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## **DJ IN THE MONEY: Buybacks Pump Market, Contribute to Froth**

By Steven D. Jones

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Stock buybacks among S&P 500 companies accelerated in the first quarter to a record \$117.1 billion, according to Standard & Poor's, a 17.5% increase over the same period a year ago.

Between 2001 and 2006, dollars spent on buybacks by companies in the S&P 500 were equal to half of earnings during the period. And the trend is continuing raising the possibility that buybacks themselves are helping sustain the bull market for stocks.

"No doubt about it," says Howard Silverblatt, senior index analyst at Standard & Poor's whose quarterly analysis of buyback activity reads like a fever chart of the market.

"We have never seen anything like this in duration, participation or dollar amounts," says Silverblatt. "There are no asterisks on this. It is uncharted territory."

Corporations enjoyed 18 quarters of double-digit earnings growth through 2006 and accumulated much of that in cash. Companies in the S&P 500 ended 2006 with about 5% of their market value in cash, compared with only 2% in 1999, says Silverblatt.

Traditionally companies invested that cash in their businesses, but last year was the first year capital spending exceeded 2000 levels, says Silverblatt. Instead companies have been buying their own shares and generally holding those shares in the company treasury, not retiring them.

By reducing the shares outstanding every dollar of earnings yields more earnings per share, so buybacks contribute to the improved per-share performance. S&P companies grew earnings per share 15% in 2006 and Silverblatt says that for one out five companies in the index, at least four percentage points of that gain came from reductions in shares outstanding as a result of buybacks.

## **A Wave of M&A**

Besides earnings management, repurchased shares held on the balance sheet convert cash to capital with more limited uses, says Silverblatt.

"The difficulty here is that companies don't have a history of hanging onto those shares," he says. "We believe that eventually these shares will come back to market through merger and acquisition activity."

In 1998, buybacks eclipsed dividends as the leading method of returning capital to shareholders, according to research published by finance professors Gustavo Grullon and David Ikenberry in the *Journal of Applied Corporate Finance*. In the 1970s, the amount spent on buybacks amounted to less than 4.5% of total earnings. In the 1990s, the ratio leapt to 25%, now it has topped 50%, at least among S&P 500 companies.

For some, the level of buybacks represents a new low in corporate performance. Rather than invest in new ideas, new plants and new jobs, gutless executives are just handing over the cash.

"There is increasing sensitivity to cash in the company," says Ikenberry, who is now chairman of the department of finance at the University of Illinois. Excess cash attracts activist shareholders and arbitrageurs too, which has led many executives to conclude "they need to get rid of it."

But in more than a decade of research on the topic, Ikenberry has come to see buybacks as a way to use cash to fine tune a capital structure, not a symptom of lazy management.

## **Just another project**

Stock buybacks have taken a place in the hierarchy of company projects along with things like building a new factory or bringing a new software product to market, says Ikenberry.

These ideas are all perishable. A new software product at the right time can help a company capture market share. An efficient new factory can cut costs. "And to the extent the company's shares are undervalued, it would be value creating to buy them back," says Ikenberry.

A buyback should be judged by the same measure as a new product or plant. If the return is greater than the cost of capital, then it can add value to the business. "Think of stock buybacks as one more corporate project," he says.

To the degree executives buy back shares to appease restless shareholders, that's Ok too, says Ikenberry. "Shareholders are grumpy. That's a good thing."

Spending money on buybacks means the cash isn't there for investing in new production, Ikenberry admits. But if shareholders use the cash to buy a condo in Aspen or put a kid through college, those are all productive uses, too. "The capital doesn't turn to vapor when it leaves the corporation," he says.

Critics concede the point, but argue that the buybacks have contributed to a bubble in stock values and herd mentality in the executive suite has never served investors well.

"The S&P companies are basically turning their earnings over to Wall Street," argues **Bob Djurdjevic**, whose independent research firm in Scottsdale has warned about a "buyback bubble" for months.

For those who argue buybacks boost share values, Djurdjevic points to International Business Machines Corp. (IBM), which recently announced it would spend another \$40 billion on buybacks by 2010, an amount equal to its spending on buybacks between 2001 and 2006.

"IBM is one of the buyback leaders, yet its stock remains in the doldrums," says Djurdjevic.

"This is a cash flow driven trend," he says. "It's not the quality of the stocks or the quality of earnings alone behind this market. It's this flow of cash. And when there is a downturn in cash flow, then the buybacks will end and I fear it will be abrupt."

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