April 23, 2020

Pandemic infects dividends & buyback policies: Part II

SHOULD WE FEAR A COLLAPSE IN BUYBACKS?

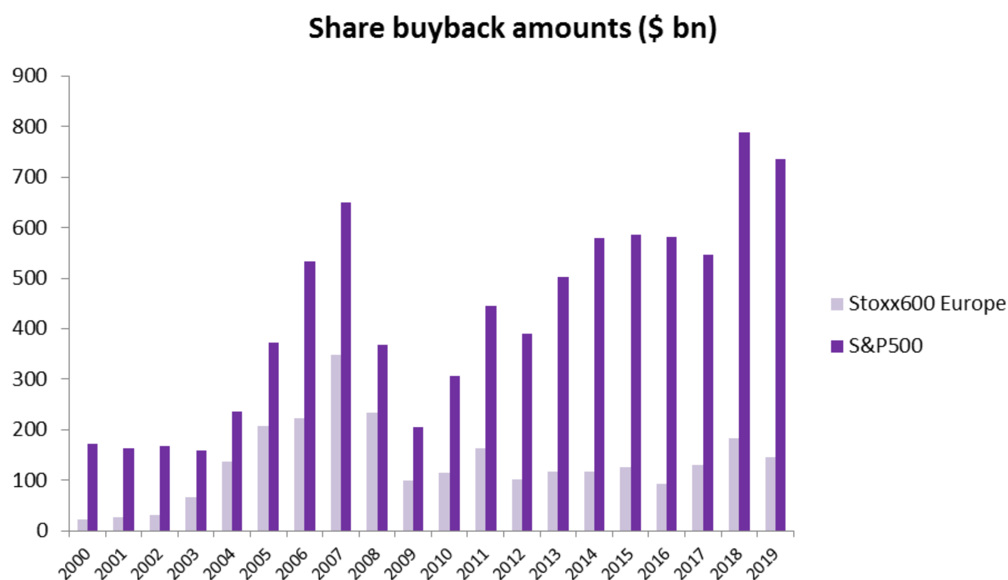
There are several ways in which a company can return wealth to its shareholders. Although stock price appreciation and dividends are the two most common ways, share buybacks are another classic way.

In a buyback, a company goes into the market and buys its own shares at the prevailing market price from a willing seller and then retires those shares, reducing the number of shares outstanding. Reasons for buybacks are multiple. A company might buy back shares because it believes the market has discounted its shares too steeply, or it my wish to invest in

itself, or it may wish to improve its financial ratios or it may do so simply because of a lack of alternative productive ideas to utilize accumulated cash, ..etc.

We are living an unprecedented experience. The “Great Lockdown” is also unchartered territory for economists and financial analysts. Never before have governments intentionally discouraged production. This crisis has called into question the value of economic modelling. Nevertheless, it is reasonable to expect that governments will carry a greater weight in our economies. New or reinforced rules and regulations are to be expected as part of the price tag.

Voices decrying share buybacks will get louder. Arguments about the manipulation of earnings and undue rewards to insiders versus stakeholders/shareholders will gain traction. At the same time, massive government bails-out will probably mean that even the more prominent neo-liberal countries will have to restrict buybacks. This mood will percolate into corporate boards as well. Board members will most likely be circumspect to agree on debt issuance to finance share repurchases.

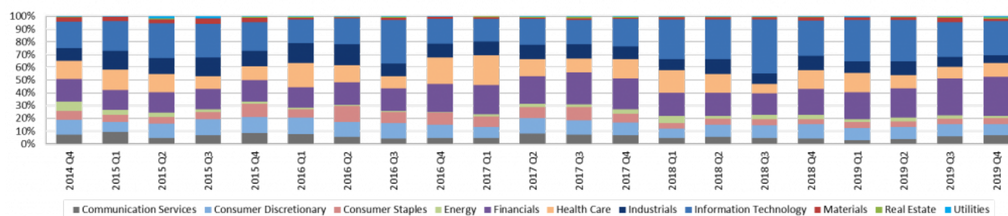


Source: Bloomberg, *BIL*

According to Kepler-Cheuvreux, “It is estimated that company share buybacks have contributed a net US$4trillion to the US equity market since the beginning of 2009. Corporations have been

by far the major net source of demand for equity. In fact, the only constant source of demand. Most estimates of the fall in net buybacks on Wall Street this year compared with 2019 are in the range of 50-70%. The recycling of the low cost of debt has probably been arrested since the outbreak of the corona world pandemic, marking the climax of the great corporate buy-back boom" [1]

S&P500 Sector Buybacks: Quarterly rolling contribution (as % of total quarterly buyback)



Source: Bloomberg, *BIL*

The largest companies based on share repurchases in 2019
were in the technology and banking sector, according to data from Factset.
Apple, Oracle, Cisco Systems, Microsoft
and Alphabet rounded off the top 10 companies purchasing a combined $164
billion of company stock. Following the Trump tax cuts, corporate America has
lavished investors with a multi-trillion dollar share buyback spree over the
past two years instead of saving up for a rainy day. In March, eight of the biggest
US banks — including JPMorgan, Citigroup and Bank of America — said they would
suspend their multibillion-dollar share buyback programmes until at least July.

Given the scale of buy-back activities, the implications for
equity markets will be significant. One of the most common techniques for balance
sheet optimization is now off the table.

Trying to gauge the historical impact of share repurchases on market direction is mostly inconclusive. The same is valid for the broader insider activity which has mostly been a case of selling high and buying low. But the bottom-line is clearly that one of the major (mostly US) marginal buyers of equities from the last couple of years has been lost indefinitely. The length of this "indefinitely" is the million dollar question. The benefit to long term investors is that the

value of a company is equal to the present value of expected cash flows from now until infinity. So, a few bad quarters because of an exceptional event should not merit perspectives of infinite doom.

Whatever goes on, part of our duty in the current context is
also to shed some light inside of the tunnel. As such we would like to share this inspiring quote from
a fund manager: “A crisis puts us in survival mode first. While the challenges
are not to be underestimated, often the long-term benefits outweigh the
short-term difficulties”. Stay healthy and safe and don’t forget that mixing
emotions and investment decision is a toxic combination.

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[1] Christopher Potts – Kepler Cheuvreux "Strategic Frame” n°65

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