NO BUYBACKS GUIDANCE IN CORPORATE GOVERNANCE PRINCIPLES

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Abstract

13 high profile CEOs of U.S. companies secretly worked for one year to develop corporate governance principles that would serve as a future pathway. They advocated their resulting document as being detailed and tough-minded with commonsense recommendations and guidelines about the roles and responsibilities of boards, companies, and shareholders (Governanceprinciples.org, 2016). However, these corporate governance principles did not provide any specific guidance or perspective on the use of common share buybacks to improve earnings per share, which has become a popular form of earnings management by U.S. public companies. This paper analyzes the buyback strategy of these CEOs' own public companies plus a sample of their major competitors. For these well-known major U.S. companies, the common stock buyback strategy to improve the profitability performance of net income growth to a larger EPS growth occurred 61% of the time for annual growth periods and 100% of the time for the four-year growth period. Accordingly, this paper recommends buybacks guidance for corporate governance, consistent with public reporting and management compensation guidelines.

Keywords: Share Buybacks, Repurchases, Corporate Governance, EPS Growth

1. INTRODUCTION

Chief Executive Officers (CEOs) of 13 prominent U.S. businesses from industry (General Motors, General Electric, Verizon, JPMorgan Chase and Berkshire Hathaway), asset management (BlackRock, J.P. Morgan Asset Management, Vanguard, T. Rowe Price, Capital Group, CPP Investment Board and State Street Global Advisors), and one activist investor (Valueact Capital), secretly worked for one year to develop corporate governance principles that would serve as a future pathway (Thakker, 2016). They wanted to provide such guidance at a time when fewer entrepreneurs are deciding to sell shares on U.S. public markets (Mathews, 2016). These CEOs advocated their resulting document as being detailed and tough-minded with commonsense recommendations and guidelines about the roles and responsibilities of boards, companies, and shareholders (Governanceprinciples.org, 2016). A financial press commentator said that these principles may set a new standard in American corporate governance and that the stakes couldn't be higher as over 90 million Americans own U.S. public companies through their investments in mutual funds, retirement plans, and pensions (Gara, 2016). A corporate governance expert summarized these principles: "I think it shifts the burden of proof onto any corporation that doesn't comply and I am delighted the signatories are such influential people" (McGregor, 2016).

However, these corporate governance principles did not provide any specific guidance or perspective on the use of common share buybacks to improve earnings per share (EPS) which has become a popular form of earnings management by U.S. public companies. Thus, this paper analyzes the buyback strategy of these CEOs' public companies from industry listed above (General Motors, General Electric, Verizon, JPMorgan Chase and Berkshire Hathaway) plus a sample of their major competitors. No specific guidance on earnings management was provided by these corporate governance principles, other than a warning not to use non-GAAP measures to obscure GAAP results, especially with equity compensation addbacks. However, this analysis uses general guidance provided by public reporting and management compensation guidelines in these corporate governance principles.

The structure of the paper includes the following sections: literature review on buybacks, buyback analytical approach, buyback analysis for major US companies, justifications for buybacks, general corporate governance recommendations including buybacks, and a summary.

2. LITERATURE REVIEW ON BUYBACKS

More than 95% of the buyback programs worldwide are through an open-market method where a company announces a buyback program and then repurchase shares in the open market or stock exchange. There has been a sharp rise in the volume of share repurchases in the U.S. from $5 billion in 1980 to $350 billion in 2005 (Fernandes, 2014). Although large share repurchases started later in Europe, they are now a common practice around the world (Bagwell and Shoven, 1989).

Academic research has shown that companies are able to profitably repurchase shares when the company is widely held by small retail investors who are unsophisticated. They are more likely to sell their shares to the company when those shares are undervalued. Conversely, when the company shares are held primarily by insiders and the more sophisticated institutional investors, it is harder for companies to profitably repurchase its own shares. Companies can also more easily repurchase shares at a profit when the stock is liquidly traded and such activity is less likely to move the share price (De Cesari et. al, 2012).

Previously financial markets were unable to accurately gauge the impact of repurchase announcements as many companies announced repurchases but then failed to complete them. However, repurchase completion rates increased after companies were required to retroactively disclose their repurchase activity which reduced the exploitation of public investors (Simkovic, 2009). Also, investors have more of an adverse reaction to dividend cuts than postponing or abandoning share buyback programs. Accordingly, rather than paying out larger dividends during strong profitability periods and then having to reduce dividends during leaner times, companies prefer to pay out a conservative portion of their earnings, perhaps half as dividends, in order to maintain an acceptable level of dividend cover. Some evidence of this strategy was found for U.S. firms where higher dividend payments lowered share repurchases (Bhargava, 2010).

Company executive compensation is often impacted by share buybacks, including the ability to meet earnings per share (EPS) targets. Share buybacks generally increase the value of stock options in incentive plans for executive compensation. Academic research found that stock options exercised by top executives increased future share repurchases by U.S. firms. These higher share repurchases then significantly lowered the research and development (R&D) expenditures that are important for increasing productivity. Also, such EPS increases did not equate to increases in shareholder value (Bhargava, 2013).

Consequently, corporate governance researchers have advocated that the use of stock-based pay be severely limited and incentive compensation should be subject to long-term performance criteria, not short-term stock performance (Lazonick, 2014; Hilb, 2012). Many boards are dominated by other CEOs who may be biased toward approving higher pay packages with enormous stock-based pay for their peers. Such packages and share repurchases often encourage a short-term stock price focus “to make the numbers” for executives and shareholders, instead of a longer term focus on R&D and capital expenditures to enhance the productive capabilities of companies. Thus, some researchers have advocated that workers, government officials, and even taxpayers have seats on boards to facilitate the allocation of resources to investments that are more likely to generate innovations and longer term value, especially with the advent of so many ongoing technological advances (Lazonick, 2014; Hilb, 2012).

3. BUYBACK ANALYTICAL APPROACH

The major obligation of a public company should be to find the best use of its capital to create long-term value for its shareholders. Company executives and board directors have to decide how to allocate such capital to develop new products and services or to maintain older ones. However, recently many companies have chosen a different option: buying back their own common shares (Minow, 2016). An August 2016 report by the Investor Responsibility Research Center Institute (IRRC 2016) found that over the last three years, at least 370 of the S&P 500 companies spent over $1.5 trillion on buybacks or about $500 billion per year. Between 2003 and 2013, S&P 500 companies doubled their spending on share repurchases and dividends while cutting their capital expenditures for new plants, equipment and service activities.

There are at least three reasons why this increase in buybacks is problematic. First, there is a concern that executives do not have any better operational or strategic ideas for creating sustainable, organic growth. Second, buybacks suggest that boards of directors may have approved incentive compensation plans that promote buybacks to achieve short-term results which may not be in the interest of shareholders. If board compensation committees set EPS performance goals, they should reward only higher earnings, not share buybacks, which achieve such targets (Minow, 2016). Third, companies may use debt, not excess cash, to fund such buybacks. Investors should be concerned when the money for stock buybacks has been borrowed and such borrowers have taken on a large amount of debt to support these buybacks (Ader, 2016).

An excellent argument against stock buybacks or repurchases is that they offer just a one-time gain, as opposed to capital expenditures in a company’s operations which may generate years of future earnings and returns. To evaluate such capital allocation decisions, Robert Colby, an equity valuation analyst, observed: “The simplest way to evaluate a company’s asset allocation decisions over the years is to see whether its net profit growth is close to its EPS growth. Unlike an investment in the business, share buybacks have no effect on net profit and there is no compounding in future years” (Morgenson, 2016).

Colby compared net income growth and EPS growth at paired company competitors each year from 2008-2015. He compared the number of shares repurchased by each company with its earnings and EPS growth rates. One such comparison was between Cracker Barrel Old Country Store and Jack in the Box, two restaurant chains. Cracker Barrel bought back only $160 million of shares while Jack in the Box repurchased $1.2 billion of shares, reducing its outstanding shares by 37%. Cracker Barrel passed this growth test very well over those years: annual net income growth was 14% while annual EPS growth was 13.6%. However, Jack in the Box failed this growth test by having a "buyback growth mirage": annual net income declined by 0.5% but annual EPS growth was 6%. To increase its net profit to the level of growth shown by its EPS, Colby calculated that the company would have had to generate after-tax returns of only 4.8% on the $1.2 billion it spent buying back shares in order to enhance long-term prospects, instead of short-term, one-time EPS gains.

For another example, he compared Costco and Target, two large discount retailers. Costco bought back $2.7 billion of shares while Target bought back $11.4 billion, reducing its outstanding shares by 20%. Costco had almost identical annual growth rates of 8.9% in net income and 9% in EPS during 2008-2015. However, Target failed this growth test by having a "buyback growth mirage": annual net income growth was 4.3% while annual EPS growth was 7.3%. To increase its net profit to the level of growth shown by its EPS, Colby calculated that the company would have had to generate after-tax returns of only 5.0% on the $11.4 billion it spent buying back shares to enhance long-term prospects, instead of short-term, one-time EPS gains. Thus, even small returns from reinvesting in the production of goods and services will be better for investors than what's effectively a buyback liquidation plan (Morgenson, 2016).

4. BUYBACK ANALYSIS FOR THESE CEO AUTHORS' INDUSTRIAL COMPANIES

Annual and four-year growth impacts from 2011-2015 periods are analyzed with this buyback test for these CEO authors' industrial firms, which are major US companies (but not for the other CEO authors' asset management companies): General Motors (270 million shares or 14.5% buyback), General Electric (700 million shares or 6.6% buyback), Verizon (no buybacks as 1.3 billion shares (46%) were issued), JPMorgan Chase (170 million shares or 4.0% buyback), and Berkshire Hathaway (111 million shares or 0.5% buyback). Similar to the prior buyback tests by Colby, major US competitors are also analyzed for buybacks over the same period. For a GM competitor, Ford had no buybacks as it issued 170 million shares (4%). For a Verizon competitor, AT&T did have buybacks (340 million shares or 5.7%). Two bank competitors of the other CEO authors' firms had the following buybacks: Bank of America (4.6 billion shares or 39.6% buyback) and Wells Fargo (140 million shares or 2.7% buyback).

Table 1. Buybacks of the studied companies

Part 1

Company	***Percent***	***Annual Profitability Growth Impact***				***Four Year***
	Buyback	***2015***	***2014***	***2013***	***2012***	***Impact***
AT&T	5.7%	0.8 x	none	0.2 x	5.1%	0.2 x
Bank of America	39.6%	0.5 x	-4.0%	0.9 x	0.6 x	1.5 x
Berkshire Hathaway	0.5%	none	none	0.8%	none	0.01 x
Wells Fargo	2.7%	0.7%	0.5%	0.4%	0.2%	2.5%
General Electric	6.6%	-0.8%	1.3%	none	0.1%	5.7%
General Motors	14.5%	1.0 x	-9.3%	none	-4.5%	18.3%
JPMorgan Chase	4.0%	1.1%	0.1%	-0.1%	3.7%	5.5%

Part 2

Summary Impact of Buybacks	***Annually***		***Over 4 Years***	
	Number	***%***	***Number***	***%***
Improved Growth	17	61%	7	100%
Increased Loss	5	18%	0	0%
None	6	21%	0	0%
Total: 4 years * 7 companies	28	100%	7	100%

Part 3

Company	***Percent Buyback***	***4 Year Average Percent Increase:***	
		Stock Price	***Market Cap***
AT&T	5.7%	14%	7%
Bank of America	39.6%	45%	4%
Berkshire Hathaway	0.5%	72%	72%
Wells Fargo	2.7%	97%	92%
General Electric	6.6%	67%	-7%
General Motors	14.5%	48%	27%
JPMorgan Chase	4.0%	98%	90%
7 Companies Average		63%	41%
Pearson Coefficient		-39%	-52%
Weak and Moderate Negative Correlations, respectively			

The application of this recommended test for this "buyback growth mirage" strategy is analyzed in Table 1 for these companies. Both four-year and annual impacts on profitability are tested to determine if the earnings per share (EPS) increase was greater than the net income increase. These major, well-known U.S. companies all had buyback growth mirages over the average four-year growth period: AT&T (2.39 times net income growth versus 2.59 times EPS growth or a mirage of 0.2 times), Bank of America (2.8 times versus 4.3 times or a mirage of 1.5 times), Berkshire Hathaway (1.35 times versus 1.36 or a mirage of just 0.01 times), Wells Fargo (44.2% versus 46.7% or a mirage of 2.5%), General Electric (16.1% versus 21.8% or a mirage of 5.7%), General Motors (5.4% versus 23.7% or a mirage of 18.3%), and JPMorgan Chase (28.9% versus 34.4% or a mirage of 5.5%). Table 1 also shows the annual profitability growth impacts or buyback growth mirages over the 2011-2015 period for these companies: AT&T (3 of 4 years), Bank of America (3 of 4 years), Berkshire Hathaway (1 of 4 years), Wells Fargo (all four years), General Electric (2 of 4 years), General Motors (1 of 4 years), and JPMorgan Chase (3 of 4 years).

Table 1 also shows the danger of buybacks for these companies when there are decreases in profitability as EPS is computed with a smaller number of shares: Bank of America (57.7% net income decrease from 2013 to 2014 versus a 61.7% EPS decrease or a 4.0% worse impact), General Electric (140.3% net income decrease from 2014 to 2015 versus a 141.1% EPS decrease or a 0.8% worse impact), General Motors (32.7% decrease versus 37.2% decrease or a 4.5% worse impact in 2012 and 26.1% decrease versus a 35.4% decrease or a 9.3% worse impact in 2014) and JPMorgan Chase (15.87% decrease versus 15.93% decrease or a 0.06% worse impact in 2013—rounded to 0.1%).

A summary impact of common stock buybacks is also provided in Table 1 for all these companies. Improved growth from the buyback mirage occurred in 17 of the 28 (4 years x 7 companies) annual growth periods (61% of the time) and all these companies (100%) benefitted over the four-year growth period. Concerning individual annual periods, the buyback danger of increased poor performance when there are fewer shares to use in the EPS calculation occurred in 5 of the 28 annual growth periods (18% of the time). There was no impact in 6 individual periods (21% of the time). Thus, the improved growth benefits of the common stock buyback or growth mirage strategy outweighed the increased loss dangers of such a strategy by 3.4 times (61% versus 18%) for annual growth periods and there were no risks over the four-year growth period for these companies. However, the stock market took a somewhat dim view of the buyback strategy of these seven companies as there were weak (39%) and moderate (52%) negative correlations of buyback percent with stock price increase and market cap increase, respectively, over the four years.

5. DIRECTORS' JUSTIFICATIONS FOR BUYBACKS AND BUYBACK USAGE

Concerning the $1.5 trillion spent on buybacks by S&P 500 companies over the last three years, S&P 500 company directors were interviewed by the Investor Responsibility Research Center Institute (IRRC). They insisted that their companies can afford both buybacks and adequate investment and listed the usual justifications for buybacks:

- to return capital to shareholders,
- to invest in the company's shares,
- to offset dilution from using equity as currency in mergers and acquisitions, and
- to alter the company's capital structure.

Since acquiring firms often issue their own shares (with shareholder approval) to buy other companies, their outstanding shares then are increased and diluted. To offset such dilution, companies may then buy back their own shares. Furthermore, anti-takeover strategies include share buybacks to increase the stock price while reducing the company's cash position in order to make a takeover or target company more expensive and less attractive to corporate raiders and other potential buyers.

Accordingly, the IRRC recommended improved disclosures about share repurchase programs: "Few companies publicly disclose details about buyback decision-making and very few state the reasons for a specific buyback program" (IRRC 2016). Nell Minow, a corporate governance analyst, summarized these buyback issues: "Concerns about misaligned incentives and the increased use of debt shift the burden of proof to require much more specific disclosure about the process and calculus used to quantify the benefits of buybacks. Shareholders need to know whether they are getting their money's worth from buybacks and from the executives and directors who approve them" (Minow, 2016).

Such disclosures are essential with all the concerns about company debt loads, executive compensation, and earnings management to achieve executive bonuses and to enhance the value of executive stock options just in the short-term. A financial press writer noted company debt concerns from bondholders' perspectives: "The bond market should be concerned about stock buybacks, but not because of their bullish effect on share prices. Instead, bondholders should be anxious about where the cash to pay for them comes from. It isn't widely appreciated that the money has been borrowed in the credit markets, and that the borrowers have taken a large amount of debt to support the buybacks. That's cause for worry on several fronts" (Ader, 2016). For example, median total debt for S&P 500 companies reached $5.43 billion in the second quarter of 2016, the highest ever and debt at global companies rated by S&P reached 3 times Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA) in 2015, the highest in data going back to 2003 and up from 2.8 times last year (Bloomberg, 2016).

Although the top 50 richest S&P 500 companies still have plenty of cash at $825 billion, the other 90% do not as their cash balances have decreased to $385 billion, down 10% from the end of 2015 and down 11% from the end of 2014. The main reason for this is deteriorating earnings as S&P 500 companies have averaged negative earnings growth for the last six quarters. Earnings Before Interest and Taxes (EBIT) for the S&P 500 companies was $1.1 trillion at the end of 2015, the lowest since 2011 (Bloomberg, 2016). In summary, a pay governance consultant commented: "It is important for corporate executives, boards, and compensation committees to remain focused not only on the efficient allocation of capital but also on the design of compensation programs that incentivize the optimal allocation of capital given the company's financial and operational circumstances" (Kay, 2016).

6. GENERAL CORPORATE GOVERNANCE RECOMMENDATIONS INCLUDING BUYBACKS

Some general recommendations in the corporate governance principles developed by the earlier mentioned 13 CEOs (Governanceprinciples.org, 2016) are listed below. All could be revised to include guidance regarding the use of buybacks.

- Public Reporting Transparency: Transparency around quarterly and annual financial statement results is important. Lack of such transparency has also facilitated numerous financial reporting frauds, like Satyam, Parmalat, and Enron.
- Public Reporting of Long-term Goals and Strategies: As appropriate, long-term goals and strategies should be disclosed and explained in a specific and measurable way. Companies should take a long-term strategic view and explain clearly to shareholders how material decisions and actions are consistent with that view. The dangers of just focusing upon short-term goals, especially for executive compensation, have been demonstrated time and time again from Enron to Volkswagen to Wells Fargo.
- Public Reporting and Explanations of mergers and acquisitions (M&A's) and capital expenditures: Companies should explain when and why they are undertaking material M&A's or major capital commitments, especially in light of the questionable strategy to grow by acquisitions, not internal operations, in order to meet executive compensation short-term targets for revenue and earnings.
- Compensation of Management for continuity and long-term performance alignment: Compensation plans should be appropriately tailored to the nature of the company's business and its industry. While such plans may evolve over time, they should have continuity over multiple years and ensure alignment with long-term performance. Compensation should have both a current and a long-term component. Concerning long-term components, many executive compensation plans do so by vesting stock options or awards over a longer term.
- Compensation of Management for disclosure of benchmarks and performance measurements: Benchmarks and performance measurements for management compensation ordinarily should be disclosed but compensation should not be entirely formula based. Companies should retain discretion (appropriately disclosed) to consider qualitative factors, such as integrity, work ethic, effectiveness, openness, etc.
- Compensation of Management for articulation of compensation plans with long-term alignment of management and shareholders' interests: Companies should clearly articulate how their approach links compensation to performance and aligns the interests of management and shareholders over the long-term. One of the major responsibilities of a company's board of directors is to determine the compensation of the company's CEO, usually the responsibility of the board's compensation committee.
- Compensation of Management for use of claw-back policies for both cash and equity compensation: Companies should maintain claw-back policies for both cash and equity compensation. A recent example is the claw-back of both the Wells Fargo CEO and a manager who led the fraudulent cross-selling efforts from 2011-2016 that resulted in 1.5 million bank accounts, 565,000 credit card accounts and 800,000 car loan insurance policies---all not authorized by Wells Fargo customers. $185 million in penalties and fines have been paid by Wells Fargo and 5,300 employees fired. The CEO had to claw-back $41 million of his $247 million equity share awards (only 17%) and the other executive had to claw-back $19 million of her $125 million in stock and options (only 15%) (Cowley, 2016; Conti-Brown, 2017).

These corporate governance principles (Governanceprinciples.org, 2016) did not address earnings management, other than cautioning against the use of non-GAAP metrics which are in conflict with GAAP earnings. These principles did specifically recommend against the strategy of adding back executive compensation in a non-GAAP earnings calculation, which is still used by many prominent technology companies, like Facebook and Apple. It's really too bad these corporate governance principles did not provide a similar, specific recommendation against the use of the common stock buyback strategy to achieve the earnings growth mirage. At least, there was relevant general guidance from the public reporting and management compensation principles as just summarized.

7. SUMMARY

For these well-known major U.S. companies, the common stock buyback strategy to improve the profitability performance of net income growth to a larger EPS growth occurred 61% of the time for annual growth periods and 100% of the time for the four-year growth period. The related buyback danger of increased losses occurred only 18% of the time annually but never over the four-year growth period. Thus, the odds of a favorable buyback strategy for improved growth versus increased loss look fairly good: 3.4 times (61% versus 18%) for annual growth periods and by 100% for the four-year growth period. Of course, future odds for doing this buyback growth mirage strategy would depend upon future operating projections for either earnings growth or decline.

This comparison of net income growth to EPS growth has been advocated as a worthwhile exercise for investors in a new program at Shareholder Forum which has workshops to help investors. Gary Lutin, its founder and a former investment banker, commented: "the net profit test cuts through to the essential logic of comparing a process that grows a bigger pie—reinvestment—to a process that divides a shrunken pie among fewer people: share buybacks. It's pretty obvious that even mediocre returns from reinvesting in the production of goods and services will beat what's effectively a liquidation plan" (Morgenson, 2016).

A financial press writer summarized this buyback strategy: "Investors may be dazzled by the EPS gains that buybacks can achieve, but who really wants to own a company in the process of liquidating itself? Maybe it's time to ask harder questions of corporate executives about why their companies aren't deploying their precious resources more effectively elsewhere" (Morgenson, 2016). Such questioning is especially relevant now since total buybacks and dividends by the S&P 500 companies equaled 128% of 2015 earnings, the most on record outside the financial crisis per an August 2016 report by Barclays Capital (Bloomberg, 2016).

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