Lead Director Network ViewPoints

November 21, 2016

Incorporating share buybacks in board-driven strategy

We are living through what the *Economist* has called "the share repurchase revolution." At least 350 public companies in the S&P 500 Index have repurchased shares in each of the last 10 quarters. Most companies are spending the majority of earnings on buybacks: during the 12 months ending with the second quarter of 2016, the average S&P 500 company spent 71.5% of its net income on buybacks, and 137 firms spent more on buybacks than they generated in earnings.[1] In the aggregate, S&P 500 companies bought back $2.1 trillion of their own shares in the last five years[2] – enough to take Apple, Exxon, Facebook, General Electric, and Johnson & Johnson private.

Lead directors said that their companies have felt pressure to increase their buyback activity, a pressure that some see as closely related to the preference for short-term results, which might imperil long-term growth prospects. *"As board directors, we're charged with long-term value creation, but that's becoming increasingly courageous,"* commented a member.

Lead Director Network (LDN) members met on October 25 in Washington, DC, to discuss capital return during this share repurchase revolution. This issue of *ViewPoints* synthesizes that discussion and conversations leading up to it. It also summarizes a review by King & Spalding partners of the Supreme Court's business docket.[3] For further information about the LDN, see page 7. For a list of participants, see Appendix on page 8.

LDN members feel the pressure to buy back shares

At the meeting in Washington, lead directors confirmed that they have experienced considerable pressure from investors and management to buy back shares. Members saw this as part of a troubling trend. *"You have to get the highest return on capital,"* said one. *"But I see this huge trend, a relentless one, to 'show me now what you can give me now.' There's shorter CEO tenure. It's an increasingly hard game to balance the long term and short term."*

A system biased toward the short term

"There's a lot of pressure on management for quarterly returns – more pressure than in the past," said a member. Another director noted calls from investors, especially activists, to return cash: *"If you have too much cash, you're a target."*

Some leaders of investment companies have emphasized the importance of a long-term focus for CEOs and boards. But LDN members viewed this with some skepticism, citing incentives that impact not only activists but also larger institutional investors. As one member explained, *"There's a difference between*

[1] Andrew Birstingl, *FactSet Buyback Quarterly*, September 20, 2016, 3.

[2] Bob Bryan, "US Companies Have Spent $2 Trillion Doing Something That Has Absolutely No Impact on Their Business," *Business Insider,* June 15, 2016.

[3] *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. Italicized quotations reflect comments made in connection with the meeting by network members and other meeting participants.

what Larry Fink [the CEO of BlackRock] *says and what his fund managers do. They are under a lot of pressure: they get fired after three years if they don't get returns."* The member added that the steps taken by firms like BlackRock seem insufficient so far: *"They are increasing the number of corporate governance people, but they are not experienced investment people … I don't know if they can fight the activists."*

Skepticism about investment opportunities

Lead directors acknowledged that shifting investment horizons toward the long term is not as straightforward as some critics assert. Several directors said that projections of returns on both organic growth and acquisitions have proven unreliable. In an environment of global political uncertainty, slow growth, and depressed profits, boards are examining investment proposals with deeper scrutiny than ever. As one member noted, *"I was brought up that you always invest in the business. But in today's world, you balance return to shareholders and growth. Boards are more tough-minded that an investment will actually produce something. They can be faulted for acquisitions or internal investments that don't pay."*

"There are very few strategies where you're certain you will get the return. You need to be cautious," one member stated. Others agreed. One cost of a failed transaction or major investment project is *"the lost trust of shareholders,"* leading to fears that investors and the public will view future opportunities skeptically.

The challenge is most acute with projects that are slow to pay off. One member expressed the dilemma for directors: *"For some capital expenditures, the return takes a long time, so it's difficult."* Another member noted, *"You want to see signs at least within three years that you will get a return on your investment. You can't go into a long, dead period."* A third member summarized the inhibitive effects of the current climate: *"We've become risk-averse. It's hard to measure the value of M&A and capital expenditures."* Returning capital to shareholders may often seem like the safer move.

Lead directors are determined to resist pressure for excessive buybacks

Despite an uncertain investment environment and strong outside pressure to return capital to shareholders, LDN members were determined to avoid buybacks that could be counterproductive for their companies. They discussed several reasons for proceeding with caution on a buyback proposal.

Although buybacks are somewhat more flexible than dividends, members observed that they have to be sustained if they are to create any value. As one member explained: *"Announcing a buyback program is actually a big commitment. If you announce and then then don't buy back, you get pressure from analysts. So you tend to buy back. We sometimes buy above the yearly average, but it worked because we continued to do it. We didn't get credit in the first few years. Only in the last three years has the multiple gone up – it's finally built in."*

Another concern for members was that buyback programs can leave companies unable to respond to value-creating investment opportunities. One member said, *"There's been a number of companies that had strong cash positions and used them for buybacks, then went into a period when they really could* *have used the cash. They capitulated to the pressure."* Something similar had happened at another member's company: investment opportunities were shortchanged to fund buybacks.

"It's very easy to create a pop in the stock price," said a lead director, *"but it doesn't do anything to advance the broader proposition."* The member suggested that there is a link between buybacks and the overall health of American companies: *"There's a staggering number of companies falling out of the S&P 500. That's not a healthy sign. It does not bode well for corporate America."* A study by the consulting firm Innosight found that the average tenure of companies on the S&P 500 was 33 years in 1965 but had fallen to 20 years by 1990. The study forecast that tenure will continue to drop, and that 50% of the S&P 500 could be replaced over the next 10 years.[4]

Rounding out the caveats, some directors warned that the easy option of a buyback can stop companies and boards from fully exploring and refining investment cases. A lack of attractive investment opportunities is sometimes the result of a failure by companies to look hard enough. Reflecting on the current business environment, one member said, *"What's missing now is the attempt to find growth."* Addressing a fellow director whose company has a track record of good investments, the member asked, *"Your company keeps finding things – why can't we?"*

Directors find strategies for managing internal and external pressure

Members described three ways in which they have managed biases for capital return:

- Broadening the search for investment opportunities
- Communicating the company strategy
- Adjusting compensation programs

Broadening the search for investment opportunities

Members discussed doubling down on the issue of investment opportunities in strategy discussions. One member said, *"Most boards invest a lot of time on strategy. How is the management team looking at opportunities? What are their aspirations? It would be a concerning sign for board members if there's not a lot of ideas for investment. You could see it in R&D."*

Another member agreed and identified investments that companies might want to consider: *"Technology and digital are affecting every industry. Are we not understanding the magnitude of the transformations, since we're returning so much cash? It's interesting that there is a record high return of cash, when there's an obvious need for the cash."*

Members mentioned having management or board committees that identify and evaluate investment opportunities. One director described overseeing the work of a management committee: *"There's a committee that vets opportunities. The board sees specific cases as they come forward. But once a year,*

[4] Ilan Mochari, "Why Half of the S&P 500 Companies Will Be Replaced in the Next Decade," *Inc.,* March 23, 2016.

we ask to see the ones that didn't come forward. We want to see the magnitude. We want to see if there's some we want to pull forward." Another member mentioned a board committee: *"We had a committee [reviewing investments] and we set the threshold low so we could really see the volume. If it dropped, we could say, what's going on?"*

Directors noted that their extensive responsibilities should not distract them from this critical mission: *"Yes, we do a lot of other things, but we have to discuss strategy and we have to have the right CEO."* One remarked, *"We really work hard to see how we can grow our business."*

Communicating the company strategy

Once the company has developed its investment strategy, the board must ensure that it is communicated to investors in a way that reduces pressure for excessive buybacks. Investors need to understand how investments will create value and how long it might take for returns to materialize.

"It's incumbent on us that the executive team is really getting the story out there," asserted a lead director. *"The team needs to explain that 'this is what you can expect.' So when investors come to you two years later, you can push back."* The member noted that shareholders want this kind of information: *"Most investors want to understand your intentions. You have to provide a reasonable amount of information. If they disagree, they should go somewhere else."*

What if the company is faced with activist investors who disagree and are not inclined to go elsewhere? A member said, *"You go to other shareholders. You go to BlackRock and Vanguard."* These large institutional investors are seeking more engagement, the member noted: *"They are saying 'come visit us.'"* But another member advised that it's best to establish and maintain a relationship with institutional investors before their support becomes critical: *"You need to have ongoing communications. Don't wait until you're back on your heels."* These points echoed advice that LDN members heard in their dialogue with Glenn Booraem of Vanguard in January 2016.[5]

One director noted that some types of investments may require more explanation than others: *"One tough issue is that there's a component of investment that needs to be made to keep the company current, like Y2K. Direct returns are not better because of this investment, so justifying it is hard. Car companies, for example, sometimes have to make gigantic investments with paltry returns. But you have to do them to be in that business."* Another member added that any investment is easier to justify if it follows other successful investments: *"You also need a track record."*

LDN members also mentioned the issue of disclosure risks. A convincing explanation might reveal too much about the company's strategy to its competitors. *"The concern is that if you get into detailed metrics, you start to give away your strategy. We are very concerned about competitive risks. At some point, we will have to increase disclosures, but we don't want to be the first to do it."*

[5] Lead Director Network, "Dialogue with Glenn Booraem of Vanguard," *ViewPoints,* February 29, 2016.

Adjusting compensation programs

Some compensation plans for the CEO and other top managers can also create a bias to buy back. If a CEO's bonus is tied to increases in earnings per share (EPS), she or he has a clear incentive to reduce the number of shares outstanding. Several members noted that their firms remove the effects of buybacks from bonus calculations.

Investors, as well as directors, have worried that buybacks can result in unjust enrichment for senior managers. This past year, the AFL-CIO filed shareholder proposals that would require companies to "exclude the impact of stock buybacks from the compensation formulas used for their senior executives."[6] In response, a few companies, such as FedEx, IBM, and Johnson & Johnson, have enhanced disclosures, stating that they adjust performance metrics to take into account the potential effect of buybacks. This is still not common practice, however. A 2015 study by Reuters found that fewer than 20 S&P 500 companies make such disclosures.[7]

Circumstances in which a company should consider repurchasing its shares

LDN members did not categorically rule out buybacks. Agreeing with the directors interviewed for a study by Tapestry Networks of directors' views on buybacks,[8] they explained that certain circumstances warrant returning capital to shareholders:

- **Excess capital.** When all value-adding investments in the growth and maintenance of the business have been made, cash that remains should be handed over to shareholders. This can be accomplished through dividends, but members preferred the greater flexibility afforded by buybacks, which can be scaled back, if necessary, without provoking investor ire. As one member explained, *"In a volatile business, dividends are risky. You don't want to cut the dividend. A buyback is a way of providing a return when the business is more robust."* Another member added, *"The trade-off between buybacks and dividends is to preserve flexibility."*
- **A low share price.** If a company deems that the intrinsic value of its shares is greater than their market value, buying the shares back may be a worthwhile investment. A key issue, though, is how confident a board can be in its assessment that the stock is undervalued. In a pre-meeting conversation, one member said, *"Nobody knows the business better than the board and the executive team."* But others were more skeptical. A member said, *"One question I always ask is, how do we know it's undervalued? Compared to what?"*

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[6] "Why the AFL-CIO's 2016 Shareowner Reforms Are Vital for All Working People," accessed October 4, 2016.

[7] Karen Brettell, David Gaffen and David Rohde, "Stock Buybacks Enrich the Bosses Even When Business Sags," *Reuters Investigates,* December 10, 2015.

[8] Richard Fields, Buybacks and the Board: Director Perspectives on the Share Repurchase Revolution (Waltham, MA: IRRC Institute and Tapestry Networks, 2016).

- **Dilution of shares driven by executive compensation.** A member who generally did not view buybacks favorably said, *"Executive compensation often includes stock and option grants, which could end up diluting shareholders, so I can see covering this dilution."*

Ultimately, the decision to initiate a buyback depends on the particulars of a company's situation. One member explained, *"It's unique to each circumstance. We're in the middle of a buyback. We have a lot of excess capital. We're generating a lot of cash. We're measured on return on capital. We're also trading at a discount. You put all the circumstances together, and it makes sense."* The member added that the company's management and board didn't find compelling alternative uses for the capital at the moment: *"We would have to do a monster acquisition, which has its own set of execution risks."*

"The hope for growth and the opportunity for investment"

Directors are determined to correct what a King & Spalding partner called *"a bias against daring to be great."* They want to ensure that good investment opportunities are uncovered and incorporated into company strategy and that investors are informed of that strategy and grasp its rationale. However, rather than categorically resisting all buybacks, LDN members are approving them when better alternatives are not at hand, especially where shares are underpriced or diluted by compensation programs. Ultimately, the goal is a sound balance between returning cash to shareholders and being able to seize new opportunities as they emerge.

Review of the Supreme Court's business docket

Jeff Bucholtz and Ashley Parrish of King & Spalding gave LDN members an update on the Supreme Court and the business-relevant cases it is currently reviewing. With the nomination of Merrick Garland still undergoing the longest wait in the history of the court, cases now face the possibility of a 4-4 tie, which is one of several reasons the court has granted review of lower court decisions at a historically low pace. Mr. Bucholtz and Mr. Parrish touched on several current cases, addressing questions that might be of interest to directors:

- Is someone who has leaked insider information to a close family member liable even if they themselves did not clearly benefit from the leak? (Salman v. United States)[9]
- If a product infringes on a patent, should the damages owed include all the profits from the product or just the profits attributable to the patented design? (Samsung Electronics v. Apple)[10]
- Can the doctrine of laches be used as a defense against long-delayed patent lawsuits? (SCA Hygiene Products v. First Quality Baby Products)[11]
- Can someone have antitrust liability merely by virtue of being a member of a business association and following its rules? (Visa Inc. v. Osborn)[12]

The Lead Director Network ("LDN") is sponsored by King & Spalding and convened by Tapestry Networks. The LDN is a group of lead independent directors, presiding directors, and non-executive chairmen drawn from America's leading corporations who are committed to improving the performance of their companies and to earning the trust of their shareholders through more effective board leadership. The views expressed in this document do not constitute the advice of network members, their companies, King & Spalding, or Tapestry Networks.

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[9] SCOTUSblog, Salman v. United States.
[10] SCOTUSblog, Samsung Electronics Co. v. Apple.
[11] SCOTUSblog, SCA Hygiene Products Aktiebolag v. First Quality Baby Products, LLC.
[12] SCOTUSblog, Visa, Inc. v. Osborn.

Appendix: Participants

The following network members participated in the meeting:

- Dick Auchinleck, Lead Director, ConocoPhillips; Non-Executive Chair, TELUS
- Peter Browning, Lead Director, Acuity Brands
- Mark Feidler, Lead Director, Equifax
- Ann Fritz Hackett, Lead Director, Capital One Financial Corporation
- Mike McCarthy, Lead Director, Cabela's and Union Pacific
- Jack O'Brien, Lead Director, TJX; Non-Executive Chair, Cabot
- Pam Reeve, Lead Director, American Tower and Frontier Communications
- Doug Steenland, Non-Executive Chair, AIG

The following King & Spalding attorneys participated in all or part of the meeting:

- Jeff Bucholtz, Partner, King & Spalding
- Gov. Bob Ehrlich, Partner, King & Spalding
- Dixie Johnson, Partner, King & Spalding
- Ashley Parrish, Partner, King & Spalding
- Cal Smith, Partner, King & Spalding
- Tom Spulak, Partner, King & Spalding
- Chris Wray, Partner, King & Spalding