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In Buyback Craze, Companies Rush to Buy High

By Michael Santoli | Michael Santoli – 37 minutes ago

A bull market feeds on forces that are good until they go too far, while shrugging of things that will be a problem eventually (but just not yet).

Low interest rates, ample liquidity, rising risk appetites and a quickening pace of corporate deal-making are all nourishing the current rising stock-market trend, and very possibly will for a while to come, until they spawn hazardous excesses or economic setbacks intervene.

Companies' present zeal to buy back their own shares in bulk also fits into this category of behavior that supports stocks in the near term, but could ultimately prove a poor use of capital.

So far this year, companies have announced new plans to repurchase more than $128 billion of their stock, according to a tally furnished by TrimTabs Investment Research. This is board-authorized buying that will occur at the companies' discretion over time, and comes atop any existing buyback programs in place.

The widespread eagerness to buy in equity reflects both a long-term trend and a cyclical pattern. Buybacks and dividends are the two main ways companies return cash to shareholders. In recent years, companies have tilted their cash-disbursement preference toward buybacks.

The standard argument is that buybacks are a more flexible, tax-efficient tool for cashing out those investors who wish to sell some of their shares, while incrementally raising other shareholders' ownership percentage as some equity is taken out of circulation. The activity also gooses reported earnings per share – a typical benchmark for executive incentive compensation - by reducing the share count.

The cyclical drivers of the buyback bandwagon are Corporate America's high profit margins, ample cash flows and low debt costs. Most big companies have or have borrowed more cash than they have an immediate use for. As CEOs and CFOs assess their options, they are nudging dividends higher, marginally investing more in growth efforts, acquiring some smaller businesses, doing very modest hiring – and buying back a ton of stock.

The buyback logic, on paper, is solid - provided the price that companies pay for their shares is right, such as when a company's shares are trading appreciably below some conservative calculation of their intrinsic value. The trouble is, the price is often very wrong, as top executives prove themselves time and again to be more momentum traders rather than value investors in bidding for company stock.

Companies in the Standard & Poor's 500 index bought back a record $589 billion worth of their shares in 2007, as the prior bull market and their own stock prices were peaking. During the recession and financial crisis, companies hoarded cash and by 2009 buyback totals for S&P 500 companies fell by 76% from their peak, even as stock prices were bargains at 13-year lows.

Now that stocks and corporate profits have more than doubled from those 2009 lows, companies are - predictably but rather perversely - on pace to challenge that record 2007 pace of repurchases.

Of the more than 165 companies tracked by TrimTabs with a new or expanded repurchase program so far this year, 29 of them have authorized buybacks of $1 billion or more. Of those 29 companies, 26 have share prices that are closer to their 52-week high than their low. As of Wednesday, these 29 stocks on average were 42% above their respective 52-week low points, and less than 4% from their all-time highs. Meantime, nearly half of all S&P 500 companies shares are trading on the expensive end of their five-year price-to-expected-earnings multiples, according to Morgan Stanley.

Sure, companies can modulate their buying pace and resist bidding for shares when they appear expensive. The trouble is,

few executives tend to see their stock as overvalued even when it is, and the motivation to shrink share count often trumps value judgments in using shareholder cash to buy in shares.

Corporate-finance consulting firm Fortuna Advisors has determined that “across the market, on average, companies that devote more of their cash earnings to buybacks tend to deliver lower total shareholder returns” over time. This is because executives don’t do hard analysis of whether buybacks are truly the best value or use of capital. Too often, they are a lazy, fallback tactic arrived at out of a reluctance to deploy cash toward something more bold (capital investments, acquisitions) or permanent (higher regular dividends).

Plenty of heavy stock repurchasers are prudent, mature companies with enough cash to shrink their equity base while also investing in the business. Home Depot Inc. (HD), for instance, unveiled the largest buyback authorization in the market this year, at $17 billion, equal to more than 16% of its market capitalization.

The company simultaneously maintains a respectable dividend payout of more than 40% of forecast 2013 profits and has been a good buyer of its stock in the past, acquiring 1 billion shares since 2002 at an average price of $37.50 or just over half today's quote. Still, at this point it's hard to argue the shares are priced much below fair value, if at all, as they command one of the higher cash-flow multiples in large-cap retail.

For an investor, of course, having companies collectively pour a half trillion dollars or so into buying stocks from the public this year is a bonus. Those who want to sell can do so at a better price, all else being equal, and some big percentage of that cash will get recycled into other stocks.

It all works out nicely while it goes on - even if, in retrospect, the folks running many of these buybacks will look back and wish they’d been more thoughtful about how they handled their shareholders’ money.

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