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Buybacks – A multi-perspective review and thoughts on best practices for company buyback policies

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Executive summary

US share buybacks are near record levels in absolute dollar terms and incrementally the discussion has shifted from academic finance journals to political stump speeches. Given the impact of the 2018 tax cuts and the upcoming 2020 US Presidential election where some are pushing for a reset of the form of American capitalism. Proponents argue that buybacks optimize capital allocation for companies unable to invest at a higher rate of return than its cost of capital, particularly when agency costs exist between corporate management and investors. On the other side of the argument, opponents of buybacks, however, contend that they are short-sighted and lead to less innovation and investment, suppress job growth and exacerbate income equality.

While we acknowledge that companies with large share repurchases do invest less, our findings suggest that the US economy does an efficient job at recycling share repurchase capital into venture capital and private equity that get investment into the most innovative hands that seldom are big, mature megacap firms. Private equity and venture capital firms have raised $2 trillion in this decade, an unprecedented amount in the history of the money management industry. Those firms have made total investments of $5 trillion, an amount that far outweighs the retained earnings of public companies. This has had a meaningful impact on innovation and growth of the US economy as we unambiguously observe that capital works its way

into the highest returning public companies across the economy over time, whereas in Europe trapped capital in low return businesses has been a disadvantage to capital allocation, and presumably economic growth.

Beyond ideological posture, the additional agency costs of buybacks are dictated by a company's leverage, growth opportunities, and capital allocation track record. Companies that have an incremental above cost of capital return opportunity set for investment should indeed invest organically. M&A gets a little trickier as it destroys incremental shareholder value more often than not. However, intrinsically if M&A can achieve a high return, then that would also be an appropriate use of capital; management history of success is very important here. If growth opportunities do not exist, then cash should be returned to shareholders if shares are undervalued and leverage is at a reasonable level. If shares are fair-to overvalued, and leverage is okay, then dividends are the best policy.

Finally, when a company executes a share buyback, the share price paid greatly matters to remaining public shareholders. Companies tend to buy back more shares when profits are at peak levels, which often coincides with peak valuations – this does not serve investors well. We question whether management teams and boards of directors perform or expect the same level of planning and analysis for share repurchases as they do for other forms of capital deployment, such as capex, R&D and M&A.

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Keywords: United States, Europe,buybacks, Equity market

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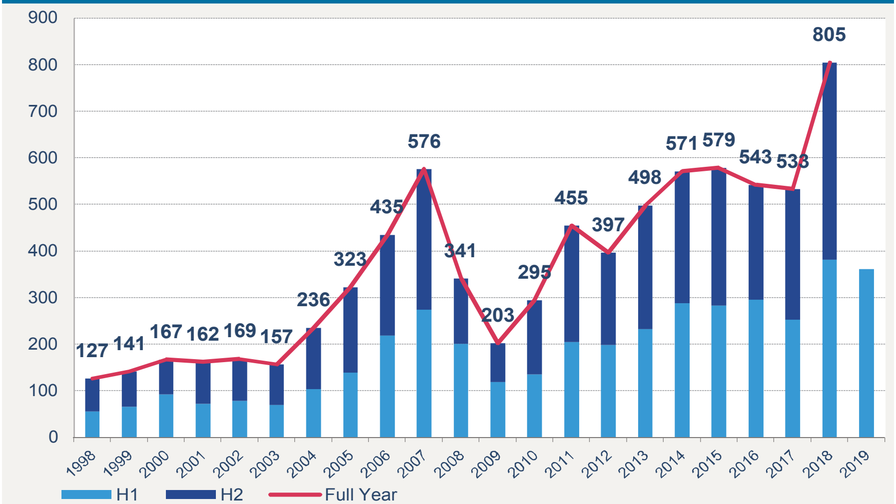
Introduction

Between the impacts of the tax reform and robust economic conditions, US buybacks meaningfully accelerated in 2018 (+51% for the S&P 500) to a record high.

However, not everyone agrees on buybacks. Typically, while some assert that they favor a better capital allocation and thus indirectly benefit the vast majority, others worry that an excessively short-term approach can adversely affect investment, innovation, and job growth, as well as weaken balance sheets.

Furthermore, in the run-up to next year's US presidential election and in response to the impact of the 2018 tax cut, talk of buybacks has taken an increasingly political turn (See Appendix A). This should not come as a surprise despite just over half of Americans directly or indirectly own stocks (which is on the high side compared to other countries), because the wealthiest 10% of Americans actually own more than 80% of the stock market wealth. In this context, many Democrats are calling for an **overhaul of buyback regulations**.

Chart 1: S&P 500 buybacks in Bn USD



Source: Bloomberg, Barclays, Amundi Research; Data as of 06/30/2019

Given the increasing attention, the time had come to perform a comprehensive review of buybacks, **examining** the reinvestment rates in public markets, allocation impacts in private markets, and prevailing best practices. We do not cover in detail the issue of management compensation and incentives as the issue has been written on extensively.

Instead, we seek to address the concept of buybacks in isolation, assuming management incentives are aligned. If they are not, that is a separate issue for shareholders and boards of directors to address.

This article will include **three sections:**

- **The case for and against buybacks with a focus on the United States,** the chosen land for buybacks.
- **A regional comparison of the buybacks dynamics** and how the recycling of capital into the most profitable and growing companies has turned out to be quite effective in the US.
- **Our assessment of buybacks and best practices** for company managements with excess capital.

I - The case for and against buybacks

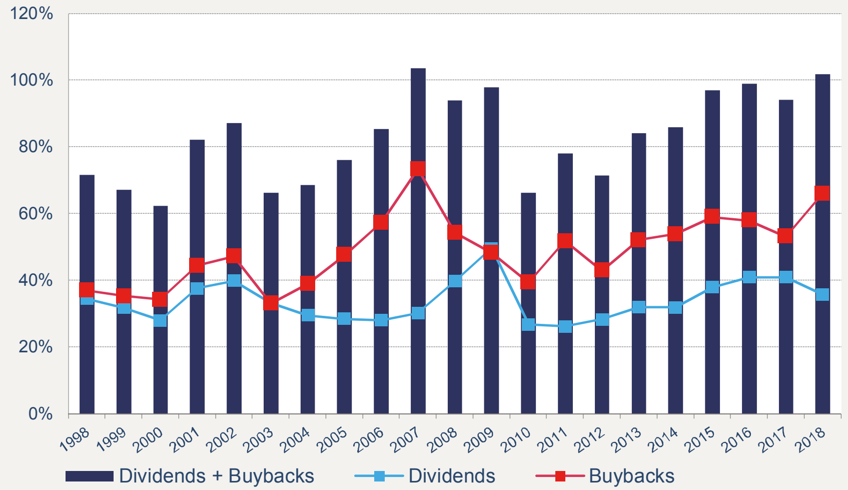
Between the extended bull market and the environment of low interest rates, the debate over buybacks has intensified since 2014. Previously limited to professional periodicals such as *The American Economic Review*, *The Journal of Business* or the NBER *Working Papers*, the buyback debates have now been taken up on several occasions[1] by the more mainstream press such as *The New York Times*, *The Economist*, or *The Washington Post*, in addition to politicians. This past year, Senators Chuck Schumer and Bernie Sanders wrote an Opinion piece in *The New York Times*, (3 February 2019): "*...That is why we are planning to introduce bold legislation to address this crisis. Our bill will prohibit a corporation from buying back its own stock unless it invests in workers and communities first, including things like paying all workers at least $15 an hour, providing seven days of paid sick leave, and offering decent pensions and more reliable health benefits*."

Box 1: A brief history

Buybacks took off in the US starting in 1982, with the advent of **SEC Rule 10b-18** (see Appendix B) governing the terms and conditions of buybacks. Up to then, buybacks were not prohibited but were uncommon, because companies feared being accused of price manipulation. **Buybacks have since become a widespread practice** – according to Factset, more than 80% of US corporations listed on the S&P 500 carried out buybacks in 2018 – **gradually edging out dividend payments**. Though *di minimis* in the beginning, with only $5bln of in 1980, the dollar value of buybacks on the S&P 500 began to exceed dividends starting in 1997. In 2018, buybacks made up **66% of net income on the S&P 500** versus **36% for dividends (see chart 2).**

[1] *The Economist ("Corporate Cocaine", September 2014), New York Times "End Stock Buybacks Save the Economy" (August 2018), "Limit Corporate Stock Buybacks" (Feb 2019) "Workers Before Buybacks" (February 2019), Forbes "What Chuck and Bernie Misunderstand About Stock Buybacks" (February 2019).*

Chart 2: S&P 500 pay-out ratios in % of net earnings



Source: Factset, Amundi Research; Data as of 12/31/2018

In addition to the appeal of buybacks for issuers, **their success with an increasingly broad segment of investors is due to tax considerations.** In practice, while dividends and capital gains resulting from share buybacks are both taxed at the same rate (currently 15%, but up until 2003, at the marginal income tax rate), dividends are taxed **each year**, whereas capital gains are only taxed when the **gains are realized.**

Together, dividends (36%) and buybacks (66%) account for slightly above 100% of net income. **Such a high percentage** may come as a surprise, but **warrants two comments:**

- The first is that, if we look simultaneously at share issues, **the net payout rate was actually closer to 50%** on average from 2007 to 2016 - a key point we will return to in detail (see § 1.3 p. 16,17).
- The second is that **this payout rate has varied significantly** depending on **inflation, growth and interest rate conditions.** According historical records, this payout:
  - declined from the late 1960s to the early 1980s, a period of accelerating inflation when dividend pay-outs were ultimately secondary to the trend in nominal rates;
  - furthermore, it was low until 2003, a period of growth but more importantly of disinflation, when investors were predominantly motivated by opportunities for capital gains;
  - however, much like the Interwar Period, between waning **growth and deflation risks,** this pay-out rate picked up again in 2007 and has remain elevated **since the Global Financial Crisis.**

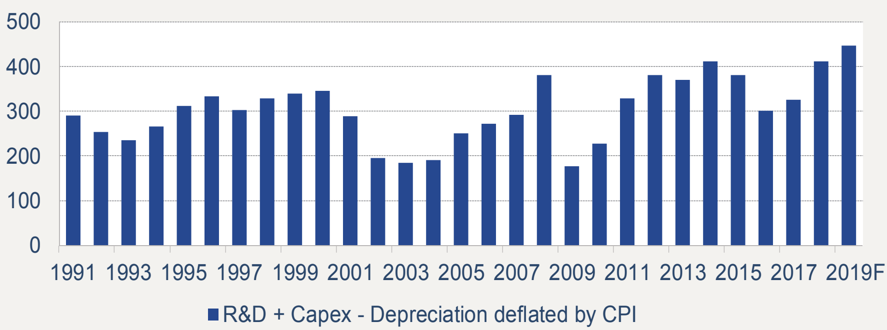
1.1 - Pros: optimizes capital allocation...

According to the proponents of buybacks, when a company is unable to invest at a higher rate of return than its cost of capital, it should return capital to shareholders. Given the improved capital allocation resulting from the practice, this would explain at least a portion of the economic momentum observed in the United States vs. Europe. Supporters of this approach notably include Dr. Damodaran[2] of the NYU Stern School of Business and Dr. Dorfman of the University of Georgia, both of whom have published different articles on the subject.

But what about the impact of share buybacks on investments? Fans of buybacks don't evade the question, but concede that while companies that repurchase their stock tend to invest less, that money is used more efficiently by other segments of the market. To some, the important thing is not that Company X repurchases its shares and therefore invests less, but that Company Y takes a more innovative approach and invests more efficiently in its place.

From an empirical standpoint, this observation is reasonable in that, despite the sharp rise in buybacks, **S&P 500 companies have a/ invested significantly more towards growth** (research & development + net capex in real terms) in recent years (see chart 3) and **b/** the percentage of **growth-oriented investments** is at the highest since 2001 and at an all-time high for R&D, which presumably is a higher value-add use of capital than capex in today's economy (see chart 4).

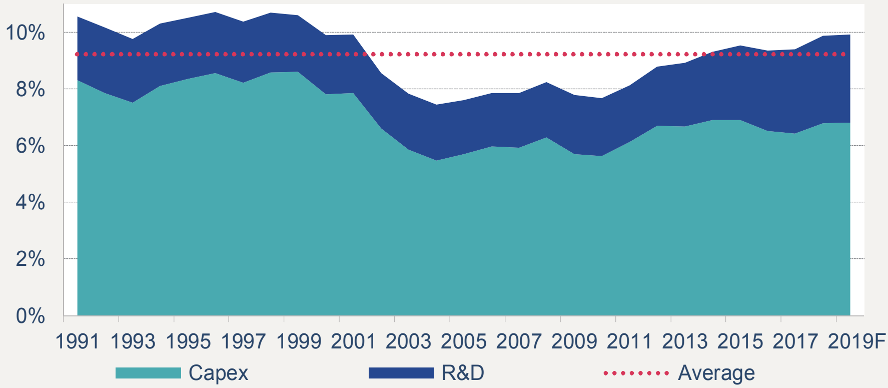
Chart 3 - S&P 500 Growth investment in real terms at record high (data in 2018 USD Bn)



Source: Factset, Amundi Research; Data as of 10/10/2019

[2] ***Dr. A. Damodaran:*** *"Stock Buybacks: Misunderstood, Misanalysed and Misdiagnosed", Journal of the American Association of Individual Investors (March 2015), Interview to Goldman Sachs Top of Mind (April 2019).* ***Dr J. Dorfman:*** *"Ten Economic Truths Liberals Need to Learn", Forbes (June 2014), Forbes "What Chuck and Bernie Misunderstand About Stock Buybacks" (February 2019).*

Chart 4 - S&P 500 R&D and Capex (in % of sales)



Source: Facset, Amundi Research; Data as of 10/10/2019

However, opponents of buybacks contend there is a **drawback** to this argument. Although the amount of growth investments by S&P 500 companies has always exceeded the amount of shareholder returns, this difference has narrowed. Thus, the percentage of buybacks relative to investments which was less than 50% from 1990 to 2003 is now closer to 85%.

1.2 - Cons: less innovation from buyback champions...

The opponents of buybacks often assert that repurchases negatively impact on investment, employment and income inequality. Given that politics have increasingly colored this debate, we will return to this point when discussing possible changes to buyback regulations (see Appendix A).

From another angle, others such as economist Dr. William Lazonick[3] **point out that, in reality, it is often impossible to know beforehand if a new concept,** much like the iPhone ten years ago, **will find its place on the market and achieve its minimum rate of return**. Which is why, they contend that corporations carrying out multiple buybacks tend to cease being innovative.

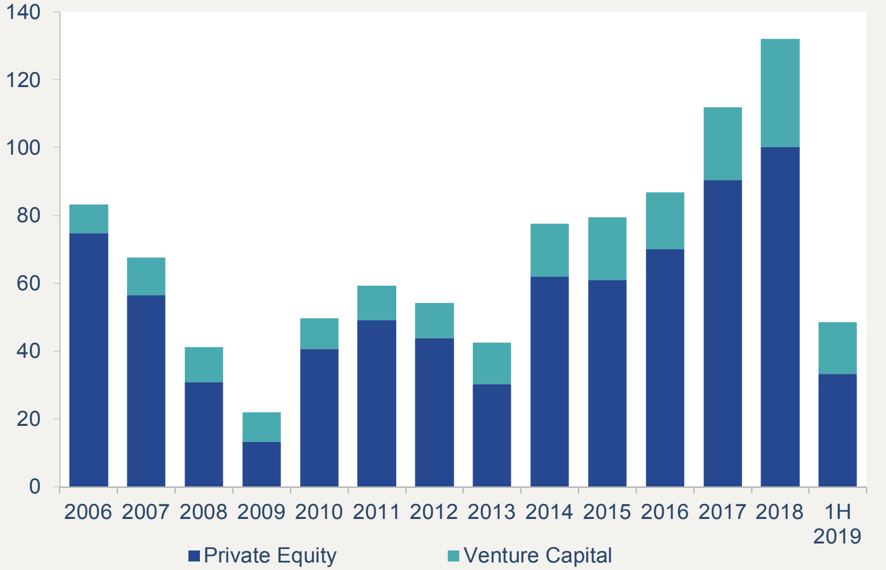
However, we would firmly nuance on Apple. While critics have asserted for years that its innovations have mostly been incremental, the facts suggest otherwise. First, Apple did not start to do meaningful buybacks until about five years ago. In this time, it has become the biggest watch company by revenues in the world (from zero), its earbuds business is bigger than anything like it, and its services business has gone from $13bln in revenues to over $40bln last year in the past six years, iPhone

[3] *Interview from Dr. Lazonick, Goldman Sachs Top of Mind (April 2019).*

revenue is up almost 100% in that period. It is fair to have asked more from Apple on innovation, but it has generally stayed in its lane and not spent too much R&D resource on risky, far-flung initiatives such as electric vehicles, solar panels, etc. It is unlikely that shareholders would have been well served by such a strategy.

Another target for the buyback critics is pharmaceuticals, where the reality is more nuanced too. While some new products are indeed incremental, we have seen an explosion in innovative therapeutics for diseases such as cancer/immunotherapy, diabetes, gene therapy, and many others. Moreover, in the past two years, private equity and venture capital investments targeting health care have totaled over $100 billion, a magnitude about equal to the retained earnings generated by the listed part of the health care sector according to Empirical Research Partners. **Without buybacks to recycle capital, we would have to count on mega cap pharmaceutical firms to innovate which is something they have not proven adept at over time**. Perhaps better to have private equity and venture capital funnel innovation dollars to motivated entrepreneurs. With the pace of new biopharma products in the past several years and the expected new product launches upon us, it is hard to argue this is not working.

Chart 5 - U.S. Health Care Companies Private Equity and Venture Capital Deal Value* (data in USD Bn)



** Includes estimates for deals with undisclosed values*
Source: PitchBook, Empirical Research Partners Analysis, Amundi Research; Data as of 6/30/2019

Dr Lazonick - in an interview with Goldman Sachs - cited the less famous case of Cisco, which we also interpret differently.

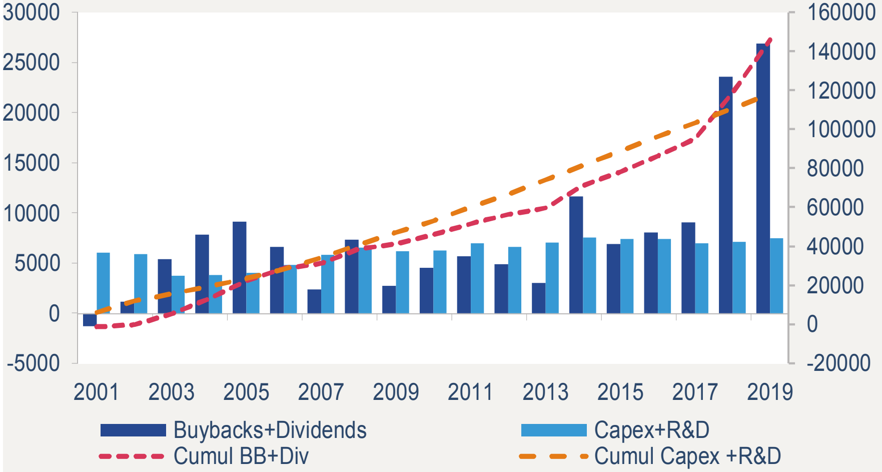
"In 2001, Cisco was positioned to become the world leader in carrier-class communications infrastructure equipment as wireless was gaining traction. But they largely abandoned promising technologies and did massive buybacks. Today, Cisco is still the biggest player in enterprise networking, but it is a non-entity in the more sophisticated service provider technologies. Instead, leaders now are Huawei and Ericsson innovative companies that have been insulated from stock market short-termism; Huawei is employee-owned and not listed, while Ericsson is controlled by dual class shares".

The conclusions based on technology regarding Ericsson and Huawei are more nuanced than Dr Lazonick lets on. It is true that Cisco has ceded market share in the global router market to telecom and enterprise market. This segment is both shrinking and also half the size of the global Ethernet switch market, which Cisco is by far the global leader in as a result of its continued investments. While it is true that Cisco has been outflanked by network switches for datacenters and cloud computing by another US company, Arista Networks, this is a case of what often happens to big companies when innovation wanes. While Cisco spent billions of dollars on technology acquisitions, Arista was founded by a co-founder of Sun Microsystems and a few former Cisco executives. Similar to biopharma, the recycled Cisco capital from its buybacks worked its way to Arista.

Moreover, while it is true that Cisco (see Chart 6) returned more money to its shareholders (a total of $146 billion from 2001 to 2019, of which $110 billion was net buybacks and the other $36 billion was in dividends) than investing and growing its business ($22 billion capex + $96 billion R&D), it is very possible that share buybacks were the best course of action for Cisco for the very reason buyback supporters assert – Cisco has made close to 200 acquisitions in the past 20 years, many of them at big premiums while also being increasingly less productive at R&D. In theory, Cisco could have continued to have its edge in networking, but it likely did not because of poor management and the drive of entrepreneurs such as those that stated Arista Networks.

The reality is that in the technology sector, companies have been displacing each other for decades and given that track record, returning capital to shareholders is optimal. With the exception of Microsoft, which had to suffer nearly twenty years of an innovation and growth drought before reinventing itself, few, if any, large technology companies have sustained an innovation competitive advantage. Consider IBM, Hewlett Packard, Intel, Oracle and Xerox.

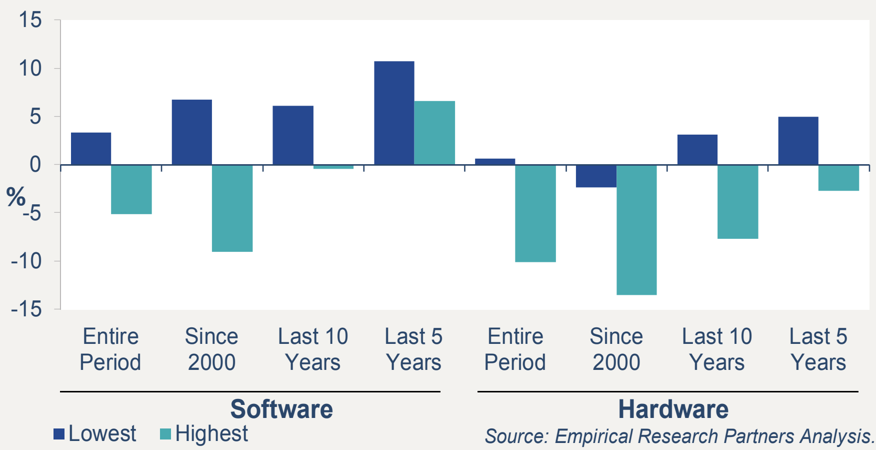
Chart 6 - Cisco: Dividends and Buybacks vs Capex + R&D (in Bn USD)



Source: Factset, Amundi Research; Data as of 10/10/2019

Chart 7 below captures the theme of this argument quite well, demonstrating how the lowest quintile of capex growth in the technology sector meaningfully outperforms the highest quintile of capex growth over time. Thus, we have evidence that innovation is best optimized through the recycling of capital via venture capital and private equity.

Chart 7 - Large-Capitalization Technology Stocks Relative Returns to the Lowest and Highest Quintiles of Capital Spending Growth*

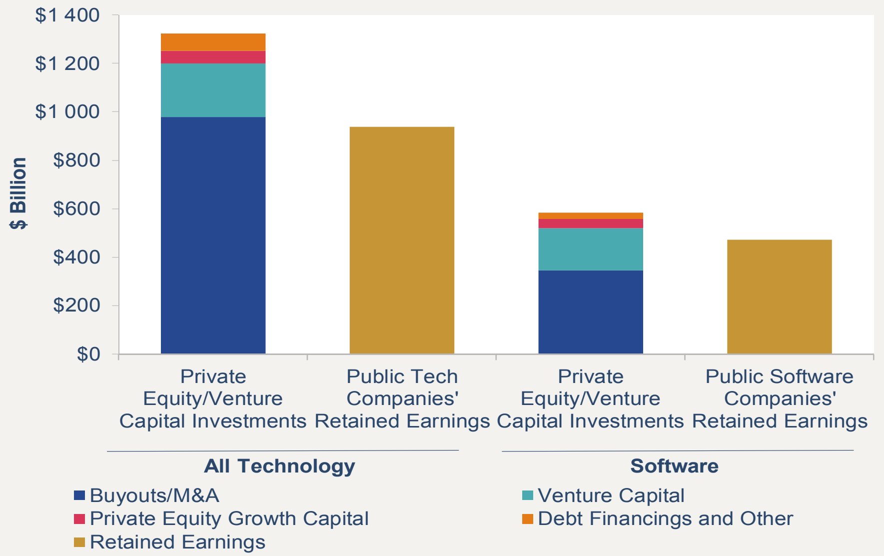


*Source: Empirical Research Partners Analysis. Monthly Data Compounded to Annual Periods 1952 Through June 2019. *Equally-weighted returns; Amundi Research Data as of 6/30/2019*

Very occasionally, mega cap companies get it right. Microsoft has returned $80 billion since 2011 via buybacks (and announced another $40 billion in September 2019) while building up its Azure cloud business, which has been a revolutionary innovation (along with Amazon Web Services). However, this was after years of poor execution on innovation and acquisitions (e.g., Nokia's handset division).

To expand upon the point raised with respect to venture capital and biopharma, the key is the notion of the recycling of capital so that it ends up in the most innovative hands. According to Empirical Research, private equity and venture capital firms have raised $2 trillion in this decade, an unprecedented amount in the history of the money management industry. Those firms have made total investments of $5 trillion. Technology has captured over 25% of private equity and over 40% of venture capital flows, which in total outweighs the retained earnings of the technology sector as shown in Chart 8.

Chart 8 - The U.S. Technology Sector Private Equity/Venture Capital Investments and the Public Companies' Retained Earnings*
2014 Through Late-June 2019



Source: PitchBook, Corporate Reports Empirical Research Partners Analysis, 2014 Through Late-June 2019.
** Private equity includes venture capital investments in technology and a portion of related industry verticals. Amundi Research Data as of 6/30/2019*

While supporters and detractors of buybacks can agree to disagree on the merits of buybacks when it comes to capital allocation, **they largely agree that companies with the largest buybacks are the most mature companies.**

1.3 - Pros and Cons on debt and payout ratios

A mixed bag in terms of debt. Buybacks have the reputation of having driven US corporations to take on more than reasonable debt. With some exceptions, this accusation appears out of proportion, but the only real way to tell will be when the US economy takes a turn for the worse. There are certainly examples of companies that have excessively leveraged their balance sheet to undertake buybacks and this likely will not end well should we enter a recession. For example, CBS has repurchased approximately $10 billion in the five years ended 2018, over a third of which was funded by debt while also having a $1.5 billion underfunded pension obligation. Free cash flow has fallen from $1.1 billion in 2014 to just over $500 million in 2018. And this is before the looming structural challenges to broadcast media hurt results, not to mention a possible recession that would hurt advertising revenues. Or consider a very cyclical industry such as airlines, which can be dangerous. American Airlines has added $6.5 billion of debt the past five years while buying back $12 billion of shares, while having a $7 billion underfunded pension liability and negative free cash flow three of the last five years for a cumulative -$2 billion in a very capital intensive industry. Questionable buybacks such as CBS and American Airlines are problematic for shareholders and stakeholders as the margin for error is slim. We would suggest opponents of buybacks look more towards limiting them for the firms that can ill-afford them such as CBS and American Airlines.

Despite a very high pay-out rate (dividends + buybacks) and considerable efforts to prepare for the future (capex + R&D), **the liquidity of S&P 500 companies look at first glance rather satisfactory** (see LHS), with a cash on hand ($.5 trillion at year-end 2018) which has more than doubled in the last ten years and which, compared to total assets, remained in line with its long-term average (10%). **Similarly**, on the financial front, although their gearing (net debt to equity) has risen sharply since 2013 (see RHS), **corporate US coverage of borrowing costs** (EBIT/financial expenses) **at year-end-2018 was still fairly high** (7.6x) due to both high profitability and low interest rates.

In a study published last July, however, Morgan Stanley issued a warning that this coverage ratio could drop to 6.9x by end-2019, i.e. an 11-year low (5.6x in 2009). This is true that the situation can quickly deteriorate, and we won't really know how robust the balance sheets of US corporates are until the next recession (2020, 2021, or later?), depending on its intensity and duration.

However, in the event of a moderate downturn, the decline in profitability of S&P 500 companies should be partially absorbed by lower interest rates and the flexibility of buybacks. **In practice, the major advantage of buybacks lies in their flexibility** because they are generally aligned with profits (see RHS), whereas corporations tend to refrain from lowering their dividends so as not to give a negative signal (see LHS).

In addition to the buyback's role as a shock absorber during lean periods, **a recent article published in the Harvard Business Review[4] put the fears associated with such apparently high payout rates into perspective**.

According to Dr. J. Fried (Harvard Law School) and Dr. C. Wang (Harvard Business School), the paradox between astronomical payouts, record-high investments and comfortable financial structure is ultimately only skin deep and can be attributed to the **ambiguity of the total payout ratio** that is generally used: (dividends + buybacks)/net income.

To support their argument, the authors propose **three adjustments** to get a better idea of what the actual distribution rate is.

The **first** addresses **equity issuances** in the ratio's numerator. As a proportion of net income, shareholder payouts by S&P 500 companies **totaled 96%** from 2007 to 2016, but **net shareholder payouts** were a much more modest **50%**, a percentage ultimately not so far from what we've seen in Europe that paints the supposedly dramatic payouts of US corporations in a more reasonable light.

The **second,** found in the ratio's denominator, has to do with **adjusted net income**. Because net income measures what's left after R&D investments, it is a poor metric for determining how well a company has prepared for the future. A better metric would be R&D-adjusted net income, which reduces the combined net payout ratio from **50% to 41%.** In a post-industrial economy, where R&D is increasingly overriding conventional fixed investment, this type of adjustment is highly relevant in order to obtain the full measure of a US corporation's innovation capacity.

The **third** and final adjustment pertains to the **incorporation of non-S&P 500 companies**. These companies, generally younger and faster-growing, are net importers of equity capital. On the whole, they issue more shares than they distribute capital to shareholders via dividends or buybacks. Given this reallocation of capital between mature companies and fast-growing companies, the payout ratios for this expanded calculation base are even lower, dropping from **41% of R&D-adjusted net income (for S&P 500 companies) to 33% for both S&P 500 and non-S&P 500 firms.**

Between the flexibility of buybacks versus dividends, and the adjustments providing a more well-rounded measure of payout ratios, the impact of buybacks on balance sheet strength is not as exaggerated as it might seem. Bearing in mind, of course, that the true litmus test will be the next major recession.

[4] *Harvard Business Review (2018), Are Buybacks Really Short changing Investment? by J. Fried, and C. Wang, March-April 2018*

II - Buybacks: an international comparison

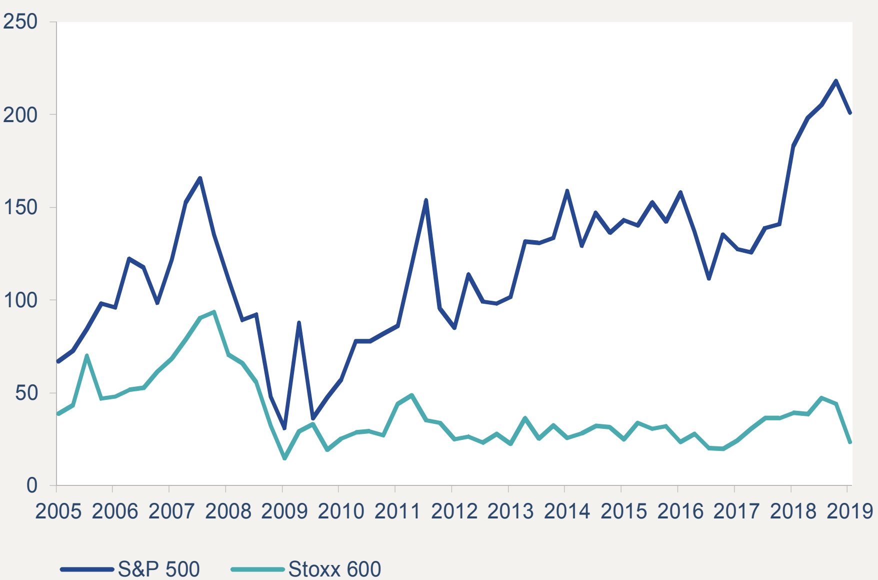
2.1 - Clearly separate pathways on either side of the Atlantic

The gap in buybacks between the United States and Europe has widened in the last 10 years, both in nominal (see chart 9) and relative terms with barely 20% of Stoxx 600 corporations having used buybacks versus more than 80% of its S&P 500 peers.

This acceleration of US buybacks in 2018 can largely be attributed to one-off factors such as the reduced corporate income tax and relaxation of offshore cash repatriation conditions. Between the dissipation of the effects of the tax reform and the projected erosion of US earnings, **the current pace of buybacks is not sustainable**.

Be that as it may, even if part of this transatlantic gap is due to temporary factors, **it is nevertheless striking to note** that the amount of buybacks carried out by S&P 500 companies is now **one-third higher than the level recorded during the previous peak in 2007**, but is still 50% lower for Stoxx 600 companies!

Chart 9 - Quarterly Buybacks in USD Bn from Q1 2005 to Q1 2019



Source: Bloomberg, Barclays, Amundi Research; Data as of 3/31/2019

2.2 - How can such a dramatic difference be explained?

In light of their very low starting point, increasingly less restrictive taxation and growing interest of certain market players, **buybacks are expected to increase in Europe**. **Even so, they are unlikely to become as widespread as in the US**, due to a number of as-yet ingrained differences that would tend to limit their use.

The **biggest differences**, in our view, are as follow:

- **Different corporate funding methods:** In Europe, corporations still rely predominantly on banks (70%) for funding, versus the financial markets for their US peers. In return, to please their bankers, European companies prefer to preserve their balance sheet than buyback shares, while, especially in a low interest rate environment, to please the market, US companies use buybacks to boost ROE.
- **Better acceptance in the US:** In Europe, outside the realm of corporate executives, shares are only marginally used as payment, whereas share-based payment is much more widespread in the US despite major inequalities. With executive and employee interests more aligned with repurchase plans in the US, buybacks are naturally more accepted there;
- **Specific expectations from European shareholders:** Some of Europe's most stable financial shareholders – namely insurers and pension funds on the one hand, and retail investors on the other – tend to show a preference for dividends. For the former group, this is because of their asset-liability management constraints, and for the latter because of the favorable tax vehicles in which their funds are generally held.

Moreover, in a recent study, **S. Bell, Senior European Equity Strategist at Goldman Sachs, underscored three additional factors**[5]

- **Visibility of quarterly EPS:** in the US, quarterly reporting plays a greater role than in Europe and buybacks might help companies to meet targets.
- **Lower profitability:** Earning power remaining under pressure in Europe, companies have had less opportunity to give back surplus cash to shareholders. This is particularly true for banks where priorities has been increasing capital ratios, protecting dividends and catching up on technology.
- **More stringent legal restrictions in Europe:** In Europe, with the exception of the UK (early 1980's), buybacks were legalized much later (late 1990's) than in the US (1982). Even post legalizations, restrictions remain more stringent both in terms of size (percentage of repurchase) or delays.

[5] ***Goldman Sachs – Top of Mind*** *(April 2019), "Explaining the Transatlantic Buyback Gap", by S. Bell, European Equity Strategist, Goldman Sachs Europe.*

Box 2: Be careful of hasty comparisons liable to be distorted by buybacks...!

- Since buybacks have an impact on earnings per share and the measurement of performance excluding dividends, international comparisons should be made with caution since buybacks are much more prevalent in the US than in other regions.
- Changes in total earnings or EPS are therefore very different in the United States (see left-hand chart), whereas they are more consistent in other regions where the use of buybacks is more limited.
- Similarly, in terms of performance by region (see right-hand chart), it is critical to compare different indices on the basis of total return (including dividends) and not on price alone. Though hard to see in the short term, the differences become huge over the long term and tend to penalise regions where buybacks are less widespread.

Chart 10: US & Europe EPS (basis 100 end-2007)

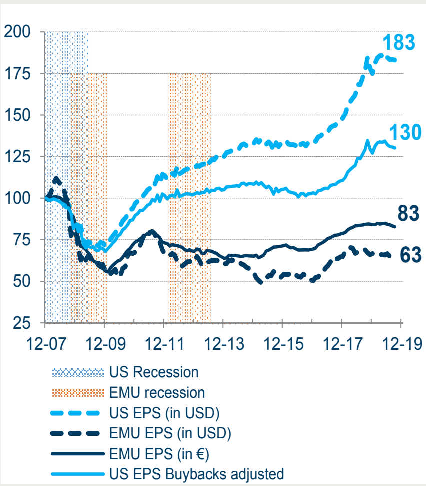
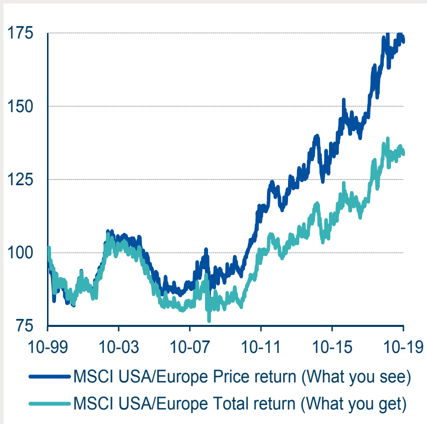


Chart 11: MSCI USA vs MSCI Europe performances _ *What you see (+72%) and what you get (+34%)*



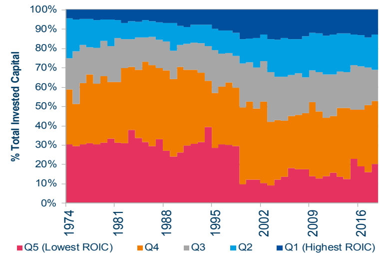
Source: Datastream, Amundi Research; Data as of 10/24/2019

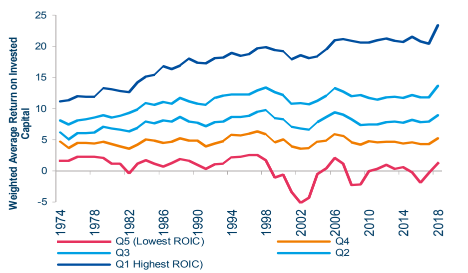
2.3 - US buybacks have obviously contributed to improve capital allocation

What detractors of buybacks often miss is the role that the return of capital to shareholders has in optimizing investment across an economy. Where buybacks are greatest, in the US, we unambiguously observe that capital works its way into the highest returning companies across the economy, whereas in Europe trapped capital in low return businesses has been a disadvantage to capital allocation. Like the US, Developed Asia Pacific does a decent job at capital allocation, but it must be noted that its highest returning companies have a meaningfully lower return on capital than that of the US or Europe. We make the point above in section 1b (pros and cons of buybacks) that venture capital and private equity play a big role in reallocating capital to innovation and growth, recycling the capital from the mature firms that do not have as many growth opportunities.

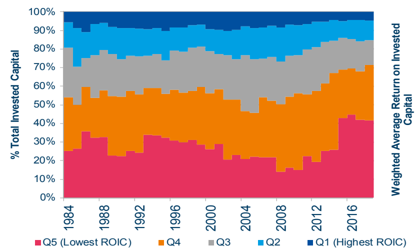
Box 3: Distribution of Invested Capital by ROIC Quintile

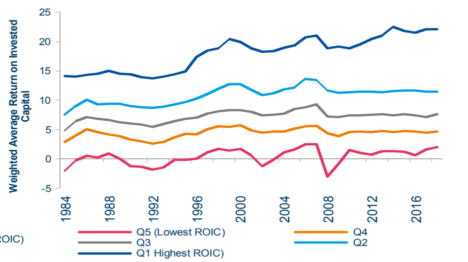
United States: Return on capital is highest in the US globally and the largest share of invested capital is in the top two quintiles of return and smallest share in the bottom quintile.



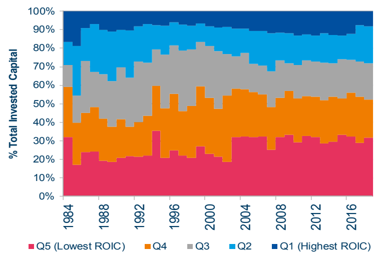


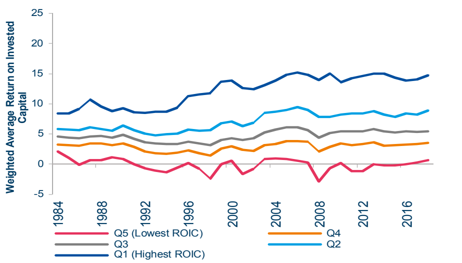
Europe: Almost 70% of the capital base in Europe is in the bottom two quintiles of return on capital. While the top quintile achieves strong profitability, it is only 5% of the capital base.





Developed Asia Pacific: The capital base is better distributed, but return on capital levels are much lower than Europe and the US, which may be due to structural issues.



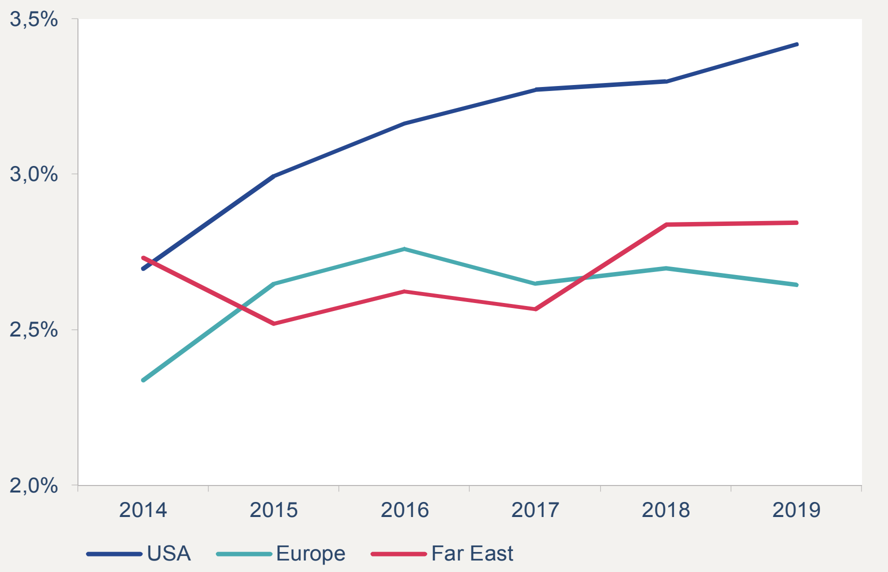


Source: Credit Suisse Holt

2.4 - Capital investment in the US has evolved while less so in Europe and Asia

In response to technological change and obsolescence, capital spending on manufacturing and traditional plant and equipment has been falling for decades in all of the world's developed economies. But U.S. corporate investment in R&D has continued to be strong, reflecting the global shift from tangible to intangible assets.

Chart 12: R&D to Sales of MSCI Indices



Source: Facset, Amundi Research, Data as of 10/10/2019

III - Our view to assessing buybacks

3.1 - The important perspectives on share repurchases

In isolation, share repurchases are not a value creating activity for a company, but rather a distribution of value among shareholders.

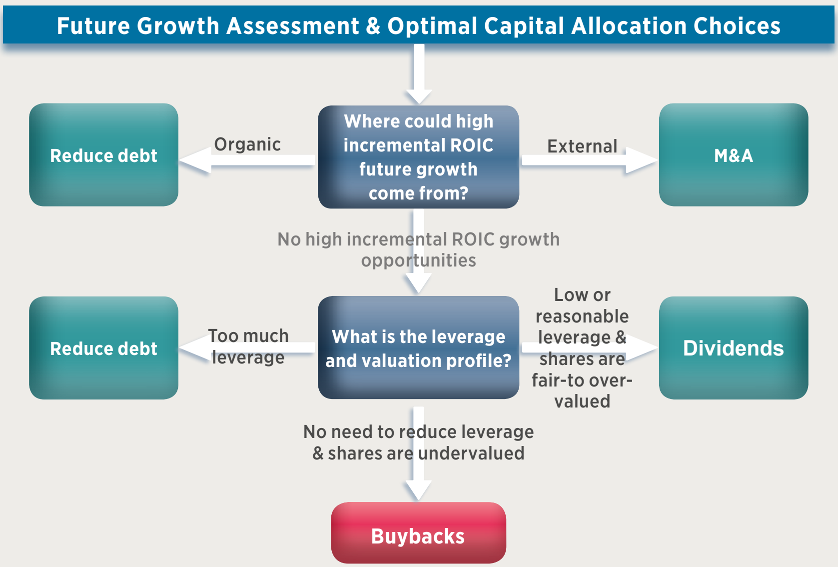
Keep in mind that the value of company = net present value of future profits. Only improvements in the fundamental operating drivers of a business can increase future cash flows and therefore the net present value of a firm. Innovation, higher operating margins, profitable and sustainable capital reinvestment are all examples of actions that can increase future profits.

Agency costs are critical considerations as the use of cash is a choice that must be considered relative to the expected return on all potential management decisions.

If management makes a poor decision such as a bad acquisition, excess cash on the balance sheet could be valued at a discount given the fear of future acquisitions. This is particularly important when the cash balance far exceeds organic investment opportunities. The example above of the 200 acquisitions by Cisco over a 20 year period, many of them value destroying, are a clear example of when it would have been optimal for the cash to be returned to shareholders rather than the management of Cisco. Other examples of agency costs from value destroying M&A: AT&T's 2018 acquisition of Time Warner or Occidental Petroleum's 2019 acquisition of Anadarko Petroleum.

Once management makes a share repurchase decision, there are important implications:

- Management signals that shares are undervalued.
- Agency costs are reduced, which, all else equal, should help valuation as the chances management will undertake a value destroying acquisition decreases.
- Considerations of future growth rates and thus, the valuation premium shares deserved by the market.



Source: Amundi.

Box 4: Example of companies at different stages

Amazon has many growth opportunities and shareholders want it to invest heavily, which it does quite nicely, having created new businesses (e.g., Amazon Web Services, logistics, Prime Video, Alexa) off of its initial retail platform. Conversely, **Home Depot does not** and, while it invests appropriately to effectively compete and grow, it no longer opens new stores.

US energy companies such as **Exxon, Chevron and virtually all E&P companies have seldom achieved their cost of capital** except for the biggest commodity boom in decades in the mid-2000s and thus rather than continuing to spend shareholder capital on value destroying capex should only reduce debt and return capital to shareholders via buybacks.

In fairness, **the outcome is not always clear ex-ante and shareholders must decide if management can invest effectively**. **Walt Disney feels that it must invest heavily** in streaming and content to sustain its competitive advantage in a rapidly evolving media landscape and thus purchased 20th Century Fox in 2019 for over $70 billion. While the success will not be known for several years, Walt Disney has earned the benefit of the doubt given its successful history of strategic M&A: Capital Cities/ABC/ESPN, Pixar, Marvel, Lucas film/Star Wars. Thus, it makes sense for Disney to invest organically and in M&A.

3.2 - The share price paid for buybacks is critical!

Even though a share buyback does not create incremental value, **a repurchase does redistribute value** among shareholders. **Thus, something that often gets missed by investors is that the share price that a buyback is executed at is critical to determining whether the buyback is successful:** if a stock is undervalued, then buying back shares at a discount to intrinsic value transfers wealth to the buyer and this is a positive for shareholders. But the opposite also holds true.

Warren Buffett, the Chairman & CEO of Berkshire Hathaway (25 February 2017 annual shareholder letter,) **describes it perfectly:**

- *"For continuing shareholders, however, repurchases only make sense if the shares are bought at a price below intrinsic value. When that rule is followed, the remaining shares experience an immediate gain in intrinsic value."*
- *"Consider a simple analogy: if there are three equal partners in a business worth $3,000 and one is bought out by the partnership for $900, each of the remaining partners realizes an immediate gain of $50. If the exiting partner is paid $1,100, however, the continuing*

partners each suffer a loss of $50. The same math applies with corporations and their shareholders."

- *"Ergo, the question of whether a repurchase action is value-enhancing or value-destroying for continuing shareholders is entirely purchase-price dependent.*

3.3 - ...Timing and management planning as well!

Poor market timing often separates value-increasing buyback programs from those that destroy shareholder value. S&P 500 companies tend to buy back more shares not only when market valuations are high, but when their own valuations are much closer to their peak levels.

This timing problem stems from the common corporate practice of prioritizing investments and dividends, and then allocating the residual capital to buybacks. Stock prices tend to be higher when company performance is strong and residual capital is greater. As a result, selling shareholders benefit from peak pricing at the expense of the shareholders that stick around.

With such large amounts of cash being spent on repurchases, it is a reasonable consideration if this form of distribution is in the best interests of shareholders, especially with the market at-or-near all-time highs.

It is not clear if management teams and boards of directors perform or expect the same level of planning and analysis for share repurchases as they do for other forms of capital deployment, such as capex, R&D and M&A?

Agency costs bring suspicions of other motivations and forces, such as EPS targeting for management compensation, overly conservative hurdles for other investments, or worries about investor short-termism?

3.4 - ...and not all EPS growth is the same!

Share repurchases, of course, reduce shares outstanding, so the **same total earnings** increase earnings per share as they are thus, distributed across fewer shares. Credit Suisse HOLT estimates that in 2018, "the **median increase in EPS** was approximately **2%** for the S&P 500 due to share repurchases." **This does not change the underlying economics of the firm, as total net income is the same and since all else is equal, total company valuation is the same.**

Troubling is that **40% of US management incentive plans have an EPS component** and management could get paid well while repurchasing overvalued shares! Adding the concern is that **most companies add back stock-based compensation** as part of Non-GAAP EPS calculations.

Thus, EPS growth that comes from reducing outstanding shares is worth significantly less than EPS growth resulting from fundamental operating results - revenue growth, operating margins, and capital intensity.

Empirically, short-term EPS accretion from buybacks alone does not drive share prices higher and shareholders typically look through it. Nonetheless, increased transparency and better aligning management incentives with that of shareholders will serve all stakeholders better.

Conclusion

Vaunted by some, vilified by others, buybacks lie at the center of multiple controversies especially in the run-up of next year's US presidential election. Taking a closer look, however, many of these controversies need to be placed in perspective.

While we acknowledge that companies with large share repurchases do invest less, our findings suggest that the US economy has done an efficient job at recycling share repurchase capital into venture capital and private equity that get investment into the most innovative hands that seldom are big, mature megacap firms. For this precious flexible capital allocation to continue, however, the takeovers of the most promising companies for the sole purpose of capturing their innovations should not become the norm[6].

Regarding the debt issue, buybacks have the reputation of having driven US corporations to take on more than reasonable debt, but here again the debate seem exaggerated. Looking at balance sheet, liquidity or interest cover of US corporates, the overall situation remain so far solid, even if the true limes test will be the next recession. Farther more, in practice, the major advantage of buybacks lies in their flexibility, as they are generally aligned with profits, whereas corporations tend to refrain from lowering their dividends so as not to give a negative signal. Having said that, there are also clearly examples of companies that have excessively leveraged their balance sheet to undertake buybacks. To address this, rather than a top down more restrictive regulation, responsible investors should push for a more stringent autoregulation for the firms operating in highly cyclical sectors or facing structural challenges.

Ultimately, as stock pickers, our perspective on buybacks is made according a case by case process, greatly depending on the situation of the Company, its leverage, its growth opportunities and track record in term of M&A. As a rule of thumb, Companies that have an incremental above cost of capital return opportunity set for investment should indeed invest organically; M&A gets a little trickier as it depends a lot from Management skills as it often destroys shareholder value more often than not. However, intrinsically if M&A can achieve a high return, then that would also be an appropriate use of capital; If growth opportunities do not exist, shares are fair-to overvalued, and leverage is okay, then dividends are the best policy; but if shares are undervalued and leverage is at a reasonable level, then buybacks should be prioritized.

In the end, the buyback probably deserves better than its reputation. In the future, we hope that our practitioner considerations will not be swept away by abrupt regulatory changes, nor abused by the irresponsible

[6] ***Les Echos*** *(5 June 2018) "Have GAFAs killed start-ups?"*

practices of some societies. It is at this price, that the unique American experience in term of more efficient allocation of capital can usefully spread in other regions. This is probably where a multi-local and responsible investor like Amundi could help to disseminate the best practices.

Appendix A

Tighter buyback regulations on the horizon?

With the upcoming presidential election rapidly approaching and the political landscape growing increasingly polarized, buybacks have become a sensitive question indeed. To put it plainly, if Trump were re-elected, buyback regulations can be expected to largely remain as-is. If a liberal Democrat defeats Trump, however, the specific issue of buybacks and corporate management is liable to take more of a negative spotlight, though without really impacting the total volume of buybacks. Conversely, were a more vocal Democrat such as Elizabeth Warren or Bernie Sanders to be elected, buybacks would likely become a much bigger target.

This recurring debate took the forefront in July 2018 when, in his response to a Senate committee, SEC Commissioner Robert Jackson argued that buyback rules should be updated to prevent corporate executives from excessively using buybacks. In his speech, Jackson stated, "*At the SEC, it's time for our rules to require corporate managers who say they want to manage for the long term to put their money where their mouth is*."

Pointing out that the SEC had not revisited its share buyback rules since 2003, Jackson suggested that in order to resolve the executive buyback issue, **at a minimum Rule 10b-18 should be revised** to deny the safe harbor if companies permit their executives to "cash out" during a buyback. Furthermore, in the context of proposed buybacks, compensation committees should be required to review whether executives will use the buyback as an opportunity to cash out and if so, approve that decision and disclose to investors the reasons why such a course of action is in the best long-term interests of the company.

To place the SEC Commissioner's arguments in context, we would point out that, although Jackson was appointed by Donald Trump, this was according to the non-partisan status of the SEC; **Jackson filling** the (only) Democratic seat on the SEC Commission. To be precise, the five-member Commission comprises one Democrat (Jackson), one Independent (Chairman Jay Clayton, also appointed by Trump) and three Republicans, as no more than three of the five Commissioners may belong to the same political party.

Being himself in an awkward position with Chairman Clayton - who himself is often in the hot seat because considered by many Republicans as too close to the Democrats[7] - **Jackson, who could have remained in office until end-2020, decided to step down in Autumn**[8] to join NYU Law School...

[7] *Reuters (December 20, 2018), Republican frustrations grow as SEC chair proves frequent ally of Democrats*

[8] ***Wall Street Journal*** *(April 16, 2019), SEC's Lone Democratic Member Expected to Step Down in Fall*

Nonetheless, expect more headlines. The House of Representatives Subcommittee on Investor Protection, Entrepreneurship, and Capital Markets Chairman Maxine Waters has scheduled a hearing for October 17th entitled, “Examining Corporate Priorities: The Impact of Stock Buybacks on Workers, Communities, and Investors.”

Appendix B

Securities and Exchange Commission (“SEC”) Rule 10b-18

What is Rule 10b-18? This rule established by the SEC in 1982 set the **legal framework** for share buybacks by publicly-traded companies, in accordance, under various conditions, with the anti-fraud provisions of the Securities Exchange Act of 1934. The rule covers the procedure for share repurchases as well as their timing, price and volume conditions. For buybacks to be considered legal, the following **four conditions** must be met on a given day:

- **Manner of purchase**: issuers shall use a single broker or dealer per day to bid for or purchase their common stock.
- **Timing**: issuers having an average daily trading value of less than $1m/day or a public float value of less than $150m/day may not bid for or purchase their securities during the last 30 minutes of the trading session (last 10 minutes where these thresholds are exceeded).
- **Price**: issuers shall repurchase their securities at a price that is no higher than the highest independent published bid or last independent transaction price.
- **Volume**: issuers cannot purchase over 25% of the average daily in their shares.

The SEC updated the rule in 2003, requiring issuers to disclose more detailed information on share repurchases in forms **10-Q, 10-K and 20-F**.

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