ICGN
International Corporate Governance Network

ICGN Viewpoint

ICGN Viewpoint: Share buybacks and their governance implications

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Introduction

Share buybacks have proliferated in recent times. This ICGN Viewpoint examines them from a governance point of view. It touches on the arguments in favour or against using buybacks as an instrument for managing capital. It focuses on how boards should decide on buybacks and how shareholders should engage with them about their decision. There are a range of issues at stake. Most are fundamental to the way the business is run and it is therefore important and appropriate that three separate ICGN Committees – Business Ethics, Corporate Risk Oversight and Executive Remuneration - collaborated in preparing this Viewpoint. The author's thanks are due to the members of a joint working group whose ideas are the basis for what follows.

The Viewpoint begins with a brief examination of buybacks. It then proceeds to analyse the principal issues for boards and shareholders. These are identified as capital allocation, calculation of net present value and impact on remuneration. A final section details a number of questions that shareholders may wish to ask.

What are buybacks and what is their impact?

Buybacks involve a purchase by a company of its own shares on the stock market. There is nothing intrinsically wrong about such an action and companies may have good reasons for doing so, especially if their business is mature and they no longer have opportunities to invest in new growth projects. Shares bought in through this process may be cancelled or they may be held in treasury to be reissued at a later stage. Some companies use buybacks to offset the dilution that occurs as a result of the issue of new shares to executives as part of their compensation packages. Some issue debt to buy back their shares, a process that may alter their capital structure significantly.

The key point to emphasise is that buybacks do not actually increase profits even though the stated earnings per share may rise as a result. For example, if a company has 100 shares and makes a $100 profit, then its declared earnings per share in that year will be $1. If it buys back 20 shares during the following year, leaving a capital of 80 shares, but still makes $100 in profit, then its earnings per share will be $1.25 even though its profits have not actually gone up. The opportunity for management to create a semblance of higher earnings without actually increasing profits is the main reason why some investors are suspicious of share buybacks.

Another way for companies to return surplus capital to shareholders is through a special dividend. Managements tend not to prefer this route partly because it is less flexible. It is seen as less helpful to those investors who have to pay tax on dividends.

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A dividend payment can create an expectation in the market that high cash pay-outs will become the norm, which ties the management's hands. Nonetheless, they may be appropriate for companies with widely fluctuating cash flows. The contrary view is that dividends are healthy because when a company which is committed to delivering a progressive dividend, the management must run the company with an eye to delivering sustainable cash generation over the longer term. Meanwhile every shareholder receives the dividend, whereas shareholders can choose whether to take the immediate benefit of a buyback. Those that do will see their stake diluted. Those that do not will be able to increase their relative stake without actually investing additional money.

Issues for consideration around capital allocation

One of the most important tasks for any corporate board is to supervise the allocation of capital. How the company chooses to invest its money, how much profit it returns to shareholders and, particularly in the case of banks and other large financial companies, how much it distributes to employees can have profound effect on the future shape and profitability of the business.

One of the accusations levelled at the banks in the 2007-08 financial crisis was that they had given a disproportionate amount of their (often illusory) profits away to their own staff. Had they kept money in the business, the banks would have been better capitalised and the crisis might have been less severe because the banks would have been better able to cope with the large losses they incurred. Instead many large banks were forced to raise large amounts of new capital from shareholders, notionally to cover the losses but essentially to compensate for the fact that so much money had been given away in bonuses.

Buybacks should therefore be considered in the context of overall capital management. How much of what it earns should a company re-invest in the business? How much should be returned to shareholders through dividends or buybacks? How much should be retained by the management as a reward? All boards should have a conscious view of the priorities for capital. Shareholders have a right to expect boards to give proper consideration to this context when considering buybacks. One important question is whether a decision to buy back shares is at the expense of the investment needed to maintain or grow capacity.

A lesson from the banking crisis is that distribution of capital, including through buybacks, can impact financial stability because financial leverage will rise and there will be less money available to cover running costs and pay for new investments. This is most obviously the case in banks but it is generally true that the less equity capital a company has and the more leveraged it is, the more risky the enterprise will be.

This poses potential risks not only for long-term shareholders, but also for another key stakeholder – a company's creditors. An important question for shareholders to ask directors about a buyback proposal is therefore how it fits with the company's willingness to take risk and its policy with regard to capital. It is also important for shareholders and directors to understand the extent to which a buyback could impair a company's credit quality, and therefore the cost of and access to debt capital. Buybacks are not simply a device for absorbing surplus liquidity or using debt capacity to bolster the share price in the short run. This is why it is also important to ask how the decision was taken, whether there was a discussion by the full board and what was the nature of the discussion.

It is worth noting that many companies do replace capital bought in through buybacks. In their January 2017 paper 'Short-Termism and Capital Flows' (HBS Working Paper 17-062) Jesse Fried and Charles Wang show that S&P 500 companies paid out only 33% of their income in net terms between 2005 and 2014 rather than the 93% gross figure on which much argument is based. They argue that the tendency to issue new capital suggests buybacks are not so much of a short term instrument which deprives firms of investment capital as their reputation suggests. However, they do point out that some of the new capital may be in debt rather than equity form.

Getting the right price

Of course, a company may decide that it has too much capital and that, since it lacks suitable investment opportunities for expansion, a buyback makes sense. Or it might appear to make more sense to wait for a business opportunity and then go to the market for more capital. Still the board must still make some critical decisions. Is the buyback being done at an appropriate price? Company executives often have a strong belief in themselves and, as a natural consequence of that, a habit of believing that their shares are undervalued. They are not always in a position to judge whether they are buying back shares at an inflated price, in which case the transaction is unlikely to represent value for money and is probably value-destructive in a way a dividend would not be.

As Warren Buffet has remarked in this context, what is smart at one price is stupid at another. In Mr Buffet's letter to Berkshire Hathaway shareholders, February 25, 2017, he said: *"It is important to remember that there are two occasions in which repurchases should not take place even if the company's shares are under-priced. One is when a business both needs all its available money to protect or expand its operations and is also uncomfortable adding further debt. Here the internal need for funds should take priority. This exception assumes, of course, that the business has a decent future awaiting it after the needed expenditures are made. The second exception, less common, materialises when a business acquisition (or some other investment opportunity) offers far greater value than the undervalued shares of the potential repurchase. My suggestion: before even discussing repurchases a CEO and his or her Board should stand, join hands and in unison declare, 'What is smart at one price is stupid at another."*

Boards need to be comfortable that the price at which the shares are being bought back is appropriate, and shareholders need to be comfortable that the issue of price has been properly discussed. It is not just a question, however, of whether the company is buying back its shares at an appropriate price. When a company buys back its shares it is making an investment. It needs to be sure that the return which will eventually accrue to shareholders will be greater than other investment opportunities on the table. While there is no point in buying back shares if the return is lower than the cost of capital, there is also a potentially important opportunity cost if these other investments promise more return than a buyback.

Here timescale may be important. Some economists argue that companies frequently undervalue the long term potential of investments. For example, Andy Haldane, chief economist of the Bank of England, has argued that companies are reluctant to allocate capital to achieve long term goals as they want to avoid missing the short term consensus estimate for earnings In his speech to the Brussels Colloquium entitled 'The Short Long' in May 2011, Mr Haldane said. *"In the UK and US, cash flows five years ahead are discounted at rates more appropriate for eight or more years hence; 10 year ahead cash-flows are valued as if 16 or more years ahead; and cash flows more than 30 years ahead are scarcely valued at all."*

Given market pressures for short term results, they may not favour investments which will deliver a return only in the medium term even if they have the potential to add much greater value to the company. A well-timed buyback, of course, will deliver returns over a shorter period, and these may be valued more by the management. It is important to know what other investment opportunities were considered and why the buyback was deemed preferable.

Net present value

Net present value (NPV) is a crucial calculation in judging buybacks. It is the figure which represents in today's money the sum total of all the returns accruing from an investment adjusted for inflation over its lifetime. Thus $1,000 invested today will cost that amount in current money, but a return of $100 generated by that investment in ten years' time will not be worth that amount in today's money. The NPV is thus a means of working out what all the returns will be worth in today's money and thus on the same basis as that on which the capital is being invested. It is calculated by discounting the expected returns by the expected inflation rate and also normally incorporates adjustment for other risks ranging from geo-political to project specific ones. When inflation is expected to be high, the discount rate will be high and the NPV will be commensurately lower, and vice-versa.

Also, the longer it takes to generate the return, the lower the NPV will be because the late stage returns will need to be discounted over a larger number of years and some additional account must be taken of the extra risk that arises from long duration. This is one reason why executives sometimes forgo long term opportunities. The NPV is not attractive to them and the return only accrues after they have moved on. Also as Andy Haldane from the Bank of England has noted, executives tend to undervalue long term returns.

A key criterion for evaluating possible investments is NPV set against the weighted average cost of capital. A positive NPV means the company should invest and board members should ask management whether they have brought all positive projects forward for consideration. In so doing they need to assure themselves of the management's ability to evaluate and manage risk. If management fails to do this, the NPV will be wrong.

Companies need to have a robust methodology in place. Boards need to have understood the methodology and not just accepted the calculations of the management. A question for shareholders to ask of directors is, therefore: have you discussed how management calculates and makes use of net present value for planning purposes and are you comfortable with their methodology?

Executive compensation

One of the most frequent criticisms levelled against share buybacks is that they are used by executives to bolster their own remuneration. Executives have an incentive to launch a buyback when their performance targets include a given rate of earnings per share. Even if this is not the case, many believe that executives launch buybacks in the run-up to a share vesting deadline because they believe this will raise the value of the shares and therefore increase the amount by which they can cash in. Academic literature shows that buybacks tend to proliferate when vesting deadlines loom. For example in a 2015 paper, Philip Geiler and Luc Renneboog found that CEOs adopt a buyback policy that increases the value of their equity-based pay[1].

A buyback launched simply to bolster a chief executive's remuneration is inappropriate because it allows the management to extract more value while bringing no visible benefit to the company. Also the timing may not relate to the value inherent in the transaction at the prevailing price but more to the forthcoming compensation deadline. Shareholders therefore need to look carefully at the connection between buybacks and compensation. They also have a right to expect compensation committees to be alert to the issue and put measures in place to ensure that buybacks are not used abusively. One possibility is to extend holding periods beyond vesting so that the executive cannot sell out immediately. Another is to use metrics other than total shareholder return or EPS which are susceptible to influence through buybacks.

Of particular importance, however, is the need for any earnings targets to be adjusted for any buyback issue. Thus the original target would be increased after a buyback to take account of the smaller number of shares in issue. Companies should be clear that their policy is to do this. Some companies issue statements to this effect. For instance one large US technology sector company announced in 2016 that for performance share awards made in that year and beyond, the *"Remuneration Committee had determined that actual operating EPS results would be adjusted to remove the impact of any change from the budgeted share count, including share repurchase transactions."* The company said this formalised the Committee's longstanding intention of not having unplanned share repurchases affect executive compensation.

[1] See Executive Remuneration and the Payout Decision, Corporate Governance an International Review, Wiley, September 2015

Conclusions

ICGN's report does not take a view as to whether companies should or should not engage in share buybacks, but it raises issues about potential abuses which suggests the need for healthy scepticism on the part of both boards and shareholders. It should be recognised that market pressures on management can sometimes be intense. Companies can be under pressure from analysts and short term traders to deliver quick gains. Sometimes companies may wish to do the right thing but face adverse comparisons when their peers are performing badly but disguising this through buyback programmes. Responsible shareholders will support companies which make informed transparent decisions to favour higher-return investments over short term payouts even when this may lead to short term pressure on boards and management.

Above all, it is important that shareholders consider the issues around buybacks and discuss them with the boards of companies they own. Among the questions to raise are:

- What is the company's approach to capital management? What is the board's view of buybacks in the context of the need to retain capital in the business and the appropriate balance for distribution of surplus as between retained earnings, return of capital to shareholders and reward of the executives? What is the objective of buybacks?

- Who makes the decision on buybacks? Is there an informed discussion involving the whole board? How far is the board equipped to take an independent view?

- Does the board have a view on the relative merits of buybacks and special dividends? Given that companies often work on the basis of a pre-determined pay-out ratio for dividends, do they also apply such a ratio to buybacks?

- How far did the board discuss the price at which buybacks were made? Did the price represent value for money?

- What is the impact of a buyback programme on a company's creditors and credit quality? Does this have an impact on credit ratings, cost of debt or access to public debt markets?

- Was there conscious discussion within the board about alternatives? Was a buyback chosen in preference to possible investment projects? In that case were the alternatives properly evaluated? Was the board satisfied with the discount rate applied to the calculation of net present value? Did it receive adequate information from the management?

- What assurances can the board give that buybacks are not used to maximise executive compensation? Does the company have formulas in place to adjust remuneration targets for buybacks? If not, why not?

About ICGN Viewpoints

ICGN Viewpoints provide opinion on emerging corporate governance issues and are intended to generate debate, whilst not defining a formal ICGN position on the subject. ICGN Viewpoints are produced by the ICGN Secretariat and ICGN Policy Committees. For more information contact:

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