JANUARY 2019 DATA UPDATE 8: DIVIDENDS AND BUYBACKS – FACT AND FICTION

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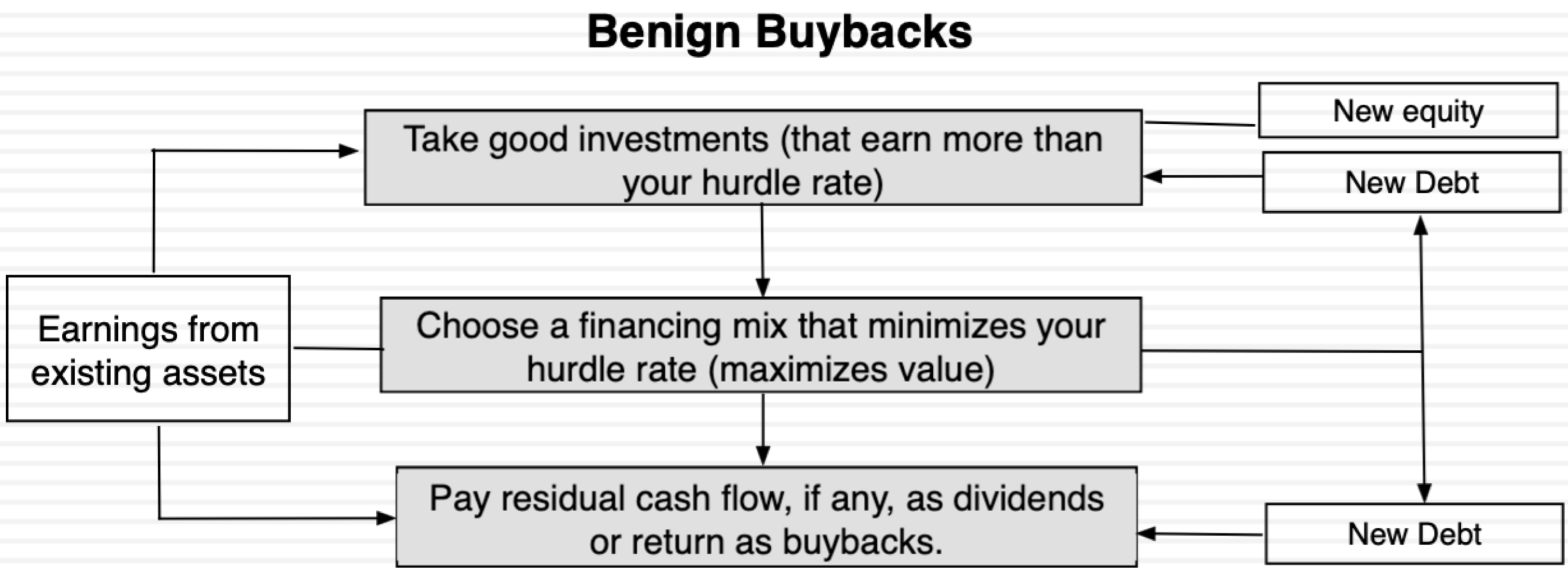
Buybacks: The Debate

- In an op ed on buybacks, outlining legislation that they plan to introduce, Senators Schumer and Sanders argue that the hundreds of billions of dollars that US companies have expended buying back their own shares could have been put to better use, if it had been reinvested back in their businesses or used to increase wages for their employees.
- Like the senators, I am concerned about the declining manufacturing base and income inequality in the US, but I believe that their proposal has the potential for making things worse, not better.

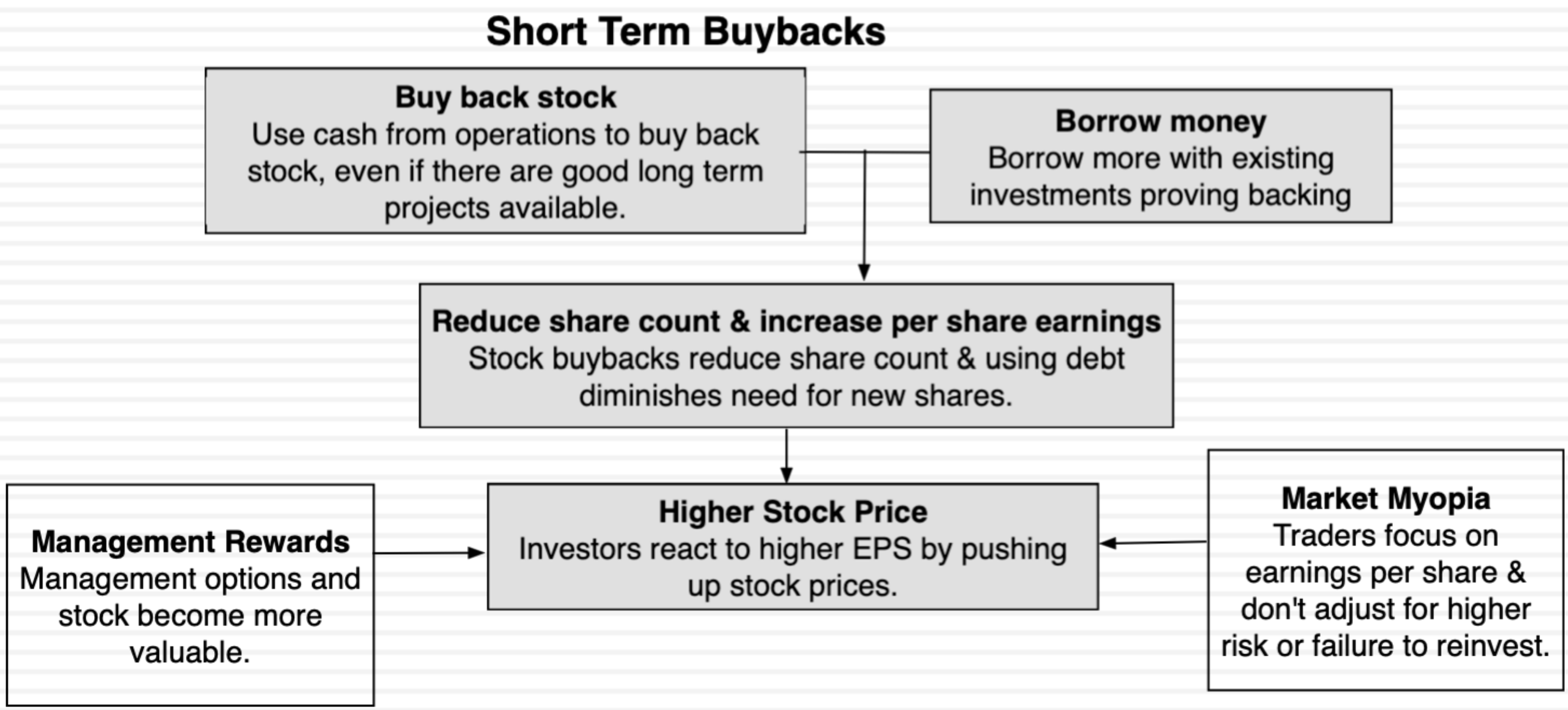
Buybacks: Why the divide?

- The very mention of buybacks often creates heated debate, because people seem to have very different views on its causes and consequences.
- All too often, at the end of debate, each side walks away with its views of buybacks intact, completely unpersuaded by the arguments of the other.
- The reason, I believe is that our views on buybacks are a function of how we think companies act, what the motives of managers are and what it is that investors price into stocks.

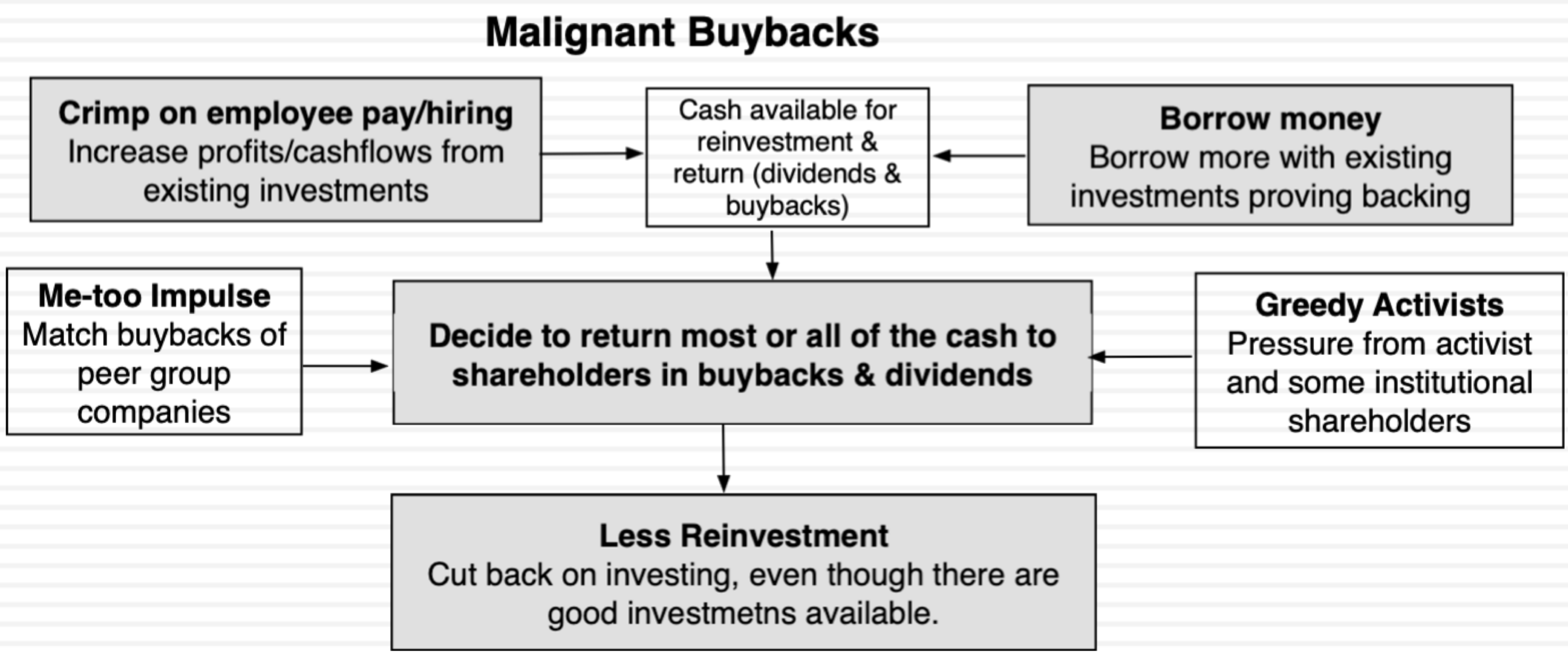
1. Buybacks as Benign



2. Buybacks as “short term”



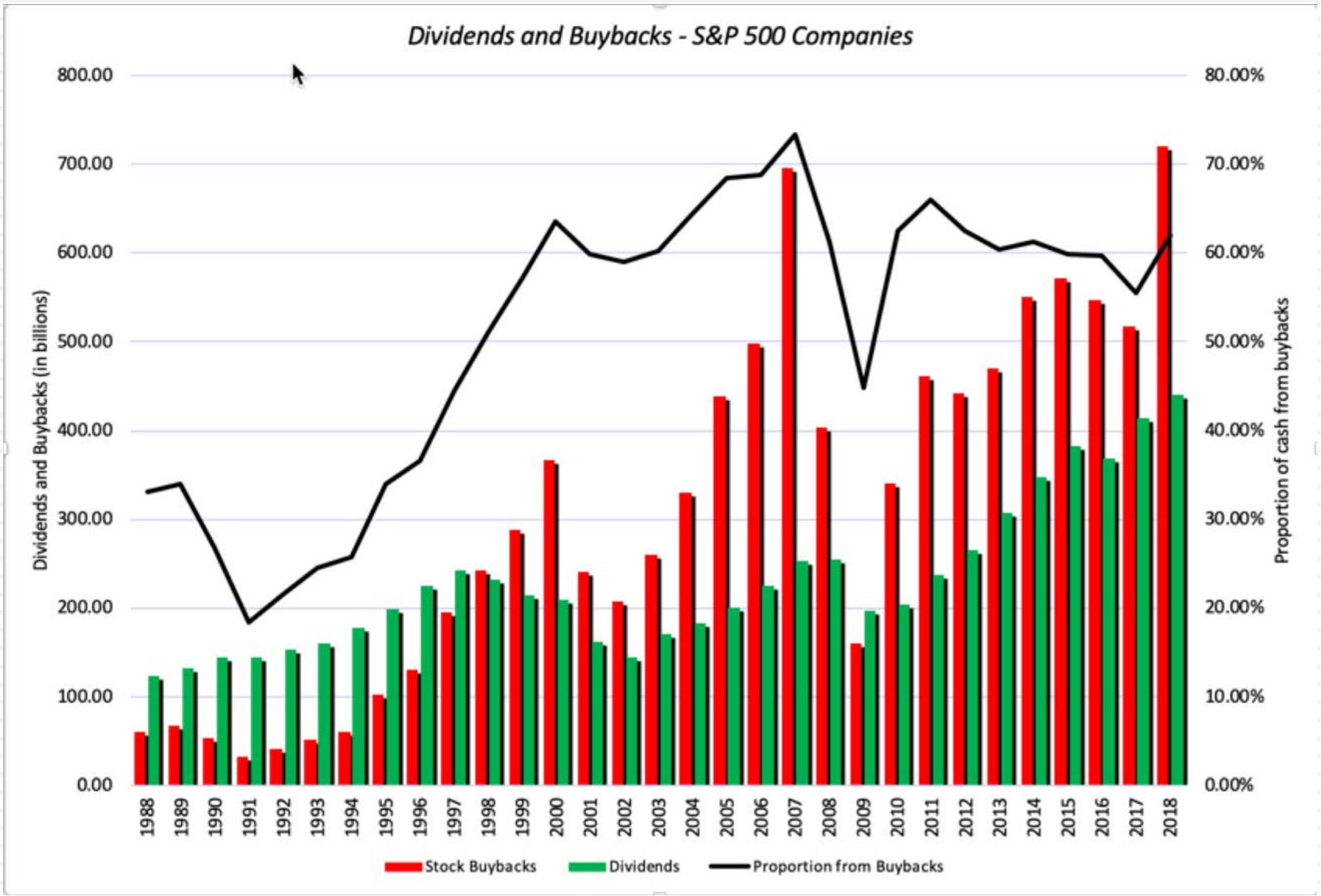
3. Buybacks as malignant



Preconceptions and Priors

- Proponents not only come in very different perspectives of corporate behavior, but they use anecdotal evidence, where they point to a specific company that behaves in a way that backs their perspective, and say "I told you so".
- The truth is that the real world is a messy place, with
  - some companies buying back stocks for the right reasons (i.e., because they have no good investments and their stockholders prefer cash returns in this form)
  - some companies buying back stock for short term price gains (to take advantage of markets which are myopic)
  - some companies focusing on buying back stock at the expense of their employees, lenders and own long term interests.

1. Buybacks are big & getting bigger



2. Companies are returning more & reinvesting less..

	As % of Market Capitalization			As % of Net Income		
Year	Dividend Yield	Buyback Yield	Cash Yield	Dividend Payout	Buyback Payout	Cash Payout
2001	1.37%	1.25%	2.62%	40.51%	36.91%	77.43%
2002	1.81%	1.58%	3.39%	34.67%	30.12%	64.78%
2003	1.61%	1.23%	2.84%	32.69%	25.05%	57.74%
2004	1.57%	1.78%	3.35%	28.09%	31.90%	59.99%
2005	1.79%	3.11%	4.90%	29.23%	50.78%	80.01%
2006	1.77%	3.39%	5.16%	28.55%	54.85%	83.40%
2007	1.92%	4.58%	6.49%	34.09%	81.44%	115.53%
2008	3.15%	4.33%	7.47%	57.46%	78.91%	136.37%
2009	1.97%	1.39%	3.36%	38.64%	27.19%	65.82%
2010	1.80%	2.61%	4.42%	27.04%	39.25%	66.28%
2011	2.11%	3.56%	5.67%	27.51%	46.40%	73.91%
2012	2.19%	3.13%	5.32%	32.28%	46.12%	78.39%
2013	1.89%	2.88%	4.77%	33.26%	50.73%	84.00%
2014	1.92%	3.03%	4.95%	34.04%	53.75%	87.79%
2015	2.12%	3.18%	5.30%	43.20%	64.63%	107.83%
2016	2.04%	2.78%	4.82%	43.01%	58.65%	101.66%
2017	1.83%	2.28%	4.11%	39.30%	48.87%	88.17%
2018	2.08%	3.37%	5.45%	35.22%	56.90%	92.12%
Average	1.94%	2.75%	4.69%	35.49%	49.02%	84.51%

3. But that may not be true, if you count issuances & correct accountants

Year	Buybacks + Dividends	Buybacks + Dividends - Stock Issues	Gross Cash Return/ Net Income	Net Cash Return/ (Net Income+R&D)	Cap Ex	Cap Ex + R&D + Acqusitions	Cap Ex/ (Cap Ex + R&D + Acquisitions)
1999	$ 297,014	$ 173,282	79.88%	38.99%	$ 426,199	$ 712,846	59.79%
2000	$ 301,668	$ 169,085	85.31%	38.67%	$ 456,466	$ 776,079	58.82%
2001	$ 262,749	$ 159,699	179.81%	68.49%	$ 456,573	$ 743,670	61.39%
2002	$ 281,315	$ 191,976	158.20%	73.06%	$ 396,486	$ 611,408	64.85%
2003	$ 296,562	$ 184,197	60.59%	31.59%	$ 372,086	$ 599,622	62.05%
2004	$ 402,183	$ 237,250	74.49%	37.04%	$ 415,657	$ 675,280	61.55%
2005	$ 564,284	$ 411,810	85.91%	53.78%	$ 479,222	$ 817,799	58.60%
2006	$ 676,008	$ 482,105	80.69%	50.09%	$ 583,353	$ 1,030,890	56.59%
2007	$ 899,067	$ 658,474	142.87%	85.83%	$ 640,526	$ 1,204,601	53.17%
2008	$ 592,262	$ 374,293	NA	315.96%	$ 710,748	$ 1,107,992	64.15%
2009	$ 326,145	$ 64,844	65.19%	10.09%	$ 519,271	$ 814,996	63.71%
2010	$ 521,017	$ 329,470	66.55%	35.00%	$ 586,715	$ 996,569	58.87%
2011	$ 667,863	$ 487,812	73.75%	45.32%	$ 723,726	$ 1,221,649	59.24%
2012	$ 715,576	$ 519,089	79.48%	47.73%	$ 816,570	$ 1,358,770	60.10%
2013	$ 836,972	$ 573,054	71.20%	41.71%	$ 838,194	$ 1,339,868	62.56%
2014	$ 993,957	$ 778,120	94.24%	61.00%	$ 925,206	$ 1,487,997	62.18%
2015	$ 1,061,666	$ 851,889	127.88%	79.50%	$ 889,704	$ 1,642,949	54.15%
2016	$ 1,002,502	$ 780,421	104.22%	63.38%	$ 824,054	$ 1,683,346	48.95%
2017	$ 1,053,894	$ 831,024	90.34%	56.57%	$ 878,583	$ 1,654,513	53.10%
2018	$ 995,035	$ 818,789	68.89%	45.97%	$ 818,536	$ 1,645,254	49.75%
Total	**$ 12,747,739**	**$ 9,076,683**	**91.72%**	52.88%	**$ 12,757,875**	**$ 22,126,098**	**57.66%**

4a. Companies with intangible assets buy back more than manufacturing companies

Industries that bought back the least				
Industry Group	*Dividends*	*Buybacks*	*Buybacks as % of Cash Return*	*Buybacks as % of Mkt Cap*
Green & Renewable Energy	$282.20	$0.27	0.10%	0.00%
Shipbuilding & Marine	$36.04	$12.81	26.22%	0.19%
Electronics (Consumer & Office)	$0.00	$50.81	100.00%	0.84%
Metals & Mining	$1,254.27	$58.09	4.43%	0.11%
Utility (Water)	$607.62	$59.73	8.95%	0.19%
Real Estate (Development)	$0.00	$63.70	100.00%	1.09%
Utility (General)	$8,922.20	$85.35	0.95%	0.03%
Real Estate (General/Diversified)	$17.52	$117.15	86.99%	4.10%
Paper/Forest Products	$276.60	$126.37	31.36%	1.29%
Precious Metals	$336.14	$137.70	29.06%	0.47%
Industries that bought back the most				
Industry Group	*Dividends*	*Buybacks*	*Buybacks as % of Cash Return*	*Buybacks as % of Mkt Cap*
Computers/Peripherals	$16,366.49	$85,461.54	83.93%	9.72%
Bank (Money Center)	$26,294.53	$73,598.00	73.68%	7.47%
Software (System & Application)	$17,051.13	$51,947.19	75.29%	2.90%
Semiconductor	$16,989.90	$49,657.73	74.51%	6.32%
Drugs (Biotechnology)	$11,577.20	$42,250.38	78.49%	5.14%
Telecom. Equipment	$6,716.79	$25,384.68	79.08%	7.94%
Software (Entertainment)	$0.00	$23,631.38	100.00%	1.98%
Information Services	$6,656.09	$22,749.62	77.36%	2.46%
Drugs (Pharmaceutical)	$27,645.04	$20,465.72	42.54%	1.82%
Banks (Regional)	$14,002.51	$19,546.19	58.26%	3.32%

4b. Big companies buy back more than small companies..

Market Cap Decile	Dividends	Buybacks	Buybacks as % of Cash Return	Buybacks as % of Mkt Cap	Buybacks as % of Net Income
Smallest	$0.19	$12.31	98.50%	1.48%	-0.31%
2nd decile	$10.21	$27.12	72.65%	0.99%	-0.88%
3rd decile	$29.43	$29.24	49.84%	0.40%	-1.15%
4th decile	$112.28	$86.40	43.49%	0.59%	-2.66%
5th decile	$303.95	$184.69	37.80%	0.65%	-5.08%
6th decile	$632.53	$280.88	30.75%	0.52%	-5.27%
7th decile	$2,683.16	$946.45	26.08%	0.79%	-12.35%
8th decile	$4,671.89	$3,332.03	41.63%	1.35%	244.13%
9th decile	$17,146.52	$18,371.11	51.72%	1.82%	61.36%
Largest	$510,448.93	$792,699.88	60.83%	3.12%	67.20%
All firms	$536,039.09	$815,970.11	60.35%	3.03%	69.06%

4c. Low growth companies buy back more than high growth companies

Expected Revenue Growth	Dividends	Buybacks	Buybacks as % of Cash Return	Buybacks as % of Mkt Cap	Buybacks as % of Net Income	% of Mkt Cap
Lowest growth	$136,387	$209,030	60.52%	4.76%	88.41%	16.63%
2nd quintile	$177,669	$313,656	63.84%	3.77%	67.44%	31.53%
3rd quintile	$115,235	$169,828	59.58%	2.90%	67.62%	22.17%
4th quintile	$ 79,555	$ 86,181	52.00%	1.71%	47.64%	19.11%
Highest growth	$ 10,522	$ 26,510	71.59%	0.95%	119.67%	10.56%

Bottom line

- The buyback boom in the United States is being driven by large non-manufacturing firms, with low growth prospects.
- If you restrict buybacks, expecting that this to unleash a new era of manufacturing growth and factory jobs, I am afraid that you will be disappointed.
- The workers at the firms that buy back the most stock, tend to be already among the better paid in the economy, and tying buybacks to higher wages for these workers will not help those who are at the bottom of the pay scale.

5. Investing back is not always better than returning cash…

Region	ROIC - WACC (median)	ROIC < WACC	ROIC=WACC	ROIC > WACC
Africa and Middle East	-3.10%	58.83%	13.09%	28.08%
Australia & NZ	-8.39%	66.89%	8.26%	24.85%
Canada	-7.37%	80.35%	6.36%	13.29%
China	-1.99%	51.13%	14.96%	33.91%
Eastern Europe & Russia	-4.03%	60.57%	14.25%	25.18%
EU & Environs	-2.15%	53.27%	12.73%	34.00%
India	-2.64%	55.94%	11.44%	32.62%
Japan	-1.18%	46.18%	19.35%	34.47%
Latin America & Caribbean	-2.10%	53.43%	17.59%	28.98%
Small Asia	-6.66%	69.39%	9.99%	20.62%
UK	-1.93%	49.31%	11.20%	39.50%
United States	-2.73%	57.73%	10.47%	31.80%
Grand Total	**-3.83%**	58.79%	12.30%	28.91%

6. Debt-funded Buybacks are more the exception than the rule..

Debt to Capital Ratio	Dividends	Buybacks	Buybacks as % of Cash Return	Buybacks as % of Mkt Cap	Buybacks as % of Net Income	% of Mkt Cap
Lowest Debt/EBITDA	$ 18,342	$ 66,968	78.50%	2.45%	66.94%	10.17%
2nd quintile	$184,461	$302,237	62.10%	2.99%	67.42%	37.61%
3rd quintile	$145,952	$239,581	62.14%	3.78%	71.64%	23.58%
4th quintile	$ 95,578	$ 55,654	36.80%	1.58%	41.05%	13.12%
Highest Debt/EBITDA	$ 82,843	$137,566	62.41%	4.79%	73.81%	10.67%
Negative EBITDA	$ 8,863	$ 13,964	61.17%	1.07%	-60.06%	4.85%

7. The buyback disease is spreading!

Sub Group	Dividends	Buybacks	Buybacks as % of Cash Return	Buybacks as % of Mkt Cap	Buybacks as % of Net Income
Africa and Middle East	$ 71,927	$ 5,437	7.03%	0.29%	4.13%
Australia & NZ	$ 54,751	$ 9,216	14.41%	0.70%	12.74%
Canada	$ 54,622	$ 38,118	41.10%	2.08%	31.29%
China	$ 359,243	$ 27,279	7.06%	0.27%	3.46%
EU & Environs	$ 358,474	$ 113,305	24.02%	1.04%	14.39%
Eastern Europe & Russia	$ 24,351	$ 1,900	7.24%	0.46%	2.81%
India	$ 20,003	$ 6,958	25.81%	0.34%	11.87%
Japan	$ 118,430	$ 41,082	25.75%	0.78%	9.31%
Latin America & Caribbean	$ 45,794	$ 7,415	13.93%	0.35%	4.49%
Small Asia	$ 139,662	$ 15,844	10.19%	0.34%	4.45%
UK	$ 109,494	$ 37,609	25.57%	1.28%	17.05%
United States	$ 536,039	$ 815,970	60.35%	3.03%	69.06%
Global	$1,892,790	$1,120,131	37.18%	1.59%	25.50%

The Buyback Argument

- My view: Buybacks are more a symptom of global economic changes, than a cause. In particular, globalization has made it more difficult for companies to generate sustained returns on investments, and has made earnings more volatile for all businesses. In conjunction, a shift from an Industrial Age economy to the economies of today has meant that our biggest businesses are less capital intensive and more dependent on investments in intangible assets, a trend that accounting has not been able to keep up with.
- Yours may be different: If you came into this article with a strong bias against buybacks it is unlikely that I will be able to convince you that buybacks are benign, and it is very likely that you will be in favor, like Senators Schumer and Sanders, on restricting not just buybacks, but cash returns (including dividends), in general.

Assume that you can restrict or even ban buybacks: Play it through!

- *On the investment front*, it is true that companies that used to buy back large numbers of their own shares will now have more cash to invest, but generally in bad internal projects or acquisitions. You will have more reinvestment in the wrong segments of the economy, at the expense of investments in the segments that need them more.
- *On the wage front*, it will cause some companies to raise wages for existing employees, but since they will now be paying much higher wages than their competitors, my guess is that these same companies will be quicker to shift to automation and will have smaller workforces in the future, and that those at the low end of the pay scale will be most hurt by this substitution.

Anecdotal Evidence?

- The senators use Walmart and Harley Davidson to make their case, arguing that both companies should not have expended the money that they did on buybacks, and taken investments or raised wages instead.
  - Investments: It is unlikely that Walmart would have opened more stores in the United States, a saturated market, but would have opened them instead in other countries. As for Harley Davidson, a company that serves a loyal, but niche market, building another factory may have created more jobs, but it is not at all clear that the demand exists for the bikes that would roll out.
- Employee wages: In a retail landscape, where Amazon lays waste to any competitor with a higher cost structure, that would have been suicidal, and accelerated the flow of customers to Amazon, allowing it to become more dominant..

In conclusion

- Macro forces at play: I believe that the shift to buybacks reflects fundamental shifts in competition and earnings risk, but I don't wear rose colored glasses, when looking at the phenomenon.
- Bad actors? There are clearly some firms that are buying back stock, when they clearly should not be, paying out cash that could be better used on paying down debt, especially in the aftermath of the reduction of tax benefits of debt, or taking investments that can generate returns that exceed their hurdle rates. They are more the exception than the rule
- The Legislative Bludgeon: Banning all buybacks or writing in restrictions on buybacks for all companies strikes me as overkill, especially since the promised benefits of higher capital investment and wages are likely to be illusory or transitory.
- Good intentions? If you are tempted to back these restrictions, because you believe they are well intentioned, it is worth remembering that history is full of well intentioned legislation delivering perverse results.