Buybacks Galore

A couple of weeks ago Nike announced that it would buy back up to $12 billion of its stock over the next four years, following an $8 billion buyback that ends early next year. And Nike is not alone. In fact, stock buybacks have been all the rage in corporate America this past year.

In the first three quarters of 2015, U.S. companies spent more than $500 billion buying back their own shares. That is the highest amount in the first nine months of the year since the record year of 2007. And if fourth quarter buybacks hold up, this year could surpass 2007.

Why are companies buying so much of their own stock? And, most importantly, should they be doing it?

What to Do With All that Cash

A company has four main options for spending the cash they generate: (1) invest the money back into their business via capital expenditures or working capital spending, (2) buy another business, (3) pay dividends, or (4) repurchase shares.

The decision on how to spend cash should be based on where that cash is going to earn the highest return. If the company generates high returns on equity, it should spend the money on its own business. If they can acquire a good company at an attractive price, they should go the M&A (mergers and acquisitions) route. And if the company can find no good use for their cash investing in their own business, them they should return it to shareholders either via a dividend or through buying back their shares. Some argue that in this current environment companies are opting more and more for option (4), when they should be going for option (1).

It is easy to see why CEOs love buybacks. Stock repurchases boost earnings per share (EPS), even if total earnings don't increase, by reducing the numbers of shares outstanding (EPS = earnings / number of shares). CEOs incentive compensation plans are oftentimes tied to EPS figures, so buybacks provide a nice way of boosting their compensation. And in this environment of low interest rates and easy money, companies can borrow substantial sums to be used toward buybacks. As a CEO what could be easier than issuing debt at a very low rate, buying back shares with those proceeds, having EPS increase not because of higher profits but because of the buyback effect, and seeing their wallets get fatter and fatter?

The Math Genius

Now that we have explored the 'why' of current buybacks let's examine the 'should.' But before we do that let's learn about someone who was a master at doing the rational thing when it came to capital allocation and, especially, when buying back stock. Meet Henry Singleton.

Henry Singleton was the founder and CEO of a company called Teledyne, which he founded in the early 1960s. Singleton had an unusual background for a CEO, as he was a world-class mathematician with a doctorate degree in electrical engineering from MIT. He built Teledyne into a conglomerate by purchasing companies in industries ranging from aviation electronics to specialty metals to insurance.

In the 1960s, conglomerates were very popular in Wall Street and they were the Internet darlings of the day. Companies like Teledyne were trading at very high valuations and Singleton used his stock as currency to make 130 acquisitions. He did not repurchase one share of Teledyne stock during this period.

In the early 1970s, however, equities entered a bear market and stock prices, especially those of conglomerates, collapsed. Singleton saw opportunity in the stock of his own company and decided to do something about it. He fired his M&A team, never bought another company again and started buying back Teledyne's stock aggressively.

To repurchase stock, Singleton executed eight tender offers, starting in 1972. The chart below shows the different tender offers, which took place during a period of a dozen years. As a result of the tender offers Teledyne bought back more than 85% of shares outstanding. Singleton also purchased another five percent of Teledyne shares on the open market, bringing the buyback total to over 90 percent of the company's shares outstanding.

Announced Date	Shares Tendered (MM)	Tendered As a % of Outstanding	Cumulative % Shares Purchased	As a % of Book Value
9/14/1972	8.9	27.9%	27.9%	35.6%
12/13/1973	1.6	6.9%	32.9%	4.2%
5/31/1974	3.9	17.6%	44.7%	10.6%
12/4/1974	1.9	10.4%	50.4%	4.2%
4/30/1975	3.6	19.6%	60.1%	13.2%
2/6/1976	2.5	18.4%	67.4%	20.3%
5/2/1980	3.0	21.6%	74.5%	27.7%
5/9/1984	8.7	42.9%	85.4%	150.1%

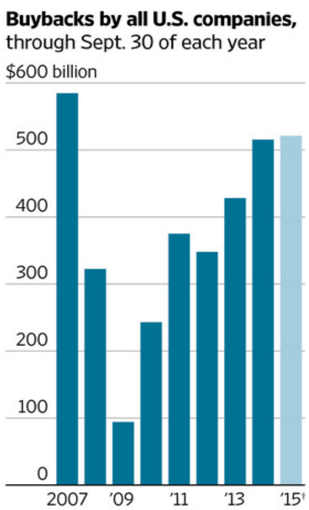
Source: Distant Force: A Memoir of the Teledyne Corporation and The Man Who Created It, pg. 288

Unlike the debt-fueled repurchases of today, Singleton financed the majority of the buybacks with cash derived from operations. In the occasional instances when debt was incurred, Teledyne quickly paid it off from operational income. Singleton was a master at buying opportunistically and he only bought back stock when it was selling at attractive prices. Teledyne generated an impressive 42 percent compound annual return for shareholders across the tenders. Singleton was the quintessential "buy low, sell high" investor.

Buying High

Are most companies now following the Henry Singleton model for repurchasing shares? Probably not. While there are, indeed, companies that are buying back their stock while trading at cheap valuations and below their intrinsic value, there are many that are buying shares trading at or close to their 52-week and all-time highs.

Actually, corporate America has a history of repurchasing shares at the wrong time. The chart below shows buybacks by all U.S. companies from 2007 to 2015 through September 30 of each year. Remember that 2007 was a record year for buying back stock. And that happened to be the year stocks peaked, just before the financial crisis. What happened in 2009 when stock prices had cratered and shares in all companies were super cheap? Companies stopped buying back their shares. And now that stock prices are near their highs again, companies can't get enough of their own stock. Buy high, sell low.



Sources: Birinyi Associates, Wall Street Journal

Conclusion

Not all buybacks are created equal. Companies should buy back stock if, and only if, the stock is selling below a conservative estimate of intrinsic value. Watch out for CEOs that buy back shares because they care more about maximizing the size of their own wallets rather than yours.

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