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Buyback Is Not a Dirty Word

Share repurchases, or buybacks, are a recent hot-button topic. Politicians are proposing to increase taxes or withhold government incentives from companies that have a share repurchase program. From TV pundits to the most famous of investors, there has been no shortage of opinions. At Crawford Investment Counsel, our view is more nuanced. We often view buybacks positively, as long as management has the prudence and foresight to implement a plan in a shareholder friendly manner.

Before diving into share repurchases, let us start with basic corporate finance. Companies have three basic questions that need to be asked regarding the cash they generate.

- **Investment decisions** are the first and highest priority. Management needs to use cash to reinvest in the business for growth. For a manufacturer, this can be a new factory. For a pharmaceutical company, this can be R&D. For a utility, this can be a new power plant. Management teams that have a disciplined capital investment process tend to outperform over time.

- **Financing decisions** take second priority. Management must determine the appropriate levels of debt, equity, and cash to hold. Financing decisions seem simple but can be complex given cyclicality of operations, the outlook for growth, market conditions, etc. Having a solid financial base can determine the long-term health of a company.

- **Shareholder return decisions** are the last priority. There are two buckets here – share repurchase and dividends. While intuitive, companies that cannot support the higher priority uses of cash – investing for growth and financing for stability – should not consider returning capital to shareholders. In the United States, there are approximately 7,000 companies, of which only 25% pay a dividend and 40% repurchase shares, with significant overlap in the two.

Share repurchase increased in popularity when the Securities and Exchange Commission adopted Rule 10b-18 in the early 1980s. As a means to return capital to shareholders, share repurchases first outpaced dividends in 1997, and by 2021, buybacks accounted for twice as much capital returned versus dividends. Companies favor buybacks because of the flexibility, because dividends are often seen as sticky, and once paid, typically are not lowered.

There are many uninformed fallacies regarding share repurchases.

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- **Buybacks provide insiders windfall profits.** Share repurchases are just not large enough to support a company's share price for an extended period of time. Most employee compensation plans that have equity components require a holding period of three years or longer, which is too long for repurchases to support a share price.

- **Buybacks destroy corporate value.** Almost all repurchases, and dividends, are value-neutral over the long term. Management adds value primarily through investing decisions.

- **Buybacks are selective.** This is true. Dividends are paid to all shareholders, but a repurchase program helps sellers. When a company repurchases shares at all-time highs, only for the stock to trade down after, the repurchase disproportionately favors the shareholder that sold.

- **Buybacks financed with debt are bad.** Broadly, it is not a feasible situation for a company to take increasing amounts of debt to repurchase shares. Using debt to fuel a buyback is largely an unwise financing decision and could lead to long-term solvency problems.

- **Buybacks are bad for the economy.** If companies repurchasing shares have already optimized their investing and financing decisions, share repurchases increase investors' income. This can help to boost spending and/or reinvestment, both of which boost the economy. It is a narrow mind that views share repurchases as anti-investment, as optimal decisions are more likely to be made by the capitalist system (i.e., the company and shareholders), than hoarding cash at a low growth company or pursuing ill-advised internal projects.

Currently, the two main sources of debate regarding share repurchases are from the United States government. In 2022, the Inflation Reduction Act (IRA) initiated a 1% tax on all share repurchases. President Biden called for this tax to quadruple in his State of the Union address. The second was a series of letters by House representatives to Commerce Secretary Raimondo asking for restrictions on buybacks for any company taking part in the $52 billion awarded under the CHIPS and Science Act. It appears any company participating in CHIPS, which provides funding to boost domestic research and manufacturing of semiconductors, will be restricted from share repurchase for five years.

If the government believes that raising taxes on buybacks will result in increased income, which is needed for the good of all citizens, then we will not argue with the tax. If restricting companies into certain behavior is necessary in order to accelerate development of a specific industry (i.e., semiconductor manufacturing), which is in the best interest of all citizens, again we will not argue. But these comments sound like a bad song that gets played over and over. If the taxes become too high, companies will find another way (probably dividends) to return capital. If restrictions become too onerous, the CHIPS incentives will be rejected, and the acceleration of manufacturing will likely take even longer. Government intervention can have unintended consequences.

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At Crawford Investment Counsel, we invest in companies that pay a dividend, and we prefer this over share repurchase. While both dividends and buybacks return capital to shareholders, the permanence of a dividend is a much stronger indicator of durability of excess free cash flow and management's long-term conviction to return capital to shareholders. At Crawford, we believe we have helped our clients survive the ups and downs of the market for over forty years with quality dividend paying stocks as the backbone of their portfolios.