

The Benefits and Costs from Implementing a Stock Repurchasing Strategy

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Several months ago, Wayne Winegarden and I wrote a paper on stock repurchases which not only critically summarized the historical literature on the subject but also provided a framework for evaluating individual corporate balance sheet policies. These corporate balance sheet policies are extraordinarily important for assessing prospective stock returns. While I am not in general a “bottom up” analyst of corporate policies, I provide you with this research in the expectations that it will help you evaluate prospective investments.

After having spent the time and energy to familiarize myself thoroughly with stock repurchases, I have come to a number of conclusions. Some of these conclusions are counterintuitive and some are straightforward. Nevertheless, what has become one of my firmly held views is that most boards of directors are woefully uninformed about stock repurchases.

Conclusions:

- The research literature generally and incorrectly assumes that boards of directors and managers of corporations know and understand what they are doing when they initiate stock repurchase programs. This assumption is made implicitly by researchers when they analyze the characteristics of corporations that do and do not repurchase their own stock (or pay dividends, for that matter) and then conclude from that analysis that those characteristics are appropriate for stock repurchases (as well as dividends). They really are not generally correct.
- An inordinate amount of the research on stock repurchases addresses the question whether stock repurchases and dividends are substitutes for each other and, if so, just how close substitutes are they. Stock repurchases and dividends can be constructed to have the exact—and I do mean exact—same impact on a company. Stock repurchases and dividends therefore are perfect substitutes for each other in the overall scheme of corporate finance. As a result, I am unable to think of one rational reason why any company should ever prefer paying dividends rather than repurchasing stock. This dilemma was noted and discussed by my friend and colleague, Fischer Black, in his 1976 paper.

Dividends and stock repurchases both have identical balance sheet affects and therefore, from a company’s balance sheet perspective, are indistinguishable. Dividends and stock repurchases can be constructed both *de jure* and *de facto* to have the exact characteristics as to timing, amounts, and stability. Literally, no intrinsic differences exist here.

From the standpoint of shareholders, dividends have been, and are taxed, very differently from stock repurchases; save in the case of non-taxable shareholders where there are no tax differences. From the standpoint of corporations, stock repurchases and dividends have no tax differences, nor have there been any tax differences in recent memory. Dividends are not tax deductible to corporations nor are stock repurchases. Neither activity affects the corporation’s tax liability.

When it comes to individual shareholders, dividends have been, and still are, discriminated against by the tax codes *vis-à-vis* stock repurchases. This dividend disadvantage for shareholders goes well beyond tax considerations, but tax considerations are huge.

Stock repurchases allow shareholders the choice whether or not to sell, consequently those shareholders can decide based on their own individual circumstances—tax or otherwise. Some shareholders may wish a greater payout than would be offered by dividends and some less. Who knows? Individual shareholders may have different perceptions of the company's prospects. Dividends allow for no self-selection. Stock repurchases do. Stock repurchases are clearly superior to dividends.

Throughout most of the recent past, dividends have been taxed at significantly higher rates than have capital gains. Even if stock repurchases represented 100% capital gains to the selling shareholder—which they do not—there still is no advantage to the selling shareholder.

Selling shareholders, however, never have their full sale taxed at capital gains tax rates because the tax basis for all shares is greater than zero. Thus, something less than 100% of the stock repurchase is taxable—and usually it is a lot less than 100%. In fact, because shareholders in a traded stock can buy and sell at will it is unlikely that much of the sale price that results from a stock repurchase on average would represent taxable capital gains. Also because of the self-selection process, sellers may well have losses or loss carry-forwards to offset any capital gains that might result. In general, the individual shareholder's capital gains tax liability from a stock repurchase will be small.

Dividends, however, are always 100% taxable to the shareholder at the full tax rate on dividends, and shareholders have no ability to self-select once they own stock in the company. Of course, shareholders can self-select across companies as to whether those companies pay or don't pay dividends. But even when shareholders do select their preferred category of stock (dividend paying or not) they are never better off with dividend paying stocks, no matter what their tax status, and most often shareholders with dividend paying stocks are significantly worse off.

The existence of dividends, given tax laws and issues of self-selection, makes no sense to me.

- Stock repurchase programs have made major inroads into dividends over the past thirty or so years but still have a long, long way to go. Even today, aggregate dividends exceed stock repurchases.
- Stock repurchases (and dividends) deplete a company's cash and alter a company's balance sheet; therefore, companies that are strapped for cash and highly levered probably should not engage in stock repurchases. Alternatively stated the greater a company's cash position is and the less debt it has, the more a company can benefit from a stock repurchase program.
- To ward off a hostile takeover a company may wish to enact a stock repurchase program even if it doesn't have excess cash and does have significant debt.

Not only does a stock repurchase make the target company's balance sheet less attractive to the would-be acquirer, but those shareholders who value the company least and who thereby are most targeted by a would-be acquirer would have their stock removed from the marketplace by a stock repurchase and thereby make a takeover attempt more costly to the would-be acquirer.

- Stock repurchases have generally been found to raise the stock price of the company above where it otherwise would have been. This affect appears to have diminished over the years, reflecting the enormous increase in the use of stock repurchases over the past quarter century. This affect, I believe, reflects management's (and directors') correct view that their company is undervalued. They know more than most shareholders and have used stock repurchases to signal their greater knowledge.

Many instances have occurred where stock repurchases reflected management's wishful thinking and were thus unsuccessful, of course. This was especially prevalent in late 2000-2003 period where companies hoped against hope to raise their stock price and would try most anything to do it.

But still the preponderance of the evidence is that stock repurchases do raise stock prices.

- Stock repurchases are better for a company than increasing investments or acquiring other companies if the expected return from new investments or acquisitions—risk adjusted and after tax—is less than the average return of the company itself. Not all companies should increase their growth. Stock repurchases are an excellent use of corporate funds when other uses aren't compelling. Holding lots of cash for the sake of holding cash makes little sense.
- Stock repurchases remove some of the temptation from management to squander the balance sheet either through empire building or through excessive compensation. Shareholders can, in some cases, really benefit from a stock repurchase program because it keeps tighter control on management. This, to my way of thinking, is good governance and a serious positive impact resulting from stock repurchases. Companies with excessive cash balances have given management a carte blanche with little or no recourse.
- Several forms of stock repurchases are currently in practice. The results from these different forms of stock repurchases vary widely. By far the least effective stock repurchase program is the open market repurchase program which allows management to pick and choose when to buy, at what price to buy and how much to buy. These programs have been shown time and again to have the least beneficial impact on a company as compared to either a Dutch auction or tender offer.

The reasons here are many, but it should be noted that stock price appreciation following a tender offer or Dutch auction is much greater than the price appreciation over the whole period of open market purchases. Tenders and Dutch auctions have an immediate and powerful impact.

Management is biased in general in favor of open market purchases because management benefits by having micro control of the process and by getting benefits from brokers.

In my opinion the literature is as clear as it can be that when a repurchase is warranted it should be carried out by a tender offer of significant magnitude at a substantial premium to the going share price.

Lastly, my perspective after reviewing this literature is that when a stock repurchase is carried out it should be of a sufficient magnitude to put the company into a zero net cash position or slightly in debt, unless of course a significant use of cash is planned, i.e., acquisition or capital outlay. The reason for this is that the return on cash is lower—or should be—than the return on other assets. Getting a company's net cash position as close to zero as possible is important.

For a free copy of Dr. Laffer's paper on stock repurchases, please send a request to request@retirementcapital.com.