

Share Repurchases: Making Corporate America Subprime

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Excessive debt-financed share repurchases are bankrupting corporate America.

The media are focused on the many homeowners who over-leveraged their personal balance sheets by using home equity lines for vacations, automobiles and expensive remodeling they could not afford. But many corporate executives did the same thing with the equity of corporations through share repurchases. Many corporations that were once strong now find themselves in economic peril. Executives blame the weak economy, but in many cases the blame lays squarely on management, their board of directors, Wall Street and large shareholders who pushed the action.

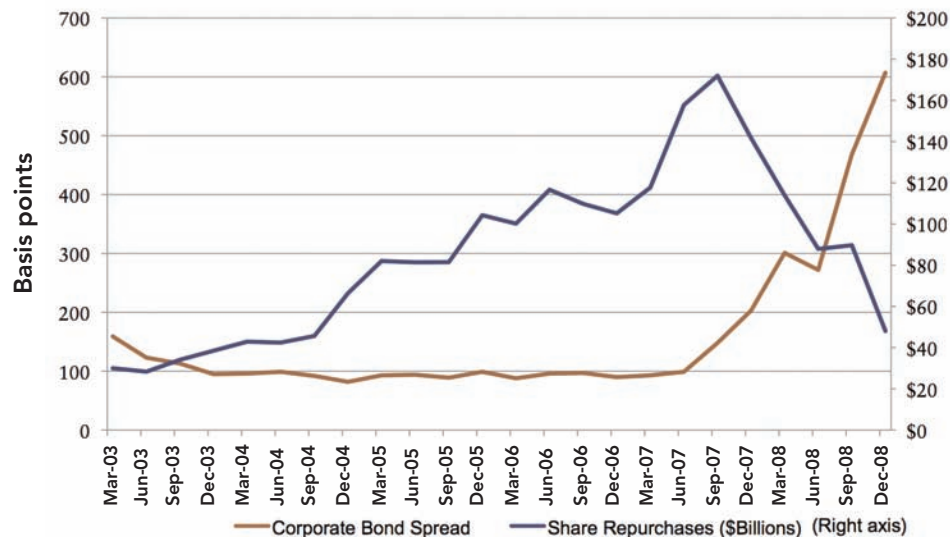
To illustrate, during the good years of the credit bubble many companies took out massive loans to buy back their stock when its price was near its peak rather than using free cash flow to pay down debt, strengthen their balance sheets for when times are

lean (such as today), and then buy back shares at a reasonable price. Using generic numbers, we see numerous examples of companies that issued, say, \$2 billion of debt at 6 percent and used the proceeds to buy back shares when their stock was \$40 a share during the height of the credit bubble in 2004 through 2007. Today, these same companies are laying off thousands of employees, cutting dividends and other costs and desperately trying to raise cash to pay off near-term maturities. Meanwhile, their stock is trading at \$10 and their cost of debt is now in the 9 to 15 percent range — if they can get a loan at all. Clearly, these companies misallocated capital through buying high and selling low.

We are not arguing against sensible share repurchases done with excess free cash flow. We are making an argument against excessive share repurchases financed with debt.

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Share Repurchases vs. Corporate Bond Spreads



Companies used cheap and easy corporate debt to finance share repurchases; when the easy credit evaporated, repurchases slowed considerably.

Who loses? Thousands of employees are being let go every month. Pensioners are nervous they will lose benefits if their former employer goes bankrupt. Shareholders are seeing both lower stock prices and dividend cuts. Dividends are being cut by record amounts, largely because of excessive share repurchases. Almost 300 companies overall have cut or suspended their dividend payouts this quarter, the most since records began 54 years ago. Aggregate dividends in the Standard & Poor's 500 Index are on track to decline 23 percent this year, which would be the largest decline since 1938. Finally, corporate and bank debt holders are seeing the value of their debt holdings decline as many once strong corporations inch ever so close to failure. These actions have exacerbated the current economic downturn.

The case for share repurchases

Corporate Finance 101 explains that carrying huge sums of excess cash is very inefficient. Thus, chief financial officers and other senior managers look at share repurchases on a cost of capital basis and internal rate of return basis relative to acquisitions, capital expenditures and other uses of cash. If senior management can't find an acquisition or capital project that currently exceeds their expected returns from share repurchases, they often pursue the share repurchases. In the context of maintaining a balanced capital structure, this can be beneficial, but it assumes a liquid market and positive returns on the share repurchases. Today's market is very illiquid, and positive returns are not at all a sure thing.

A common theme among senior managers defending excessive share repurchases is that they are simply growing their debt burden in line with their sales growth in order to maintain an optimum capital structure as the company grows. While good in theory, it assumes constant growth. Our economy has been cyclical throughout history, and constant growth is a flawed assumption for any manager at any company.

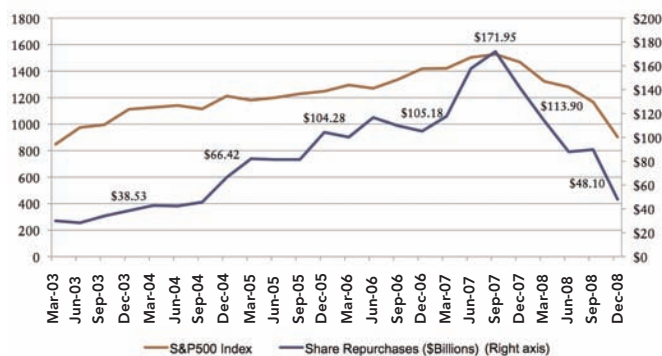
Escalating problems with share repurchases

Excessive debt-financed repurchases have accelerated over the past five years. Companies typically pursue share repurchases when they are flush with cash — when business is booming. As a result, many share

repurchases happen when share prices are at or near cycle highs. This violates the basic rule of buying low and selling high.

So why do company stakeholders allow senior management so much freedom on share repurchases? Some say company insiders know their company the best and should know when the best time is to buy back stock. Similarly, some view share repurchases as a vote of confidence that senior management thinks the stock is undervalued. (Don't managers always believe their stock is under-valued?) Remember, though, that senior managers receive a majority of their pay in company stock, and often their pay package is partially determined by the stock price. They have a strong incentive to make share repurchases. But the market will value the company in terms of its cash flow and earnings prospects. Often, excessive debt-financed share repurchases put a company in financial distress.

Share Repurchases vs. S&P 500



Share repurchases increased and peaked along with the market; companies bought when prices were high and many are now raising capital with prices low.

Further, these debt-financed share repurchases have accelerated over the past five years. According to Standard & Poor's, between the fourth quarter of 2004 and the end of 2008, S&P 500 companies spent roughly \$1.78 trillion on stock buybacks. At the end of 2008, the S&P 500 market capitalization was \$7.85 trillion, so \$1.78 trillion in share repurchases represents more than 20 percent of the S&P 500.

Over the same period, earnings from continuing operations totaled \$3 trillion (or roughly \$700 billion

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per year), and reported earnings (including mergers and acquisitions, financing, layoffs and unusual items) were \$2.34 trillion. Subtracting \$2.03 trillion of capital expenditures and \$970 billion of dividends from operating earnings leaves nothing available for share repurchases, acquisitions and debt repayment. Assuming other sources (depreciation, amortization, working capital) and uses (working capital, pension costs, interest expense and income taxes) offset each other, we estimate that these companies collectively financed the entire \$1.78 trillion of share repurchases with debt.

Why is this such a big deal? These companies have collectively added roughly \$1.78 trillion of debt, or more than two turns of leverage, to estimated average annual operating earnings of \$700 billion. Using a 7 percent cost of debt, these companies are paying nearly \$120 billion per year in interest expense; this has to come out of cash flow before they can make a dent in the debt balance. Thus, companies will have to drastically reduce capital investments, dividends, labor costs and other costs in order to pay more interest expense, contribute to pension plans and attempt to reduce their debt burdens.

In another comparison, the \$1.78 trillion of share repurchases is bigger than the current recognized losses from the global banking crisis of \$870 billion in the U.S. and \$1.3 trillion worldwide. While not a perfect comparison by any means, the \$1.78 trillion would provide the nearly 6 million Americans who have lost their jobs during this recession with a job averaging \$50,000 per year for nearly six years. Not all companies are guilty, so we have provided some case studies.

Case studies

Harley Davidson

Harley Davidson is a good recent example of the negative impact of share buybacks. Harley announced in February that it had to line up \$600 million of unsecured financing from Warren Buffett and Davis Selected Advisers, L.P. The new notes pay a whopping 15 percent and mature in 2014. Since Harley's \$1.6 billion of other corporate notes pay between 5 percent and 6.8 percent, these new notes are extremely expensive capital.

Harley also has nearly \$2 billion of bank debt outstanding, with nearly \$1 billion maturing in 2009. Because banks apparently want to reduce exposure to Harley, they are refusing to roll Harley's bank line out to a later maturity date. Thus, Harley is desperately looking to raise an additional \$400 million in 2009. Is Harley just another victim of the severe economic recession and credit crunch? In our view, the answer is no.

Harley enjoyed great success over the past decade as baby boomers and other motorcycle enthusiasts took advantage of the easy credit to purchase fancy new Harleys. Harley did a lot of great things from an operating perspective. From 2005 through 2007 Harley generated more than \$800 million per year from operations. A cash flow loss of \$685 million in 2008 still meant that Harley generated more than \$1.8 billion in the past four years. Harley shareholders deservedly enjoyed nearly \$1 billion in dividends over the period, leaving nearly \$1 billion available for debt payments, cash reserves and share repurchases. The critical decisions focused on how to use that money.

Many companies would use \$1 billion to pay down some debt, increase cash reserves and repurchase some shares to offset option dilution. Harley, however, repurchased more than \$3.5 billion in its stock over the past four years, far exceeding the \$1 billion of free cash flow available to them. As a result, their net debt ballooned by more than \$2.5 billion to a total of \$3.3 billion.

If management had acted differently, debt could now be as low as \$800 million. Harley would be in much better position to weather the economic downturn, and certainly their cost of debt would be less than 15 percent. You can guess how this has worked out for the shareholders.

MGM

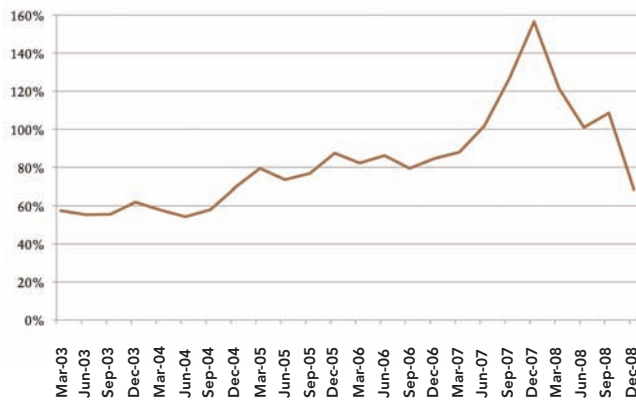
MGM exhibits all of the reckless behavior that occurred during the credit bubble. MGM's casinos made money hand-over-fist through 2007, and they spent even more. From 2005 through 2008, MGM generated cash from operations of nearly \$4.2 billion, but spent \$8.7 billion on acquisitions and new projects, plus another \$2.5 billion on share repurchases, leaving a \$7 billion financing need.

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In May 2007, MGM was raising \$750 million of unsecured debt to help fund their \$7 billion City Center project in Las Vegas. When asked about covenant protection for lenders, MGM management stated that the company's long standing reputation of doing "what's right for all constituents" should be enough for bond investors. That was the last unsecured MGM bond deal that priced easily, at 288 basis points over Treasuries without any protective covenants.

However, even as it became increasingly apparent that MGM was having difficulty raising enough money to finish the City Center project, management was repurchasing more than \$2 billion in shares, including \$1.2 billion in the first half of 2008. Now MGM is looking to sell assets in a depressed market and the

Share Repurchases Plus Dividends as Percentage of Operating Earnings



Historically, about 60 percent of earnings were paid back to shareholders through dividends and repurchases. During the credit bubble, companies borrowed and returned more than 150 percent of earnings, mostly through share repurchases, which are now worth about half of their original value.

entire company could face Chapter 11 this year despite needing to contribute only \$500 million to City Center in 2009. The \$2 billion used for share repurchases could have provided much-needed capital today.

Retail Industry: Macy's, Target, Home Depot

During the past four years Macy's generated more than \$12 billion of cash flow from operations and spent \$5 billion on capital investments and only \$900 million on dividends. This left more than \$6 billion of

free cash flow to be used for paying down debt and strengthening the balance sheet for a cyclical economic downturn. Instead, Macy's spent \$6.7 billion on share repurchases and didn't strengthen their balance sheet. Now, Macy's has \$8.4 billion of net debt as we make our way through the worst recession since World War II. But it didn't have to be this way. Macy's could have been nearly debt-free going into this recession. Instead, Macy's debt ratings have been cut to junk status and investors are wondering if Macy's will survive this long economic downturn. Macy's filed bankruptcy in 1992 after entering the 1990-1991 recession with too much debt. Why didn't management know better?

Target generated almost \$18 billion in cash flow over the past four years. As a fast grower, however, Target has reinvested more than \$19 billion into new stores. Dividends of \$1.6 billion left Target a free cash flow deficit of \$3 billion to finance. With undue pressure from a large activist shareholder, Target announced a \$10 billion share repurchase program in November 2007. During the credit bubble, activist shareholders encouraged companies to utilize cheap easy credit to juice equity returns with leverage. It worked to a modest degree through 2007, but that game is over now that cheap, easy credit is gone. Unfortunately, some of these activists are still trying to play the game with the old rules. Target completed more than \$7 billion of share repurchases in the past four years and has added nearly \$10 billion of debt to its balance sheet. In January 2009, Target laid off 9 percent of its headquarters staff, cutting roughly 1,000 positions. As a strong, fast-growing company for many years, layoffs have been very rare in Target's history. (We found one layoff in 1994 during which Target cut 80 jobs.) We can't deny that some layoffs may be necessary during this difficult economic period. However, we raise two issues: first, we estimate the layoffs will save Target roughly \$75 million per year, assuming an average compensation package of \$75,000 per employee. We note that Target's \$7 billion of share repurchases would have covered those employee costs for 93 years. Second, we wonder whether Target will ultimately get more economic value from \$7 billion worth of treasury shares or 1,000 employees stocking shelves, cleaning stores, greeting customers and competing with Wal-Mart. Only time will tell how much permanent damage has been done to the Target balance sheet. In 2007, Home Depot announced a \$22.5 billion share repurchase plan just as housing was really starting

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to turn down. From 2006 to 2008, Home Depot generated free cash flow of more than \$8 billion, but actually increased debt by nearly \$11 billion after pursuing more than \$20 billion of share repurchases. Not a great deal for anyone, really.

The entire retail industry has mostly the same story. These companies could have entered the economic downturn with strong balance sheets and virtually no debt. Instead, they entered the downturn with little cash, lots of debt and virtual certainty that many will file bankruptcy before economic growth revives.

Industrials, Financials and Energy

But the retail industry is not alone. Many financials and industrials were buying back their stock right up to the middle of 2008 when even the most inexperienced economist could ascertain that the U.S. economy was heading south. **Caterpillar** did more than \$9 billion of share repurchases and \$3 billion of dividends against \$3.5 billion of free cash flow over the past four years. **Starbucks** is in trouble because of more than \$3 billion of share repurchases against \$1.3 billion of free cash flow. **Janus**, a professional money manager, repurchased nearly \$2 billion in shares against \$800 million of free cash flow for a \$1.2 billion deficit. **Alcoa** returned \$2.2 billion in dividends and \$4 billion in share repurchases against only \$665 million of free cash flow leaving a huge financing need. **Marriott** repurchased \$5.6 billion against cash flow of \$3.5 billion, but would probably like some of that money back. Most of the giant banks that have been bailed out by the American taxpayers engaged heavily in share repurchases during the credit bubble.

General Electric generated \$160 billion in cash during the past four years, but spent \$197 billion on capital investing and paid almost \$44 billion in dividends, leaving a financing deficit of \$80 billion. Still, they bought back \$27 billion of shares for a total financing deficit of \$107 billion. No wonder they are laying off thousands of employees and cutting the dividend. That dividend money is in treasury ready to provide leverage to the stock price whenever things turn around assuming General Electric makes it through the dark tunnel ahead. Let's hope investors demand better stewardship going forward.

Virtually all of the energy giants are equally guilty. These companies used mostly free cash flow to

repurchase shares and rarely pursued debt financed share repurchases. However, we wonder what these companies will say about how they utilized their massive windfall profits of the past several years. Are share repurchases the best use of cash? Perhaps a higher allocation to exploration and development, R&D and dividends could be justified. For example, **Exxon** generated net income of \$161 billion and cash from operations (CFO) of \$209 billion from 2005 through 2008. They invested \$50 billion (or 24 percent of CFO) back into the business through capital investments. Exxon paid dividends of \$30 billion, or 14 percent of CFO, and used most of the rest of their free cash flow to repurchase \$115 billion worth of shares over the past four years (a whopping 71 percent of net income and 55 percent of CFO). Despite the egregious amount of share buybacks, Exxon still improved its balance sheet. But we wonder how these share repurchases will be viewed a couple of years from now, when production and profits are sure to fall. Will shareholders look back and feel enriched by Exxon's chosen method to return cash to shareholders through share repurchases? We doubt it.

Finally, there are even many very strong companies that are simply buying back too much stock. Household names such as **3M**, **Pepsi**, **Kimberly Clark**, **Procter & Gamble**, **IBM** and many of the tech names simply have repurchased too many shares. We have not found a single sector that has avoided reckless share repurchases.

Google

Many companies are resetting options, as Google recently did at the expense of long-term shareholders and to the benefit of certain employees and senior management.

Google recently announced it was re-pricing from \$500 to \$308.57 per option 7.64 million stock options belonging to 15,642 non-executive workers. This calculates to 488 options per employee, or the equivalent of \$93,418 (488 options times (\$500 - \$308.57) = \$191.43) for each employee. A grand total of about \$1.46 billion was granted at the direct expense of long-term existing shareholders and other stakeholders.

Taking the \$1.46 billion divided by Google's 240 million shares outstanding means the average existing

shareholder is giving back more than \$6 per share to help retain employees. Whether that action was necessary with unemployment skyrocketing is a valid question. Regardless, it will cost Google more than \$3 billion, or another \$12 plus per share (7.64 million shares times \$388 current price), to repurchase the shares so that they are anti-dilutive. This is nearly \$4.5 billion of total cash outflow that will be transferred from existing stakeholders to employees and senior management for retention purposes. It seems many long-term shareholders are providing interest-free loans for the benefit of employees and executives. This doesn't include the executives' new options package yet, but you can bet they will receive an even better deal.

Berkshire Hathaway

Warren Buffett's Berkshire Hathaway has often been criticized for carrying huge amounts of low earning cash on its balance sheet. For the last several years Berkshire has carried between \$30 and \$50 billion of cash because they could not find investment opportunities that made good economic sense.

Rather than borrowing to make share repurchases, Buffett has found a different way to use excess capital: making loans earning 15 percent interest. Buffett has a tremendous track record. Berkshire's stock is likely to outperform most of the companies that made excessive share repurchases.

Investors can protect themselves

Share repurchases are not always the wrong choice, but investors—including stockholders and lenders—can use their influence to encourage company management to protect them. Stockholders would normally fare better if management offered dividends rather than stock buybacks. And, lenders should demand covenants that protect bonds in the event of excessive share repurchases.

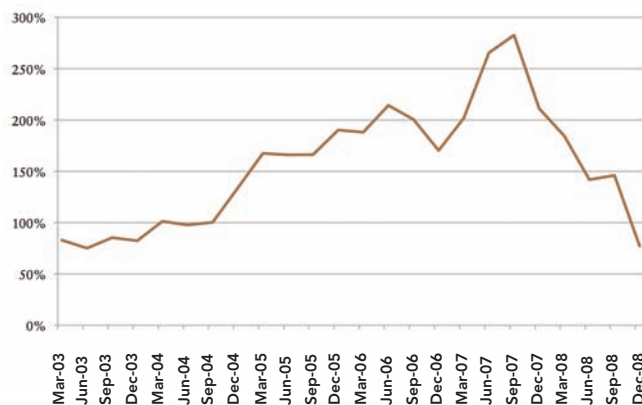
Dividends

Dividends should be the preferred method of returning cash to shareholders, although the tax code and executive compensation plans need to be addressed to help encourage that. Since 1900, dividend income has provided about 70 percent of average U.S. equity returns after inflation, Elroy Dimson, Paul Marsh and Mike Staunton at the London Business School stated in a study published by Credit Suisse in February. Michael Tsang,

Bloomberg News, wrote an article about the study: "Dividend income made up all of the 5.3 percent return U.S. stocks delivered to investors during the first half of the 20th century. However, between 1980 and 2000, investors increasingly sought price gains as dividends contributed only 25 percent of returns."

The decreasing importance of dividends is due to several factors, including double taxation of dividends and executive pay schemes that seem to feature an ever-increasing pay gap relative to the average worker and ever-increasing option grants. Option holders are hurt by dividend payments, since they usually are not eligible to receive dividends. Shareholders need to demand better accountability from senior management regarding the use of excess cash flow, debt and the ultimate return of cash to shareholders. Many of these once great companies have made such colossal miscues with their balance sheets that survival is not a foregone conclusion.

Repurchases as a Percentage of Dividends



Share repurchases exploded relative to dividends when cheap and easy debt was available.

Covenants

Lenders deserve some of the blame for allowing poor financial decisions to continue. Lenders need to demand stronger covenant protection at all levels of lending. More restrictive bond covenants would protect bond holders and other lenders and provide a natural watchdog over corporate behavior. Every corporate bond deal should come with minimum

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covenants, including change-of-control provisions and coupon steps. A change-of-control covenant forces acquiring companies to repurchase the outstanding bonds at some level near par (100 cents on the dollar). It would be triggered if a company makes a large debt-financed acquisition that results in both a change of control and a downgrade to below investment grade. This covenant protection could help keep a company from overpaying for a large acquisition and gives investors and other stakeholders peace of mind that their investment is somewhat protected. Many new industrial deals now come with change-of-control covenants, but that protection was nowhere to be found during the leveraged buyout/credit bubble. Coupon steps are covenants that force a company to increase its coupon if the company falls below a particular rating level, such as BBB-. Company ratings typically only fall several notches at once for one of three reasons. Either they've made a large debt-financed acquisition or share repurchase, or the business fundamentals are seriously deteriorating.

While we would prefer even stronger covenants, this minimum protection would be a huge step forward. Company management would think twice about excessive share repurchases if it meant paying a higher interest rate on their debt. In addition to protecting lenders, strong covenant protection would ultimately protect and support equity holders, company management and employees by discouraging companies from making potentially harmful financial decisions. However, Wall Street likes share

repurchases and acquisitions and dislikes covenants. Wall Street makes money when companies do deals. When companies do debt financed share repurchases, Wall Street earns fees for underwriting the bond deals that fund the repurchases or large acquisitions. Wall Street firms also make money advising companies on acquisitions. Wall Street would lose a lot of revenue if fewer share repurchases and large acquisitions occurred. But more corporations would remain strong.

Keeping management accountable

Prior to the credit crunch, companies used relatively cheap bank lines, commercial paper and corporate bonds to make share repurchases in hopes of boosting share prices. This is like using an adjustable-rate mortgage to buy more house than you can afford at an inflated price. Share repurchases have their place, but too often they reward too few individuals and come at too high a price.

Unfortunately, all company stakeholders have been far too lenient on repurchases. It is ultimately the responsibility of company management, but lenders, large shareholders and Wall Street advisors share the blame. All company stakeholders have to keep management accountable for their stewardship. Shareholders can demand dividends and lenders can demand protection through covenants.

We hope more companies will begin to view capital as the precious asset that it is.

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