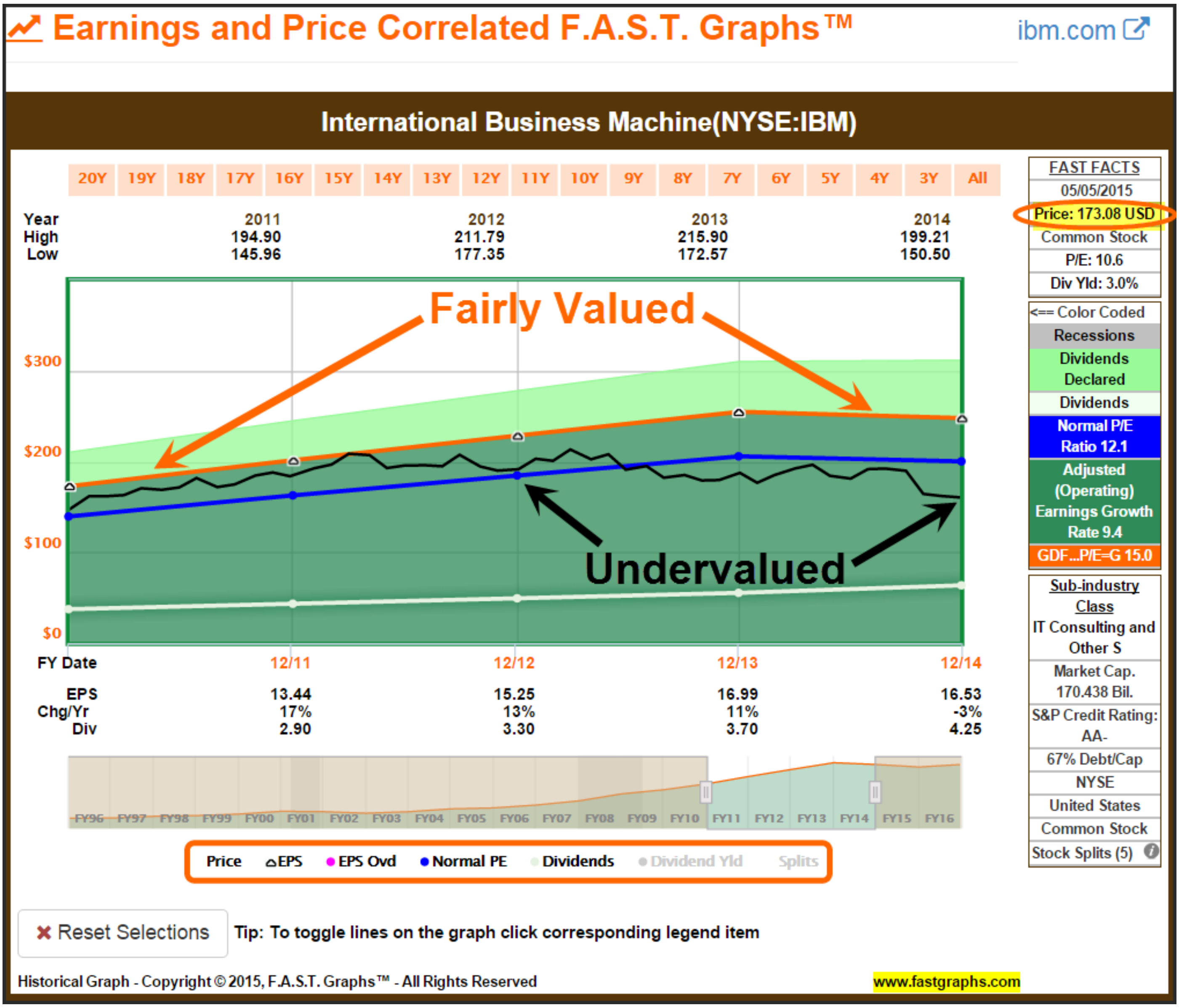


Warren Buffett's Wishes Were Fulfilled

Regarding the price action that he hoped for, his wishes were fulfilled and then some. Here is what he hoped for:

"Charlie and I don't expect to win many of you over to our way of thinking – we've observed enough human behavior to know the futility of that – but we do want you to be aware of our personal calculus. And here a confession is in order: In my early days I, too, rejoiced when the market rose. Then I read Chapter Eight of Ben Graham's *The Intelligent Investor*, the chapter dealing with how investors should view fluctuations in stock prices. Immediately the scales fell from my eyes, and low prices became my friend. Picking up that book was one of the luckiest moments in my life."

Since 2011 IBM's stock price has languished between the $175-$200 range since he made his wish, he and partner Charlie should be quite happy. The following earnings and price correlated F.A.S.T. Graphs™ on IBM since 2011 illustrates the undervaluation that supported their share repurchase activity.

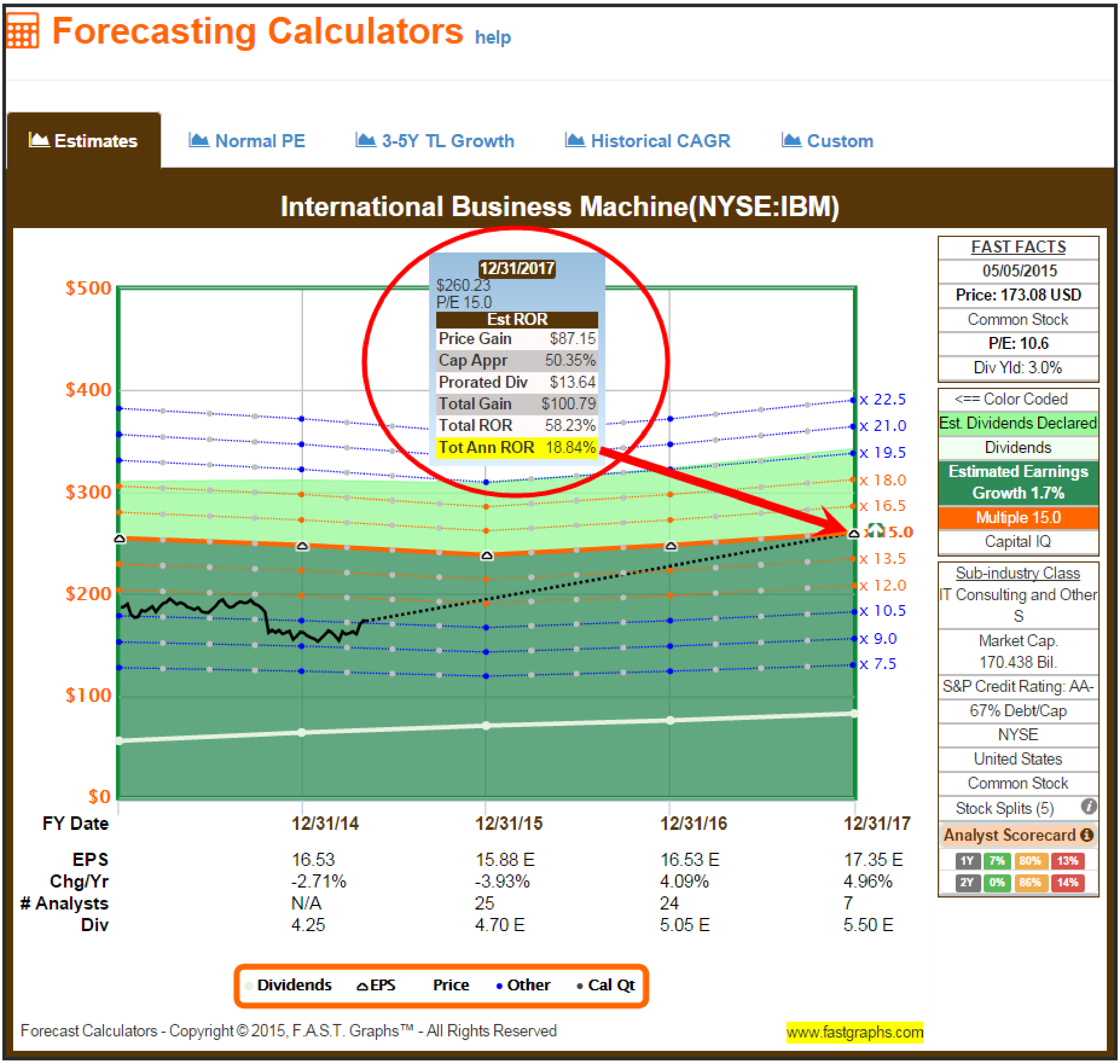


Intermediate Consensus Estimates for IBM

Later in that same letter, Warren Buffett went on to point out that his investment in IBM will be determined primarily by its future earnings as follows:

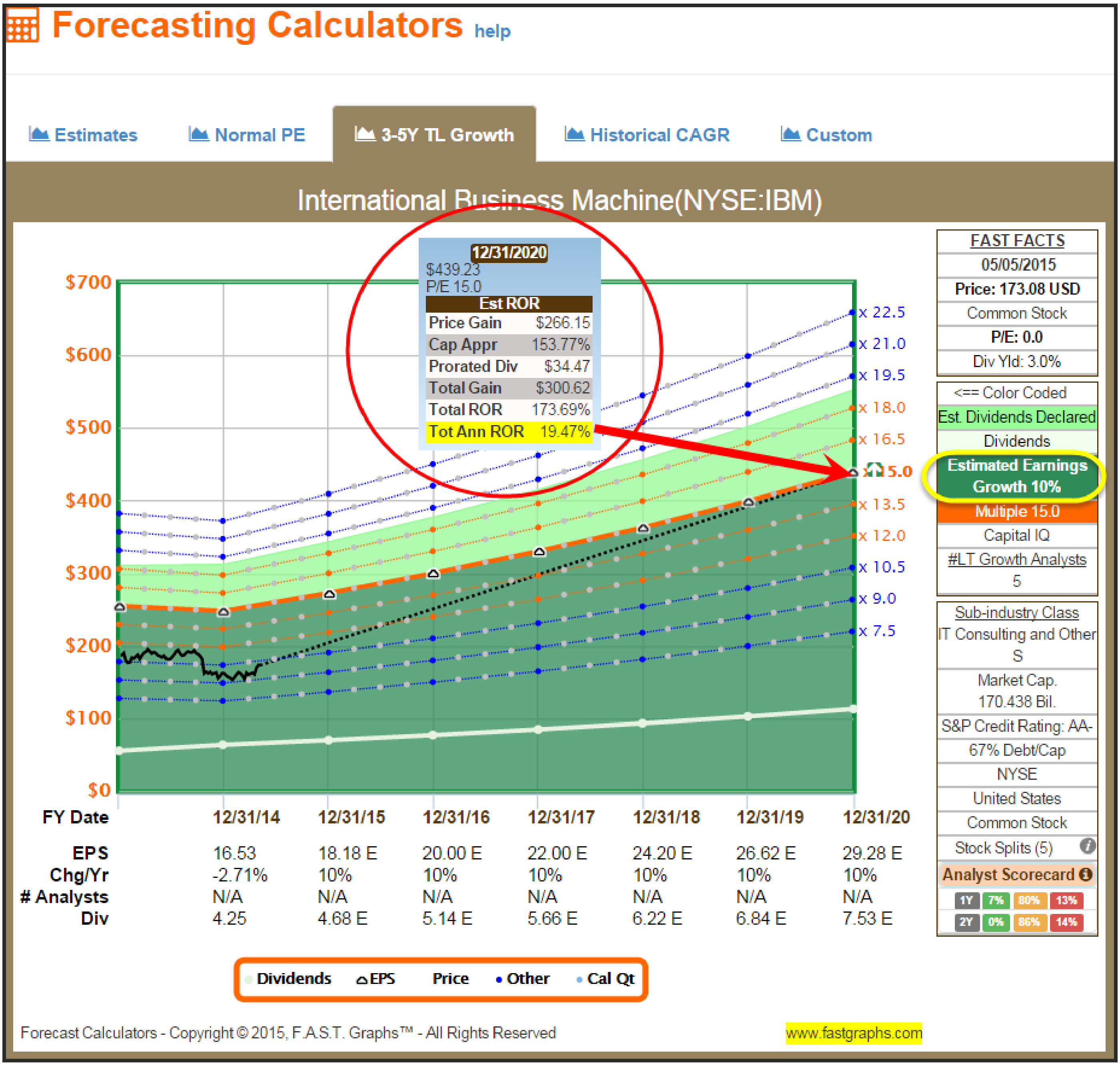
“In the end, the success of our IBM investment will be determined primarily by its future earnings. But an important secondary factor will be how many shares the company purchases with the substantial sums it is likely to devote to this activity. And if repurchases ever reduce the IBM shares outstanding to 63.9 million, I will abandon my famed frugality and give Berkshire employees a paid holiday.”

The following “Forecasting Calculator” based on consensus intermediate-term earnings estimates for IBM represents an attractive opportunity out to year-end 2017.



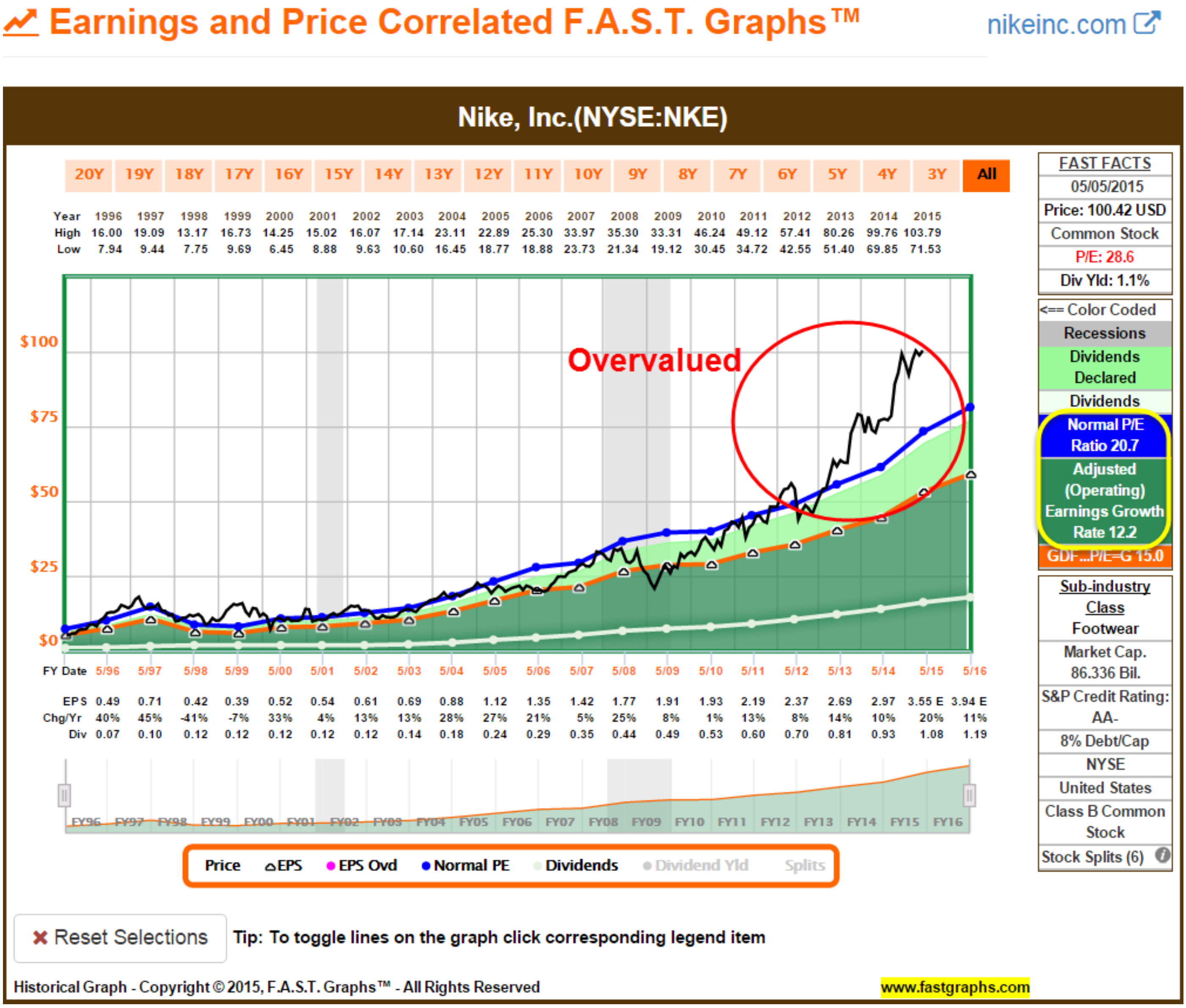
Long-Term (3 to 5 Year) Consensus Estimates for IBM

Since Warren Buffett understands that his future returns will be a function of future earnings growth, the longer-term (3-5 year) consensus trend line earnings growth rate for IBM is even more promising. It seems logical to me that if IBM comes close to meeting those earnings estimates, then the combination of potential P/E ratio expansion and earnings growth promise to be quite rewarding.

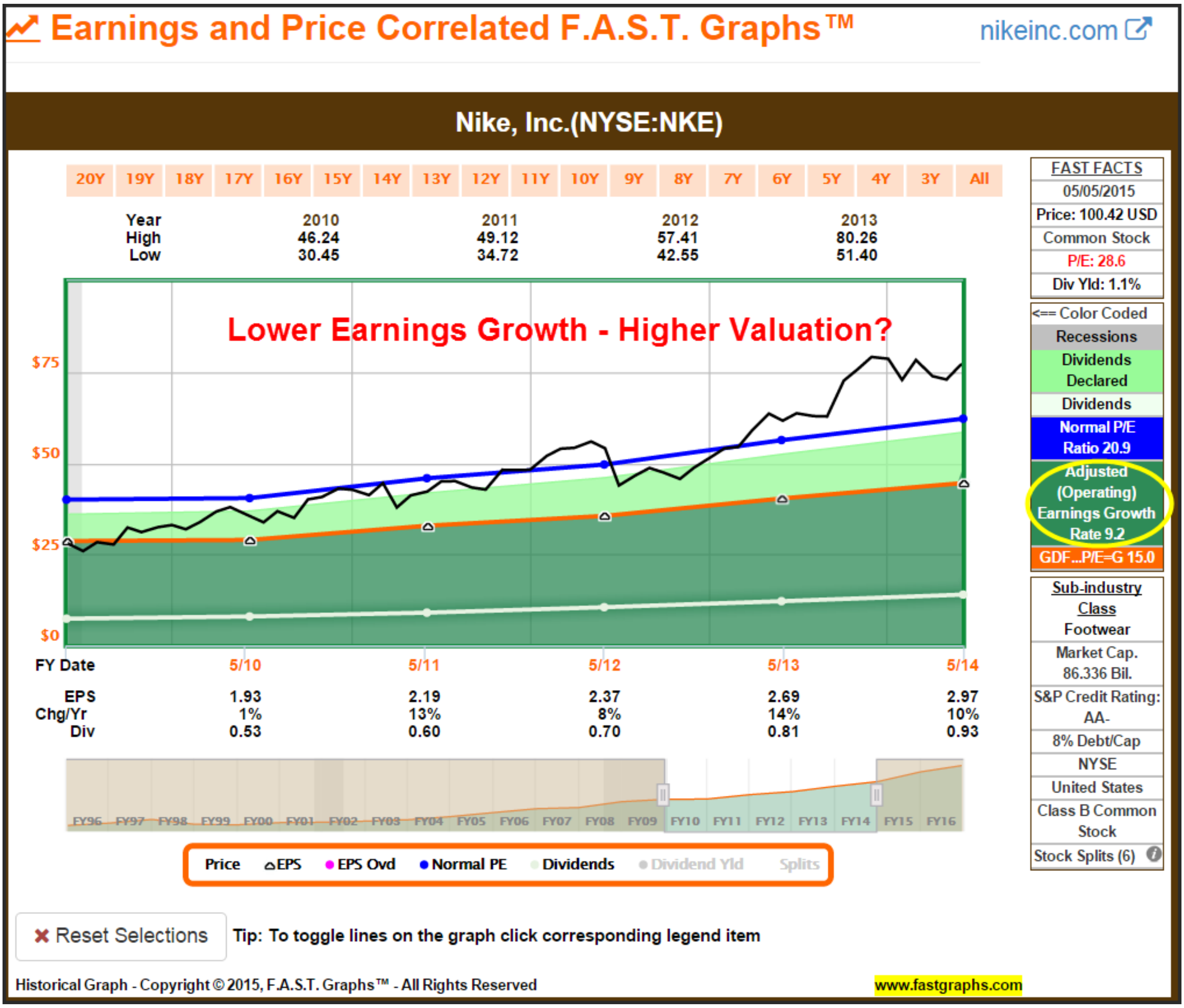


Two High Valuation Cases Where Share Buybacks May Be Imprudent: Nike and McDonalds

There are two other high profile companies that have been aggressively buying back their shares, they are Nike (NKE) and McDonald's (MCD). With the first example, Nike, there are a couple of facts that should clearly support current overvaluation. First of all, Nike grew earnings at the strong rate of 12.2% since 1996. But more importantly, the company's stock price rarely traded above a P/E ratio of 20 (the dark blue line on the graph) over that timeframe. However, since the beginning of 2013, Nike's stock price has continuously traded at a P/E ratio valuation significantly above the long-term norm.



What is really both amazing and confusing about Nike's recent high valuation is the fact that its earnings growth rate has actually fallen dramatically to 9.2% since fiscal year 2009 (May). Clearly, Nike's stock has become popular, but that popularity is not clearly supported by any surge or acceleration in its operating results.



Nevertheless, in spite of Nike's current high valuation, management has been aggressively repurchasing shares outstanding. The share count has fallen from 948 million in fiscal year 2010, to only 863 million during their last quarter. If Nike's stock price were to revert to the mean, as logic would indicate it should, then significant shareholder capital would be destroyed. Consequently, where I would give IBM a high grade on their buyback program, I would give Nike a very low grade, and potentially even a failing grade.

My second example looks at McDonald's, who also has been repurchasing shares at a high valuation. However, in this case, I believe the argument could be made that McDonald's and its shareholders would be better served investing capital directly in their business. Their recently announced turnaround plan somewhat supports my contention.

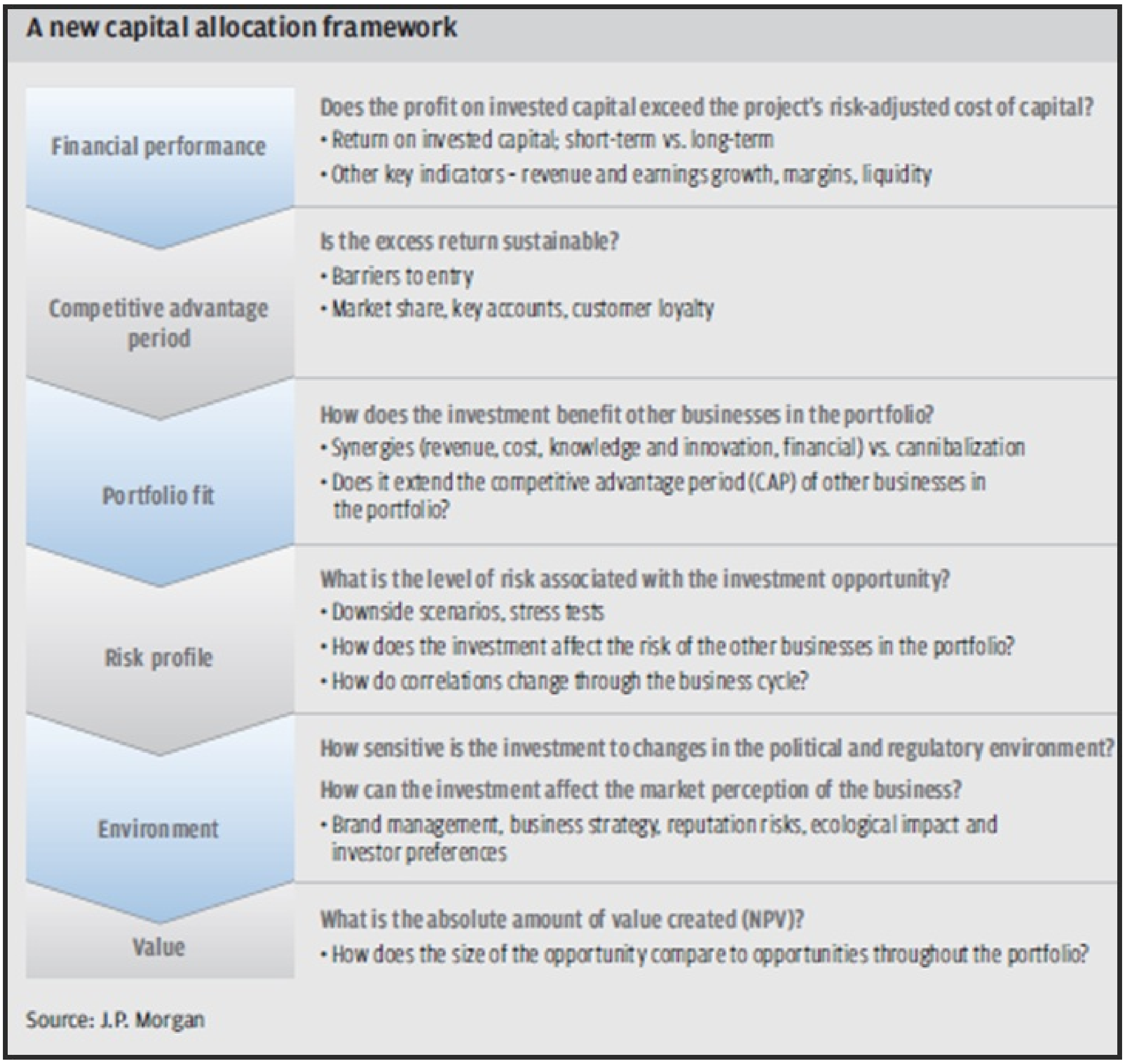
Just as I did with Nike, the following earnings and price correlated graph followed by McDonald's share repurchase activity supports my contention. Once again, we see a case where management may be misguided by purchasing shares when valuations are high. Especially considering the fact that this company may, in fact, require capital investment in order to right their ship.

Determining Effective Capital Allocation – Invest or Buyback

Sound and effective capital allocation strategies and behaviors are complex. I would argue that it is naïve to believe that corporations can simply throw money at their company in order to stimulate or instigate greater growth. Consequently, when companies do not have investment opportunities that are greater than their cost of capital, it is both prudent and rational for them to return cash to the shareholders.

The two primary methods of returning cash to the shareholder are through share repurchases and/or dividends. When a company needs their capital to grow, they should retain more capital and invest accordingly. However, as companies become large and mature, investment opportunities that will improve the growth of their businesses decrease. Consequently, it is common that management teams of large and mature companies do not require retaining all their earnings to fund growth or maintain their businesses.

On October, 2009 J.P. Morgan published a report titled 'Creating Value through Best in Class Capital Allocation' and in that report they presented a new capital allocation framework that provides insights into the complexity that corporations face when deciding how to best utilize their capital as follows:



In 2007 a paper was published in the Journal of Applied Corporate Finance that provided additional insights into the challenges facing corporate management teams and directors for analyzing capital allocation strategies that create shareholder value. The following are a few excerpts that are appropriate to the thesis of this article:

"In this article, I begin by presenting a relatively simple life-cycle valuation model that is rooted in both discounted cash flow (DCF) principles and the economic concept of competitive corporate life-cycles. Then, with the aim of grounding corporate governance in sound principles of value creation, I recommend that corporate boards undertake a dialogue with management about the content of a periodic Shareholder Value Review (SVR). Although mutual agreement is expected, the board must insist that management respond to the board's oversight authority.

The Life-Cycle Valuation Model

Ever since Miller and Modigliani published their explanation of how discounted cash flow (DCF) principles can be used to value a firm, DCF has been at the core of much valuation modeling. Broadly speaking, DCF says that the value of a firm is the sum of its future expected stream of net cash receipts (operating cash flows less cash outlays for reinvestment) discounted to a present value at the firm's cost of capital.

When investors expect a company to achieve returns on future investments that are just equal to the cost of capital, those new investments create zero additional economic wealth—in which case, the firm's total market value would be roughly equal to the value of its existing assets. To the extent investors expect returns on future investments to be greater than the cost of capital, those investments will create value; and to the extent returns are expected to fall below this standard, value will be destroyed.

Moreover, for companies where future investments are expected to earn returns above the cost of capital, greater wealth is created when more capital is invested, especially when such wealth-creating opportunities can be extended farther into the future. In this sense, a company's current value depends on *competitive life-cycle* patterns that reflect expected future economic returns and reinvestment rates.

As illustrated in Figure 1, the idea of competitive life cycles is based on the premise that competition and capital flows operate over the longer term to force companies' economic returns toward the cost of capital. This relationship was succinctly summarized by George Stigler in 1963, when he wrote:

There is no more important proposition in economic theory than that, under competition, the rate of return on investment tends toward equality in all industries. Entrepreneurs will seek to leave relatively unprofitable industries and enter relatively profitable industries."

The primary point being, that as corporations become big and mature, it becomes exceedingly difficult to find suitable places to invest their capital that will in actuality create shareholder value. The following "Corporate Competitive Life-cycle" graphic from the above paper presents a simplified model of this phenomenon.

Summary and Conclusions

Share buybacks are neither good nor bad, because in reality they can be either or both. When a company's stock is being highly valued by the market, buying back shares at those high valuations can lead to long-term shareholder capital destruction. The rules and principles of only investing when valuation is sound equally apply to the corporation as it does individual investors. If it's a bad idea for us to invest in a stock at a high valuation, it's also a bad idea for the company to behave that way.

On the other hand, when valuations are sound, or better yet, excessively low, the best investment opportunity a company may have is to invest in their own stock. Therefore, we as investors should not hold a prejudicial view of share buybacks. Instead, we should evaluate and judge a company's share buyback policy on an individual case-by-case basis. Prejudging anything in the general sense is both illogical and wrong.

Furthermore, as it is with all matters regarding investing, decisions should always be driven by a rigorous factual based analysis. There is no room, nor should there be, for opinion or broad prejudicial generalizations. Clearly the answer to the question whether a company should buy back their shares or not can simply be stated as - it depends.

Disclosure: Long IBM, MCD at the time of writing.