Equity Research
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MACRO STRATEGY

U.S. Equity Strategy
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U.S. Equity Strategy

Trading growth for buybacks

Our core thesis on U.S. equities is that we have entered a period of lower returns as faster revenue growth becomes a prerequisite for another re-rating higher. Central to this thesis is slow top-line growth, which is unique to this recovery, although tangential is the use of cash flow, as companies decide between investing and returning capital to shareholders.

Buybacks are approaching previous peaks: S&P 500 companies continue to allocate a large share of cash flow to buybacks, with $159bn of stock repurchased in 1Q14 alone, the second most on record. Preliminary data suggests the pace of repurchases remained high in the second quarter and the peak achieved in 2007 could soon be surpassed.

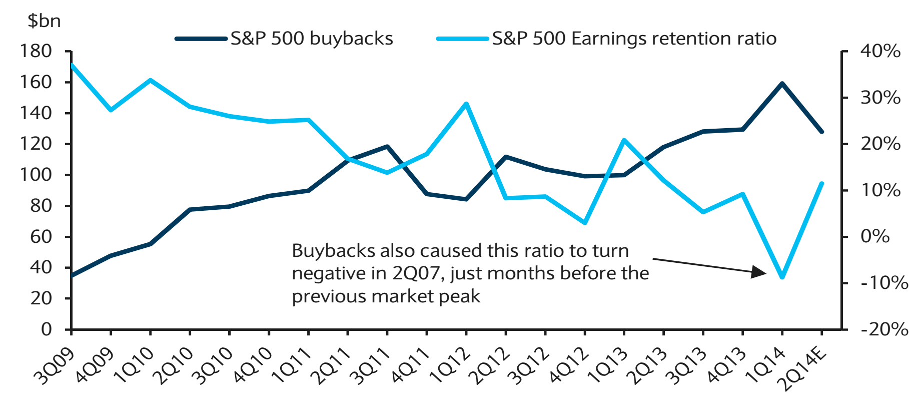
Buybacks have made stocks go up: Our analysis indicates that the share repurchase factor has consistently outperformed the market over the past five years, although recent performance has not been as good. Importantly, we find that the stocks of companies with high repurchases and high net income growth perform much better than companies with high repurchases and low net income growth. In other words, buybacks do not solve for slow growth.

Is there a downside? Share repurchases have contributed to rising stock prices, appeal to investors, and make economic sense given the financing environment. The downside risk is slower growth, as earnings retention has plummeted and growth in book value per share has stalled. Still, the price-to-book value ratio for the S&P 500 at 2.6x continues to expand. This would be more justified if return on equity was increasing, but it is not.

Conclusion: We expect less robust outperformance from the buyback factor and believe buybacks are unlikely to spur further expansion of valuation multiples. We reiterate our S&P 500 price targets of 1975 for 2014 and 2100 for 2015.

FIGURE 1

As buybacks have increased, earnings retention has moved lower, curtailing growth

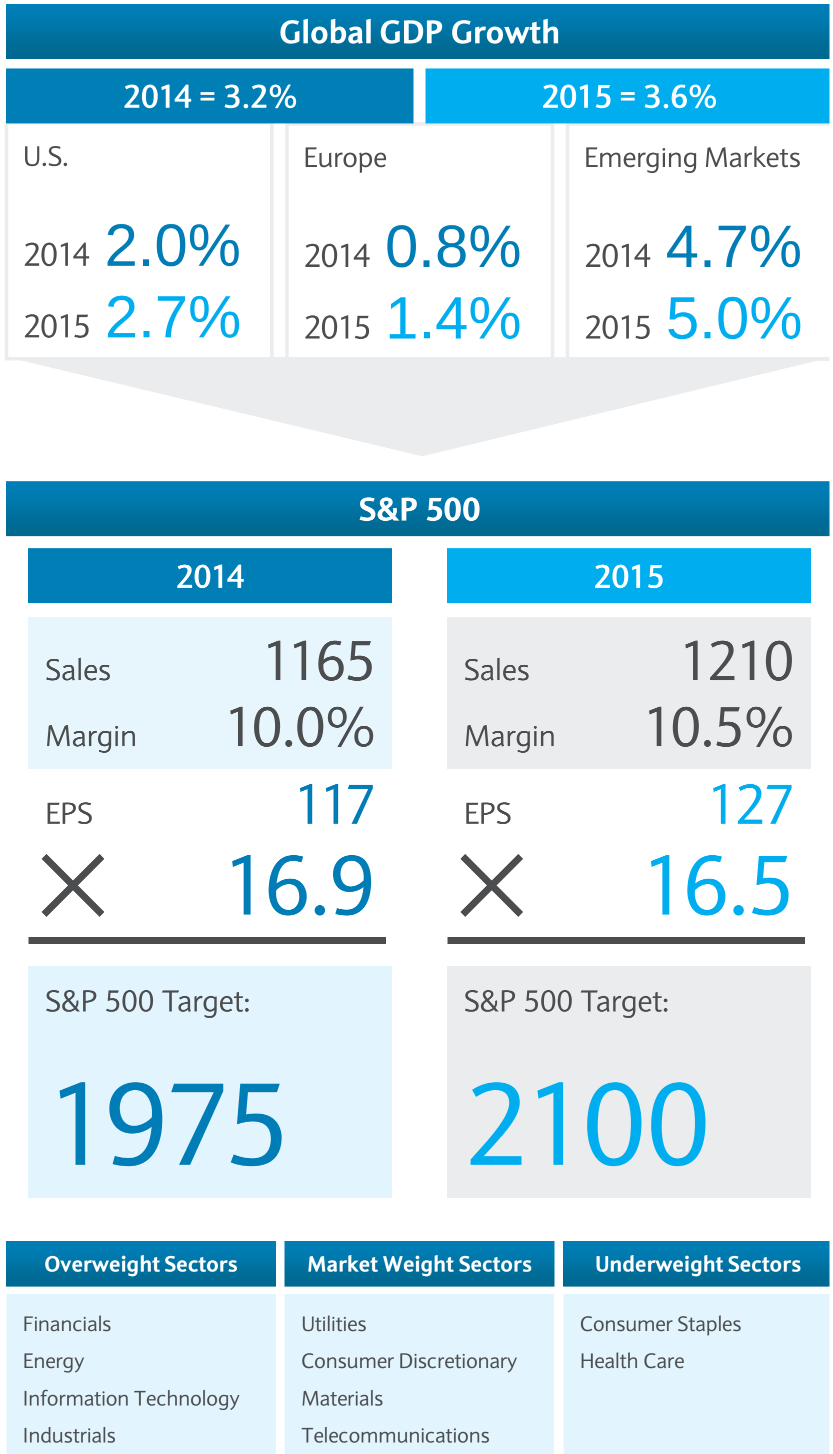


Source: S&P, Haver Analytics, Barclays Research

View video

Before we begin - a summary top down view

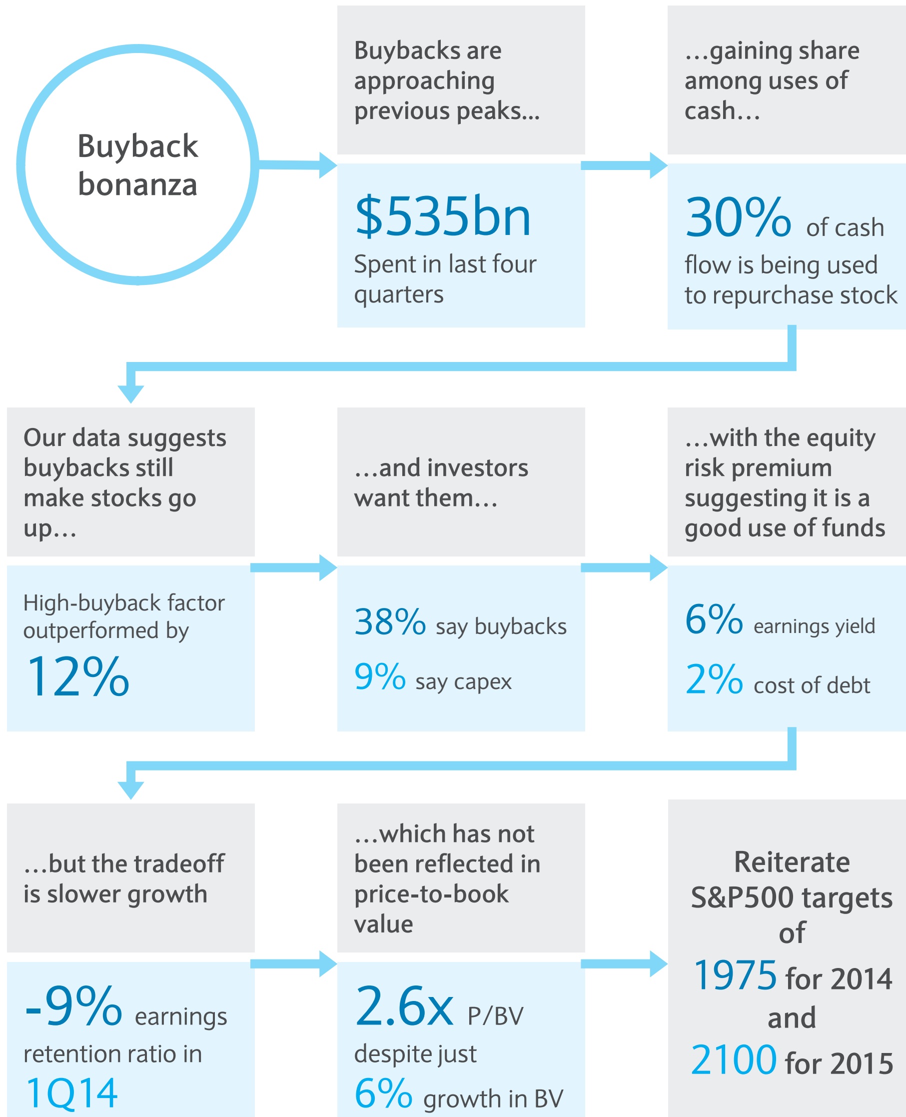
FIGURE 2
Our S&P 500 earnings and price targets



Source: Barclays Research
Overweight - The performance of the S&P 500 sector is expected to outperform the performance of the S&P 500 index in the next 3–6 months. Market Weight - The performance of the S&P 500 sector is expected to perform in line with the S&P 500 index in the next 3–6 months. Underweight - The performance of the S&P 500 sector is expected to underperform the performance of the S&P 500 index in the next 3–6 months.

Our thought process on share repurchases

FIGURE 3
Summary of our view



Source: Barclays Research

Hooked on share repurchases

Margin expansion and share repurchases are likely priced in

Our core thesis on U.S. equities is that we have entered a period of lower returns as the benefits of margin expansion and share repurchases prove to be already priced in and a return of faster revenue growth becomes a prerequisite for another re-rating higher (see *U.S. Equity Strategy: Transitioning to lower returns*). Central to this thesis is slow top-line growth, which is unique to this recovery. The primary cause has been subdued global economic growth, with the U.S. expanding at just 2%, Europe below 1%, and even EM tracking slower.

But it is not just the economy, in our opinion. Another important consideration is the use of cash flow, as companies decide between investing for future growth and returning capital to shareholders. We note that capital expenditures are growing slowly while share repurchases are surging toward new records. Share repurchases are often cited as a leading cause of increased earnings per share, but we believe there is a downside, as organic growth opportunities are passed over.

> Capital expenditures are growing slowly while share repurchases are surging toward new records

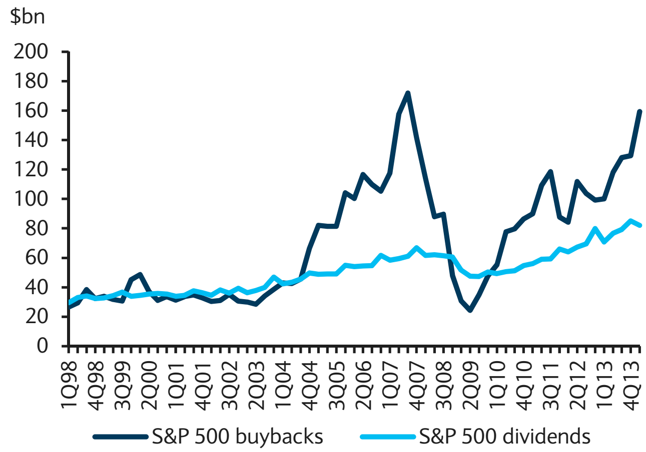
Share repurchases are an increasingly popular way to return cash to shareholders. When balanced against dividends they have the advantage of better tax treatment and more flexibility. When considered against investing in long-term projects, they have the benefit of certainty and in many cases an immediate payoff in the form of higher earnings per share. What company does not believe their shares are an attractive investment and what could be a better way to prove it than executing a buyback, especially when there is ample free cash flow to fund it?

Buybacks are approaching previous peaks and will likely surpass them soon

In the first quarter of 2014, S&P 500 companies repurchased $159bn of stock, the most since the third quarter of 2007 (Figure 4) and the second highest quarterly total on record, by our calculations. Back in 2009, repurchases were less than $50bn per quarter. Since then the growth rate has been strong, and we predict the peak achieved in 2007 will soon be surpassed, although it does not appear to have occurred in the second quarter, based on preliminary data. We estimate that share repurchases have been boosting earnings per share growth by 100bp for the median S&P 500 company (Figure 5). Buybacks are adding more than $2 per share to earnings at the index level, by our calculations, equating to roughly 200bp of accretion.

FIGURE 4

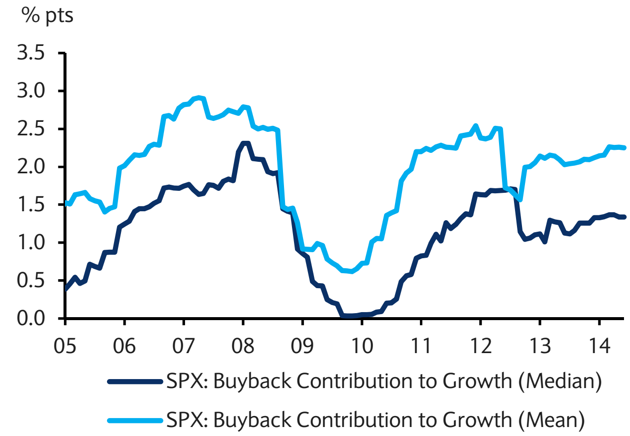
Repurchases are nearing prior cycle highs, far outpacing growth in dividends



Source: S&P, Haver Analytics, Barclays Research

FIGURE 5

Gross repurchases boosted earnings growth by 100 bp for the median company in the S&P 500



Source: Barclays Research

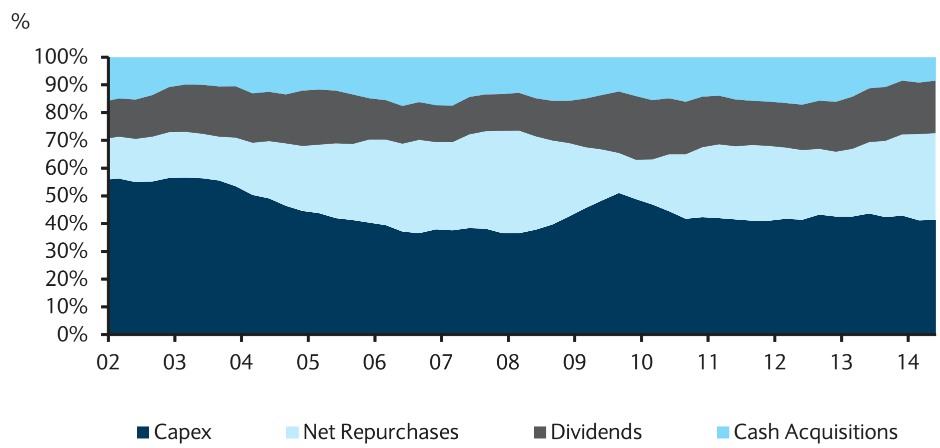
Buybacks have captured a larger share of cash flow spending

The portion of cash flow allocated to buybacks has increased to more than 30%

Our analysis of S&P 500 cash flow statements shows that repurchases are absorbing an increasing amount of discretionary cash flow. Repurchases are historically the most elective use of cash flow, typically taking a secondary role to dividend payments, which nowadays seem obligatory to maintain outside of financial stress, and investments such as capital expenditures or cash-funded acquisitions. In Figure 6 we display a common size use of cash flow for the S&P 500 and we note that the portion allocated to repurchases has increased to more than 30%, nearly twice what it was in 2002. The portion allocated to capital expenditures has remained stable at approximately 40%, although this is down from more than 50% back in the early 2000s. Figure 7 presents the same data in absolute amounts, showing that cash flow has increased materially in the last five years, allowing all uses of cash to grow, although share repurchases have experienced the largest expansion.

FIGURE 6

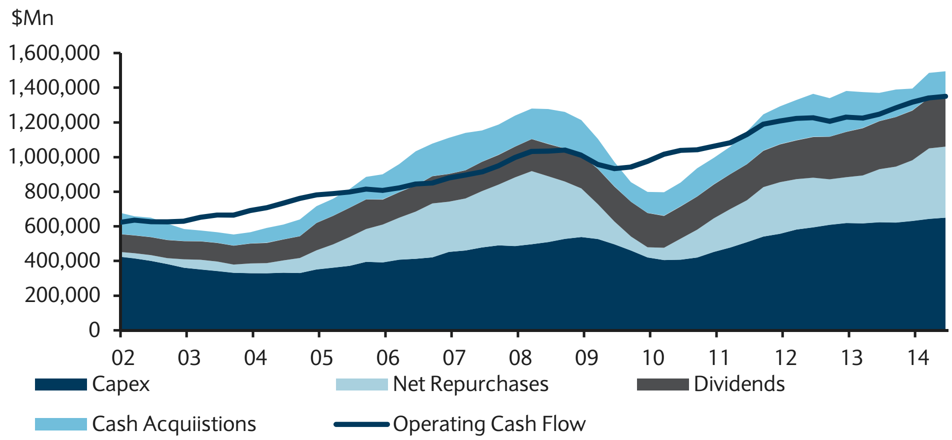
Repurchases are absorbing an increasing amount of cash flow (use as a % of cash flow)



Source: Barclays Research

FIGURE 7

Share repurchases have shown the largest expansion since the financial crisis, $mn

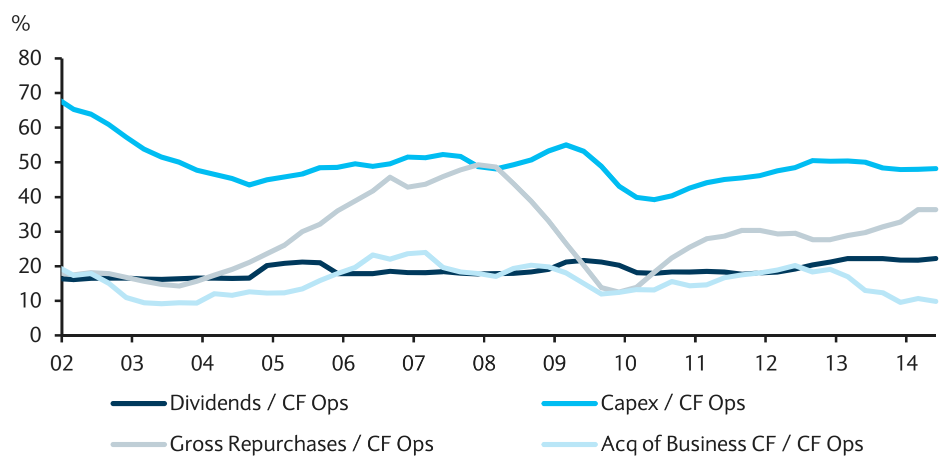


Source: Barclays Research

One use of cash that has not expanded is acquisitions. The pattern of M&A often resembles the pattern of share repurchases, increasing toward the top of the cycle and sharply falling once an economic slump sets in. This cycle has not been different. The number of announced M&A transactions has increased alongside share repurchases, with the six month moving average of completed deals close to the previous cycle peak achieved in 2006. But most of these acquisitions are being paid for with stock, and the portion of cash flow being allocated to acquisitions has actually declined. Figure 8 shows that the portion of cash flow allocated to dividends and capital expenditures has remained relatively constant, while share repurchases have taken ground from acquisitions.

FIGURE 8

Share repurchases have largely taken share from cash-based acquisitions



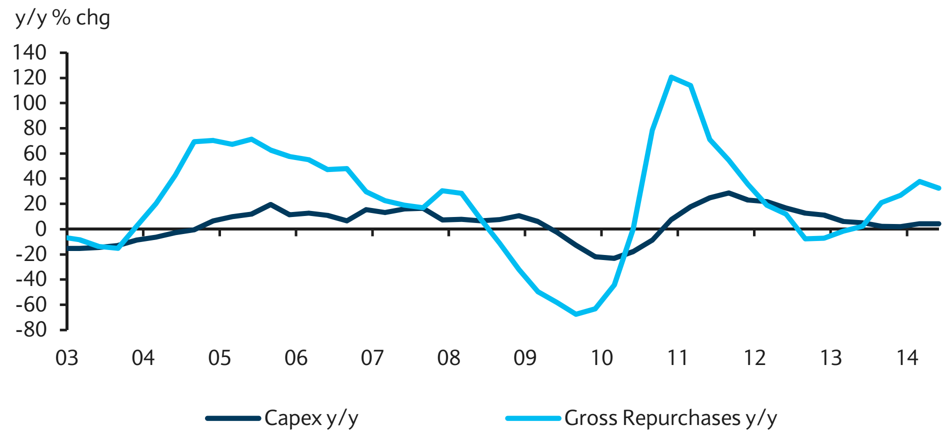
Source: Barclays Research

The growth rate of capex has been around 5% while the growth rate of share buybacks has been far higher

As mentioned, capital expenditure remains the top form of cash flow spending, still in front of share repurchases. This masks the trajectory of capex, however, as the growth rate has been poor. We show this in Figure 9, which demonstrates that the growth rate of capital expenditure has been hovering around 5%, still not reflecting the recovery in investment that is expected to occur. Meanwhile, the growth rate of share repurchases has been far higher. The volatility of these two lines is indicative of the different speeds at which capital expenditures and repurchases can be expanded or curtailed. It typically takes a substantial amount of time to alter capex plans while share repurchases require little more than a board meeting to be approved and can be abandoned immediately, if desired.

FIGURE 9

The growth rate of capital expenditure has been slow in relation to share repurchases



Source: Barclays Research.

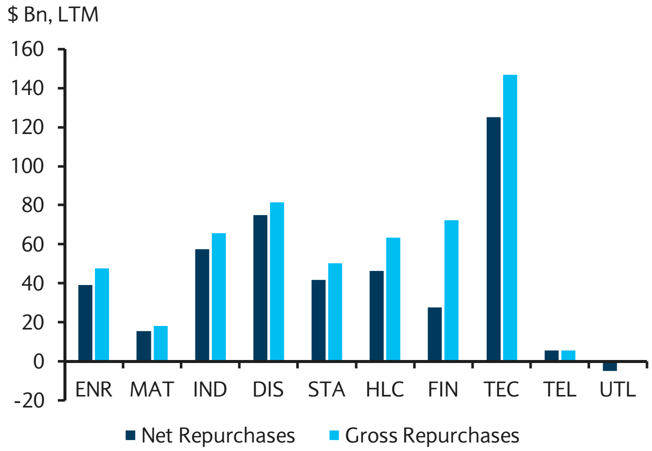
Buybacks are not evenly distributed by sector

We estimate ~26% of buybacks are done by the technology sector, twice as much as the next largest sector

When it comes to buying back stock, not all sectors are created equal. In fact, there is a clear champion: the technology sector. As we show in Figure 10, the technology sector spends almost twice as much on share repurchases than the next largest sector in the market. We estimate approximately 26% of buybacks are done by the technology sector. Apple and IBM spent more on buybacks than any other companies in the S&P 500 over the last twelve months and they alone account for 40% of the $125bn of net repurchases done by the technology sector. Now, the technology sector is also the largest sector in the S&P 500 based on market capitalization, and when adjusted for this its efforts to buy back stock are less outsized. In fact, the consumer discretionary sector is just as active when measured on this basis (Figure 11). Another sector that is noteworthy is energy, where repurchases totaled approximately $50bn over the last twelve months. What makes it noteworthy is that the bulk of these buybacks were done by just one company, Exxon, while the median company repurchased a modest amount. We believe this highlights the disparate use of cash among energy verticals.

FIGURE 10

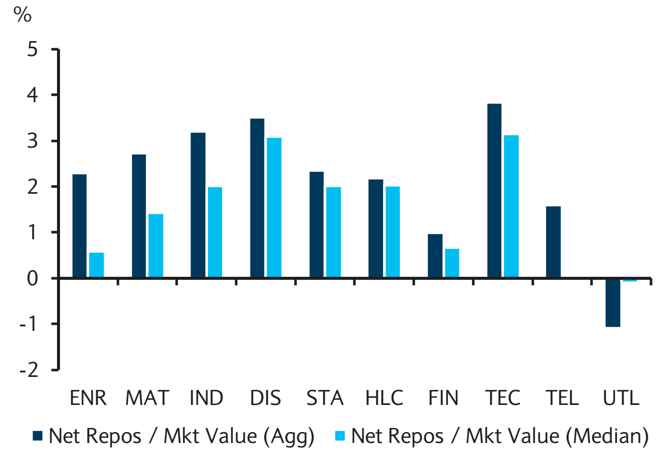
The technology sector buys back the most stock…



Source: Barclays Research. Note: Trailing 12 month repurchases

FIGURE 11

…although it is not as outsized in relation to market cap



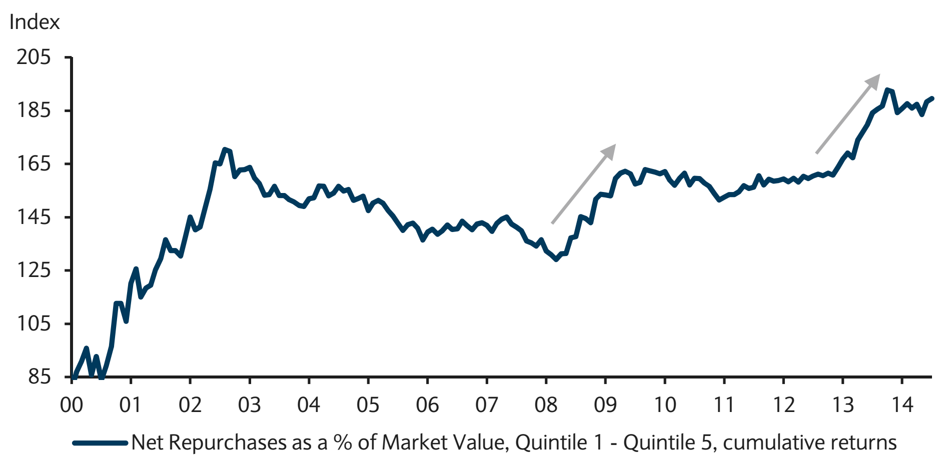
Source: Barclays Research. Note: Trailing 12 month repurchases and 12 month average market value

Repurchases continue to show outperformance

Companies with high share repurchases have significantly outperformed their peers since mid-2008, despite a few periods when the strategy stagnated or fell slightly. In 2013, a strategy of buying the highest repurchasers outperformed by the largest margin since the initial stages of the recovery, concurrent with S&P 500's highest annual returns since 2009. The strategy faltered at the beginning of 2014 (Figure 12).

FIGURE 12

The top share repurchasers outperformed in 2013 by the largest margin since 2009



Source: FactSet, Barclays Research

To better assess the efficacy of a share repurchase approach, we tested multiple strategies of buying the top quintile of share repurchasers and selling the bottom quintile. Our repurchase ranking methodology included gross and net repurchases relative to market capitalization as well as cash flow. While each iteration showed a similar trend, net repurchases (trailing 12 month sum) as a percent of market value (12 month average) showed the most significance in our model, was the least prone to skew from negative values (e.g., negative cash flow), and showed the highest cumulative returns. **Importantly, we find that the stocks of companies with high repurchases and high net income growth**

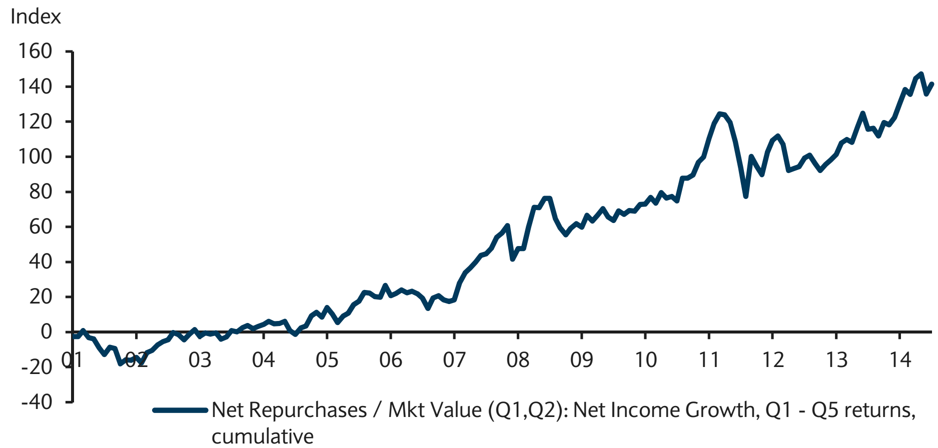
perform much better than companies with high repurchases and low net income growth. In other words, buybacks do not solve for slow growth (Figure 13**).**

High repurchases have provided positive and significant contributions to returns through most of the recovery

We also evaluated unintended biases on factors by creating size, value, momentum, and sector neutral portfolios in order to better isolate the impact of repurchases on performance. The bottom line is that repurchase factor returns are not dictated by other factors. But the tracking error among our repurchase factors highlights the periodic influence of other factors, with the run-up in 2013 a case in point. Tests of factor significance unsurprisingly show that the predictive value of the repurchase factor ebbs and flows; however, unlike the prior cycle, high repurchases have provided positive and significant contributions to returns through most of the recovery (Figure 14). Our repurchase factors peaked most recently at the end of 2013 before falling out of favor in 1H14 as the factor underperformed and its significance fell sharply negative. However, in recent months the strategy shows signs of stabilization.

FIGURE 13

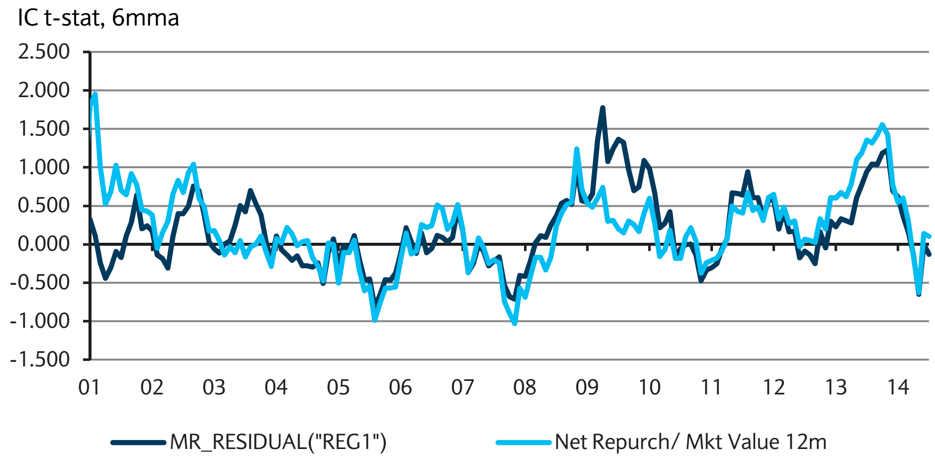
Growth matters – companies with high repurchases and high net income growth outperform companies with high repurchases and low net income growth



Source: FactSet, Barclays Research

FIGURE 14

Repurchase outperformance peaked at the end of 2013 and fell out of favor in 1H14



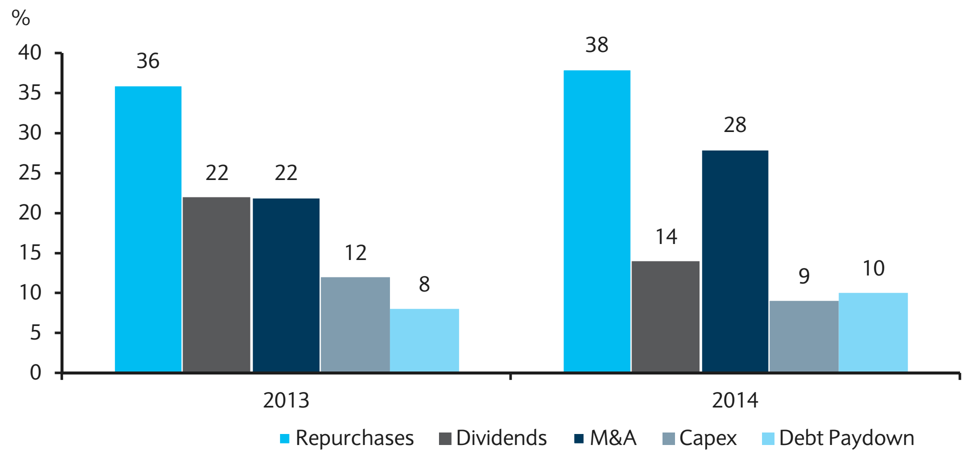
Source: FactSet, Barclays Research. Note: The Information Coefficient ("IC") measures a factor's correlation with (subsequent) returns; specifically, it is the correlation between the factor rank and the return rank for all companies in the period's cross section. The IC is between -1 and +1; a strong positive (negative) IC suggests companies with high factor values tend to yield high (low) returns. The t-stat measures the significance of the IC.

Surveys indicate that investors want buybacks more than dividends or capital expenditures

As we have shown, the common stock of companies involved in buybacks has outperformed. This implies that investors view buybacks as a good use of cash, and want to invest in companies that are returning capital to shareholders in this way. This is corroborated by survey data that also shows a preference for share repurchases compared to other uses of cash. Figure 15 is a reprint of survey data from the Barclays 2014 Industrial Select conference. The responses show a clear preference for repurchases, especially in relation to capital expenditures. We note that recent conversations with our industrials analysts signal that companies are shifting their preference from buybacks toward acquisitions, although we do not have confirmation of this change in preference from investors.

FIGURE 15

What do investors want industrials companies to do with excess cash?



Source: 2014 Industrial Select Conference Sentiment Data, Barclays Research

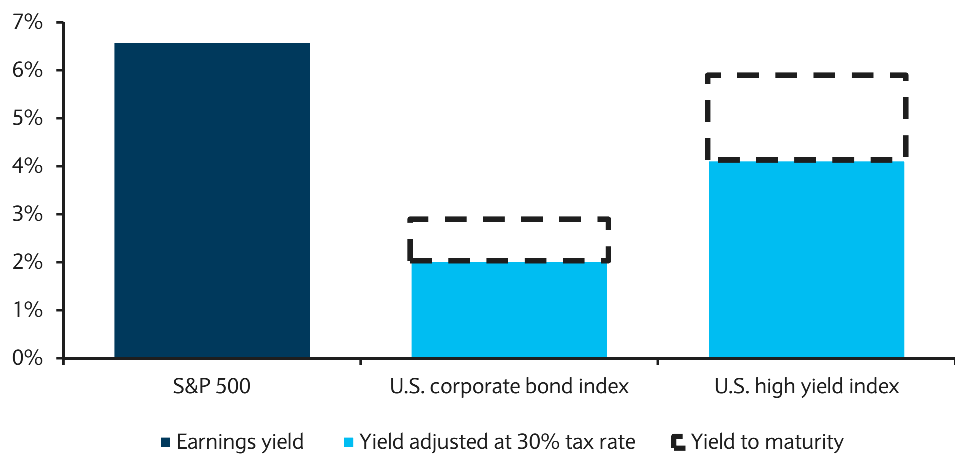
The debt markets are a cheap way to finance share repurchases

The equity risk premium suggests buybacks are a good use of funds

One strong argument for repurchasing shares is the cheap cost of debt financing and the gap between earnings yields and debt yields. As shown in Figure 16, U.S. corporate bonds yield less than 3% and the high yield market yields less than 6%. This implies an after tax cost of debt financing of just 2% for an investment grade company and 4% for a high yield company. At the same time, the earnings yield of the S&P 500 is more than 6%, signaling that debt financed share repurchases are likely to be immediately accretive to earnings per share. This positive arbitrage has been available throughout the recovery, although we note the difference is now less than it was in 2012 and 2013.

FIGURE 16

The after-tax cost of debt is well below the earnings yield on equity



Source: Barclays Research

What is the downside?

As discussed, share repurchases have contributed to rising stock prices, are aligned with investor demands, and make economic sense given the financing environment. Could there be a downside? We believe there is. Share repurchases also lower future growth, as less capital is reinvested in the business. As shown in the graphic below, when return on equity is stable, growth is directly linked to the portion of earnings that are retained. In other words, a company that retains all of its earnings will grow at a rate equal to its return on equity while a company that pays out all of its earnings through dividends and share repurchases will not grow at all. This is based on the classic corporate finance equation that states that growth equals return on equity multiplied by one minus the payout ratio.

The combination of steadily increasing dividends and rapidly increasing share repurchases caused the earnings retention ratio of the S&P 500 to turn negative

Two things must be considered to determine if the increase in buybacks is lowering growth. First, it must be determined if repurchases are increasing the payout ratio, as opposed to simply growing with earnings or substituting for dividends. Second, return on equity must be considered, as an increase in return on equity can offset a decline in earnings retention.

As indicated in Figure 17, share repurchases are growing faster than earnings and are not substituting for dividends, leading to a higher payout ratio to shareholders. This was obvious from earlier charts that showed that dividends have also been steadily increasing. The combination of steadily increasing dividends and rapidly increasing share repurchases caused the earnings retention ratio of the S&P 500 to turn negative in 1Q14 for the first time since the financial crisis. The last time earnings were increasing and this ratio was negative was the second quarter of 2007, coinciding with the last surge in share repurchases and just months before the previous market peak.

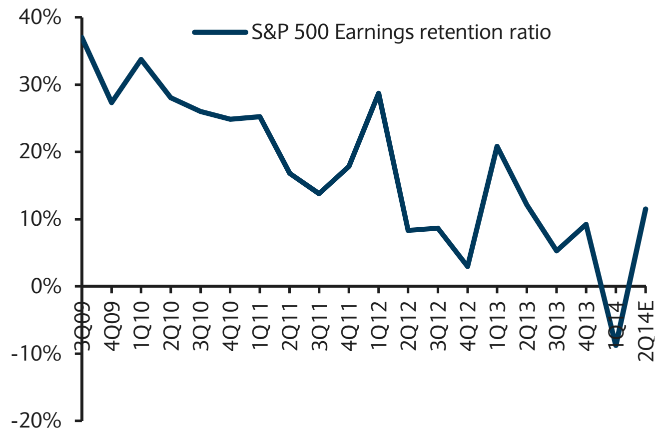
To maintain growth, a low earnings retention ratio can be offset by an increase in return on equity. Unfortunately, we find there has been no sustained increase in return on equity for the S&P 500. Figure 18 displays the return on equity ratio of the S&P 500 and while there have been large cyclical swings there is no discernible improvement in relation to other cycles. In fact, it could be argued from the graph that return on equity this cycle has peaked at a lower level than previous cycles. Over the past 40 years the return on equity of the S&P 500 has averaged 13%, similar to the current ratio of 14%.

Book value per share for the S&P 500 was growing at more than 10% in 2010, but has slowed to just 6% recently

While the equation above that related growth to return on equity and earnings retention is theoretical, we can determine with actual data if the growth rate of the S&P 500 has declined. In Figure 19 we display the annual increase in book value per share for the S&P 500 and as shown, it has clearly deteriorated. While book value per share was increasing at more than 10% as the S&P 500 recovered from the financial crisis in 2010, the recent growth rate has slowed to just 6%. We believe this is indicative of more limited investment in operations and more focus on share repurchases. Buying back a near-record amount of stock in a market that trades at 2.6x book value is certain to decrease the growth in book value per share, all else being equal. Still, it is noteworthy that the S&P 500 price to book value ratio has continued to move higher, despite the reduction in the growth rate of book value per share.

FIGURE 17

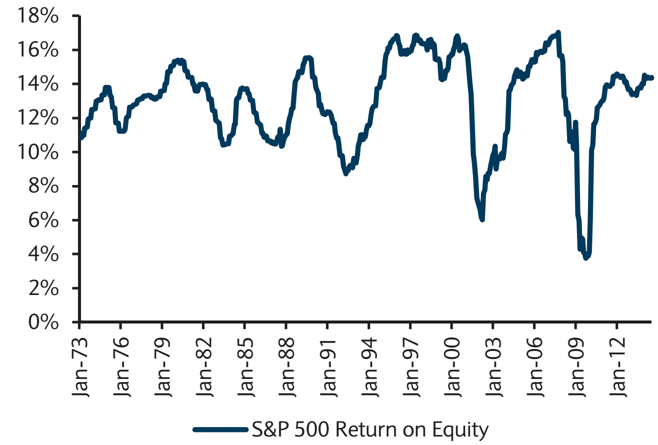
Earnings retention has plummeted…



Source: S&P, Haver Analytics, Barclays Research

FIGURE 18

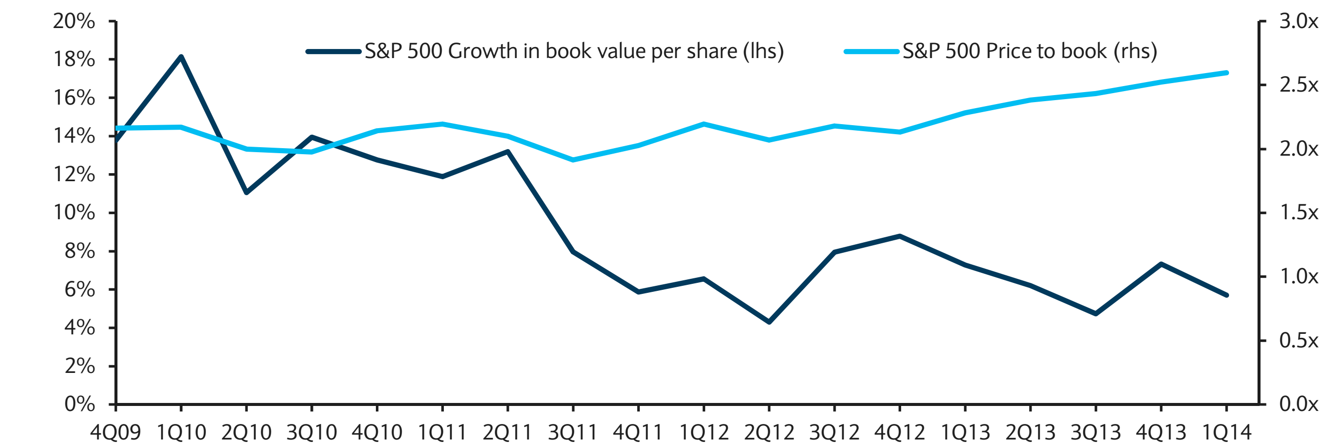
…and there has not been an offsetting improvement in ROE



Source: Compustat, Barclays Research

FIGURE 19

The growth rate of book value per share has declined yet price to book is higher



Source: S&P, Haver Analytics, Barclays Research

Conclusion – reiterate S&P 500 price targets of 1975 for 2014 and 2100 for 2015

As we have written previously, we believe organic revenue growth is the missing ingredient for the S&P 500 and that further advances will be constrained by this lack of growth, with high profit margins and record share repurchases already priced in. One of the reasons that revenue growth is slow, in our opinion, is because companies have been allocating large amounts of cash flow to share repurchases rather than reinvesting in the business. While the preference for buybacks among investors and the success of the buyback factor remain, we believe the tide may be turning. Going forward, we believe the outperformance of the buyback factor will be less robust. This view incorporates the weaker performance exhibited already in 2014 and the higher valuations in the market, which make buybacks less effective. In addition, during this cycle we find that the buyback factor has worked best in periods when the market was advancing rapidly, such as 2013 – but we do not forecast another rally of that magnitude. Importantly, we find that the stocks of companies with high repurchases and high net income growth perform much better than companies with high repurchases and low net income growth. In other words, buybacks do not solve for slow growth. We are reiterating our S&P 500 price targets of 1975 for 2014 and 2100 for 2015.

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Overweight: The performance of the S&P 500 sector is expected to outperform the performance of the S&P 500 index in the next 3–6 months.
Market Weight : The performance of the S&P 500 sector is expected to perform in line with the S&P 500 index in the next 3–6 months.
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