

Shareholders, Don't Buy In to Buybacks

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On Wall Street, the more popular something is, the more skeptical you should be.

Stock buybacks, in which companies take their own shares off the market by buying out the investing public, suddenly are sexy. But they don't always pay off for shareholders.

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How sexy are buybacks now? Even [Berkshire Hathaway](#) Chairman [Warren Buffett](#), who has never done a share repurchase, is getting in on the act. This week, Berkshire announced it would buy back an unlimited number of its shares whenever, in Mr. Buffett's eyes, they trade below their true value. All told, buybacks by companies in the Standard & Poor's 500-stock index jumped 22% in the second quarter to \$109 billion, according to Standard & Poor's.

Companies must find ways to put their excess cash to use. When the market price of a company's stock is lower than the "intrinsic value" of its business—the present worth of the cash it will generate in the future—then the company should buy back all the shares it can.

As Mr. Buffett wrote in his 1984 letter to shareholders, when the stock of a growing business with plenty of cash sells "far below" intrinsic value, then "no alternative action can benefit shareholders as surely as repurchases."

But buybacks are far from an exact science. "You have to take a position on what the intrinsic value of the company is and buy stock only below that number," says Richard Reese, chief executive of data-management company [Iron Mountain](#), which has repurchased about \$120 million worth of its shares since early 2010. Mr. Reese pauses, then adds, "I hope we get it correct."



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Christophe Vorlet

At their worst, buybacks can be a form of corporate cannibalism. Often the unspoken motive is to use extra cash to boost earnings per share by reducing the number of shares among which the company's profits are divided. But that can be a slippery slope.

"If companies use buybacks to try to increase earnings per share, they can almost become trapped," says Kevin Beech, an analyst at [Behind the Numbers](#), an investment-research firm in Dallas. "If they

don't keep repurchasing stock, their earnings will take a hit. So it can turn into a sort of an addiction."

[Hewlett-Packard](#) has spent \$57.6 billion repurchasing its own stock since 2004, according to S&P. The total value of H-P's outstanding stock, after years of management turnover and strategic change, is only \$47 billion.

According to H-P's quarterly and annual reports, the company spent \$7.6 billion to buy back

nearly 200 million shares over the first seven months of 2011, at an average price of around \$38. In 2010, H-P spent \$11.3 billion to repurchase more than 250 million shares at an average price of more than \$44. The shares traded this week around \$24.

Declining to elaborate, an H-P spokesman cited a remark from incoming CEO Meg Whitman on a recent conference call: "In the near term, there is a need to moderate our share buybacks and investments so that we can rebuild the balance sheet."

H-P isn't alone. [Yahoo](#) also paid more for many of its shares than they are worth today. A spokeswoman says that as the company has repurchased 14% of its stock since 2009, its return on invested capital, a measure of profitability, has more than doubled. But are investors better off? Yahoo, which was above \$33.50 in late 2008, traded below \$13.50 this week after years of uncertainty about the company's future wore on the share price.

Imagine two companies, each with \$100 in cash and 10 shares of stock. The intrinsic value of each is \$10 a share. But the stock market undervalues one company's shares at \$5 apiece and overvalues the other at \$20. Each company decides to buy back \$10 worth of stock.

The undervalued company gets to buy back two shares at \$5 each, leaving \$90 in assets spread across eight shares. That raises the intrinsic value of each share to \$11.25.

The overvalued company uses \$10 to buy back half a share, leaving the same \$90 in assets spread across 9½ shares. That lowers the intrinsic value of each remaining share to \$9.47.

With a buyback at a cheap company, "the continuing holders benefit to the detriment of the sellers," says Michael Mauboussin, chief investment strategist at Legg Mason Capital Management, while in an overvalued repurchase "the sellers gain at the expense of the ongoing holders."

So how can you spot a bad buyback? Here is a red flag: If cash is dwindling as buybacks are growing, the firm may be starving future growth to pay off present shareholders. That is fine if you sell into the buyback. But it is bad if you hang onto your shares. Owning a bigger piece of a corporate cannibal may leave you hungry in the long run.

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