The Future for Share Buybacks Under Trump

By Theo Vermaelen , INSEAD Professor of Finance

Despite his protectionist tone, some of President Trump's proposed policies indicate a positive environment for buybacks ahead.

Buyback lovers were relieved after the defeat of U.S. presidential hopeful Hillary Clinton who was a vocal **critic of share buybacks**. Her criticism boils down to the argument that buybacks are short-term price manipulation tools and come at the expense of future growth. As Warren Buffett **recently pointed out**, this concern makes no sense as "investors today are awash in funds looking to be sensibly deployed." If there is a lack of investment then it is because of a lack of investment opportunities, not because of a lack of cash. Critics, including Clinton, ignore the fact that when cash is distributed to investors the cash does not disappear but is likely to be re-invested in firms that need cash.

How can politicians influence buyback activity? Empirical research shows that a company is more likely to buy back stock if it is a low growth, profitable company (which means it has excess cash), if it underperformed in the recent past, if it pays out low dividends and if it announced a buyback programme in the previous two years. Politicians can influence some of these variables through regulatory policy, tax policy and the creation of a favourable business environment that inspires confidence and low volatility. If we analyse President Donald Trump’s proposed policies across these dimensions, we get a sense of what the future holds for buybacks.

The impact of regulation

While **some are concerned** that Trump will use his bully pulpit to force companies to reduce buybacks to create more jobs for American workers, this is more or less the same argument used by Clinton. While this may be a risk for large firms with a lot of political visibility, we believe other firms should not be concerned. I also hope Trump gets better advice than Clinton, who was advised by William Lazonick, **a vocal critic of share buybacks**.

Trump plans to deregulate business, in particular banks which have been constrained by stronger capital requirements, limiting risk taking and especially returning cash to shareholders. According to an **estimate by Morgan Stanley**, the largest 18 American banks have more than US$120 billion in excess capital which they will at least partially spend on share buybacks. Bank deregulation together with higher expected interest rates explains why the KBW bank index has risen by 25 percent since the election of Trump.

The impact of taxation

When it comes to his taxation plan, Trump wants to lower the tax on repatriated funds to 10 percent. According to estimates by Morgan Stanley, U.S. firms have parked approximately US$2.5 trillion of cash abroad. Figure 1 lists the estimated amount of money to be repatriated from the largest firms.

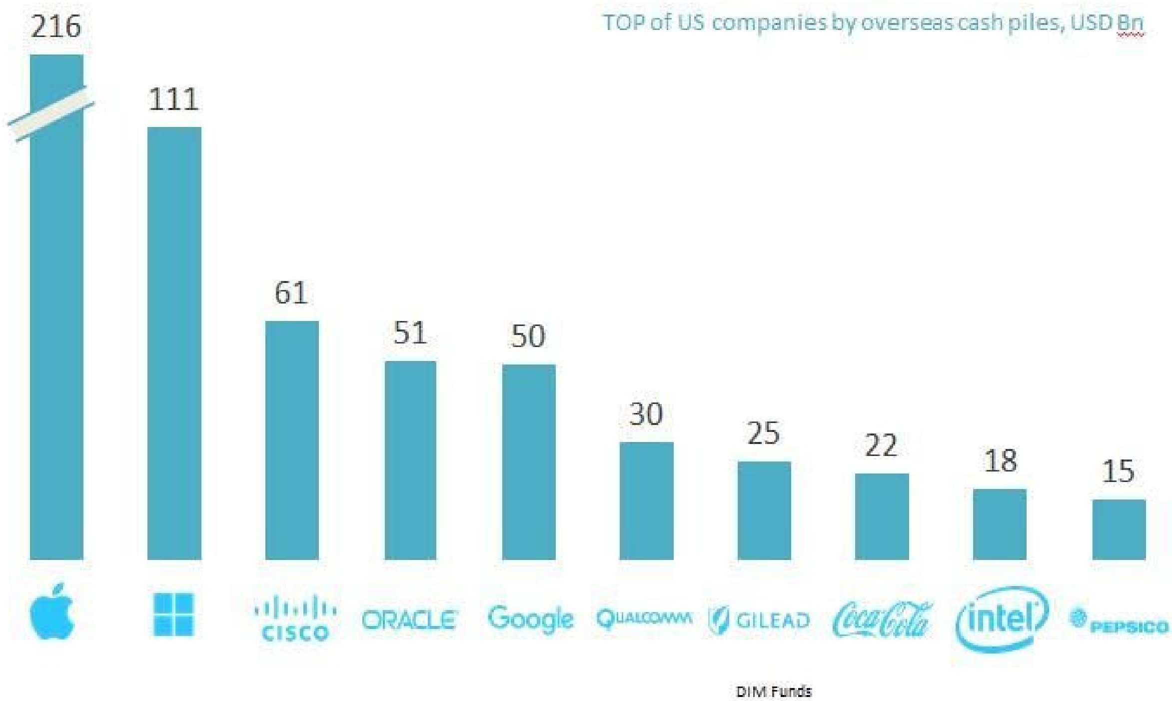

Figure 1
The largest holder of excess cash is Apple with more than US$200 billion. Note that these are relatively large global firms. While there is concern that these firms would be the largest victims of Trump-inspired protectionism, it is also a fact that they would benefit the most from the reduction in the repatriation tax. As it seems unlikely that firms will suddenly discover US$2.5 trillion of new investment projects, one may expect that most of these funds will be returned to shareholders, both as buybacks as well as extra dividends.

Trump’s tax plans also include lowering the corporate tax rate from 35 percent to 20 percent which will increase profitability, and therefore buybacks. However, to the extent that this will increase the net present value (NPV) of investment opportunities, buybacks may actually be reduced.

Another fiscal measure includes a proposal to allow capital expenditures to be expensed for tax purposes, instead of depreciated, which should encourage investment in fixed assets rather than investing in the company’s shares so this is likely to lower buyback activity.

Finally, Trump wants to abolish the tax deductibility of interest payments, which should discourage borrowing money to buy back stock to take advantage buybacks driven by the tax benefits from leverage. Note that this also will lower the incentive for banks to prefer debt to equity financing and may be another motivation to relax bank capital regulation. Although this tax reform will increase the cost of capital of highly levered firms, the increase in the discount rate will be compensated by the higher after tax cash flows so that overall the tax law change will not lower the NPV of investment projects.

In short, the tax reforms send a mixed message regarding the future of buybacks.

The impact of the business environment

But the general macroeconomic climate may have an influence on buyback activity. A repurchase is an investment decision so firms need to have confidence to invest in themselves. On the other hand, confidence may spur capital expenditures and will lower buybacks, all things being equal. The second effect that may deter buybacks is market volatility. If managers are uncertain, in the future it will be more difficult for them to convince the board that a buyback is necessary to take advantage of undervaluation. Again, as with CEO confidence, lower volatility may increase capital expenditures as well. According to the **Conference Board**, CEO confidence reached its highest level in nearly six years in the final quarter of 2016.

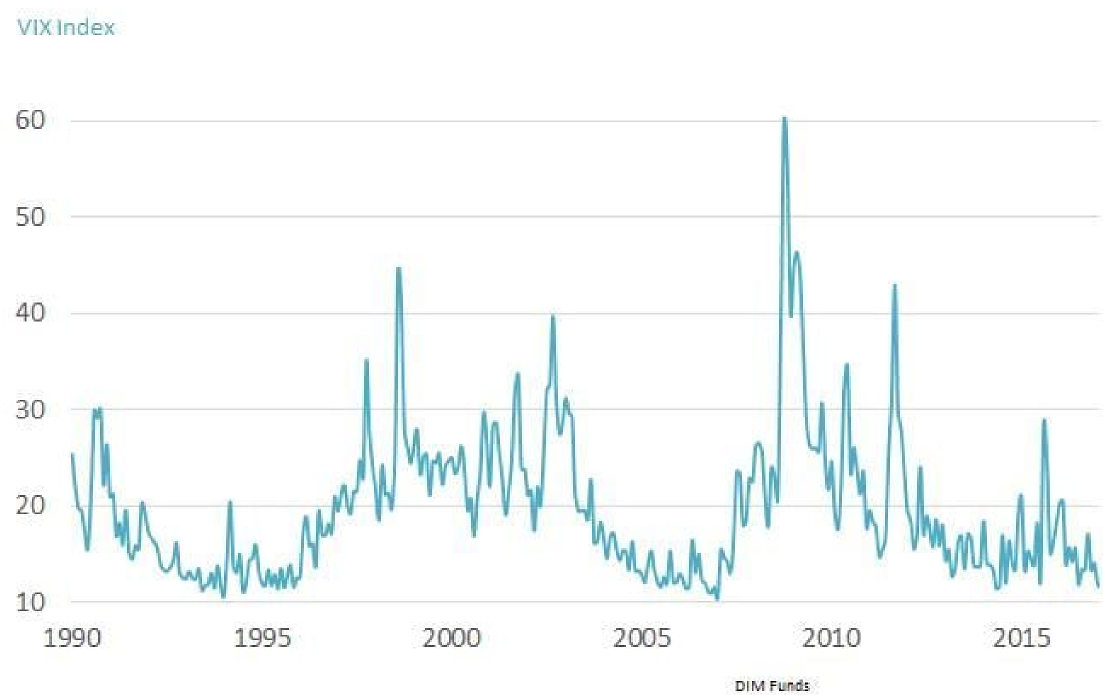

Figure 2

Consumer confidence hit **a 15-year high** and the implied market volatility (measured by the VIX, see Figure 2) is close to an all-time low. CEOs, consumers as well as financial markets seem to ignore the continuous doomsday scenarios predicting Trump’s failure in the media. So the favourable business climate bodes well, both for real investment as well as investments in company shares.

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