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EY Center for Board Matters

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Buybacks vs. backlash

The board's role in weighing the pros and cons of stock repurchases

Cash may be king, but over the long post-2008 recovery, liquid capital on balance sheets has swelled to the point that corporations and their boards feel serious pressure from markets and shareholders over what to do with it. In the fourth quarter of 2015, non-financial S&P 500 companies reported cash holdings – including short-term investments – totaling $1.77 trillion, the highest quarterly level in 10 years. Since the beginning of 2009, when S&P 500 companies reported cash stockpiles of about $750 billion, that figure has more than doubled.

These cash holdings were widely dispersed on both a company and on an industry level. While the companies that comprise the S&P 500 Industrials Index led the way with a combined $13.2 billion surplus, sectors as diverse as health care ($5.3 billion), telecom ($4.5 billion) and energy ($3.9 billion) all face the same problem: what to do with the excess cash on their balance sheets?

As the 2016 proxy season approached, attitudinal data relevant to this cash question was released by the EY Center for Board Matters. Conducting interviews with more than 50 institutional investors, advisors and investor associations, EY gathered insights into investor priorities and heard many investors express concern over whether buybacks are the best strategy for long-term value creation. Investors said they expect directors to carefully oversee capital allocation decisions and they want to better understand why capital used for stock repurchases is not better off invested in human capital, innovation and other long-term strategies.

Scrutiny of the practice has become fairly intense of late. Critics point to the first quarter of 2015, when companies in the S&P 500 index returned more money to shareholders than they earned. The anti-buyback voices consider the practice to be symptomatic of a short-term mindset, one likely to harm business operations in the long run.

The pro-buyback counterpoint is perhaps most loudly voiced by activist shareholders. In 2015, 70 activist investor campaigns sought buybacks or higher dividends at S&P 500 companies – a 37 percent increase year-over-year – and 31 of those campaigns were successful. Both figures were record highs since the analytics firm FactSet began tracking this data in 2005.

Even more noteworthy is the success of activist shareholders. At the 10 companies that got the most out of their buyback purchases – as measured by the difference between their average stock price and their average buyback price – the buyback discount ranged from 12 percent to more than 26 percent.

Time frame priorities

Finding a balance between near-term and long-range priorities is the ongoing challenge for public companies, requiring nuanced judgment at the top and careful oversight by directors.

Institutional investors participating in the EY report cited the importance of having the "right mix of directors, with a depth of diverse skills and backgrounds, in place to oversee long-term strategies and risk management." One benefit of having this optimal mix of board directors would involve "how a company manages – and how the board oversees – the company's environmental and social impacts." Surveyed investors called performance in this area "integral to whether the company is being run well for the long term."

An investor who takes the long-term view may feel positive about share repurchase programs when the cash balance is sky-high, but there appear to be few promising investments in the core operation or in mergers and acquisitions (M&A). Investors may also prefer share repurchases late in periods of significant M&A activity, when companies are more likely to overpay for the businesses acquired. Both situations require vigilant directors who are asking the tough questions about proposed capital allocation strategies.

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Corporate decisions around buybacks are also judged in light of what sector peers are doing. Last year, when a rise of 23.5 percent in fixed-capital expenditures was occurring in the consumer discretionary category, any firm in that space that made only modest capital outlays while ramping up distributions and buyback programs would be an outlier as to its capital allocation approach.

Ultimately, the underlying subject is how a given company and its board are perceived. Stock price, over an extended period, is one obvious way perception gets expressed — and repurchase efforts can affect that. However, absent the signaling that comes from technical analysis or the belief that a stock is undervalued, buybacks don't necessarily create new value.

Repurchasing shares (to either cancel them or stow them in the treasury) has the effect of dressing up quarterly earnings reports: fewer shares lifts the key earnings-per-share (EPS) metric, giving a perhaps contrived boost to the profitability story. Buyback programs also address the dilution issue that arises as top executives exercise their stock options. Because the shares executives acquire are newly issued, a repurchase by the company of open-market stock provides a way to reset the number of shares outstanding and positively impact EPS, although some companies do adjust for this.

Management bonuses linked to share price and/or EPS may also be positively affected by repurchase programs, contributing to some investors' views that executive bonuses must be reined in. In the EY Center for Board Matters report, executive compensation made the top three shareholder-proposal categories. Included are shareholder proposals asking compensation committees to adjust executive pay metrics to exclude the impact of stock buybacks.

In February, an open letter penned by BlackRock's Larry Fink, the CEO of the world's largest investor with $4.6 trillion in assets, illustrated how the mood of institutional investors has shifted. Addressing the leadership at US and European companies, Fink supported the return of excess cash to shareholders, but not at the expense of value-creating investment, decrying today's "culture of quarterly earnings hysteria" and warning of the risks of focusing on near-term profit over long-term value. Fink also earned plaudits for encouraging all CEOs to lay out an annual strategic framework for value creation, and to explicitly affirm that their boards have reviewed those plans.

The short-term viewpoint and stock buybacks begin to look like yesterday's strategy, at a point when higher aims and a broader view of value are emerging. For its proponents, the likely hope is that there will be cash on hand to fund that vision going forward. For boards, the challenge is to oversee capital allocation decisions with an eye toward the long term.

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