A Sign of the Times: The ESG Buyback

Using ESG sensitivities to market financial products.

Economics & Finance

In 2020, BNP Paribas announced a financial innovation: the ESG share buyback. Buybacks and ESG are not natural bedfellows. The “E” for environment and the “S” for social emphasise the importance of stakeholder value, while the most common motivation for share buybacks is “commitment to shareholder value”, i.e. returning excess cash to shareholders rather than investing in negative NPV projects. In an ESG buyback, the company commits part of the buyback profits to finance a socially responsible or green initiative. Early adopters include BIC, Campari and Enel.

Campari, one of the companies that embraced this innovation, described its green initiative and profit sharing in a press release: “The Programme includes a contractually-agreed reward mechanism. An amount deriving from the outperformance in the purchase cost of the shares during the Programme will be allocated by Campari to an energy efficiency project, namely the installation of photovoltaic panels in Campari’s main plant located in Italy”. A footnote defines “outperformance” as the difference between the purchase price and the average VWAP (volume weighted average price) during the execution period.

Admittedly, this is a rather peculiar way to calculate profits. For example, if at the end of the execution period, the stock trades at 10 euros but the company purchased shares at an average price of 12 euros, it will be considered that the company made profits if the purchase price was below the VWAP. That’s why academic studies consider repurchases as profitable if the company was able to buy shares in the past below the most recent stock price.

Why single out buybacks?
Why do companies use “profits” on buyback programmes to pursue green and other CSR initiatives? Why not use profits from other activities?

One explanation is that, following US politicians’ lead, Europeans are now suffering from the **Buyback Derangement Syndrome**. A recent illustration is the proposal by US Senators Sherrod Brown and Ron Wyden to levy a 2 percent tax on share buybacks. This effectively means that corporate profits paid out as a buyback will be taxed three times. First, the company pays corporate taxes based on its before-tax profit. Next, when the company uses part of this profit to buy back stock, it must pay an additional tax of 2 percent, and then finally, the investor who sold her shares to the company will pay a capital gains tax. Note that all shareholders (including those who don’t sell their shares) have to pay taxes on funds distributed to others. This is very different from the taxation of dividends or taxation principles in general.

Discussions with European bankers and company executives reveal that the ESG buyback is not driven by concern that buybacks are in some ways bad for the world. As one banker puts it: In Europe, most investors don’t understand how buybacks can benefit them. When they receive a dividend, they receive cash while a buyback gives cash to an investor who leaves the company. This may reflect investors’ confusion.

When a company trades at $10 per share and the company declares a $1 dividend, the ex-dividend share price will fall to $9. So, dividend policy does not matter: The total wealth of the shareholder remains at $10. When a company buys back stock at $10 and the true value of the share is $12, remaining shareholders will profit from the purchase of undervalued stock. Of course, if the stock is overvalued, long-term shareholders will lose. Empirically, at least on average, managers are able to repurchase stock below fair value. So, the ESG buyback is really a mechanism used to encourage companies to perform buybacks. In order to convince CEOs of this, banks now have assistance from their ESG department. So, the ESG buyback is really a buyback marketing strategy.

**The ESG buyback relative to other industry initiatives**

Although the impact of ESG buybacks is small, at least it encourages decision making that is good for the world and also good for long-term shareholders. A buyback may reduce the waste of excess cash in negative NPV projects and, if shares are undervalued, it will benefit long-term shareholders. This is in contrast with the efforts of the ESG asset management industry to exclude fossil fuels from its portfolios and the efforts of banks to refuse new oil and gas financing.

Such actions create opportunities for politically incorrect investors to earn excess returns by investing in “brown” stocks or by lending to carbon-heavy companies, as was recently pointed out by the *Financial Times*. For example, this year’s coal stocks increased by 84 percent, in contrast to the S&P Global Clean Energy Index which has lost almost 15 percent year-to-date. So, eliminating brown stocks from a portfolio does not make the world a better place as it creates arbitrage opportunities for the non-politically correct and is likely to hurt the financial returns of politically correct investors. New fund concepts that avoid “woke” companies may also arise.

A recent paper from Chicago Booth and Wharton scholars shows the positive abnormal returns earned by green stocks in the past are largely explained by media coverage of climate concerns, but expected returns on green energy stocks are likely to be lower than that on brown stocks. This reflects a basic principle in finance: If something such as risk is “disliked”, investors require a higher rate of return for more risky securities. On the other hand, if something is “liked” such as low carbon footprint, investors will require a lower rate of return.

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