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The Pros and Cons of Stock Buybacks

If done right, share repurchases can create more value for stockholders. But how often are they done right?

By MAXWELL MURPHY

As share buybacks climb toward record, prerecession levels, the debate over the tactic is heating up.

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Companies sitting on piles of cash are under increasing pressure to return that value to shareholders, but are buybacks the best way to do that? Or should companies raise dividends, use the money for acquisitions or invest it in their business instead?

We invited two Wall Street personalities with strong views on the issue to participate in an email discussion of the merits and drawbacks of stock buybacks.

Whitney R. Tilson is the founder and managing partner of T2 Partners LLC, a New York hedge fund, and an outspoken proponent of share repurchases.

Gregory V. Milano is the co-founder and chief executive of Fortuna Advisors LLC, a corporate-finance consulting firm based in New York, who rarely encounters a buyback he considers the best use of a company's cash.

Here are edited excerpts of their discussion.

Crowding Out

WSJ: Mr. Milano, why you do think buybacks are so often a bad idea?

MR. MILANO: Though some are successful with share repurchases, the evidence overwhelmingly shows that heavy buyback companies usually create less value for shareholders over time.

Many managements have become so infatuated with how buybacks increase earnings per share that these distributions are crowding out sound business investments that create more value over time.

In one study, those that reinvested a higher percentage of their cash generation into capital expenditures, research and development, cash acquisitions and working capital delivered substantially higher total shareholder return than those that reinvested less.

Fortuna Advisors

'The evidence shows that heavy buyback companies usually create less value for shareholders over time.' — Gregory V. Milano

The problem with buybacks is considerably compounded by poor timing: the propensity to buy when the price is high and not when it's low. A measure called buyback effectiveness compares the buyback return on investment to total shareholder return, and indicates whether the company buys low or high relative to the share price trend. From 2008 through mid 2011, nearly two out of three companies in the S&P 500 had negative buyback effectiveness.

Most academic research shows that share prices typically increase when buybacks are announced, which benefits short-term owners. For those interested in long-term value creation, which should be the focus of managements and boards, the evidence convincingly shows that buybacks usually do not help.

WSJ: Mr. Tilson, what makes buybacks work for investors, rather than against them?

MR. TILSON: I agree with Greg that most companies do not think or act sensibly regarding share repurchases and therefore end up destroying value.

T2 Partners LLC

'Share repurchases, like acquisitions, can create enormous long-term shareholder value if done properly.' — Whitney R. Tilson

It never ceases to amaze me—and, when a company we own does the wrong thing, infuriate me—how few companies think sensibly about this topic and thus buy back stock for all the wrong reasons: to prop up the price, signal "confidence," offset options dilution, etc.

But the same could be said of acquisitions, and does anyone believe that all acquisitions are bad? Share repurchases, like acquisitions, can create enormous long-term shareholder value if done properly.

Warren Buffett, in his 1999 letter to Berkshire Hathaway shareholders, perfectly captures the key elements of a smart share repurchase program:

"There is only one combination of facts that makes it advisable for a company to repurchase its shares: First, the company has available funds—cash plus sensible borrowing capacity—beyond the near-term needs of the business and, second, finds its stock selling in the market below its intrinsic value, conservatively calculated."

In other words, once a business has a strong balance sheet, then it should first take its excess cash/cash flow and reinvest in its own business—if (and only if) it can generate high rates of return on such investment.

Then, if it still has cash/cash flow left over, it should return it to shareholders, who are, after all, the owners of the business—it's their cash. But this raises the question of whether cash should be returned via dividends or share repurchases.

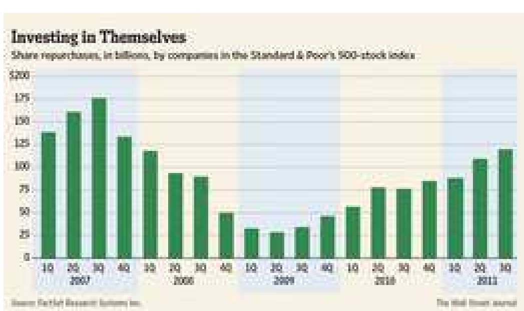
That depends on the price of the stock versus its intrinsic value.

My rule of thumb is that if the stock is trading within 20% of fair value, then the company should use dividends; if it's trading at greater than a 20% discount, buybacks. If it's trading at a big premium to fair value, then the company should issue stock, via compensation to employees, a secondary offering and/or as an acquisition currency.

Getting It Wrong

MR. MILANO: I agree with the Warren Buffett quote completely, and Whitney's view on how often managements get it wrong is really one of my main principles.

As an investment banker at Credit Suisse in 2007 I visited scores of companies to explain that their share prices were so high that the expectations they needed to achieve just to justify their price, let alone grow it, were unrealistic in a world where we experience the ups and downs of business cycles. I suggested they use convertible-debt financing to fund their growth.



Many of them rebuffed me, saying in fact their share prices weren't high enough, and instead of taking my advice they bought back shares. In total the S&P 500 members repurchased over $500 billion of their own shares that year, while most of them hit record highs.

As a whole, we humans haven't learned much about buying low and selling high since the tulip mania. For many, the effectiveness of buybacks would be better if they simply acquired the same dollar value of shares every quarter. They would buy somewhat more shares when the price is low than when it's high, which would be far better than what most companies accomplish today.

The problem, though, is broader than the simple conclusion that managements often overestimate the value of their companies—there are fundamental defects with most overall capital-deployment strategies.

Many believe capital deployment should follow a "pecking-order theory" that prescribes that managements should apply their cash flow, in order of priority, to fix their balance sheet if overleveraged, fund organic investments, pay dividends, fund acquisitive growth and, only when there is additional cash left over, to distribute it via share repurchases. While this may seem theoretically sensible, in practice it leads to buying back more shares when the market value has increased significantly in response to stronger cash flows.

Sometimes it may be best for companies to hoard cash at the top of the stock-market cycle and use it in the next trough to buy back shares at a discount.

Whitney mentions acquisitions. There are countless studies of mergers and acquisitions showing that in the days surrounding acquisition announcements the share price of the buyer usually declines. These short-term "announcement studies" are often cited as evidence that acquisitions destroy value for the acquiring firm. But they typically examine shareholder reactions over a few days or weeks and assume the immediate reaction is correct over time, at least on average.

In fact, acquisitive companies tend to suffer declining share prices in the near term and rising prices over the longer term.

Interestingly, share repurchases present the converse situation, in which share prices tend to rise when the repurchase is announced, yet companies executing heavy buybacks tend to underperform over the longer term. These two uses of capital are viewed and rewarded very differently for the short-term investor versus the long-term investor.

WSJ: Mr. Tilson, do you disagree with Mr. Milano's assessment of acquisitions?

MR. TILSON: I don't have the research at my fingertips, but I know I've read about numerous studies showing that, on average, acquirers overpay and thereby destroy long-term shareholder value about two-thirds of the time.

MR. MILANO: There have no doubt been many bad acquisitions over the years, but the studies most people quote are "event" studies that merely check the share price reaction to the announcements rather than examining results over time.

Over time, most frequent acquirers outperform the market.

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