May 22, 2020

SKBA Market Update

Buybacks Are Dead, Long Live Stock Buybacks

"The King is dead!" – or at least the king that sings the praises of stock buybacks. At SKBA, we've done enough research over the last 30 years to understand that when the goin' gets tough for companies, buybacks are the first to go. It's happening once again.

Here is how the S&P 500 companies are dealing with their disappearing corporate cash flow so far this year:

- *Suspending* earnings guidance…………………Widespread and rapidly expanding
- *Suspending* stock buybacks……………………..Over 100
- *Suspending* dividends……………………………..36
- Cutting dividends……………………………………12

Since early March of this year, S&P 500 companies have been *suspending* guidance, *suspending* buybacks and *suspending* dividends at an unusual rate for such a short period of time. As counted by FactSet, including U.S. companies not in the S&P 500, over 260 companies have cut their dividends since the beginning of March. SKBA's portfolio holdings have seen only three suspensions and two dividend cuts, both of which left the stocks attractive on a post cut relative yield basis. As we've alluded to in our past notes, these actions go beyond normal responses in regards to what we've typically seen in the past for the *suspension* of earnings guidance, buybacks and dividends. It's not hard to understand why companies have thrown up their arms regarding what the future holds for earnings; the specific timing of this recovery is harder than usual to predict.

With everything that's going on right now, we're seeing the good, the bad, and the ugly. For free market capitalism to function properly, companies have to be allowed to choose how to allocate their capital towards capital spending, acquisitions, dividends, debt reduction, and/or stock buybacks. If a company does not have the investment opportunities to grow its business, its excess cash flow can and should be used to shrink debt, capitalization, or payout more in dividends to shareholders. Unfortunately, it becomes "ugly" when politicians, regulators, and the federal government decide to stigmatize such actions as hurting the economy or employees and even possibly ban the payment of dividends or the repurchase of shares. This happened not all that long ago in 2009 when the banks were basically commanded to cut both dividends and stock buybacks. Today, the targets are even broader. So companies have stopped in their tracks and progressively stopped buying back stock.

The Federal Reserve Board and the U.S. Treasury have a responsibility to set policies that contribute to the stability of the U.S. financial system. Despite the fact that the Fed and the Treasury let Fannie Mae and Freddie Mac run amok when they were buying up subprime mortgages leading up the 2008-09 financial crisis, their ultimate decision to put restrictions on banks in an effort to retain capital by reducing dividends and stock buybacks was necessary. The same can be said today regarding industries such as airlines, as restricting the use of capital for stock buybacks and dividends will increase the chances they pay back at least part the government loans (or grants) they've been given to survive. Yet the general hullabaloo regarding permanently restricting the use of corporate capital and cash flow to buy back its own stock will hurt free market capitalism's function of capital allocation to its highest and best uses. So let's hope buybacks live long and return! *OK, enough on the soapbox.*

The “good,” perhaps contrary to most investors’ thinking, is the widespread suspension of earnings guidance. This should improve capital market efficiency, not hurt it. The posting of narrow guidance ranges (i.e. “we should earn between $2.75 and $2.85 per share this year….) increases market volatility by setting up thresholds that will either cause investors to rush to buy (beating guidance) or rush to sell (falling short of guidance). Certainly some businesses are stable enough to offer a narrow range to Wall Street analysts, but there are events like COVID-19 constantly lurking out there to upset the applecart; this pandemic is just one example that has become reality. We have long advocated that companies should at least widen their guidance to consider a +/- 1 standard deviation of possible events in the economy, product development, competition, capital spending cost overruns, and such that could help or hurt earnings to a far greater degree than what is currently being considered in today’s regime of company earnings guidance. This would be a plus for financial markets in general, injecting resiliency in their valuations, and perhaps given the dire straits many companies face at this moment, it might give cause to rethink the current strategy. Given how markets (both Wall Street analysts and senior management) are hooked on guidance, an improvement in the post COVID-19 environment would be to establish a significantly wider range for such guidance.

Or perhaps they won’t learn such lessons. That would be the “bad.” Yet, we continue to believe that establishing a consistent dividend policy creates a good proxy for what is happening to underlying earning power.

While important to capital allocation in a free market economy, buybacks, in contrast to dividends, aren’t as good a use of cash flow as their supporters claim them to be. We like companies that have the free cash flow to shrink “net” diluted shares outstanding. We like buybacks even more if the company pays a low price to book value to acquire them. In fact, if buying back stock was based on some measure of valuation attraction to support the price at market bottoms, that would be good. Yet, except for a few companies, such as Berkshire Hathaway, we rarely see that. The table below tells the story – examining the aggregate dollars spent by companies in the S&P 1500 index. If buybacks are such a smart thing to do, why do companies STOP buying back stock at market bottoms when valuations are most attractive? In the bear markets of 2002 and 2009, valuations plunged, but buybacks fell 22% and 55%, respectively. During the current bull market, buyback activity shot up at twice the pace of the aggregate change in market capitalization for the index. Note also that dividend payments fell modestly during these prior recessions, even in 2008-09 with the impact from the financial crisis on banks and financial companies.

S&P 1500 Aggregate Data^

% Cumulative Change by Period

	Market Capitalization	Dividends Paid	Value of Stock Buybacks
Peak-to-Trough Periods			
1999 to 2002	-34%	-1%	-22%
2007 to 2009	-22%	-15%	-55%
Trough to Peak Period			
2010 to 2018	80%	111%	160%

^Source Data: S&P Global

But wait! There’s even more to this story. As the next table on companies in the large-cap S&P 500 index demonstrates, companies routinely buy back stock when valuations are high, not low! We’ve included three metrics in this table looking at the peaks and troughs of the market over the past 20 years – Price to Operating EPS, Price to SKBA’s Earning Power Per Share, and Price to S&P’s measure of Book Value Per Share. Stock buybacks peaked in 1999 when P/E ratios reached 36 times SKBA’s calculation of normal earning power and 5 times book value. With the pop of the Tech Bubble and plunge in stock prices, far less stock was bought at half those peak valuation levels. Later as we headed to the peak prior to the Great Recession, valuations were lower this time at 19 times SKBA's earning power estimate and only 2.8 times book value. However, buybacks plunged when valuations later hit a depressed level of 14 times earning power and only 2.2 times book value.

This isn't too hard to understand—companies are flush with cash at market peaks and find cash scarce at market bottoms.

S&P 500 Index Valuation Ratios^

	S&P Price to Operating EPS	**S&P Price to SKBA Normal Earnings**	**S&P Price to Book Value/Share**
1999 Peak	28.4x	36.8x	5.1x
2002 Trough	19.1x	17.7x	2.7x
2007 Peak	17.8x	19.1x	2.8x
2009 Trough	19.6x	13.8x	2.2x
2019 Peak	20.6x	19.9x	3.5x

^Source Data: S&P Global & SKBA

Yet the problem is deeper. *The board of directors and senior management of many companies lose both the financial capacity <u>and the will</u> to buy back stock when times are tough*. They fall prey to the same fears that retail investors, and even professional investors, face. When times get good again, like 2019, companies once again pay up (via higher valuations as shown above) and even borrow to buy back stock as the market peaks! There's certainly no virtuous cycle on display in such decisions. This is where dividend policies are distinctly different. By setting a long-term dividend policy, companies are forced to manage cash flows more responsibly.

So why do companies find themselves playing a "bad" game of yoyo? There are four reasons: agency problems, options awards, the hollowing out of equity capital, and tax rate differentials. Let's start with the latter.

Some investors argue that its more tax efficient to use cash to buy back stock as capital gains are taxed at a lower rate than dividend income. That was true in spades in 1997 when the top marginal bracket on income (including dividend income) was raised from 28% to 39.6% while the capital gains tax rate was cut from 28% to 20%. This was one factor that helped growth stocks vastly outperform dividend-paying value stocks in the second half of the 1990s. Growth companies bought share after share until the bubble popped in 2000. Since the tax law changes in 2003, equalizing the capital gains and dividend tax rates at 20%, the influence of tax policy on the preference for dividends versus buybacks was removed. The difference in tax rates remained the same even after the 3.8% tax was added to each in 2010.

In the seven years from 2012 to 2019, Treasury stock on the balance sheets of S&P 500 companies doubled to $3.2 trillion. The big fiction we see regarding the benefit of these purchases is the massive award of stock options that create a huge contingent liability on corporate balance sheets to buy back stock to prevent the dilution from the exercise of options. We believe true outright stock ownership best aligns management incentives with those of shareholders, not the agency problem that comes with the issuance of options that result in a deferred bonus for members of management. With interest rates suppressed at such low levels, borrowing to buy back stock became management mantra. Yet this has hollowed out shareholder's equity in much of corporate America. No wonder so few companies have maintained the fortress balance sheets that would allow them to get through this terrible crisis without financial assistance from the government.

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Some companies have that fortress balance sheet, but don't expect to get your price boosted from huge stock buyback programs at most companies. We believe the ones that sustain dividends or restore today's "suspended" dividends the quickest will be the best ideas going forward. This is why we've been willing to hang on to the three stocks suspending them.

So "Long live the King!" – no, not the king that sings the praises of stock buybacks – the king that respects the importance of free market capitalism, allocates capital to all appropriate uses, maintains a strong balance sheet, **and of course, pays quarterly dividends to prove it.**

Our very best wishes to you,

Andrew W. Bischel

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