WHAT TO LOOK FOR IN A STOCK REPURCHASE PROGRAM

By David R. Fried

Stock buybacks can be extremely beneficial to shareholders, but they have their subtleties: Companies don't always follow through on announcements, and firms have different motivations for repurchasing shares.

With the stock market at an all-time high level, it seems increasingly difficult to find value in the stock market. Fortunately, there is a very important form of value that is still available in the market that is often overlooked by investors: the value created by companies that repurchase their own shares.

Buybacks benefit stockholders in a number of ways. By decreasing the number of shares outstanding, they increase the purchasing company's earnings per share. As earnings per share increase, the price of the stock generally rises. This increases the value of the shareholders' current holdings without requiring any additional investment and without the taxes that would be incurred if the company had paid the same money out as dividends.

Additionally, buyback companies provide shareholders with a margin of support under their stock by stepping in and buying shares when their stock price declines. This often causes shares to rebound faster after the market correction, as there are fewer shares available when demand returns.

WHAT THE STUDIES FOUND

The beneficial nature of stock buybacks makes intuitive sense, but it has also been demonstrated in several major academic studies. In "The New Issues Puzzle" by Tom Loughran and Jay Ritter of the University of Illinois, published in the Journal of Finance (March 1995), the authors examined the investment performance of 2,680 public companies that issued additional stock, versus similar companies that did not issue extra shares over the period 1970 to 1990. The study found that the returns from non-issuing companies were much stronger, with average returns of 15.3% annually compared to 7% annually for firms that issued more shares.

And in "Market Underreaction to Open Market Share Repurchases," by David Ikenberry of Rice University, Josef Lakonishok of the University of Illinois, and Theo Vermaelen of the University of Limburg, published in the Journal of Financial Economics (October 1995), the authors examined the price performance of 1,290 companies that announced open-market buyback programs from 1980 to 1990 (however, the study did not include buyback announcements made after the 1987 Crash, since subsequent strong performance would have biased the study in favor of buyback companies). The study found much stronger price performance from the buyback firms, compared to the reference group of non-issuing firms, with the benefits increasing over a four-year period. Interestingly, the authors also divided up the buyback firms into five groups based on book value relative to share price, and found that the highest returns were from the "value stocks" (the highest book value relative to share price) of firms that had repurchased their shares.

BUYBACK SUBTLETIES

While stock buybacks can be beneficial to shareholders, it is important to

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understand that, for a variety of reasons, buybacks are not as straightforward as they may seem.

First of all, a buyback is only useful to shareholders when it actually occurs, and companies don't always follow up on their buyback announcements with actual share repurchases.

In addition, different companies have different motivations for repurchasing their shares. One company's motivation may be to use them for the exercise of stock options, while another firm may be repurchasing because it feels its shares are underpriced and represent a good investment. In fact, most buyback announcements do not disclose the reason or the motive behind the announcement.

Even if you know why a company is buying back its stock, you may find it difficult to know when it is buying. Many firms, particularly small and mid-size companies, will not say when they are buying back their stock because they do not want to tip their hand to the rest of the marketplace—if investors knew a company was trying to buy its shares, they could drive prices higher, costing the company money. Additionally, companies do not generally announce that they are canceling a buyback plan.

Share repurchases are also often unreported and neglected by the financial press, or mistakenly reported to be of no consequence. A closer look at how a buyback works compared to other corporate events makes it easy to see where the confusion lies.

Share repurchases usually take place through the open market. However, it is not a specific event that happens at a specific time. Initial public offerings, secondary offerings, debt issues, insider buying and selling, private placements, and 13-D filings all are specific events that transpire on a given date and are registered with regulatory authorities.

Buybacks are quite different. The public's first notice typically comes when a company announces that its board of directors has authorized it to repurchase stock, but with no firm timetable for doing so. And there is no requirement that a company will follow through with its announced authorization. In addition, companies generally don't make a public announcement if they do not follow through with their buyback plans.

GETTING THE INFORMATION

How can investors find out about stock buybacks?

For any stock, examine the quarterly changes in the number of shares outstanding. However, it is important to understand that the percentage decrease in shares outstanding is more important than the raw number of shares or the dollar value of the buyback. Any year-over-year decrease of over 2.5% of outstanding shares should be considered a bullish sign for the company and 5% is very bullish.

For stocks that you already own, you should monitor the increase in the number of shares outstanding as diligently as you monitor the company's quarterly earnings.

What if you want to look for prospective companies that are actively repurchasing shares? That is a more difficult task, since there is no widely available public listing of these firms. You can monitor the "Company News" section of the New York Times, although it cannot be counted on as space in a newspaper is granted based on what stories the editor deems important on a particular day. Another way to find out about companies that are repurchasing shares is to look at the earnings tables that are published in many newspapers and on-line services with a company's quarterly earnings. These tables include average shares outstanding for the reporting period versus the same period one year ago; from this you can calculate the percentage difference. These figures are published with the earnings every quarter.

The most complete source of information about buyback announcements is Securities Data Corporation (973/ 622-3100), a computer-based information source that monitors newspapers and news services worldwide to compile their data. While it doesn't cost anything to subscribe to SDC, they charge $50 for each log-on session plus a charge for each data item downloaded, so obtaining a complete list of companies that are repurchasing shares can be very expensive. And, of course, The Buyback Letter keeps track of buyback stocks.

BENEFITING FROM BUYBACKS

While the studies indicate that companies that engage in stock buybacks provide higher rates of return than those that don't, a buyback is not reason alone to invest in a company. But it can be useful in conjunction with other screens—particularly value screens—as an indication of the long-term value in holding a particular stock. Growth prospects that are not yet appreciated by the market or turnaround situations can also be good situations for stock buybacks.

On a more qualitative level, an investor may want to question the reasoning behind the company's decision to buy back stock. Does management feel there is unrecognized growth potential? Are there new products coming down the road? Are there strategic alliances that will enhance the company's performance?

Companies that make repurchase announcements typically can be divided into three basic categories:

- Firms that never follow through with their announced plans. This often happens when the company uses the buyback announcement to *signal* its stockholders that the stock is too cheap due to temporary conditions. If the stock rebounds, then the company takes no action as it no longer considers

TABLE 1.

S&P 500 MAJOR STOCK REPURCHASERS

(S&P 500 STOCK REPURCHASES GREATER THAN 5% OVER LAST FOUR REPORTING PERIODS.)

Company Name	Ticker	Share Buyback* (%)	Price-Book Ratio (X)	Price-Earnings Ratio (X)	Latest Price (3/31/98) ($)	Dividend Yield (%)	Market Capitalization ($ mil)
Tele–Communications A	TCOMA	–24.2	9.58	N/A	31.12	0.0	15,783
Unilever N.V.	UN	–22.4	3.88	13.9	68.62	1.2	77,470
Dow Jones & Co.	DJ	–22.3	5.11	N/A	53.00	1.8	3,980
Pioneer Hi–Bred Int'l	PHB	–20.3	5.05	35.1	97.62	1.1	6,414
W.R. Grace & Co.	GRA	–16.4	12.12	24.3	83.75	0.7	6,239
Campbell Soup Co.	CPB	–16.2	16.50	28.2	56.75	1.5	25,770
Briggs & Stratton Corp.	BGG	–14.2	3.60	22.5	45.87	2.4	1,138
Edison Int'l	EIX	–13.3	1.97	16.9	29.37	3.5	11,039
Moore Corp Ltd.	MCL	–11.6	1.24	30.2	16.62	5.7	1,470
Tandy Corp.	TAN	–11.5	4.85	228.5	47.00	0.9	4,897
PNC Bank Corp.	PNC	–11.1	3.28	18.2	60.00	2.6	18,024
Times Mirror Co.	TMC	–10.6	29.61	27.6	63.37	1.1	5,609
Corestates Financial	CFL	–10.6	5.40	22.5	89.75	2.2	17,932
Wendy's Int'l	WEN	–10.4	2.15	23.1	22.37	1.1	2,591
Supervalu	SVU	–10.3	2.28	12.8	46.62	2.2	2,802
Phelps Dodge Corp.	PD	–9.8	1.48	9.9	64.62	3.1	3,787
Knight–Ridder	KRI	–9.5	2.73	14.0	55.87	1.4	4,716
Chrysler Corp.	C	–9.1	2.30	10.2	41.62	3.8	26,989
NACCO Industries	NC	–8.9	2.59	17.7	134.00	0.6	1,099
Pulte Corp.	PHM	–8.6	1.20	20.0	46.50	0.5	990
Morton Int'l	MII	–8.5	2.65	19.9	32.87	1.5	4,287
Wells Fargo & Co.	WFC	–8.5	2.23	26.2	331.25	1.6	28,752
General Motors Corp.	GM	–8.4	2.59	7.8	67.75	3.0	46,977
May Dept Stores	MAY	–8.2	4.03	20.4	63.50	2.0	14,681
First Chicago NBD	FCN	–7.9	3.14	17.9	88.12	2.0	25,785
Rockwell Int'l Corp.	ROK	–7.5	2.48	22.2	57.37	1.8	11,618
Asarco	AR	–7.2	0.62	8.0	26.75	3.0	1,062
Dow Chemical Co.	DOW	–7.2	2.82	12.6	97.25	3.6	21,930
Darden Restaurant	DRI	–7.1	2.19	N/A	15.62	0.5	2,322
Dell Computer Corp.	DELL	–6.9	28.00	51.7	67.75	0.0	44,173
Hershey Foods Corp.	HSY	–6.9	11.30	31.7	71.62	1.2	10,242
Great Lakes Chemical	GLK	–6.8	2.43	45.8	54.00	1.2	3,186
Digital Equipment Corp.	DEC	–6.7	2.22	33.3	52.25	0.0	7,670
Int'l Business Machine	IBM	–6.5	4.76	17.2	103.87	0.8	100,561
Navistar Int'l	NAV	–6.4	3.21	17.9	35.00	0.0	2,415
American Stores Co	ASC	–6.3	3.10	25.5	26.00	1.4	7,106
Waste Mgmt	WMX	–6.2	10.72	N/A	30.87	2.2	14,394
Columbia/HCA	COL	–6.1	2.24	38.4	32.25	0.2	20,343
Seagram Co. Ltd.	VO	–5.8	N/A	41.6	38.25	1.7	13,349
Pitney Bowes	PBI	–5.8	7.34	27.9	50.25	1.8	14,055
National Service Ind	NSI	–5.5	3.88	23.3	58.87	2.1	2,532
Gap	GPS	–5.4	10.69	34.4	45.00	0.4	17,802
Unum Corp.	UNM	–5.2	3.07	21.3	55.25	1.1	7,669
Deere & Co.	DE	–5.1	3.47	15.9	62.00	1.4	15,519
J.P. Morgan & Co.	JPM	–5.1	2.28	18.7	134.37	2.8	23,717
Maytag Corp.	MYG	–5.1	6.96	25.3	47.87	1.3	4,548
Dresser Industries	DI	–5.1	4.90	25.9	48.12	1.6	8,446
Crane Co.	CR	–5.0	4.09	21.8	53.00	0.9	2,311
S&P 500 Average	**SP500**	**5.8**	**4.22**	**27.2**	**1,101.75**	**1.5**	**17,056**

Market data as of 3/31/98.

**Represents percentage decline in number of shares outstanding.*

Source: The Buyback Letter

the purchase of its stock to be a wise use of capital. But shareholders only benefit when the company is actually putting its money where its mouth is, so buyback programs announced by companies that don't follow through with their plans are of no benefit to shareholders.

- Companies that buy back stock only if and when their shares are bargain priced. An example of this type of company is SkyWest Airlines, which repurchases shares when the market price of its stock is close to its book value; if the price rises significantly beyond that level, the company abstains from open-market repurchases. These kinds of companies provide investors with opportunities to profit over a two- or three-year period if shares are purchased at or near the price that the company repurchases its shares.
- Companies committed to long-term buyback programs as a means of building shareholder value. This group can be counted on to fulfill their promise when they make a repurchase announcement, and it is this group that holds the most appeal for long-term investors.

A prime example of the third type of company is Coca-Cola, perhaps the ultimate buyback company. Since beginning its buyback program in 1984, it has repurchased 966 million shares (adjusted for splits). The company states in its annual report that it has "always viewed its stock as a consistent bargain for long-term holders." During the past 12 years, the stock buyback plan at Coca-Cola has turned 14% annual gains in profitability into 18% annual growth in per share earnings.

General Electric and McDonald's are two other examples. Table 1 provides a list of current S&P companies that have repurchased more than 5% of stock as reported over the last 12 months through March 31, 1998.

THE GOOD AND THE BAD

There are various characteristics an investor should look for in a buyback program if it is to have a long-term beneficial impact on shareholders. In the best of all situations, the company is generating enough cash to buy back its stock without sacrificing research and development, marketing, expansion plans, or dividends. In other words, a strong buyback situation is one in which the purchases are funded from excess cash flow. In this situation, bigger is better. In our experience in order for a buyback to be significant, it must reduce net shares outstanding by 2.5% to 3% on a continuous year-over-year basis or by over 5% for a one-time announcement.

Companies that have made multiple announcements—those with a long-term history of share repurchases—are most likely to go through with and continue their share repurchasing program.

The question of share issuance also needs to be addressed. It is entirely possible for a company to repurchase shares and still have its total share count increase. This occurs when the shares being issued to satisfy outstanding stock options are greater than the number of shares being repurchased. This situation is not necessarily a negative, since it is transferring ownership from the general public to insiders and employees of the company. Additionally, shareholders in such a company are clearly diluted less by stock options than would have been the case had the company not repurchased any shares. Intel and Microsoft are two examples of companies that have been buying back shares to partially offset share issuance due to the exercise of stock options while their total share count has increased. These repurchase programs should not be entirely ruled out, but those that result in an actual decrease in shares outstanding are clearly more beneficial to shareholders.

There are also certain types of situations to avoid when companies engage in repurchase programs. The most prominent warning sign is heavy insider selling. Significant insider selling begs the question of why insiders would sell if prospects at the company were so good as to warrant a significant buyback. The word significant is the operable phrase as insiders often have a great deal of their net worth tied up in their employer's stock. Selling is often the only way to fund life events such as home and college. But if the amount of insider selling totals to more than 10% of the proposed stock repurchase, you may want to look elsewhere.

Investors should also be wary of buybacks when the company's margin or overall business is deteriorating or the company does not have a sustainable market share. Since share repurchases will boost share price and per share ratios, they can be used by management to mask poor results. Over the past year, Novell and Fruit of the Loom engaged in buybacks in spite of the fact that their basic businesses were under pressure from competitors. Thus far, the management of these companies would appear to have been overly optimistic about their companies' prospects.

One way to examine whether share repurchases are being used to mask mediocre growth rates is to compare the annual compounding growth rate of the company's actual net earnings against the annual compounding growth rate for *per share* earnings. If per share earnings increased greatly while total earnings declined, the share repurchase may be masking poor results. These situations are unattractive.

What about companies that stop or suspend long-term buyback programs? There are some good reasons for discontinuing a buyback program that are not necessarily negative signs. A company may stop repurchasing because it needs capital to make a strategic acquisition. J.C. Penney is a good example of this. Last year they acquired Eckerd Drug. The capital needed for purchase meant that the company had to stop repurchasing shares. However, the acquisition actually enhanced the company's long-term prospects.

CONCLUSION

Share buybacks are often the long-term investor's friend.

However, not all buybacks are equal, and here are some key points to keep in mind when examining a company's buyback announcement:

- Is the repurchase likely to occur? The best way to tell if a company is likely to go through with a buyback is to speak to the company. When a company announces a buyback, it should start buying back stock immediately. Call shareholder relations and ask questions about the buyback. If the buyback program has not started by the time you call, it is natural to be suspicious.
- If the program has begun, find out how many shares are open against the repurchase authorization. You also should try to determine if the number of shares outstanding is going to continue going down, or if there are employee stock options that, when exercised, will increase the number of shares outstanding.
- Try to inquire about the company's reasoning behind their decision to repurchase shares. The answer can provide valuable insight into management's decision-making processes.◆