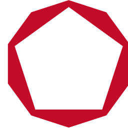

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COMMENTARY

Share buybacks: When procyclicality becomes expensive

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Yeah, even Warren Buffett did it. The investor legend repurchased shares of his investment company Berkshire Hathaway in the past financial year for the equivalent of almost 5 billion US dollars. This is a strong signal for the company's shareholders. Buffett once announced that he would only buy back his own shares if the intrinsic book value of the company did not exceed the market price by more than 20 percent. And who, if not Buffett himself, should have any idea where this intrinsic value lies. If one applies this assumption to the large US corporations from the S&P-100, one was recently led to believe that the high buyback activity of the companies must indicate a permanent undervaluation of the stock market. However, this thesis is currently being painfully falsified at many companies due to the sharp recession that is emerging in the wake of the corona crisis.

The discussion about the pros and cons of share buybacks is as old as the method itself. Critics like to dismiss it disrespectfully as „financial engineering", suggesting a lack of creativity on the part of those responsible. In their eyes, share buybacks should be an ultima ratio that may only be used if no other attractive investment opportunities arise for the free capital. This implies not only that management has carefully sounded out other investment opportunities, but also that the funds to be used are actually free. It is doubtful whether this is always the case in practice. The theory is indeed on the side of those who advocate share buybacks „on tick". For example, the capital structure can be optimised by buying back own shares, as the proportion of comparatively cheap debt capital is increased. This results in a reduction in the cost of capital, as the cost of debt is generally lower than that of equity capital. This works as long as the marginal costs of additional borrowed capital are below the so-called Weighted Average Costs of Capital (WACC). A debt-financed equity capital reduction therefore kills two birds with one stone. Equity down, debt up. However, it is currently becoming apparent that this is not a recommendation for the long-term thinking, honourable businessman, but rather a purely capital market theoretical consideration of „modern finance". Because now cash is king again and a company's ability to cover its debts is the foundation of the investment decision of the investors more than ever.

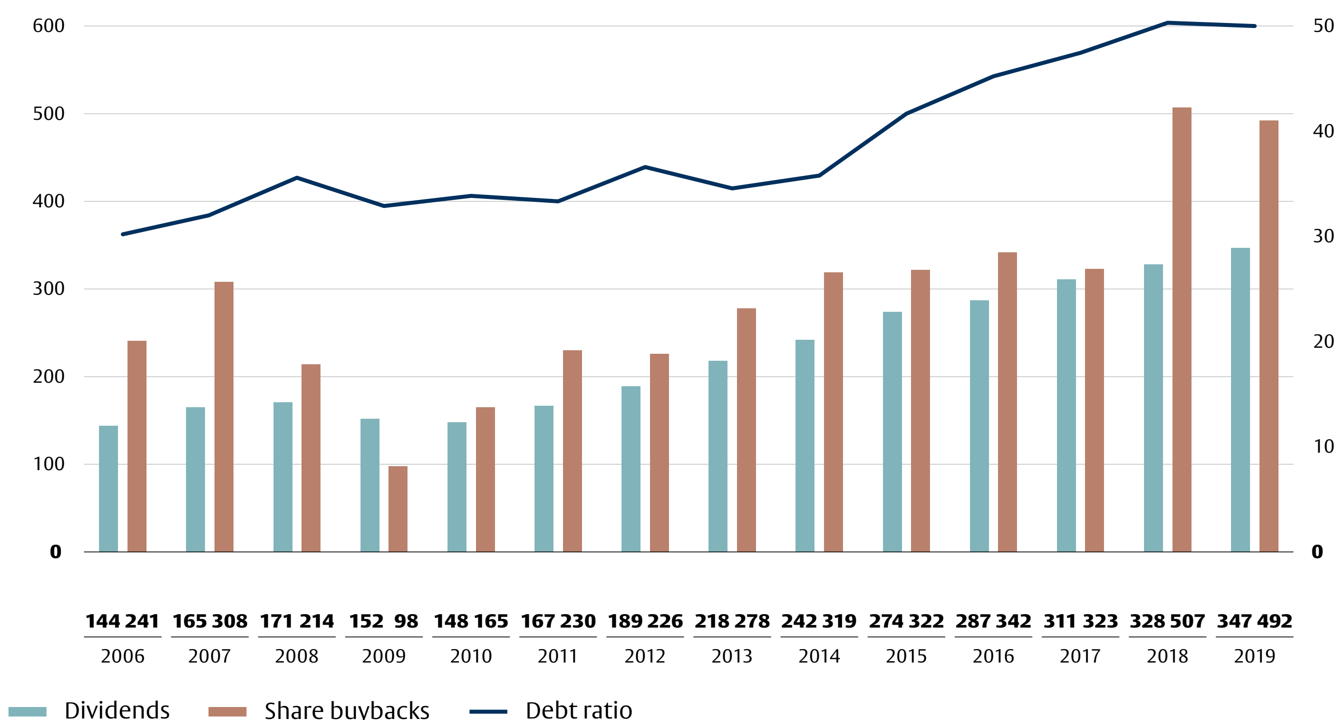
If we look at the buyback activity of the large US corporations, it becomes clear that the credo of recent years has obviously been different. For example, in the past two fiscal years, driven by the comprehensive tax reform in the US, S&P-100 companies have bought back shares with a value of around USD 500 billion

per year. This is roughly five times the amount repurchased in 2009. While the groups have been comparatively continuous in their dividend payments, they seem to have acted a little more opportunistically in their share buybacks (see Figure 1). However, it must be concluded that companies were not too lucky in their efforts to time the market. Not only was spending on share buybacks low in 2009 due to low share prices, but less than half of the companies carried out buybacks. Uncertainty about future macroeconomic developments was simply too great. The situation was quite different in the 2019 financial year, with confidence seldom higher in the face of strong economic activity and low interest rates, with the vast majority of companies (85%) buying back their own shares. The companies were therefore unable to escape the typical procyclicality. When share prices are at rock-bottom, corporations prefer to keep their money together. If, on the other hand, share prices have risen sharply over the years, they fire from all pipes in order not to run the risk of lagging even further behind. As the debt ratios, which have been rising simultaneously since 2014, suggest, firms have also made use of credit that is supposedly available free of charge.

Only a few quarters later, the world is suddenly a completely different place. While it seemed for years to be virtually value-destroying to maintain a solid liquidity buffer in the face of a humming economy and record low interest rates, preferences changed in no time at all. Funds that were previously invested in the buyback of own shares are suddenly lacking. No less suddenly, the same managers are confronted with a mountain of debt, the scale of which seems more threatening with each additional day of cash flow shortfalls.

However, the fact that even investors with an outstanding reputation, such as Warren Buffett, opportunistically carry out share buybacks suggests that these are not per se to be demonised. But it is also a fact: USD 5 billion is a manageable size with a reported annual profit of more than USD 80 billion and an extremely solid balance sheet. As this is an exception rather than the rule, investors should always ask themselves whether the management always takes the solvency of the company into account when deciding to buy back shares and is not subject to the institutional imperative.

Figure 1 **Aggregate spending on share buybacks and dividends in USD bn. (l.S.) and debt ratio (r.S., median) of S&P 100 companies**



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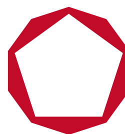

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