

# BUYBACKS, PLASTIC BANANAS, PAYOUT AND DIVIDENDS



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**W**hen discussing the merits of our high dividend equity strategy with Trustees and their advisors, one of the most frequent questions we get asked is “what about buybacks?” The assumption (understandable given the way they are usually hyped) is that buybacks and dividends are opposites of, or substitutes for, each other. Either a company tries to reward its shareholders through repurchasing shares or it does so through dividend payments. Right?

This mindset was brought home to me again when I read an article over Christmas called “Buybacks: Plastic Bananas for Investors”. The basic gist of it was that buybacks can be a bit of a con, some have merit, but generally they are no substitute for dividends. A bit like giving plastic bananas to hungry gorillas - they look the part but will leave investors disappointed and frustrated.

While I can empathise with where the author is coming from (buyback announcements on their own can be very misleading) he is falling for the same illusion as everyone else – that buybacks and dividends are substitutes for each other. However more often than you think, repurchases are complementary to, and not replacements for, dividends.

That said, not all repurchases are the same and there are many things you need to check before deciding whether they are good or bad. While they are too numerous to cover here, there are two very dangerous assumptions that are commonplace.

## JUST BECAUSE IT LOOKS LIKE A BANANA...

The first dangerous assumption is that announced buybacks and actual buybacks are the same. Believe it or not companies can officially announce a repurchase programme but not actually follow through with the announcement, and it's far more prevalent than you might think. Table 1 shows the difference between announced buybacks and completed buybacks since 1987. Clearly, sustainable shareholder value cannot be created from announcements alone.

It also shows a more realistic measure that investors should look for – net repurchases. This is the level of repurchases left after the company's management has taken what it needs for share options. Again the motivation behind buyback programmes isn't always the release of value to ordinary shareholders. Net repurchases is the genuine measure of the level of buybacks available for ordinary shareholders. However the dilution of the apparent benefits of buybacks doesn't stop here. There are more things to examine before deciding if the bananas are real!

## APPETITE FOR DESTRUCTION?

This brings us to our dangerous assumption number two - that shares are destroyed after repurchase. Remember that buybacks only create value if the shares are destroyed after they are bought

back. (The number of shares fall, increasing the value of the remaining ones.) However, even if we just look at genuine net repurchases there are still a high percentage of these that are not destroyed. Oftentimes they are used for M&A's, or even reissued at a higher level. This point is missed by most investors and academic studies.

In 2005 for example, S&P500 constituent companies bought back 300 billion worth of shares, and paid out dividends of €201 bn. However, if you check the number of outstanding shares, they actually **increased** by 1.45%. So despite huge buybacks, shares were not being destroyed.

The most obvious example is Proctor and Gamble who bought back 5.6 million shares of its own stock in Q4 2005 - more than any other company in the world. However they were all used to pay for the acquisition of Gillette. Nothing to do with payout or returning value to the shareholder - just another way for the company to finance an acquisition.

So the actual amount of companies using buybacks to genuinely boost shareholder value is significantly smaller than it appears. Most companies see buybacks as a creative way of using their capital structure for finance purposes, and dividend payers appear to be more adept at managing their capital than non dividend payers.

## HOW DO YOU LIKE THESE BANANAS?

However, as Table 2 shows, none of these corporate finance tricks take away from the initial proposition - that repurchase programs, once genuinely executed and accompanied by share destruction, are an attractive form of payout for investors. And armed with this higher level of payout they tend to outperform on a total return basis also.



To calculate these figures the S & P index is divided into each of its industrial sectors. Companies are then ranked based on the reduction (or increase) in their outstanding shares. The companies with the highest level of share reduction are ranked at the top. The chart shows the relative out performance of the top 20% of share reducing companies against the bottom 20%. The period covered is 1974 – 2004.

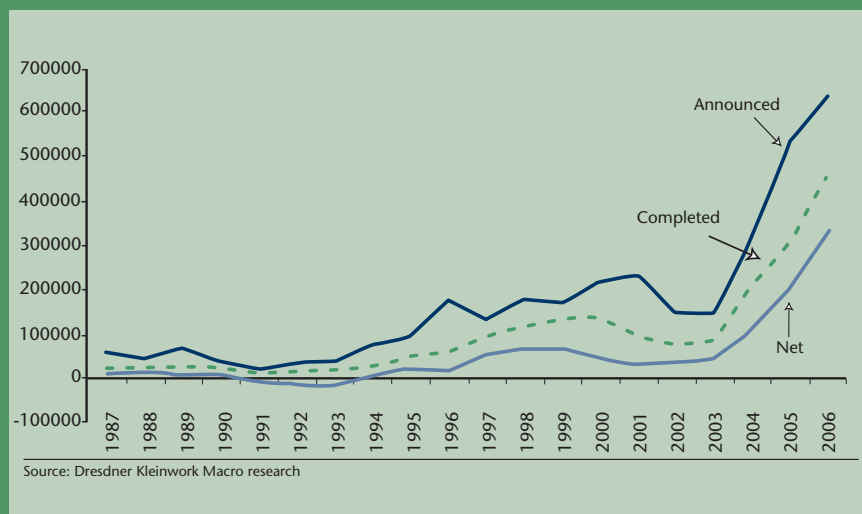
What is true is that the corporate finance tricks we mentioned earlier create a lot of decoys and distractions which makes the genuine share decrease harder to find. Harder to find that is, unless you remember that dividends and buybacks (the executed kind, and accompanied by share destruction) are complements, not substitutes. In order to do either companies need to have a culture of shareholder awareness and be cash rich in the first place. Dividends tend to be paid from long run sustainable cash flows, while repurchases tend to be paid from temporary cash surpluses. Shareholder oriented repurchases are mainly undertaken by dividend payers and tend to increase their already high payouts. Repurchases are flexible (and as a result unpredictable) and tend to be juggled/traded off with reinvestment decisions, whereas dividends are treated with more consistency.

### SUMMARY

In the same way as it's important not to confuse dividend yield with dividend payout, and not all companies that pay good dividends are good investment propositions, the same is true for buybacks. It's really important not to generalise. There is a great deal of hype surrounding buybacks. Mostly from the management teams of the companies who initiate them and mostly because it's in their interest, not the shareholders. Nonetheless, there are a significant number of share decreaseers out there that are returning value to their shareholders.

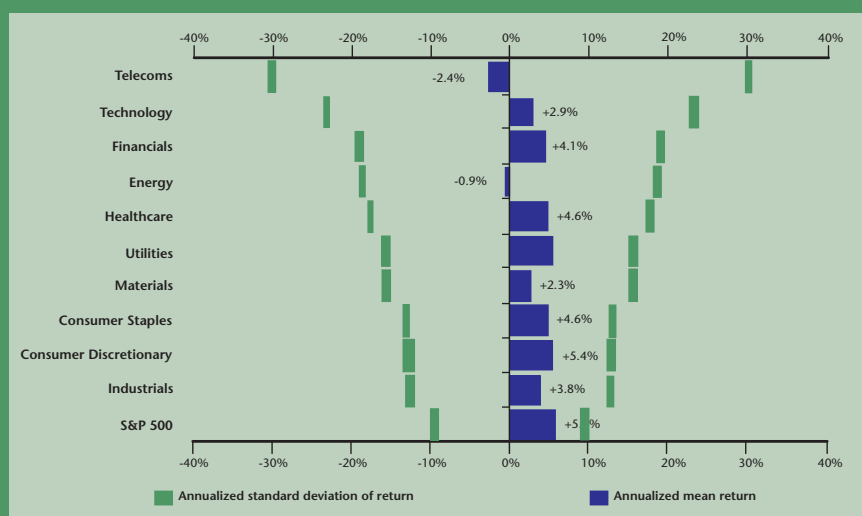
Share repurchases have surged from the 1980's. As a percentage of dividends they have gone from 13% to over 100%. Crucially however, over this period, dividend payouts have not fallen, so they can't be substitutes. A number of studies, all reveal the same thing - investors who are looking for sustainable value creation should think of repurchases as complements to, and not replacements for, dividends.

**Table 1: Announced, completed and net repurchases (US\$ mn)**



*Note: Net repurchases = level of repurchases after the issuance for share options has been deducted.*

**Table 2: Share Decreasers Tend to Outperform**



*Source: Morgan Stanley Quantitative Research. Chart shows cumulative total return to a portfolio which is long the top quintile, and short the bottom quintile, of the individual sectors in the S&P 500 as sorted by year-on-year changes in total shares (adjusted for share splits), rebalanced monthly, from 1974 to 2004.*

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