The Power of Buybacks

While researching companies to buy for client portfolios, we come across a wide variety of companies in different industries. Here are four to look at:

> *Torchmark (NYSE: TMK), based in McKinney, TX, is an insurance holding company which provides individual life insurance, supplemental health insurance, and annuities, in the U.S. The company has a market cap of just over $5 billion.*
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> *AutoNation (NYSE: AN) is America's largest automotive retailer, operating 265 new vehicle franchises across 15 states. Selling 32 brands, the company has sales of about $14 billion and a market cap of $5.5 billion.*
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> *Loews Corporation (NYSE: L) is one of the largest diversified holding companies in the U.S. Its operating subsidiaries are involved in commercial property-casualty insurance, offshore drilling, natural gas, and luxury hotels. The company has a market cap of around $17 billion.*
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> *AutoZone (NYSE: AZO) is a leading auto parts retailer. The company has more than 4,700 stores in 49 U.S. states, the District of Columbia, and Puerto Rico, 325 stores in Mexico, and one store in Brazil. AutoZone has a market cap of $13.4 billion.*

What do these companies have in common, if anything? Before we examine this, let's go on a slight tangent and explore the different alternatives that companies have for capital allocation.

What to do with all this cash?

Companies have two basic choices to spend their cash: (1) invest in their business, or (2) return capital to shareholders. Investing in the business can be done via capital expenditures, working capital spending, or mergers and acquisitions. Companies can return capital to shareholders by paying out dividends or by repurchasing shares.

The decision on how to spend cash should be a mathematical one (i.e., companies should spend cash where it would earn the highest return). If the company generates high returns on equity, it should spend the money on its own business. Nevertheless, great companies typically need little capital to operate their business. Look at Coca- Cola (NYSE: KO) or Microsoft (NASDAQ: MSFT).

To obtain growth, many companies opt to buy other companies, oftentimes in widely different industries than their main business. Did you know, for example, that in the 1980s Coca-Cola owned Columbia Pictures? These acquisitions are typically only justified by the big egos of CEOs and rarely add any value. In fact, academic studies have shown that most mergers and acquisitions are detrimental to shareholder value.

If companies find no good use for their cash investing in their business, then they should return it to shareholders. Again, the decision here hinges on getting more bang for your buck. If, and only if, the stock is trading at a discount to intrinsic value, companies should buy back shares; if not, they should pay a dividend.

Buying it back

Let us go back to the four companies at the beginning of the article. What these companies have in common is that all of them have dramatically reduced the number of shares outstanding by buying back stock consistently through the years.

The table below shows the amount of shares outstanding (in millions) for each of the companies from 2002 to 2012. As the table illustrates, these four companies reduced their shares outstanding somewhere between 27% and 60%.

	Shares outstanding (in millions)			
Year	**TMK**	**AN**	**L**	**AZO**
2002	177.4	298.0	556.3	99.3
2003	169.1	269.7	556.3	88.7
2004	161.9	264.3	556.8	79.6
2005	155.4	262.2	557.5	76.5
2006	147.2	206.8	544.2	71.1
2007	138.3	180.4	529.7	66.0
2008	127.1	176.9	435.1	59.6
2009	124.3	171.7	425.1	50.8
2010	118.9	148.4	418.7	45.1
2011	108.3	135.8	404.5	40.1
2012	**99.0**	**122.0**	**393.0**	37.0
Share reduction	*39%*	*54%*	*27%*	*60%*

Source: Value Line; figures in bold are estimates.

So, how has the stock of these companies performed? And, more importantly, how have they done against the S&P? Before looking at the stock performance, though, let's look at some financial data for the companies. The tables below show the revenue and net profit for all four companies, along with the per share amounts.

TMK Year	Revenue ($ mill)	Net profit ($ mill)	Revenue per share	EPS
2002	2279.0	424.0	12.85	2.34
2003	2375.8	446.4	14.05	2.57
2004	2471.9	473.4	15.27	2.82
2005	2508.1	485.5	16.14	3.06
2006	2784.7	504.4	18.92	3.33
2007	2827.2	522.1	20.45	3.63
2008	2758.3	513.3	21.71	3.87
2009	2687.2	495.6	21.63	3.98
2010	2651.8	526.0	22.31	4.27
2011	2656.3	514.4	24.53	4.68
2012	**2773.0**	**525.0**	**28.00**	**5.25**
10-Year Change	*22%*	*24%*	*118%*	*124%*

Source: Value Line; figures in bold are estimates.

AN Year	Revenue ($ mill)	Net profit ($ mill)	Revenue per share	EPS
2002	19479	381.6	65.36	1.19
2003	19381	378.6	71.86	1.32
2004	19624	370.0	74.26	1.36
2005	19253	395.5	73.42	1.48
2006	18989	352.5	91.84	1.54
2007	17692	288.0	98.09	1.44
2008	14189	179.1	80.23	1.01
2009	10813	207.2	62.96	1.17
2010	12476	246.8	84.09	1.56
2011	13832	285.6	101.87	1.94
2012	**15600**	**305.0**	**127.85**	**2.52**
10-Year Change	*-20%*	*-20%*	*96%*	*112%*

Source: Value Line; figures in bold are estimates.

L Year	Revenue ($ mill)	Net profit ($ mill)	Revenue per share	EPS
2002	17495	982.6	31.5	1.50
2003	16461	802.0	29.6	1.44
2004	15242	1284.8	27.4	1.96
2005	16018	833.8	28.7	1.50
2006	17911	2544.7	32.9	3.69
2007	18380	2568.7	34.7	3.82
2008	14543	572.0	33.4	1.20
2009	14774	1069.0	34.8	2.48
2010	14559	1617.0	34.8	3.83
2011	14179	1095.0	35.1	2.71
2012	**14505**	**1095.0**	**36.9**	**2.75**
10-Year Change	*-17%*	*11%*	*17%*	*83%*

Source: Value Line; figures in bold are estimates.

AZO Year	Revenue ($ mill)	Net profit ($ mill)	Revenue per share	EPS
2002	5325.5	428.2	53.65	4.00
2003	5457.1	517.6	61.52	5.34
2004	5637.0	566.2	70.79	6.56
2005	5710.9	575.1	74.61	7.23
2006	5948.4	569.3	83.68	7.50
2007	6169.8	595.7	93.54	8.53
2008	6522.7	641.6	109.43	10.04
2009	6816.8	657.1	134.19	11.73
2010	7362.6	738.3	163.23	14.97
2011	8073.0	849.0	201.28	19.47
2012	8603.9	930.4	232.36	23.48
10-Year Change	*62%*	*117%*	*333%*	*487%*

Source: Value Line

It is evident from the data that the per-share numbers show a completely different picture than the absolute numbers. The AutoNation (AN) numbers, in particular, are pretty remarkable. From 2002 to 2012 revenues and net profit each declined by 20%. But, the per-share numbers tell a much better story: revenue per share and earnings per share increased by about 100%.

AutoZone's massive reduction of shares outstanding is also evident in the per-share numbers. While revenue has increased by more than 60% and net income has doubled, revenue per share is up more than 300%, while earnings per share are up almost 6-fold.

"Per share" is what matters

Finally, let's look at the stock performance. As can be seen from the graph below, all four stocks have handily beat the performance of the S&P 500 in the last ten years. While the stock market has not done much for this time period, the four stocks have risen at least 100%. AutoZone, our list's most aggressive buyer of its own shares, has been well compensated for its efforts; its share price has increased about 400% in the last ten years.

Source: Yahoo! Finance

Conclusion

When analyzing companies and deciding what stocks to buy, it pays to look at the capital allocation decisions of management. Repurchasing shares is one way that companies can reward shareholders, and, as we have seen, can lead to staggering market-beating returns. Of course, one should look at all the characteristics of a company and not only at whether a company is buying back stock. Take Dell (NASDAQ: DELL), for example; they have spent tens of billions of dollars buying back stock, and they have nothing to show for it.

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