Share buybacks: good, bad or ugly?

April 4 2018, by Marie-Morgane Le Moel

Investors like the share price rise that buybacks almost always bring

Share buybacks are all the rage among the world's companies, to the delight of many shareholders but not of critics who say they are lazy, short-sighted and mostly designed to enrich corporate fat cats.

Be it Adidas and Total in Europe or Cisco and Boeing in the United

States, big names are rushing to announce such buybacks which involve using surplus cash to pick up the company's own stock in the open market.

Usually the shares are then cancelled, meaning the company's value is now spread over fewer shares.

Share buybacks are not new, but 2018 portends to be a particularly big year for such operations.

According to TrimTabs, an independent institutional research firm in the United States, US firms have already announced $226 billion in share buybacks since the beginning of the year.

A JP Morgan analyst expects $800 billion from companies listed on the S&P 500 alone this year, up from $530 million last year, thanks in no small part to tax reforms of US President Donald Trump.

Companies, sitting on big profits from last year when the economy grew briskly, need to decide whether to plough the cash back into the business, or give it back to shareholders, either via dividends or share buybacks.

US firms tend to opt for buybacks, a choice that's becoming more frequent in Europe as well.

"Share buybacks are an option that provides more flexibility than dividends," said William De Vijlder, chief economist at BNP Paribas.

"But for shareholders turns out to be the same, expect for tax treatment," he told AFP.

By going for the shares option rather than a cash payout, companies support their share price, which typically increases in such operations.

As there is less stock in circulation, they also mechanically boost their profits per share, a measure of performance that market analysts consider key.

Some observers suspect that the enthusiasm of top managers for share buybacks may also be motivated by boosting the value of the variable part of their remuneration package which often includes stock options and outright share allocations.

Adidas said last month it would buy back three billion euros worth of stock

"The remuneration incentive of executives based on the share price is without a doubt behind this increase in share buybacks," said Christophe Moussu, a professor at the ESCP Europe business school.

Dividends and share buybacks have doubled in 15 years, he noted.

Wage compression

While most shareholders welcome share buybacks—which can reach billions of dollars per company—some experts call them a manifestation of short-term thinking by corporate leaders.

Larry Fink, the chief executive of the world's largest asset manager, BlackRock, has criticised share buybacks for undermining a company's long-term strategy.

A 2015 study by US economist Heitor Almeida found that share buybacks can have a detrimental effect on research and development spending.

"When a company buys its shares, that is saying it doesn't have anything better to do with its cash, which is somewhat worrying from an investment perspective," said Patrick Artus, chief economist at French corporate and investment bank Natixis.

"There is an issue, but is there a problem?" queried BNP Paribas's De Vijlder.

"We could also ask how shareholders accept companies having way too much cash, which is saying that part of their assets aren't bringing in anything," he added.

For Natixis's Artus, it hasn't been investment that has suffered from the cash spent on share buybacks.

"US companies invest a lot. The cuts haven't been made there, but more on wages, which have under considerable pressure for 20 years," he said.

Artus pointed to another, perhaps unintended, effect of share buybacks: Thanks to share buybacks "there are half as many listed firms in the United States than 20 years ago. US capitalism is gradually becoming non-quoted," he said.

Relying on private capital instead of listed stock means "there is less short-termist pressure," said Artus. "That could have a positive effect on US capitalism in the long term."

Citation: Share buybacks: good, bad or ugly? (2018, April 4) retrieved 26 June 2024 from https://phys.org/news/2018-04-buybacks-good-bad-ugly.html