

# ANNEX BULLETIN

Annex Bulletin 2007-16

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Updated 4/25/07, 9:30AM PDT

*Analysis of Stock Buyback Trends in Corporate America*

## To Buy (back shares), or Not to Buy?

"Growth" by Implosion: Number of Shares Drops (S&P); Dell Abdicates as "King of Fluff;" IBM, HP Pick Up Slack

*To be, or not to be: that is the question:  
Whether 'tis nobler in the mind to suffer  
The slings and arrows of outrageous fortune,  
Or to take arms against a sea of troubles,  
And by opposing end them?*

[William Shakespeare](#) - To be, or not to be (from Hamlet 3/1)

SCOTTSDALE, Apr 25 - "To buy (back shares), or not to buy: that is the question?" What would Shakespeare's Hamlet do if he were a CEO of a large public company today?

Well, buy, of course. That's a "no brainer" answer on Wall Street today. For, that's what our metaphorical Hamlet's peer-CEOs have been doing for the last 12 years. The result is a veritable explosion in stock buybacks. S&P companies have been gobbling up gobs of their own shares in the last four years. In the last four years, their share repurchases have grown at a compound annual rate of 48%.

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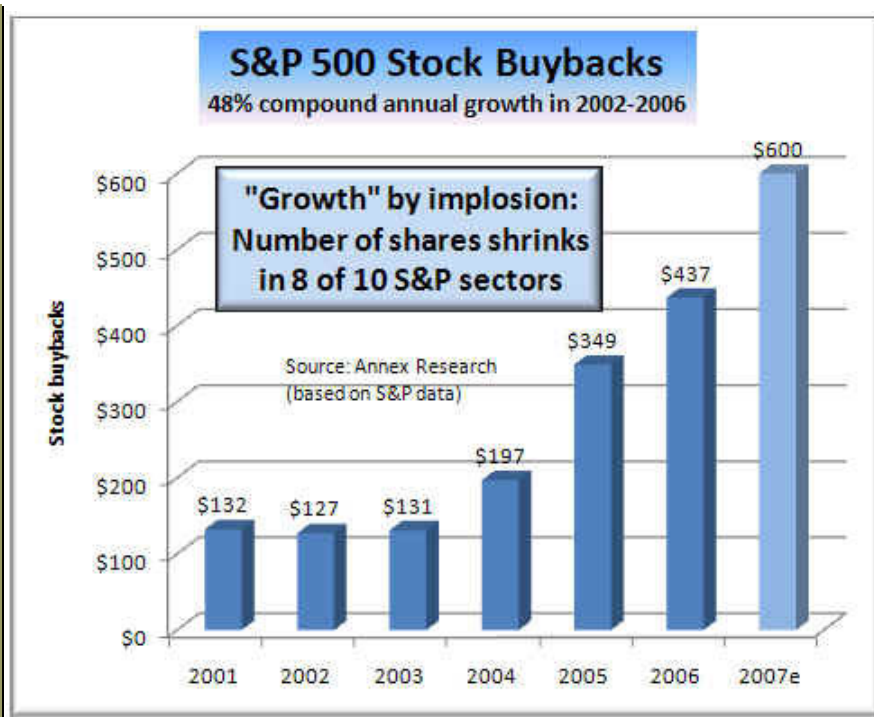
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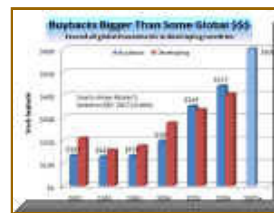
[HP: Toward New Highs? \(Excerpts from analysis of HP's 1Q07 business results\)](#) [Annex clients click here]

[Capgemini Caps Great Year, Saves Best for Last \(Analysis of Capgemini's fourth](#)



Last year, for example, they spent a record \$437 billion on share repurchases, 25% more than in 2005, and more than double the 2004 total. If the five year-trend holds this year, the 2007 total could exceed \$600 billion (see the chart).

Just to put things in perspective, the above figures mean that the S&P stock buybacks are now bigger than the sum total of all global direct investments in developing countries, according to the latest UN reports (see "[Globalization Accelerates](#)," Dec 2006). And as you can see from the right chart, the latter (red bars) have been also growing at a healthy clip in the last six years. Except that the stock buybacks generated no new jobs, products or other tangible economic benefits, while direct foreign investments improved the livelihoods of millions.



### "Growth" by Implosion

The explosion of stock buybacks has led to an implosion in the number of shares outstanding. The record levels of stock buybacks by S&P 500 companies has resulted in a reduced share counts for 8 of the 10 S&P 500 sectors (see [S&P, 9/19/06](#)). Total shares in the S&P 500 fell by about four billion in 2005.

The resulting [reduced float](#) is one of the chief reasons for the market's strength in the past year or so, according to S&P, the Wall Street Journal noted in a [Jan 24 article](#).

To us, that's "growth" by implosion, the latest of Wall Street perversions. It's "fool's gold." By shrinking the number of shares outstanding, companies are creating an illusion of growth without making a penny more at the bottom line. All it takes is a cheap calculator to debunk this simplistic ploy.

Large IT companies have been at the forefront of this trend. Led by IBM, Microsoft and

[quarter business results](#))

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[Globalization Accelerates](#) (Analysis of United Nation's annual survey of global investments)

[IBM: A \\$125-Stock?](#) (An update to "From Small Acorns Mighty Oaks Grow")

[Capgemini: Longest Sustained Stock Price Rise](#) (An update to "By Leaps and Bounds")

Intel, 10 top IT firms have spent \$300 billion in the last 10 years shrinking their float in an effort to flaunt their growth.

Why would they do a fool thing like that? That's because Wall Street pressured technology companies for larger buybacks, according to a [Bloomberg News Apr 24 report](#):

"Microsoft Corp. in August boosted its buyback program to \$36 billion over five years after the company failed to complete a \$20 billion tender offer. Instead, Microsoft combined the unused funds from the tender offer into its regular buyback. Hewlett-Packard Co., the world's largest maker of personal computers, last month authorized an \$8 billion repurchase plan, its largest ever."



[HP: New King of the Hill](#) (Analysis of HP's fourth quarter business results)

[IBM: From Little Acorns Mighty Oaks Grow](#) (Analysis of IBM's "State of the Union")

[Cappgemini: By Leaps and Bounds](#) (Analysis of Cappgemini's preliminary third quarter business results)

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[IBM: Services in a Box](#) (Analysis of IBM Global Services' Ground-shifting Announcements)

[Strong Comeback by IT Stocks in Third Quarter](#) (Analysis of top 20 IT companies' market and business trends)

[Stock Buybacks: A Fading Fad](#) (Dell, erstwhile "King of Fluff," suspends its stock buybacks)

[Cappgemini: Growth Continues](#) (Revenues, net profit up in double digits, margins also improve)

[HP Firing on All Cylinders](#) (Stock sets new multi-year record following excellent third fiscal quarter results) [[Annex clients click here](#)]

[Power of Manpower](#) (While

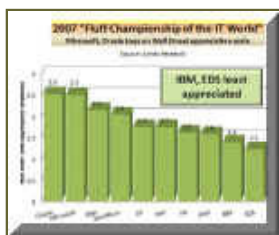
Nor are IT companies unique in their quest to "grow" their earnings by imploding their shares. Exxon, for example, topped the S&P 500 buyback binge, having repurchased 42.3 million of its shares in the 24 months through the third quarter of 2006, according to S&P. Microsoft was No. 2, buying back 34.6 million shares. Procter & Gamble, Citigroup and Intel rounded out the top five.

And yesterday, IBM took the lead with its record new \$15 billion authorization for stock buybacks (see "[IBM Ratchets Up Buybacks, Dividends](#)," below). This amount could reduce the IBM float by about 10%. No wonder Big Blue has been promising double digit earnings growth. Even if its net profit were flat, the earnings per share could be up 10%.



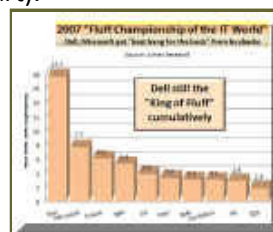
Since the current bull market started in 2002, 29 of 30 companies in the Dow Jones Industrial Average have seen such a "positive impact" on per-share earnings from buybacks, the [Wall Street Journal noted back in January](#). The lone standout: General Motors. This erstwhile American icon doesn't have an active buyback program.

Among the 10 top IT companies whose stock buybacks we have been following for years, Oracle and Microsoft seem to be getting the "best bang for the buck" in terms of Wall Street appreciation. They have the highest cumulative *market cap/ (equity+buybacks)* ratios - 2.5 each. IBM and EDS, on the other hand, are at the bottom of that list with corresponding ratios of 1.4 and 1.2 respectively (see left chart).



But when it comes to "best bang for the buck" from buybacks alone, Dell is still the cumulative "King of Fluff," even if the company is no longer participating in this charade (see right chart).

[For those of you who may be new to our stock buyback analyses, we dubbed the market cap/buybacks ratio the "fluff ratio" back in 1998, as it measures the amount of fluff, or hot air, in the stock - see "[Cabbage Patch Dolls of the 1990s](#)," Oct 1998].



### Do Buybacks Lead to Higher Stock Prices?

One justification we often hear from executives who advocate stock buybacks is that they lead to higher stock prices. Really? Here's what the Fortune magazine had to say on that topic just over a year ago:

Do share buybacks lead to higher stock prices? That's debatable. Supporters cite the fact that repurchases usually mean the company is flush and is looking to return cash to shareholders. Buybacks can -- but don't always -- lift earnings per share by spreading the same earnings across a smaller number of shares. And buybacks can indicate management's belief that its stock is undervalued.

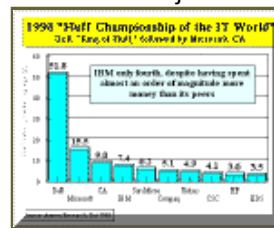
The opposing argument starts with the idea that buying back stock is a confession that management can't find a way to use its money to grow the business. Moreover, managers often buy their shares when prices are highest, says Nicholas Colas of Rochdale Research. Indeed, companies are gobbling up way more shares today than they did when prices were low in 2002.

(The Fortune, "Two Buyback Buys," 3/29/06)



Massive stock buybacks have certainly not helped the IBM stock in the last five years (see the left chart), though they worked magic for Big Blue in the late 1990s. And not just IBM.

Dell, for example, the company we dubbed "The King of Fluff" in a 1998 article - for its prowess of getting maximum market cap advantage from share repurchases (see the right chart), suspended its share repurchases in September of last year (see "A Fading Fad," Sep 2006). So you'd think investors would have punished the erstwhile stock buyback champ?



Think again. Dell shares kept climbing in the fourth quarter to new 52-week highs (see

others move to India, Russia... AMD invests in New York, hailing "phenomenal" quality of its labor force)

[Ebb Tide Lowers Most Boats](#) (Analysis of EDS' and CSC's latest quarterly results)

[IBM Stock Grossly Undervalued?](#) (Analysis of stock market valuations of IBM and its major competitors) [adds latest Fujitsu, Capgemini results]

[IBM vs. HP: A Tale of Two Blues](#) (Both companies are doing well in business, but only HP is favored by Wall Street; Big Blue trying to change that now with its new "India Opus") [Annex clients click here]

[Go East, Young Man!](#) (A speech delivered in St. Petersburg, Russia, May 25, 2006; click here for slides)

[IBM 5-Yr Forecast: Steady As She Goes](#) (Emphasis on quality continued) [Annex clients click here]

[Octathlon 2006: Accenture Again Wins "Gold!"](#) (HP gets "Silver," IBM "bronze") [Annex clients click here]



above chart). It was the management shakeup and disappointing earnings that eventually pushed the stock down in the first quarter of this year.

### Some Negative Effects of Buybacks

While stock buybacks don't necessarily lead to higher stock prices, they most certainly have a detrimental effect on companies that have stock option plans (which means most of large companies). That's because companies buy back their shares at market prices, while offering stock options to their officers and employees at discounted prices.

Sometimes, this can phenomenon create real dichotomies in the marketplace... that a company's float actually rises in the midst of a buyback program that's supposed to shrink the number of shares outstanding. Just ask Intel, for example...

Every year since 1992, the semiconductor manufacturer has bought back stock. But in 1996, for example, while it issued only \$261 million of stock and bought back a whopping \$1.3 billion of stock under its share-repurchase plan, its common and common-equivalent shares outstanding actually grew to 888 million from 884 million, Salomon notes. The reason? The company paid \$77.38 a share for the stock it repurchased -- but received only \$15.35 for each share issued through options.

(The Wall Street Journal, 7/07/1997)

### Summary

The fact that hundreds of S&P companies are not only engaging in such dubious activities as stock buybacks, but are, in fact, accelerating them despite detrimental effects on their businesses, speaks volumes about both the power of Wall Street and the herding mentality among the S&P leaders.

What will it take to reverse this trend? Well, 10 years ago, we would have said (and did, in fact, say it) - common sense and logic. The last decade has proven that that is not enough. Just like millions of smokers keep inhaling the substance that they know will do them harm, so do the hundreds of S&P executives. They can't seem to shake the habit.

Maybe passing a legislation that would force them to put a label on their Annual Reports stating that, "share repurchases are harmful to corporate health," could help? [just kidding]. Or the S&P leaders could consider the "just say no!" - a Reagan era slogan - as the answer to our Hamlet's quandary, "to buy or not to buy?"

Or they can keep on imploding till the ultimate extinction of Wall Street. Large companies can just keep on doing what they are doing until they buy up all their stock, and there are no shares left for Wall Street to trade.

Guess that would be the ultimate privatization nirvana. Alas, we have a feeling that Wall Street will come up with another harebrain scheme before it eradicates itself with this one.

[Click here](#) for detailed stock buyback analysis table (Annex clients only)

*Happy bargain hunting!*

*Bob Djurdjevic*

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## IBM Ratchets Up Stock Buybacks, Dividends

SCOTTSDALE, Apr 24 - The IBM Board ratcheted up its stock buybacks today by earmarking another \$15 billion for it. Including the remaining balance at the end of March from prior authorizations, IBM has now about \$16.4 billion available for share repurchases. Big Blue said in a release that it "may complete a substantial portion of the repurchases over the next several months." Since 1995, IBM has spent more than \$79 billion on stock buybacks (see the chart).



But what really boggles one's mind, however, is that IBM plans to *borrow* a large portion of the funds for this repurchase. Borrow the money to pay the shareholders?



O tempora o mores... The only winners we can see in this type of a deal are the bankers. Some of them may be also IBM shareholders (see the chart). So it's a win-win deal for them.

Jesse Greene, IBM treasurer, defended the idea of borrowing the money to buy back shares. Speaking in an interview today, he said IBM is doing it because "the interest rates are still relatively low," and because "IBM has lots of unused borrowing power."

But credit agency Fitch Ratings said today that it may downgrade its rating on IBM because of this move. What worries Fitch is not only that the new stock buybacks are more than double the IBM historical levels, but the very issue that also stymied us - that a substantial portion will be funded with debt.

But any downgrade is likely to be limited to one notch in the near term, Fitch said. It currently rates IBM at "AA-minus," the fourth-highest investment grade.

Asked about why everybody is so infatuated with stock buybacks in the first place, the IBM treasurer Greene said that it was because they provide a company more flexibility than the dividends.

"Dividends are a one-way trip," he said. "With stock buybacks, we can decide when and how much money we want to return to shareholders."

Speaking of which, the company also boosted its dividend by 33% to \$0.40 per share. This was the 12th consecutive year that IBM has increased its quarterly cash dividend. And that's a good thing. For, it rewards *all* shareholders, not just those willing to sell their shares to the company (such as with stock buybacks).



## Stock buyback, dividend increases bolster IBM stock (up over 4 pts)

Obviously, both moves are intended to bolster the IBM stock, which is still grossly undervalued, in our opinion (see "[No Big Surprises in Good Opening Quarter](#)," Apr 17, and "[IBM Stock Still Grossly Undervalued](#)", Apr 16). Wall Street reacted favorably, pushing the IBM stock up by over four points to just under \$100.



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