Private & Confidential

# Share Buybacks
## Friend or Foe?

**Terry Smith**
Chief Executive Officer
Fundsmith

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# **Share Buybacks** Friend or Foe?

## Capital allocation

Capital allocation decisions are amongst the most important decisions which management of companies make on behalf of shareholders.

To be a business by any definition which bears scrutiny, a company must generate a positive return on the capital which it has invested, in cash, and indeed a return above its cost of capital. Management regularly has to decide what to do with that cash.

The basic choices are to invest to try to achieve organic growth in revenues, profits and cash flows – I have yet to find a business which does not require some additional capital in order to grow, whether in the form of additional working capital or capital expenditure (capex). Indeed some capex is required merely to maintain the current state of most businesses – so-called maintenance capex – just as it is to maintain our homes.

Businesses can also use the cash they generate to buy other businesses, either the whole (acquisitions) or investments in part of other businesses (shares in trade investments, or associates).

And of course, it is usual to return part of the cash generated to shareholders. This can take the form of dividends, either regular dividends or a special dividend where a company has a build up of excess cash and capital, or share buybacks or repurchases.

The future prosperity of a business and its owners will, to some extent, depend upon whether the management makes logical and good decisions about the allocation of capital between these choices. Companies can no more increase in value if they take in capital at a cost and invest it for a lower return than that cost than individuals can if they invest at a lower rate of return than they pay to borrow the funds they invest.

## Growth in share buybacks

During my time working in financial markets there has been a sea change in attitudes towards share buybacks.

In 1977, 95% of distributions made by quoted US companies were made by way of dividend. By 1997, the majority of the amount distributed was by way of share buybacks, a situation which persists to this day (See figure 1). Nor is the US market unique in this regard.

What has led to this change is in part a change in regulation. In 1982 Congress enacted Rule 10b-18 which provided "safe harbour" to protect companies undertaking buybacks from being sued for manipulation under the terms of the Securities Exchange Act.

**Fig. 1: Dividend and share repurchase history (1977 – 2004)***

| Year | Dividends | Buybacks | Dividends as a % of total payout | Buybacks as a % of total payout |
|---|---|---|---|---|
| 1977 | 34,861 | 2,018 | 95% | 5% |
| 1978 | 40,551 | 4,049 | 91% | 9% |
| 1979 | 45,050 | 4,825 | 90% | 10% |
| 1980 | 50,675 | 5,037 | 91% | 9% |
| 1981 | 56,606 | 6,866 | 89% | 11% |
| 1982 | 63,097 | 7,189 | 90% | 10% |
| 1983 | 66,051 | 9,869 | 87% | 13% |
| 1984 | 70,375 | 11,318 | 86% | 14% |
| 1985 | 78,512 | 30,413 | 72% | 28% |
| 1986 | 81,519 | 48,063 | 63% | 37% |
| 1987 | 91,050 | 50,990 | 64% | 36% |
| 1988 | 102,284 | 67,932 | 60% | 40% |
| 1989 | 105,842 | 61,636 | 63% | 37% |
| 1990 | 107,844 | 56,868 | 65% | 35% |
| 1991 | 108,759 | 40,122 | 73% | 27% |
| 1992 | 108,499 | 36,498 | 75% | 25% |
| 1993 | 114,697 | 41,421 | 73% | 27% |
| 1994 | 119,507 | 51,087 | 70% | 30% |
| 1995 | 125,186 | 77,144 | 62% | 38% |
| 1996 | 137,611 | 100,077 | 58% | 42% |
| **1997** | **136,794** | **129,821** | **51%** | **49%** |
| 1998 | 144,140 | 184,693 | 44% | 56% |
| 1999 | 146,299 | 180,690 | 45% | 55% |
| 2000 | 160,561 | 194,778 | 45% | 55% |
| 2001 | 163,321 | 179,563 | 48% | 52% |
| 2002 | 163,262 | 176,378 | 48% | 52% |
| 2003 | 175,288 | 166,494 | 51% | 49% |
| 2004 | 202,190 | 223,717 | 47% | 53% |

In $ Millions.
*Source: Corporate reports, Empirical research Partners, Bernstein Research, FactSet, LMCM Estimates.

## Attitudes to share buybacks

But there was also a sea change in attitudes. During the 1970s and much of the 80s the commonest criticism heard of share buybacks was that they demonstrated that a management had run out of ideas on how to invest the capital generated by a business. By the 1990s, this attitude had begun to change. This is evidenced by the rise in the percentage of capital returned by companies in the form of share buybacks – in the UK as well as the US market.

Commentators on share buybacks are now almost universally and uncritically supportive of them (See figures 2, 3, 4). Share buybacks are praised by the press and analysts as evidencing management confidence, increasing earnings per share (EPS), and are even regarded by some as 'positive under any scenario' (UBS comment on Quest Diagnostics buyback of half the GSK stake – figure 5).

**Fig. 2: Financial Times**

**BHP buy-back portends slew of shares repurchases**

**Guthrie, Jonathan**

**17 February 2011**

Companies devote much energy to persuading investors to buy their shares. So there is a contradiction implicit in share buy-back programmes of the kind pursued by BHP Billiton and GlaxoSmithKline. The mining group has raised the target for its buy-back scheme from $4.8bn to $10bn (£6.2bn). The pharmaceuticals company plans to repurchase £2bn of shares this year. Perhaps they should employ disinvest or relations officers to hype the advantages of dumping their stock.

There is another cognitive dissonance embodied in a buy-back. A well-run business would surely have better purposes for investors' capital than returning it. BHP Billiton is less challenged here than GSK. The Melbourne-based group will invest eight times the value of its share repurchases in lucrative mining. Returns from drug discovery have, meanwhile, diminished in parallel with the scope for discovering new blockbusters.

Philosophical objections aside, **buybacks make a lot of sense financially. Whittling down a company's equity base automatically increases earnings per share.** Buy-backs also spare remaining shareholders the tax liabilities created by dividend payments. So we should see plenty more this year as surging profits generate spare cash. The last peak was in 2007, when buy-backs worth £5.7bn were completed, according to Thomson Reuters. The total for 2010 was just £1.1bn.

Repurchases are more popular with big companies than smaller ones because their larger pools of equity are less prone to price-repressing illiquidity. Growing from a low base, motor insurer Admiral utilised special dividends as an alternative means of returning spare cash to shareholders.

One-off pay-backs, in whatever form, are a good way to shed cash without unsettling long-term investors, a breed as prone to nervous shocks as neuralgic maiden aunts. Tweaking the dividend is a more dangerous policy. BHP has not cut its own dividend, which it describes as "an annuity", since the Great Depression.

Finally, chief executives love buy-backs for one discreditably egotistical reason. Usually it is their lot to whine impotently about how low the shares are. Buy-backs let them to do something about it.

## Analysts love buybacks too...

**Fig. 3: Citi**

"...dividend and modest share buybacks... viewed as more suitable actions than a special dividend or recapitalization."

17 February: **Lear Corporation**

"Share buyback a welcome surprise – the main highlight was the announcement of a £150m share buyback programme. At c6% of market cap, this should be 3 – 5% earnings accretive."

3 March: **Cobham**

**Fig. 4: J.P.Morgan**

"Share repurchases or acquisitions should boost EPS and limit downside in AIZ...."

3 February: **Assurant Inc.**

"Recent expensive acquisitions appear to have replaced the scope for a buyback in 2011E which is disappointing and does little to allay concerns about the lack of medium term growth."

17 February: **BAE Systems**

**Fig. 5: UBS**

"One of the biggest positives for property-casualty re/insurers has been the return of excess capital to shareholders through share buyback and dividends."

24 January: **US Insurance market**

"We see DGX's willingness to repurchase half of GSK's shares as positive under any scenario."

1 February: **Quest Diagnostics**



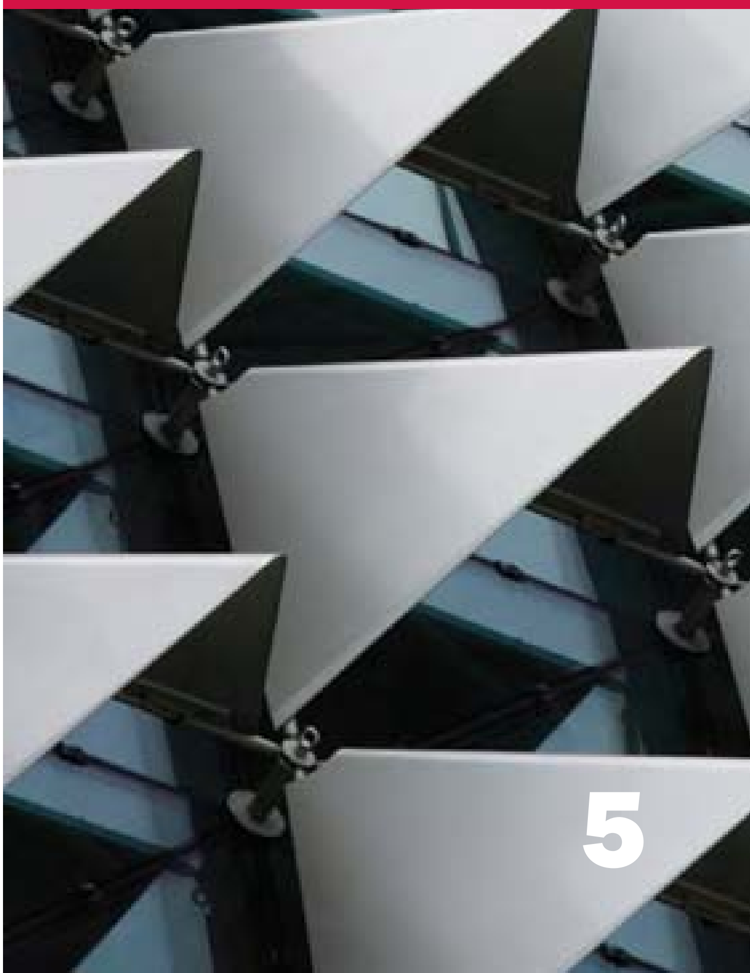
What is universally absent from press and analytical commentary on share buybacks is any discussion of the price at which they are executed, the returns which this implies for the remaining shareholders who are in effect funding the repurchase, and whether they therefore create or destroy value.

This omission seems surprising and even shocking, especially since it is in contrast to the analysis which is typically undertaken when a company buys shares in another company through an acquisition. However, it is matched by a similar lack of discussion by management who almost never seem to feel the need to justify share repurchases by making reference to anything so mundane as the share price or implied returns.

## Buffett on buybacks

**"Nevertheless, it appears to us that many companies now making repurchases are overpaying departing shareholders at the expense of those who stay. In defence of those companies, I would say that it is natural for CEOs to be optimistic about their own businesses. They also know a whole lot more about them than I do. However, I can't help but feel that too often today's repurchases are dictated by management's desire to "show confidence" or be in fashion rather than by a desire to enhance per-share value."**

**Warren Buffett**
*Berkshire Hathaway 1999 Annual Report*



### How do shareholders and management currently think about share buybacks?

To illustrate how companies and investors currently "think" (I use the term loosely) about buybacks we have put together an example focusing upon two identical companies – the snappily named Company A and Company B.

Company A and Company B have the same profits, tax rate, number of shares in issue, shareholders funds and debt (none) and as a result they have the same EPS, Return on Equity (20% pa) and are both rated on a PER of 10x. (See figure 6).

**Fig. 6**

| | A | B |
|---|---|---|
| Profit | 100 | 100 |
| Tax at 25% | 25 | 25 |
| Net profit | 75 | 75 |
| | | |
| Number of shares | 100 | 100 |
| EPS | 0.75 | 0.75 |
| Equity | 375 | 375 |
| Debt | 0 | 0 |
| ROE | 20% | 20% |

### Buyback or dividend?

- Both companies decide to distribute an amount equal to 10% of their equity – i.e. 10% of 375 – to shareholders
- To fund this, they borrow at 5%
- Their stock is trading at 7.5, i.e. 10x earnings
- The choices are therefore to buy back 5 shares at 7.5 each (Company A) or pay out a 37.5 special dividend (Company B)

They both decide to return the same amount to shareholders, but Company A repurchases shares at the current share price whereas Company B pays a special dividend.

The effects of these actions are shown in figure 7. The Return on Equity (ROE) at the two companies will remain the same but the EPS will be higher at Company A which executes the buyback, and if you review the comments of management, analysts and the press you will find that this will almost universally mean that Company A will be seen as having created more value. But can that really be so if their ROEs remain identical and so does the amount of equity capital employed and they have both returned the same amount of cash to shareholders?

### The impact on ROE is identical but a repurchase increases EPS whereas a dividend reduces them

**Fig. 7**

| | Before | After A | After B |
|---|---|---|---|
| | | Buyback | Special dividend |
| EBIT | 100 | 100 | 100 |
| Interest | 0 | 1.875 | 1.875 |
| PBT | 100 | 98.125 | 98.125 |
| Tax | 25% | 24.53 | 24.53 |
| Net Profit | 75 | 73.59 | 73.59 |
| Shares | **100** | **95** | **100** |
| **EPS** | **0.75** | **.7746** | **.7359** |
| Debt | 0 | 37.5 | 37.5 |
| Equity | 375 | 337.5 | 337.5 |
| ROE | **20%** | **21.81%** | **21.81%** |

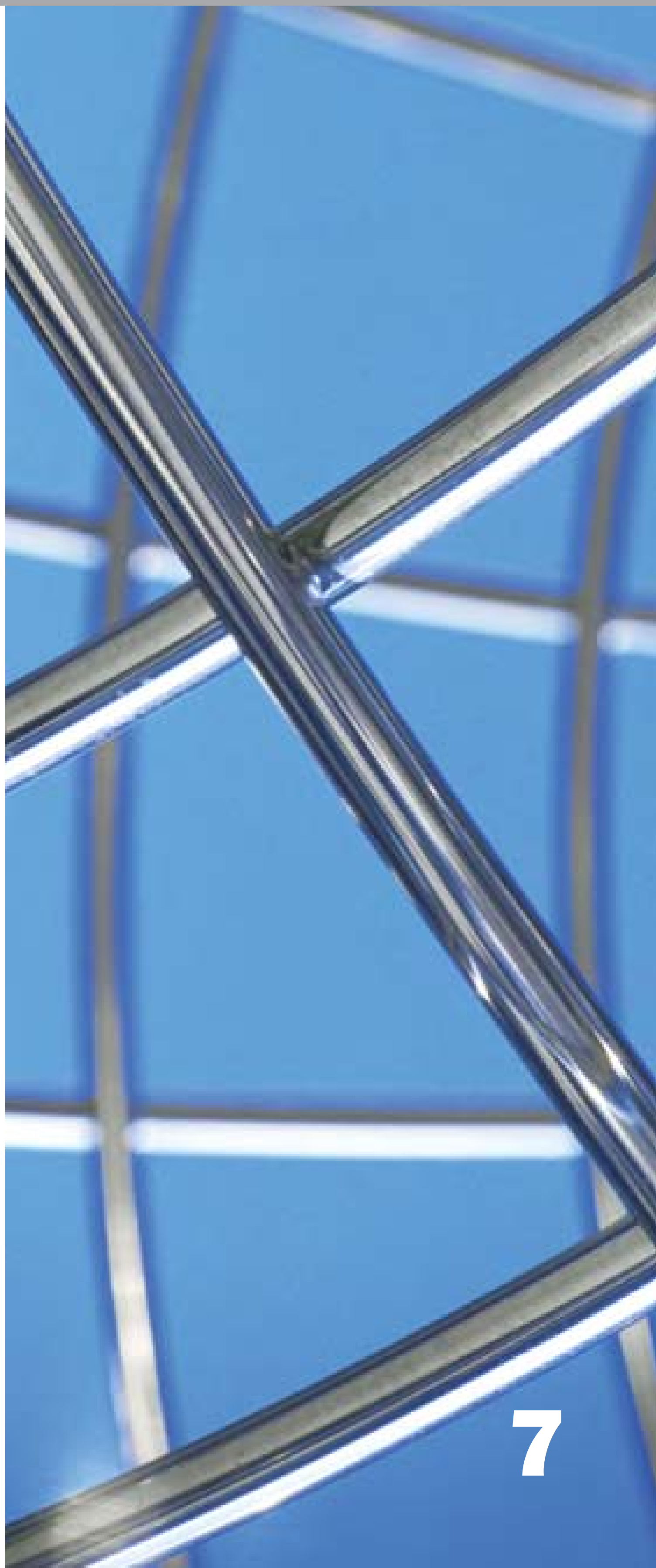


### Moral of the story

- Under conventional accounting, a share repurchase and a special dividend, at the same price, have an identical impact on a company's ROE
- Given this, management inevitably chooses the route that will have the most beneficial effect on EPS
- Since special dividends always exert a negative impact on EPS, while buybacks tend to increase EPS, it is not surprising managements have increasingly chosen the buyback route
- Unfortunately, there are many problems with this EPS-driven approach

### Problems with an EPS-driven approach

- The positive impact on EPS of a share repurchase is the simple arithmetic result of the earnings yield of what you're buying being higher than the after-tax cost of what you're funding the purchase with
- It is not the same as value creation – Bank Account PLC



## Bank Account PLC

This raises the whole subject of whether growth in earnings per share should be the primary or even the sole measure of value creation, or is even valuable at all for this purpose, a myth which we thought had been exorcised many years ago but which seems to keep coming back to life like a character in a vampire movie.

To illustrate the problem with growth in earnings as a measure of performance we put together an example of a bank account. Bank accounts do not produce growth in earnings. If you had a bank account with a 7% interest rate (I first used this example in the 1990s) and you invested 100, you would expect "earnings" of 7 pa which you could remove and spend each year without any diminution in the amount of your capital (figure 8).

If you doubled the amount of capital employed in the account to 200, its "earnings" would be 14 pa, but this would hardly be cause for celebration. Yet when it comes to analyzing companies, investors and commentators seem to forget simple principles like looking at how much capital is required to generate the earnings. To illustrate this, what if our bank account earning 7% pa was incorporated as Bank Account PLC in which we were shareholders? The management looking after our bank account decides it can see "excellent investment opportunities" and instead of paying out all the earnings of the bank account each year they retain 75% to reinvest in the bank account. This would not be unusual for a company – it would represent a dividend cover of four times. And it would produce a compounding effect as shown in figure 9. The 'earnings' of Bank Account PLC would compound at 5% pa.

**Fig. 8: Bank Account**

Rate of interest = 7%

| | Capital | Return | "Retained earnings" | "Earnings" |
|---|---|---|---|---|
| 1992 | 100 | 7% | 0 | 7 |
| 1993 | 100 | 7% | 0 | 7 |
| 1994 | 100 | 7% | 0 | 7 |
| 1995 | 100 | 7% | 0 | 7 |
| 1996 | 100 | 7% | 0 | 7 |
| 1997 | 100 | 7% | 0 | 7 |
| 1998 | 100 | 7% | 0 | 7 |

**Fig. 9: Bank Account PLC**

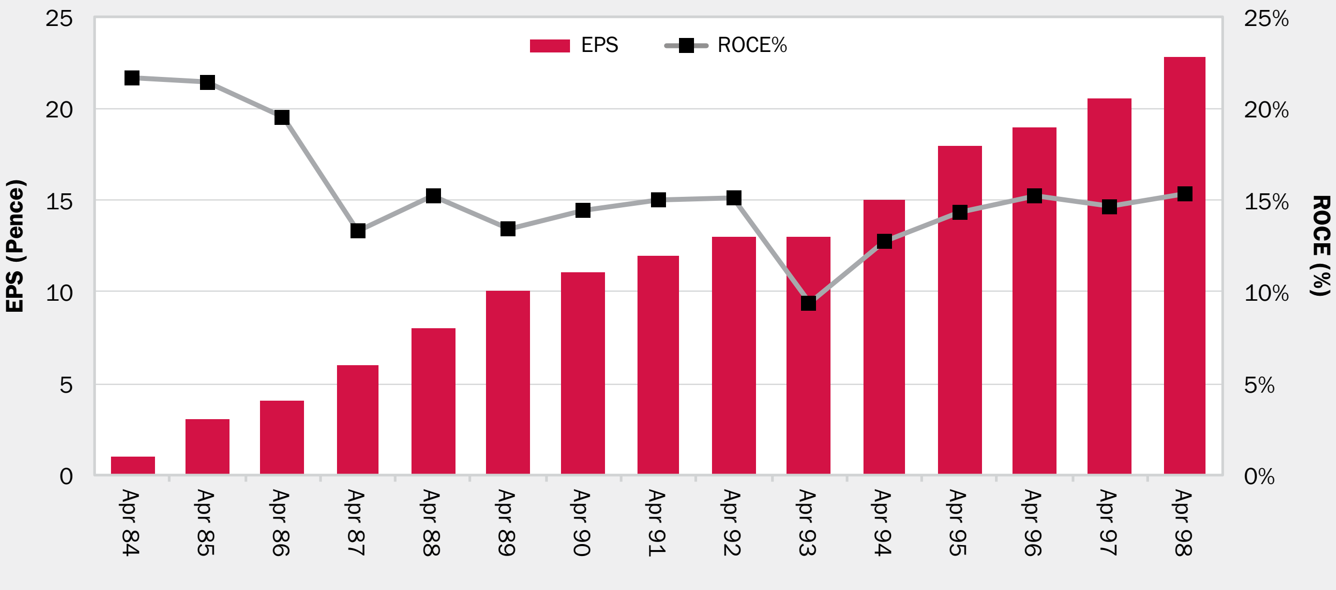
| | Opening Capital | Return | "Earnings" | "Retained Earnings" | Closing Capital | EPS Growth | Cum EPS Growth |
|---|---|---|---|---|---|---|---|
| 1992 | 100 | 7% | 7.0 | 5.3 | 105.3 | | |
| 1993 | 105.3 | 7% | 7.4 | 5.5 | 110.8 | +5% | +5% |
| 1994 | 110.8 | 7% | 7.8 | 5.8 | 116.6 | +5% | +11% |
| 1995 | 116.6 | 7% | 8.2 | 6.1 | 122.7 | +5% | +17% |
| 1996 | 122.7 | 7% | 8.6 | 6.4 | 129.2 | +5% | +23% |
| 1997 | 129.2 | 7% | 9.0 | 6.8 | 135.9 | +5% | +29% |
| 1998 | 135.9 | 7% | 9.5 | 7.1 | 143.1 | +5% | +36% |

You might feel that this example is far fetched, but at the time when I used this example, I would superimpose a bar chart of Bank Account PLC's "earnings" on a slide of the front cover of the annual report of the acquisitive conglomerate Tomkins, which had one thing on the cover of its annual report – a bar chart of its earnings growth. Bank Account PLC's earnings growth exceeded that of Tomkins for the years covered. Sadly I no longer have the Tomkins annual report cover but I do still have a slide which I made up from it (see figure 10) which shows not only Tomkins EPS growth but the consistently declining Return on Capital Employed as more and more capital was deployed at diminishing returns to fuel it.

So value is not created per se by earnings growth especially if it is fuelled by increased capital invested at lower returns. Return on capital employed is a much better measure of value created by companies – just as the interest percentage is on our bank accounts.

Interestingly, there is no advantage in terms of ROE from the share buyback in our example of Company A and Company B so why would investors or commentators regard one company as having created more value with the buyback than the other did with its special dividend? And why do so many companies opt for share buybacks as a means of returning capital to shareholders?

**Fig. 10: Tomkins' Plc EPS & ROCE%**



## Fred Futile CEO of Stagnant Inc

The answer of course lies in how company performance is judged and management incentives are set.

Earnings per share is still the single most frequently used measure of company performance and metric used to set performance targets for equity incentive plans. This fact was not lost on Fred Futile, the newly appointed Chief Executive of Stagnant Inc.

When Fred took over as CEO of Stagnant Inc he realised that he had no hope of generating any growth so he just did two things: a) he got himself a 10 year option over 1% of the company's issued share capital at the current share price, and b) stopped paying a dividend.

Instead he used all of the net profits to repurchase stock.

The outcome is shown in figure 11.

The assumptions are not outrageous – we assume that the PE on Stagnant Inc's stock remains at a constant 10x. But just by dint of stopping payment of the dividend and pursuing the buyback programme, Fred was able to make Stagnant Inc's EPS rise – like those of Bank Account PLC. So at the end of 10 years with the PE remaining at a constant 10, Fred's options had become worth $158m. Not bad work if you can get it. Maybe this explains part of the enthusiasm for share buybacks over dividends, because after all, dividends reduce share prices whereas buybacks make them rise. But has Fred earned his options by creating any value? I don't think so – all he has done is use Stagnant's shareholders' funds to repurchase stock. In all other respects, Stagnant remains the same as it was the day he walked in.

**Fig. 11: Stagnant Inc**

| Year | 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 | 10 |
|---|---|---|---|---|---|---|---|---|---|---|
| Earnings $m | 1000 | 1000 | 1000 | 1000 | 1000 | 1000 | 1000 | 1000 | 1000 | 1000 |
| Shares m | 100 | 90 | 81 | 72.9 | 65.6 | 59.0 | 53.1 | 47.8 | 43.0 | 38.7 |
| Buyback m | 10 | 9 | 8.1 | 7.3 | 6.6 | 5.9 | 5.3 | 4.8 | 4.3 | 3.9 |
| EPS $ | 10.0 | 11.1 | 12.3 | 13.7 | 15.2 | 16.9 | 18.8 | 20.9 | 23.2 | 25.8 |
| Share $ | 122.7 | 7% | 8.6 | 6.4 | 129.2 | +5% | +23% | +23% | +23% | +23% |
| Price (PE 10) | 100 | 111 | 123.5 | 137.2 | 152.4 | 169.4 | 188.2 | 209.1 | 232.3 | 258.1 |
| 1m options @ $100 a share | | | | | | | | | | |
| *Option value $m | 0 | 11.1 | 23.5 | 37.2 | 52.4 | 69.4 | 88.2 | 109.1 | 132.3 | 158.1 |

*Options: over 1% stagnant Inc at a strike price of $100



## Buffett on buybacks

**"Sometimes, too, companies say they are repurchasing shares to offset the shares issued when stock options granted at much lower prices are exercised. This "buy high, sell low" strategy is one many unfortunate investors have employed – but never intentionally! Managements, however, seem to follow this perverse activity very cheerfully."**

**Warren Buffett**
*Berkshire Hathaway 1999 Annual Report*

### Alternative approach needed

- Managements should think about share repurchases the same way they think about other forms of capital allocation
- Investors should think about share repurchases the same way they think about share purchases – price and valuation are critical
- The accounting treatment of share repurchases should be changed to more accurately reflect their impact

### Possible alternative approach

- A repurchase of your own shares should be treated as an investment
- Like other investments, the repurchased shares should be reflected as assets on the balance sheet
- As with other investments, the return on these assets should be reflected in the P&L account
- The most sensible way to do this is to equity account the share of net income attributable to the repurchased shares
- Because one asset – cash – has been replaced with another asset – shares – under this alternative approach there is no impact on shareholders' equity

### How should shareholders view share buybacks?

We would suggest that management and investors should view share repurchases the same way that they would view purchases of shares in another company.

We have constructed a real life example to illustrate this using two similar companies – Coke and Pepsi. Coke and Pepsi make a good example for two reasons. Firstly, they are similar.

They are both named by their most famous brands which are the world's biggest selling carbonated soft drinks. As it happens in 2007-08 the companies' financial condition and market rating were similar in several key respects – their net income, and PEs were also pretty similar (see figure 12).

Secondly, we can make a real comparison because in 2008 Pepsi engaged in share buybacks, repurchasing shares with a total value of $4,720m at a PE of about 21x (see figure 13). You may notice one other thing about figure 13 – the pattern of Pepsi's share buybacks.

Its lowest level of buybacks in 2008 was in the fourth quarter. This was the quarter in which the effect of Lehman's bankruptcy in September hit the market and Pepsi's shares hit their low for the year (along with the shares of almost every other company). Pepsi dealt with this by virtually stopping its repurchase programme.

**Fig. 12: Real life example – Pepsi v Coke**

| | Pepsi | Coke |
|---|---|---|
| 2007 net income | $5,658m | $5,981m |
| Price at Jan 1st 2008 | $75.90 | $61.37 |
| 2008 EPS | $3.21 | $2.49 |
| P/E | 23.6x | 24.6x |

**Fig. 13: Pepsi share buybacks 2008**

| Year to December | Q108 | Q208 | Q308 | Q408 | Total 2008 |
|---|---|---|---|---|---|
| Shares purchased m | 21.3 | 21.6 | 18.7 | 6.8 | 68.4 |
| Average price $ | 71.11 | 68.87 | 67.28 | 67.35 | 68.98 |
| Value $m | 1515 | 1488 | 1258 | 458 | 4720 |
| EPS $ | 3.21 | 3.21 | 3.21 | 3.21 | 3.21 |
| P/E | 22.15 | 21.45 | 20.96 | 20.98 | 21.49 |

I will return to the theme of the timing of companies' share repurchases later, but what actually happened in Pepsi's accounts as a result of the share buybacks?

Figure 14 shows the fall in shareholders' equity and average equity (we calculate returns such as ROE or ROCE on the average of equity or capital in each year's opening and closing balance sheet). Pepsi's net income fell 9% in 2008, but its EPS fell 6% from $3.41 to $3.21. It would have tracked the fall in net income without the share buyback so the effect of the buyback was to increase EPS from what they would otherwise have fallen to. In short, the buyback enhanced EPS. But it had no effect on ROE which remained at 34%.

## An alternative way of accounting for buybacks

The problem is that when a company repurchases shares they disappear from the balance sheet. Unlike an investment in the shares of another company or any other form of investment, the results are not shown in the balance sheet and profit and loss account for all to see and assess.

But what if the shares were shown as an investment?

Figure 15 shows what the effect on Pepsi would have been if the repurchased stock was added back to shareholders funds and shown as an asset. To be fair to Pepsi, profits are increased by equity accounting – increasing profits by the proportion

**Fig. 14: Effect of buyback – actual numbers**

| $m | 2007 | 2008 | |
|---|---|---|---|
| Total repurchased common stock | **(10,387)** | **(14,122)** | |
| Common shareholders equity | 17,325 | 12,203 | |
| Average equity | 16,386 | 14,764 | |
| Net income | 5,658 | 5,142 | -9% |
| No of shares | 1658 | 1602 | -3% |
| EPS | **$3.41** | **$3.21** | -6% |
| Return on average equity | **34.53%** | **34.83%** | |

**Fig. 15: Effect of buyback – alternative accounting**

| $m | 2008 |
|---|---|
| Shareholder's equity | 12,203 |
| Add back repurchased stock | 4,720 |
| New 2008 shareholders equity | 16,923 |
| 2007 shareholders equity | 17,325 |
| New average | 17,124 |
| Net income | 5,142 |
| Plus: net income attributable to repurchased stock | 220 |
| New net income | 5,362 |
| New ROE | **31.31%** |
| New share count | 1670m |
| New EPS | **$3.21** |

of profits which relate to those shares. The result is that EPS would still remain at $3.21 as it does with the usual form of accounting for share buybacks as the number of shares in issue has been increased back to the original amount and so has the net income, but ROE is reduced to 31% which is a bit worrying, if, like me, you believe this is a better guide to value creation, or in this case, destruction. This effect occurs because of the implied return on which Pepsi has repurchased its own shares. It has an ROE of 34% in 2007 before the buyback whereas with its shares on a PE of 21 the earnings yield (the inverse of the PE) is about 5% which is the implied return on purchasing the shares.

There is a way of illustrating the fact that this is a better way of representing the effect of Pepsi's buyback. What if instead of buying its own shares back it had used the cash to purchase shares in Coca-Cola? After all, Coke is in a similar business and on a similar rating – surely the effects in terms of value created or destroyed would be about the same.

Figure 16 shows the outcome if instead of buying back its own stock in 2008, Pepsi had spent $4.7bn on purchasing shares in Coca-Cola. Investments on the balance sheet would increase. Shareholders funds would remain unaltered as would the number of shares in issue (there are still small changes relating to stock options exercised in 2008). The net effect is that EPS would remain virtually unaltered at $3.20 per share, which is hardly surprising as Coke was on about the same PE as Pepsi. But ROE would be reduced to 31%.

This is the same as in our alternative accounting example. It illustrates that the alternative accounting method shows the reality of Pepsi's share buybacks in 2008 – they destroyed value for remaining shareholders.

The outcome is summarized in figure 17.

**Fig. 16: Pepsi buys Pepsi v Pepsi buys Coke**

| $m | 2007 actual | 2008 actual | Buys Coke |
|---|---|---|---|
| Investments | 1,571 | 213 | 4,933 |
| Common equity | 17,325 | 12,203 | 16,923 |
| Net income | 5,658 | 5,142 | 5,346 |
| No of shares | 1,658 | 1,602 | 1,670 |
| EPS | **$3.41** | **$3.21** | **$3.20** |
| Average equity | 16,386 | 14,764 | 17,124 |
| ROE | **34.53%** | **34.83%** | **31.22%** |

**Fig. 17: Pepsi summary**

| | 2007 | 2008 Conventional accounting | 2008 Alternative accounting | 2008 Pepsi buys Coke |
|---|---|---|---|---|
| EPS | $3.41 | $3.21 | $3.21 | $3.20 |
| ROE | 34.53% | 34.83% | 31.31% | 31.22% |

### Buy high sell low (I think that's the right way around)

What we are discovering is that companies can no more create value when they buy their own shares when they are expensive than they can if they buy the shares of other companies which are overvalued.

The only way to create value from such activity is to deploy the so-called Greater Fool theory of investment. This allows you to over pay for investments on the basis that a greater fool will pay even more for them and enable you to sell at a profit. It is evident from their investment record that most investors are incapable of implementing the Greater Fool technique successfully. But it is surely impossible to even try it in relation to share buybacks.

Buying back shares for cancellation is surely a buy and hold strategy and it is impossible to profit from the greater fool, even if he or she exists, if you are not going to sell.

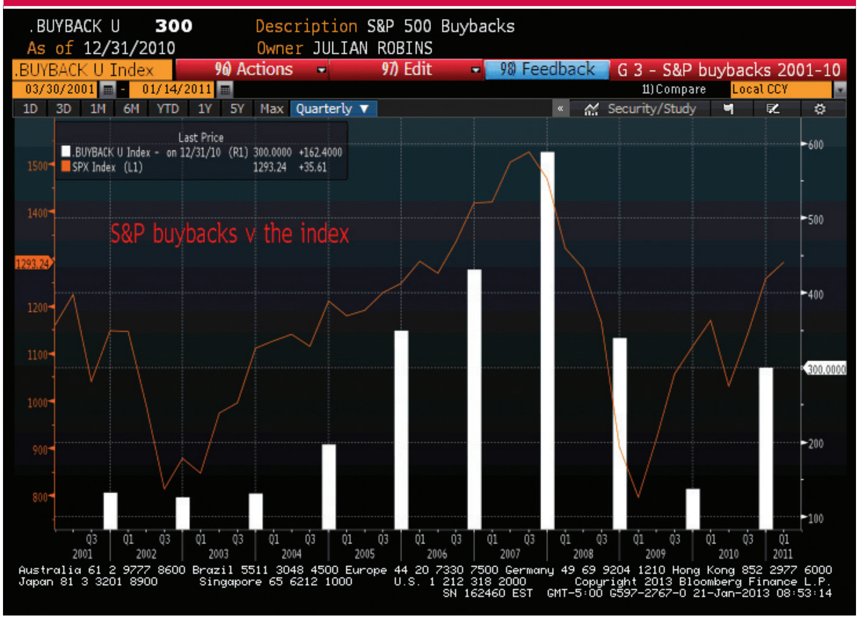
This makes companies (mis)adventures in implementing share buybacks all the more alarming from the perspective of their remaining shareholders who are in effect funding their purchases. Figure 18 looks at buybacks by companies in the S&P 500 Index from 2001-2010. The build up of buybacks relative to dividends is evident. So is the build up of buybacks relative to the level of the market with buybacks reaching a peak in 2007 at the peak of the market and falling significantly in 2008 and even more in 2009.

A picture is worth a thousand words, and this buyback activity is plotted relative to the market on figure 19. From this it is clear that company management are employing a buy high investment technique. As a fund manager once wryly expressed it to me when describing how counter intuitive most investors value destroying activity is: "They wait for shares to risen to a buying level."

**Fig. 18: S&P buybacks 2001 – 2010**

| $bn | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 |
|---|---|---|---|---|---|---|---|---|---|---|
| Buybacks | 132.2 | 127.2 | 131.0 | 197.5 | 349.2 | 431.8 | 589.1 | 339.6 | 137.6 | |
| Dividends | 142.2 | 147.8 | 160.6 | 181.0 | 201.8 | 224.2 | 245.7 | 247.3 | 195.6 | |
| Buybacks % | 48.2 | 46.3 | 44.9 | 52.2 | 63.4 | 65.8 | 70.6 | 57.9 | 41.3 | 58.5 |
| Dividends % | 51.8 | 53.7 | 55.1 | 47.8 | 36.6 | 34.2 | 29.4 | 42.1 | 58.7 | 41.5 |

**Fig. 19: 2001 – 2010 market v buybacks**



## Never mind the theory-companies that do buybacks outperform. Don't they?

Some investors and commentators maintain that you can ignore the high falutin' theory which demonstrates that most buybacks destroy value, the fact is that they create demand for the shares and show management's confidence and so shares outperform after buybacks.

Do they? We have a study of 1239 US companies which did buybacks in the decade 1980-1990 (see figure 20). This decade was chosen because it was the decade which included the Rule 10b-18 enactment which started the buyback craze.

At first glance it would appear that it is true that companies which do buybacks outperform.

Figure 21 shows the performance of companies which buyback as a portfolio compared to a reference portfolio with the same number of companies randomly chosen. The buyback companies outperformed the reference portfolio every year for three years after the buybacks and the compound returns were 12% higher over the three years.

**Fig. 20: Share buyback announcements between January 1980 and December 1990**

| Year | No. | $ billion |
|---|---|---|
| 1980 | 86 | 1.429 |
| 1981 | 95 | 3.013 |
| 1982 | 128 | 3.106 |
| 1983 | 43 | 1.645 |
| 1984 | 203 | 10.105 |
| 1985 | 113 | 14.38 |
| 1986 | 145 | 17.189 |
| 1987 | 92 | 27.38 |
| 1988 | 121 | 14.967 |
| 1989 | 117 | 31.971 |
| 1990 | 96 | 17.403 |
| All Years | 1239 | 142.587 |

**Fig. 21: Annual buy-and-hold returns following share repurchase accouncements, 1980 – 1990**

| | Annual Buy and Hold Returns | | | | Compound Holding Period Returns | | |
|---|---|---|---|---|---|---|---|
| | No. | Repurchase Firms | Reference Portfolio | Diff. | Repurchase Firms | Reference Portfolio | Diff. |
| All firms | | | | | | | |
| Year 1 | 1208 | 20.8 | 18.76 | 2.04 | 20.8 | 18.76 | 2.04 |
| Year 2 | 1188 | 18.12 | 15.81 | 2.31 | 42.69 | 37.53 | 5.16 |
| Year 3 | 1047 | 21.77 | 17.18 | 4.59 | 73.75 | 61.15 | 12.06 |

Case for share buybacks proven? Not if you consider valuation. Figure 22 shows the companies broken down into quintiles based upon a very simple valuation yardstick: price to book value. You will see that we have labeled the highest price to book value stocks “Glamour stocks” and the low price to book value stocks imaginatively “Value stocks”.

Figure 23 shows that from one year to three years after buyback the Glamour stocks underperform the reference portfolio, whereas the Value stocks generate a massive 34% compound outperformance over the three years.

Share buybacks do create value for remaining shareholders and share price outperformance but only if the shares are cheap.

**Fig. 22: Market to book value quintiles**

| | |
|---|---|
| 1 (“Glamour stocks”) | 201 |
| 2 | 260 |
| 3 | 276 |
| 4 | 230 |
| 5 (“Value stocks”) | 241 |

**Fig. 23: Annual buy-hold returns following repurchase announcement, 1980 – 1990**

| | Annual Buy and Hold Returns | | | | Compound Holding Period Returns | | |
|---|---|---|---|---|---|---|---|
| | No. | Repurchase Firms | Reference Portfolio | Diff. | Repurchase Firms | Reference Portfolio | Diff. |
| **Book-to-Market Quintile 1 (Glamour stocks)** | | | | | | | |
| Year 1 | 201 | 15.72 | 16.83 | -1.11 | 15.72 | 16.83 | -1.11 |
| Year 2 | 195 | 17.86 | 16.60 | 1.26 | 36.40 | 26.22 | 0.18 |
| Year 3 | 184 | 12.00 | 13.61 | -1.61 | 52.77 | 54.75 | **-1.98** |
| **Book-to-Market Quintile 2** | | | | | | | |
| Year 1 | 260 | 20.59 | 18.43 | 2.16 | 20.59 | 18.43 | 2.16 |
| Year 2 | 250 | 12.34 | 15.07 | -2.73 | 35.47 | 36.28 | -0.81 |
| Year 3 | 223 | 22.39 | 17.29 | 5.10 | 65.80 | 59.84 | 5.96 |
| **Book-to-Market Quintile 3** | | | | | | | |
| Year 1 | 276 | 19.49 | 16.46 | 3.03 | 19.49 | 16.46 | 3.03 |
| Year 2 | 268 | 18.23 | 17.33 | 0.90 | 41.27 | 36.64 | 4.63 |
| Year 3 | 225 | 20.77 | 16.57 | 4.20 | 70.61 | 59.29 | 11.32 |
| **Book-to-Market Quintile 4** | | | | | | | |
| Year 1 | 230 | 23.43 | 22.84 | 0.59 | 23.43 | 22.84 | 0.59 |
| Year 2 | 228 | 15.16 | 12.73 | 2.43 | 42.14 | 38.48 | 3.66 |
| Year 3 | 198 | 24.05 | 18.32 | 5.73 | 76.32 | 63.85 | 12.47 |
| **Book-to-Market Quintile 5 (Value stocks)** | | | | | | | |
| Year 1 | 241 | 24.15 | 19.49 | 4.66 | 24.15 | 19.49 | 4.66 |
| Year 2 | 234 | 26.01 | 17.23 | 8.78 | 56.44 | 40.08 | 6.36 |
| Year 3 | 199 | 29.81 | 20.49 | 9.32 | 103.77 | 68.78 | **34.29** |



### Valuation matters

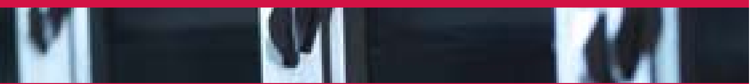
**Companies which buyback expensive shares destroy value and underperform.**

### The press gets it wrong

**"The way in which cash is returned to the shareholders is irrelevant."**

8 January 2010: **FT Lex**

**This is wrong – Buying back shares when they are not cheap destroys value for remaining shareholders.**



### Buffett on buybacks

**"When companies with outstanding businesses and comfortable financial positions find their shares selling far below intrinsic value in the marketplace, no alternative action can benefit shareholders as surely as repurchases."**

**Warren Buffett**
*Berkshire Hathaway 1984 Annual Report*

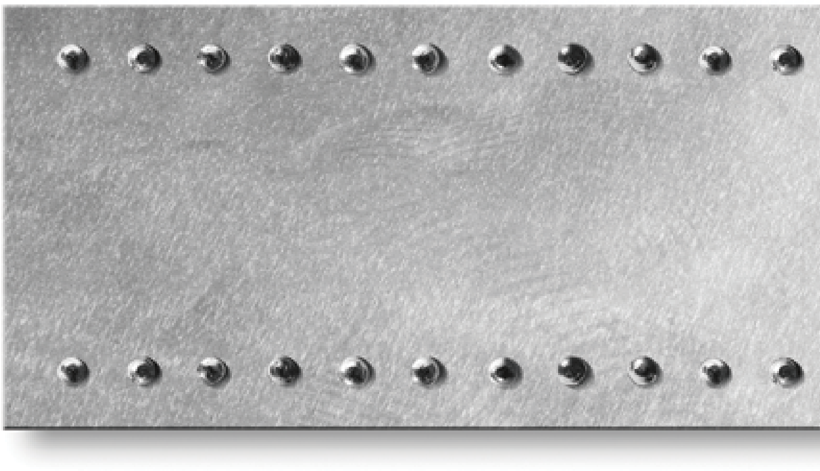
### What to do?

We would suggest the following conclusions from all this:

- Share buybacks are not sufficiently understood by company investors and commentators, and maybe by company managements (although some of them may understand them perfectly well but not be using them to create value or anyone other than themselves)
- Share buybacks only create value if the shares repurchased are trading below intrinsic value ***and*** there is no better use for the cash which would generate a higher return
- Current accounting for share buybacks conceals their true effect
- Most share buybacks now destroy value for remaining shareholders

And we would suggest the following actions to remedy this:

1. Management should be required to justify share buybacks by reference to the price paid and the implied return and compare this with alternative uses for the cash
2. Investors and commentators should analyse share buybacks on exactly the same basis as they would if the company bought shares in another company
3. Investors and commentators should use return on equity to analyse the effect of share buybacks rather than movements in earnings per share
4. Share buybacks need to be viewed with more than average skepticism when done by companies whose management are incentivised by growth in Earnings Per Share
5. Accounting for share buybacks should be changed so that the shares remain as part of shareholders funds and as an equity accounted asset on the balance sheet in calculating returns



Fundsmith

33 Cavendish Square
London
W1G 0PW
UK

T +44 (0)330 123 1815
E enquiries@fundsmith.co.uk
W www.fundsmith.co.uk