Share Buybacks Are Corporate Suicide

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When firms invest too heavily in buying back shares, there is likely to be trouble ahead.

The revival of supply-side economics, exacerbated by the election of U.S. President Donald Trump and his promises of pro-business reforms, is doing little to increase the rate of economic growth and improve returns for long-term investors, such as pension funds. In fact, the current management love affair with share buybacks is having quite the opposite effect.

At first glance, stock buybacks may seem a good way to enhance value for the shareholders. By reducing the number of shares outstanding, firms can hike up their earnings per share and inflate share price, to the benefit of hedge funds and other short-term investors. Other winners are top corporate managers who are allocated a large proportion of their pay through stock-based instruments and receive bonuses triggered by a rise in the share price. If things look solid, long-term investors may have no problem with this, but what if the money spent on buybacks is money that would otherwise be spent on new product development and innovation? Worse, what if that money is borrowed?

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Buybacks affect a firm’s ability to survive and grow

When share repurchases increase debt and reduce spending on innovation and R&D it directly affects a firm’s long-term ability to survive and grow in a disruptive and uncertain business environment. Meanwhile, the question arises: What happens to the money that is "returned" to shareholders by share buybacks? Economic theorists suppose that this money will be re-invested in more promising opportunities. What seems certain is that much of the money will be ploughed into ever-riskier investments in the search for even higher returns. We suspect that much of the money spent on buybacks by established "mature" companies has created a stock market bubble in **FAANG** stocks (and others) where conventional PE ratios no longer restrain investors in search of growth.

Buybacks and a decline in market value

To get a better understanding of the impact of buybacks, we set out to compare the performance of companies that rely heavily on repurchasing shares with those that do not. Our study, **"Secular Stagnation"**, examined 1,839 public companies in the United States over a five-year time-scale. We found that the more money a firm spends on buybacks, the less likely it is to grow over the long-term. In fact, as the chart below makes clear, we discovered that not only do buybacks not lead to growth in a company’s market value, they are strongly correlated to a declining market value.

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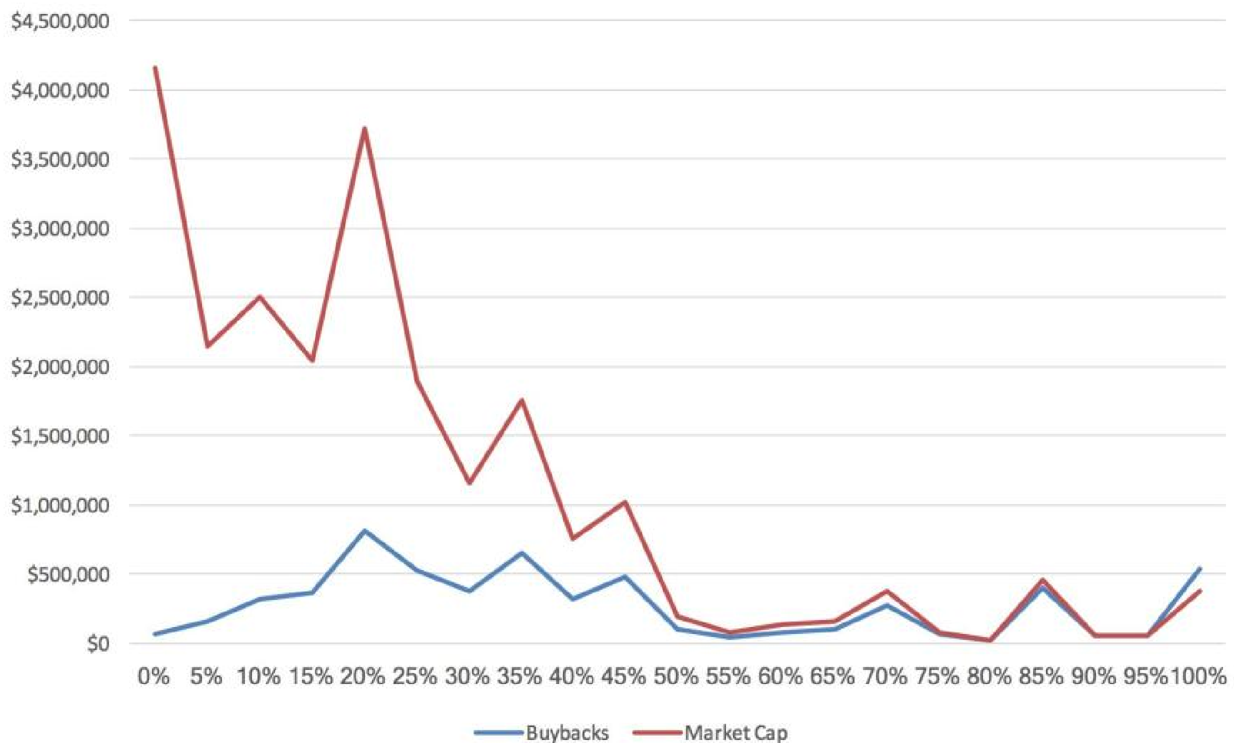

There are many high profile examples of the impact of excessive buybacks at the expense of healthier re-investment. Take IBM Corp, which has spent US$125 billion on buybacks since 2005, and $32 billion on dividends, while laying off large numbers of employees and investing only $69.9 billion in R&D. We wonder: What If the 20th century computer giant had spent a lot less money on share buybacks and more on pre-empting the innovations stemming from its nimbler competitors in Silicon Valley?

General Electric is another case in point. The world is electrifying, but without GE. It repurchased US$114.6 billion of its own stock and by the end of the first quarter of 2016 had a market capitalisation of $253.25 billion, a ratio of 45 percent. Its stock underperformed both on the S&P 500 and in comparison to competitors such as United Technologies (40 percent), Honeywell (22 percent), and Danaher (2 percent), all of which grew their market value faster than GE while spending less on buybacks.

And there's more. Sears spent US$6.92 billion buying back its own stock. The company is now only worth $729 million. Over the past five years Sears has seen its market value contract by 87 percent. Consider HP, the grandfather of Silicon Valley, which spent US$81.56 billion on buybacks but contracted

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25 percent in market value over the five-year period. Or Xerox, which spent US$8.6 billion on buybacks and is now worth only $7.2 billion, having contracted by 30 percent.

In fact, 64 companies in our review, including retailers The Gap, JCPenney and Macy's, spent more buying back their own stock than their businesses are currently worth in market value. The management at Target spent 95 percent of its current market value buying its own stock.

On the flip side, we identified 269 companies that repurchased stock valued at 2 percent or less of their current market values, (including Facebook, Xcel Energy, Berkshire Hathaway and Amazon). All are strong market performers. To say the least, the evidence does not suggest that buybacks are good for long-term growth. In fact, far from suggesting that buybacks are a sign of confidence in the future by top executives, the evidence suggests the opposite: Buybacks are a way of disinvesting – we call it "committing corporate suicide" – in a way that rewards the "activists" and executives but hurts employees and pensioners.

A growing phenomenon

Stock buybacks are a relatively new phenomenon in the U.S. They were only legalised in 1982, when President Ronald Reagan's newly appointed Chairman of the Securities and Exchange Commission (SEC), John S.R. Shad "re-interpreted" banking legislation from 1933 that prohibited firms from purchasing their own shares in the stock market. At first, the money spent buying back shares was negligible, but by 2000, 38 percent of the earnings of large U.S. companies was spent on buybacks and dividends. This steadily increased to 79 percent in 2011, before soaring to 110 percent in 2015; fuelled by demand for ever higher quarterly earnings per share and so-called "activist" investors.

For reasons deserving another article, the shareholder value-maximisation (SVM) ideology has been accepted in most corporate board rooms and promoted as a legal obligation on the part of executives ("agents") to the shareholders ("owners"). As William Lazonick has also pointed out, this logic is false. In law, companies own themselves and executives are supposed to do what is best for the company, using business judgment. We doubt that corporate suicide is the right policy for most companies, even those facing great disruptions.

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