

Returning capital to shareholders

Many leading public companies devote a substantial and growing portion of their income to repurchase shares of their own stock. Because of pressure from shareholders, particularly activist investors, to return capital, companies must carefully evaluate their capital allocation and return strategies. Reasons to consider a share buyback include the amount of cash a company has on hand, the low cost of capital, the perception that share prices are undervalued, and dilution caused by equity compensation plans.

Executive summary

On September 26–27, 2016, members of the Audit Committee Leadership Network (ACLN) met in New York to discuss these trends and how their boards consider capital allocation decisions. This *ViewPoints* includes background information and synthesizes the perspectives that members shared before and during the meeting on the following topics:¹

- **The rise of share repurchase programs** (*page 2*)

A substantial group of large public companies are allocating a growing share of their income and cash flow to buying their own stock on the open market. Companies consider the perspectives of their investors when deciding whether a buyback is an appropriate use of capital – though investors disagree with each other about capital return issues. While critics have identified some potential flaws in buyback programs, audit chairs discounted many of the criticisms and said that these programs remain an effective use of capital for a company that is performing well and generating excess cash, especially given sustained low interest rates.

- **Corporate capital allocation decisions** (*page 5*)

Companies deploy a range of options for allocating their capital to grow their business, from expanding into new geographies, to investing in research and development, to acquiring other companies. ACLN members said that in nearly every case, their companies try to exhaust their options for growth before returning capital to shareholders. When they do conclude that there is enough remaining capital to distribute to their shareholders, companies must choose between share buybacks and dividends. These decisions have practical implications, such as the tax consequences for investors, but the signals that these decisions transmit about the company and the future are often more important considerations.

- **Board oversight of capital allocation** (*page 7*)

Capital allocation is an area in which directors, particularly those with financial expertise, play an important role in a company's decisions. To effectively participate, board members work closely with their finance organizations to understand plans and proposals, and to challenge management's assumptions about their alternatives.

¹ *ViewPoints* reflects the network's use of a modified version of the Chatham House Rule whereby names of members and their company affiliations are a matter of public record, but comments are not attributed to individuals or corporations. Quotations in italics are drawn directly from conversations with network members in connection with the meeting.

The rise of share repurchase programs

Companies today are returning an extraordinary amount of capital to shareholders, often in the form of share repurchases. During the meeting, audit chairs considered the prevalence of share buybacks, investor perspectives on capital return, the reasons companies are buying back their shares, and criticisms of these repurchase programs.

Record levels of share buybacks

From 2013 through 2015, S&P 500 companies spent more than \$1.5 trillion buying back shares of their own stock.² During the last three years, an average exceeding 75% of S&P 500 companies repurchased shares in each quarter.³ In the first quarter of 2016 alone, share repurchases totaled \$166.3 billion, with 41 companies each spending more than \$1 billion on buybacks.⁴

Beyond the large aggregate numbers, share buybacks consume a growing share of companies' income and cash flow. At 137 S&P 500 companies, buyback spending exceeded reported earnings over the course of the last four quarters.⁵ According to data from McKinsey, since 2011, US companies have used about 47% of their income to buy back shares, up from 23% in the early 1990s and less than 10% in the early 1980s.⁶ In 2015, buybacks made up 68.1% of S&P 500 companies' net income, up from 64.9% in 2014, and the dollar amount spent on repurchases represented 101.7% of their free cash flow after dividends.⁷ A range of economic factors, including companies' substantial cash holdings (even after record buyback activity), low interest rates, and slow growth all point to share repurchase programs remaining popular in the near term.⁸

Investor interest in capital allocation decisions

Pressure from investors, particularly activist investors, is one reason members cited for the increase in buyback activity. Some activists are more aggressively seeking buybacks, putting pressure on companies to evaluate and articulate the alternative uses of capital. For each of the prior three years, activists have launched between 50 and 70 campaigns to pressure S&P 500 companies to return capital to shareholders.⁹

Members cautioned boards against reflexively dismissing an activist's suggestion, noting that some of them can and have been "very smart, good contributors," as one member said. Another added, "In my case, an activist made [one company] better" when engaging with an activist about capital allocation and return. Nevertheless, many companies still strive to make capital allocation choices that forestall activist interventions. One member described a board that considered how activists might respond to its capital

² Justin Lahart, "What \$1.5 Trillion in Stock Buybacks Doesn't Buy," *Wall Street Journal*, November 8, 2015.

³ Andrew Birstingl, *FactSet Buyback Quarterly*, September 20, 2016, 2.

⁴ Andrew Birstingl, *FactSet Buyback Quarterly*, June 23, 2016, 1.

⁵ Andrew Birstingl, *FactSet Buyback Quarterly*, September 20, 2016, 1.

⁶ Tim Koller, "Are Share Buybacks Jeopardizing Future Growth?" McKinsey & Company, October 2015.

⁷ Andrew Birstingl, *FactSet Buyback Quarterly*, March 17, 2016, 3.

⁸ Richard Fields, Tapestry Networks, *Buybacks and the Board: Director Perspectives on the Share Repurchase Revolution* (Investor Responsibility Research Center Institute, 2016), 4.

⁹ Andrew Birstingl, *FactSet Buyback Quarterly*, June 23, 2016, 13.

allocation strategy: *“We were concerned about activists. The board pushed management to return capital at the higher end of the proposed range to signal to the investor community that this was a priority.”*

Members emphasized that when faced with pressure to return capital, it is important to remember that not all investors favor large buybacks. One said, *“You hear very different opinions based on who your shareholders are.”* In particular, many institutional investors prefer management to strategically reinvest capital in employees, innovation, or other strategic priorities, rather than repurchase shares.¹⁰ Members emphasized the benefits of having an open dialogue with investors so that they and the company understand each other’s priorities. One opined, *“It is important for board leadership to be out talking to investors. You need a narrative about where the company is going from a board and management perspective. If you don’t have a story out there, the only story your institutional investors will hear is the one presented by the activist.”* Other members suggested that the board and management focus their attention on attracting investors who support the company’s long-term plans rather than trying to justify those plans to skeptical owners. One said, *“Companies make a mistake when they try to satisfy a set of shareholders who have priorities that are not consistent with their strategy.”*

Reasons to buy shares back

Activist investors are not the only ones advocating for buybacks. ACLN members said that, under the right circumstances, a repurchase program is an effective way to deploy capital. There are a variety of reasons why a company considers repurchasing its own shares:

- **Cash flow exceeds cash requirements.** Some companies generate more money than is necessary to fund ongoing operations and profitable growth opportunities. Members said it is appropriate in those cases to return the excess to the company’s owners. One member described a company in which *“the rule was that we only need to keep enough cash to be able to operate for three months, and we sent the rest back in buybacks. We did not want to hold on to too much excess cash because we thought it would make us a target for an acquisition.”* Another added that keeping too much cash can also act as a drag on the company’s return measures: *“You need to deploy the cash, or you are effectively losing money.”*
- **Capital costs are low.** Sustained low interest rates have also contributed to the rise in share repurchases. Members explained that the availability of low-priced debt to fund future capital needs makes it easier for a board to authorize a buyback. In some cases, low interest rates lead companies to issue debt to fund their share repurchases, thereby altering their capital structure.¹¹ Because certain investors and ratings agencies take an unfavorable view of borrowing money to fund a buyback, members emphasized the importance of testing the rationale for such a decision. One explained, *“We had the company go through an intense analysis to examine the company’s ability to generate cash. The results of that scenario testing gave us the fortitude to borrow [to fund a repurchase].”* Other members noted that

¹⁰ EY Center for Board Matters, *2016 Proxy Season Preview: A Focus on the Long Term* (New York: Ernst & Young LLP, March 2016).

¹¹ Mike Cherney, *“The New Bond Market: Debt Investors Wary as Offerings Fuel Buybacks.”* *Wall Street Journal*, September 21, 2015.

issuing debt can be a particularly attractive alternative for companies with substantial overseas earnings to buy shares back without having to repatriate those earnings.

- **Share price is undervalued.** A share buyback can be a good use of capital when the board and management team believe the company's share price is undervalued. One member agreed that the company's share price must be a factor in the decision to buy shares back: *"Why embark on an initiative to buy part of the company if, at the end of the day, you don't have conviction that the company is being undervalued?"* However, some members questioned whether management is in the best position to determine whether share prices are undervalued, citing examples where companies invested substantial sums in buybacks only to see the share price drop shortly thereafter. For example, many companies were buying back their own stock during the market highs prior to the 2007–2009 crash (when values were likely to be inflated), but gave up on buybacks during the crash (when prices were very low).¹²
- **Companies seek to offset executive compensation dilution.** Buybacks can replace the shares or fund the options that companies award as compensation. One commentator said, "Many buyback programs appear to be prompted less by a company's enthusiasm for its own shares and more by a desire to offset the dilution caused by executives exercising stock options."¹³ One member described this practice as *"preventing equity creep."* A director recently cautioned that this practice could cause companies to inadvertently increase the cost of executive compensation plans: "If we are using hard dollars to offset stock dilution, we should treat those hard dollars as a compensation expense. Otherwise we are not recognizing what we are actually spending to compensate our people."¹⁴

While share buybacks often have strategic benefits, members emphasized that they view capital return as a means of distributing the proceeds of a successfully implemented strategy; it is not a strategy itself. One member said, *"Buying stock back doesn't offset poor performance. It has to be part of a bigger plan."*

Criticism of share buybacks

Some stakeholders have pointedly criticized companies for the high level of share buybacks. These critics point out a number of issues with repurchases:

- **They reduce investment in growth.** Critics also worry that companies are buying back stock rather than investing in their businesses. Last year, presidential candidate Hillary Clinton said, "Large public companies now return eight or nine out of every 10 dollars they earn directly back to shareholders, either in the form of dividends or stock buybacks, which can temporarily boost share prices ... That doesn't leave much money to build a new factory or a research lab, or to train workers, or to give them a raise."¹⁵ Members strongly disputed the contention. One member said, *"It is only after we consider all options for investing in the business and funding our liabilities that we might talk about a buyback."*

¹² Jonathan Clements, ["The Downside to Stock Buybacks,"](#) *Wall Street Journal*, October 25, 2014.

¹³ [Ibid.](#)

¹⁴ Richard Fields, ["Buybacks and the Board: Director Perspectives on the Share Repurchase Revolution,"](#) 16.

¹⁵ Hillary Clinton, ["Moving Beyond Quarterly Capitalism,"](#) speech given at NYU's Stern School of Business, New York, July 24, 2015.

One related theory is that companies are not prioritizing long-term investments because they substantially discount the value of future cash flows. One study found that, “cash-flows 5 years ahead are discounted at rates more appropriate 8 or more years hence; 10 year ahead cash-flows are valued as if 16 or more years ahead; and cash-flows more than 30 years ahead are scarcely valued at all.”¹⁶ Members, however, were generally comfortable that their companies’ consider opportunities thoughtfully and with the proper diligence to reach sound conclusions about potential investments. They explained that their companies regularly make “*big bets*” that may not pay off for many years – so long as they believe they will be adequately compensated for the risk and uncertainty.

- **Compensation plans may encourage them.** Some connect the rise in buybacks to the prevalence of executive compensation metrics tied to share price. A report in *The Economist* contended, “Buy-backs can also give a superficial boost to EPS: the number of shares falls more than the decline in profits from higher interest costs. If managers are paid on the basis of EPS targets – as up to half of American bosses are – they have a temptation to go buy-back bananas.”¹⁷ Members said this concern might be overblown because boards ordinarily make adjustments to account for buybacks when they use EPS in their compensation plans. In addition, a number of members noted that many public companies do not use EPS as a metric in their incentive plans; more companies tie a significant percentage of variable compensation to relative total shareholder return (TSR), a metric that is not ordinarily calculated on a per-share basis.¹⁸

Corporate capital allocation decisions

Audit chairs discussed the circumstances in which a capital return is appropriate and the different options for returning capital.

Is capital return appropriate for the company?

The first question that a company and its board face when considering a capital return is whether it is an appropriate use of company resources. Most ACLN members said their companies only consider capital return after exhausting other capital allocation options.

Among the other uses of capital that members consider are the following:

- **Capital expenditures.** In many industries, companies must allocate large amounts of capital for long-term projects. These might include building facilities, expanding into different geographies, purchasing equipment, and implementing marketing strategies. Members explained that these investments are closely aligned with the strategic plans of the company and are often made with a long time horizon in mind. Some members noted that as more companies move to asset-light business models, these kinds of expenditures are likely to decline.

¹⁶ Andrew G. Haldane and Richard Davies, “[The Short Long](#),” speech to 29th Société Universitaire Européenne de Recherches Financières Colloquium: “New Paradigms in Money and Finance?” Brussels, May 2011, 1.

¹⁷ “[The Repurchase Revolution](#),” *Economist*, September 13, 2014.

¹⁸ Meridian Compensation Partners, [2016 Trends and Developments in Executive Compensation](#) (Lake Forest, IL: Meridian Compensation Partners, 2016), 21.

- **Research and development.** Members said internal investments in innovation and technology are fundamental to the growth and ultimate survival of their companies. One member said, *“Investing in the business to find ways to grow organically is the first and best use of capital.”* Pressure to fund research and development is especially acute in industries in which large portions of a company’s value are tied to intangible assets like intellectual property.
- **Strategic acquisitions.** Companies also use capital to acquire other businesses. One member said that transactions are often a way to expedite a growth strategy: *“An acquisition might allow you to do something faster or put you solidly in a space with a good brand. It can be a good alternative to trying to build something from scratch internally.”* Another member described a situation in which a company altered its capital allocation plan in order to make an important acquisition: *“In a consolidating industry, it was important for us to do a deal. We gave up on our repurchases so we could reallocate the capital. We would never pass on a strategic acquisition so we could keep doing our buybacks.”* Members cautioned that acquisitions can be a risky way to allocate capital compared with other alternatives. One said, *“We go back and look at how past acquisitions performed versus our expectations. By evaluating our track record, we are able to assess the risks and bet on the transactions where we feel we have a greater probability of success.”*
- **Cash cushion.** Some companies prefer to keep excess capital on hand. Members said this is especially important in times of uncertainty for the company or the broader economy. They explained that excess cash may also be needed to cover tax contingencies if the company is under audit, or it may be helpful in protecting the company’s credit rating.

What capital return options are available?

Public companies can return capital to shareholders in a number of different ways. Because the vehicle a company chooses for distributing capital often sends a particular signal to investors and other stakeholders, members said companies often consider the perception of their choice as much as its actual implications. For example, one member contended that *“you send different signals with a dividend versus a share repurchase. Paying a regular dividend signals that you are no longer a high-growth company. Buybacks are not a long-term signal in the same way.”*

There are benefits and drawbacks to each method of returning capital:

- **Open-market share repurchase programs.** Companies frequently buy their own shares through open-market transactions. These transactions rose to prominence in 1982, when the Securities and Exchange Commission allowed boards to authorize managers to repurchase shares this way, subject to a public announcement of a buyback program.¹⁹ One of the principal benefits of an open-market share repurchase program is the flexibility it provides. One member said, *“If you are the board and CEO, a buyback is the friendliest way to return capital, because buybacks can be dialed up or down.”* Another

¹⁹ William Lazonick, [“Profits Without Prosperity.”](#)

added that buybacks do not generally come with the expectation that they will recur: *“Buybacks are more short term because you can enter and exit.”*

- **Tender offers to repurchase.** Companies also conduct share buybacks through tender offers: they reach out to shareholders with an offer to buy a certain number of shares at a stipulated price. Shareholders can then take advantage of the offer by tendering their shares to the company.²⁰
- **Regular dividends.** Many companies pay their shareholders a regular dividend, usually on a quarterly basis. Members said once a company starts paying a dividend, investors generally expect the dividend to continue and grow; thus, a decision to decrease or discontinue a dividend can have substantial consequences. One member said, *“Dividend decisions are long term in nature. You need to have a serious debate about the certainty of future cash flows before committing to a change in your dividend strategy.”* Some members find value in that certainty. One explained, *“Dividends create a discipline, which is more likely to force the right decisions. They send the signal to the market that you will have the capacity to pay them.”*
- **Special dividends.** In certain circumstances, companies may choose to provide shareholders with a one-time cash payment, known as a special dividend.²¹

It is common for companies to use more than one of these methods. Members said preferred practices are often unique to each company or industry. One member described a company that did not pay dividends historically: *“As we mature, we are looking at what our view on dividends should be. It is causing us to focus our capital allocation discussions on balancing dividends and share buybacks.”* Members said their companies also consider investor preferences, noting that certain investors only invest in companies with dividend yields above a set level, or they have a stated preference for dividends over buybacks. Other members noted that there are other investors who favor buybacks, often for tax reasons.

Board oversight of capital allocation

Members agreed that there are opportunities for boards to play a meaningful role in capital allocation choices. Some members emphasized a focus on oversight. Members explained that it is important for the board to work closely in this area with the chief financial officer and his or her team, who are initially responsible for the details of a company’s capital allocation plan. It is critical for board members to educate themselves on these transactions by asking management for details. One director recently explained, *“We do get into the weeds on capital allocation variables and decisions. These are fundamental questions for the company, and we need to satisfy ourselves that we understand everything built into the models and projections.”*²² Some members said this task is often appropriate for the financial expertise of audit committee members, whether or not capital allocation is part of the committee’s charter.

Directors consistently identify the board’s role in capital allocation and return decisions as closely tied to its role of overseeing corporate strategy. The board’s involvement in these decisions typically occurs both

²⁰ William Lazonick, [“Profits Without Prosperity.”](#)

²¹ [“Extra or Special Dividends.”](#) Nasdaq.com, accessed August 26, 2016.

²² Richard Fields, [Buybacks and the Board: Director Perspectives on the Share Repurchase Revolution](#), 7.

annually – often during a strategy review – and throughout the year as internal and external circumstances change.²³ Members said that their unique position as directors allows them to challenge management to consider bold ideas, whether it be to dramatically alter the company’s capital structure with a debt-funded buyback or to ensure all viable investment options have been exhausted before launching a new buyback program. One member explained, *“Sometimes the board needs to be on top of the management team, encouraging them to allocate capital to innovation. In others, management needs to provide the board with more information about the long-term innovations the company is considering, to determine whether they are worthy investments.”*

Conclusion

There are a wide range of options available to large public companies for allocating capital. Directors emphasized that companies that fund their reasonable opportunities for profitable growth and still have excess capital are wise to consider buying back their own shares. Directors who work closely with their management teams to understand investment options and capital allocation alternatives, play a critical role in their companies’ strategic decisions.

About this document

The Audit Committee Leadership Network is a group of audit committee chairs drawn from leading North American companies committed to improving the performance of audit committees and enhancing trust in financial markets. The network is organized and led by Tapestry Networks with the support of EY as part of its continuing commitment to board effectiveness and good governance.

ViewPoints is produced by Tapestry Networks to stimulate timely, substantive board discussions about the choices confronting audit committee members, management, and their advisers as they endeavor to fulfill their respective responsibilities to the investing public. The ultimate value of *ViewPoints* lies in its power to help all constituencies develop their own informed points of view on these important issues. Those who receive *ViewPoints* are encouraged to share it with others in their own networks. The more board members, members of management, and advisers who become systematically engaged in this dialogue, the more value will be created for all.

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²³ Richard Fields, *Buybacks and the Board: Director Perspectives on the Share Repurchase Revolution*, 6.

Appendix 1: Participants

Members participating in all or part of the meeting sit on the boards of 38 public companies:

- Alan Bennett, Audit Committee Chair, Halliburton
- Mary Anne Citrino, Audit Committee Chair, HP Inc.
- Carolyn Dittmeier, Chairman Statutory Audit Committee, Generali²⁴
- Tim Flynn, Audit Committee Chair, Wal-Mart
- Michele Hooper, Audit Committee Chair, PPG Industries
- Blythe McGarvie, Audit Committee Chair, Viacom
- Chuck Noski, Audit Committee Chair, Microsoft
- Mary Schapiro, Audit Committee Chair, General Electric Company
- Tom Schoewe, Audit Committee Chair, General Motors
- Guylaine Saucier, Audit Committee Chair, Wendel²⁵
- Dick Swift, Audit Committee Chair, CVS
- Jim Turley, Audit Committee Chair, Citigroup
- David Vitale, Audit Committee Chair, United Continental

EY was represented in all or part of the meeting by the following:

- David Kane, Americas Vice Chair of Assurance Professional Practice
- Steve Howe, US Chairman and Americas Managing Partner
- Frank Mahoney, Americas Vice Chair of Assurance Services

²⁴ Member of the European Audit Committee Leadership Network

²⁵ Member of the European Audit Committee Leadership Network



Appendix 2: Discussion questions

The following questions may stimulate fruitful conversations among audit committee members:

- ? What circumstances do you believe must be present for a share buyback to be a good use of capital?
- ? When, if ever, is it appropriate for a company to issue debt to fund a buyback?
- ? Which criticisms of share buybacks have the most merit? How do those criticisms influence your decision to authorize a buyback?
- ? Are you concerned with how buybacks may affect executive compensation awards? How and when does the board consider the executive compensation implications of repurchase programs?
- ? What, if any, concerns do you have when the best capital allocation decision is a buyback, as opposed to an investment in the company?
- ? What factors might a company consider when choosing between a share repurchase program and instituting or increasing a regular dividend?
- ? How do your companies determine the amount of capital to return to investors? Is it a percentage of free cash flow? Do you use another metric?
- ? How much does the board defer to management on buyback recommendations?
- ? How often does the board alter or tweak management's capital allocation recommendations? How often with buyback recommendations in particular?