Stock Buy-Backs: Bite Or Boost?

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Stock Buy-Backs: Bite Or Boost?

By Linda McDonough (bio at end)
June 13, 2018

Do stock buy-backs boost or bite shareholders? It is a good question without an easy answer. But as I will explain, buy-backs are not the panacea that many investors think they are.

For example, just this week in 1930, New York Stock Exchange President Richard Whitney bid $9.6 million of his own money (the equivalent of $134 million in today's dollars) to purchase 60,000 shares of U.S. Steel stock at $160 per share. The idea was to increase shareholder confidence in the stock and the overall market, in the wake of the 1929 crash. Mr. Whitney invited the media along to photograph his bid. Shortly after that, the stock sank below $150 and bottomed out at $21 two years later.

I am not saying that every stock with a buy-back will suffer the same temporary demise. However, the optimistic lift in price that many stocks enjoy post a stock repurchase announcement is likely a tad too cheerful.

This year is a tremendous year for stock buy-backs. Market pundits at Birinyi Associates estimate $500 billion in stock buy-backs have been announced as of mid-year. This level compares to $685 million for all of 2017 and $670 million in 2016.

Much of the boost arrived post the implementation of the Tax Cuts and Jobs Act of 2017. This Act cut the U.S. tax rate on most corporations from 35% to 21%. Foreign profits are still taxed at prior levels, but any corporation with the bulk of its operations in the U.S.A. will enjoy a dramatic drop in tax payments. Those lower tax payments will pile up into a mountain of unexpected cash. Since the tax cut, many companies have announced their formal plans for putting that cash to use. Some of the cash will be spent on employee pay or bonuses. Walmart, for example, will use 20% of its expected $2 billion in tax reduction to pay employees a bonus ranging from $250-$1,000, depending on their years of service.

Other options for putting the cash to use include capital expenditures, such as higher spending on new facilities and factories or expansion projects. Another use is an increase in dividend payments, although most corporations are less inclined to tether themselves to a semi-permanent payout.

The stock buy-back is a useful balm for excess cash. It is flexible and, unlike pesky investments in factories that might take years to generate a return, buy-backs immediately boost a company's earnings per share.

The simple math on this calculation is that spending the cash does not alter the total pool of profits generated by a company. When those profits are split up by fewer shares, the earnings per share jumps.

Buy-Backs; Don’t Chase the Bait!

However, investors need to think longer term about the return they may or may not receive from those buy-backs. If the price of the stock sinks after the company buys back its shares, that is not a very good use of that cash.

In the U.S. Steel scenario above, the buy-back was completed by an individual. I doubt he felt satisfied while watching the value of his investment decline. A company making an ill-timed buyback should feel the same. It is unsettling that buy-backs are hitting records when the stock market is trading at sky-high valuations. Buy-back announcements equaled $174 billion in May, the highest level ever, according to TrimTabs.

Even more alarming is the recent analysis by Robert J. Jackson, Jr., a commissioner at the Securities and Exchange Commission. Last week, Jackson highlighted his research which shows that insiders sold more of their shares into the temporary lift that often occurs after a company announces a buy-back.

While studying trades at almost 400 companies that announced buy-backs in 2017 through this year's first quarter, Jackson found the number of insiders selling doubled following their company's buy-back announcements.

One thing for investors to be acutely aware of is that a buy-back announcement is non-binding. Just because a company says it has approved a program to potentially use a specific level of funds to repurchase shares does not mean it will do it. Even if it does execute on the repurchase plan, it may not be the company's best use of the cash.

Most companies do not publicly announce when the buy-back is actually occurring. Only after the end of the quarter do investors know how much stock, if any, was repurchased and at what price.

There are insufficient long-term data on how stocks announcing buy-backs perform in the ensuing years. However, there are mounds of data showing that spikes in insider sales often correlate to under-performing stocks. The upshot: don't make investment decisions solely based on a company's buy-back plans.

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See About the Analyst below.

About the Analyst

Linda McDonough is a veteran hedge fund analyst who loves to break down company financial statements and identify market inefficiencies to uncover big opportunities. She believes in a boots-on-the-ground approach that includes surveying customers, interviewing company executives, or doing whatever it takes to see what others don't. She's now brought her experience as a hedge fund analyst to subscribers of her *Profit Catalyst Alert* service. Her system identifies small- and mid-cap stocks that are about to move due to catalytic events that few others can identify…until it's too late. These events often times result in massive gains for her followers.