Stock Buyback ABCs

What is a stock buyback?

A company uses its cash to purchase its stock from a stockholder who wishes to sell, generally on the open market.

What is the effect of a stock buyback?

For the company, it has less cash on hand to spend for other purposes (investment, acquisitions, compensation).

For the former shareholder, it now has cash that it can invest in another company or spend.

For the remaining shareholders, they own a larger percentage of the company but the company no longer has the cash. The value of those two things are equal, so they are neither better nor worse off.

Why would a company deplete cash that it could be using for other purposes?

Basically, if a company has attractive investment opportunities, it will use cash for that purpose. Those uses could include technology, investments in new lines of business or acquisitions. Research shows that buybacks tend to be more common in mature companies that are generating a lot of cash but do not have sufficient growth opportunities to invest all that cash.

From the perspective of a shareholder (whom the company's board of directors has a duty to serve), the company should invest the cash if that investment will yield a relatively high rate of return, but should return it to the shareholders if it can generate a higher rate of return if invested elsewhere. Both share repurchases and dividends are ways of returning profits to shareholders.

In a share repurchase, some shareholders sell their shares back to the company in exchange for cash that they can invest in a company that can earn a higher rate of return on that money. Or the shareholder can spend that money. For shareholders who do not take advantage of the repurchase and instead retain their shares, they now own a larger percentage of the future earnings of the company.

So, for example, if the company's best alternative is simply to park cash in a deposit account at a bank or purchase a Treasury security at a very low rate of interest, then a shareholder would prefer to get that cash back and invest it in a growing company. And the remaining shareholders would prefer to earn a greater share of the existing, now smaller company than to hold a smaller share of a larger company holding low-yielding cash.

What sort of analysis does a company do in deciding whether to buy back shares?

The company considers what its rate of return on a new investment will be. The company also will consider where its shares are trading. Buybacks are common when based on market or idiosyncratic factors, a company's stock price is depressed, and trading close to its tangible book value (what it would have realized if it ceased operations and sold off its tangible assets – so basically, the value of the assets on the books, with zero value given for the franchise or its intangible assets).

So is it fair to say that buybacks tend to shift investment dollars to where they can produce greater economic growth?

Yes.

Why wouldn't a company generating excess cash just pay all of that cash out to its employees and executives?

Companies compete for investment dollars, and shareholders expect a company to maximize its returns. That generally means paying employees and executives compensation to attract and retain a talented workforce, but with the profits of the enterprise going to its shareholders.

Here, a corporation is no different from a small business. The owner of a new restaurant might use her revenues to purchase new equipment (appliances, cutlery, linens) and raise pay to attract better cooks and waiters. On the other hand, the owner of a long-established restaurant that already has sufficient equipment and is paying employees a competitive wage might keep those revenues as profit.

What is the difference between a stock buyback and paying a dividend?

With a dividend, profits are distributed pro rata to all the shareholders. With a repurchase, that cash is returned only to shareholders who choose to sell their shares, which allows the remaining shareholders to increase their stakes.

Consider the simplest possible firm – Simple Co. – whose asset consists of $200 in cash. Clearly, Simple Co. is worth $200. Assume that Simple Co. has two shares of stock outstanding, each, of course, worth $100. Those shares are owned by Bob and Carol. The Simple Co. board of directors decides to distribute $100 to its owners. It could do so in two ways.

First, Simple Co. could pay a $100 dividend. Bob and Carol each receive $50 in cash. The company is now worth only $100, so Bob and Carol now each hold a share of stock worth $50. They are in the same economic position they were originally: they each have $100 ($50 in cash, $50 in stocks).

Second, Simple Co. could repurchase Bob's shares for $100. Bob now has $100 in cash and no interest in Simple Co. Carol gets no cash but is now the sole owner of Simple Co.'s remaining $100 in assets.

Note that Bob's choice to sell back stock and Carol's decision to keep it may be tax driven. Bob will have to pay a capital gains tax on any gain on his sale, whereas Carol will continue to be taxed at her income tax rate for the dividends she receives. For both, the capital gains rate could be higher or lower than the income tax rate.

Doesn't management frequently engineer buybacks to boost the share price (and thereby their compensation tied to the stock price)?

First, dividends are a decision of the board of directors, not management.

Second, by definition a stock buyback leaves the stock price unchanged, all things being equal. (The only exception is if the market grows more confident about the stock because it interprets the board of director's decision to buy back stock as an indication the stock is undervalued.

(There is one scenario where management will recommend repurchases for compensation-related reasons. Some companies offer employees stock or stock options as part of their compensation, and these stock awards increase the number of shares of the company and thus dilute the ownership of the existing shareholders. In that case, the firm might engage in a share buyback to neutralize the effect and leave existing shareholders with the same stake in the company. But these repurchases are small in size.)

Why might one company favor using its excess profits for dividends and another favor share repurchases.

It depends on the type of company. Shareholders that invest in mature companies that pay dividends are typically seeking a steady stream of income. To satisfy this investor base, corporations prefer to change dividends only rarely if possible. Moreover, because corporations prefer to change dividends rarely, any reduction in dividends sends a signal that the corporation anticipates lower profits for an extended period, and therefore often sparks an outsized reduction in stock price.

By contrast, it is much easier for such a corporation to vary its stock repurchase program. Typically, the corporation will announce a target size for the program over a year but will then repurchase shares when convenient to do so, often purchasing less than the total amount. For this reason, a reduction in repurchases does not disappoint existing shareholders and discourage potential investors.

In practice, buybacks are common and most companies both pay a dividend and have a buyback program. In 2018, for example, 424 of the S&P 500 firms repurchased shares.

Much of the focus of buybacks has been on banks – is their situation any different?

As an economic matter, no. Large banks tend to be mature companies and are seen by the market as akin to utilities. Thus, they generate a lot of cash that may not have productive investment options. Also, their shareholders tend to be those looking for steady income. As a result, banks are generally high dividend companies that also make share repurchases.

Regulation, however, tends to push larger banks away from dividends and toward share repurchases. The Federal Reserve recognizes the greater flexibility of share repurchases relative to dividends and treats them favorably in its stress tests. In explaining the different treatment, the Board cites an FRBNY staff report by Beverly Hirtle, now Head of Research, which demonstrated that large banks were much quicker to cut share repurchase programs than dividends during the 2007-09 financial crisis. Hirtle notes that "…supervisory measures encouraging BHCs to rely more on repurchases could enhance the stability of individual BHCs and of the banking system if these distributions can be reduced without sending potentially destabilizing signals to market participants."[1]

[1] Beverly Hirtle, "Bank Holding Company Dividends and Repurchases during the Financial Crisis," Staff Report No. 666, March 2014, Revised April 2016, p.19. https://www.newyorkfed.org/medialibrary/media/research/staff_reports/sr666.pdf