The Role of Share Buybacks in Earnings Growth

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In an environment where achieving top line growth has been a struggle, companies have turned to other approaches to boost earnings growth. Achieving EPS growth is a highly visible and highly prized goal for many reasons, including clearing the bar set by analysts, meeting externally published company goals, and hitting targets for incentive compensation plan payouts.

Cutting costs is one obvious alternative to increasing earnings in the absence of revenue growth, and companies have indeed been busy streamlining operations, reducing headcount, negotiating lower prices from vendors, etc. Yet what happens when most of the "excess" costs have been wrung out of the system and operational improvements are harder and harder to come by?

A common method used to produce growth in EPS, that of a company buying back its own shares, falls outside of the basic revenue – expenses = net income equation. Share repurchases increase EPS by reducing the number of shares outstanding and therefore decreasing the denominator in the EPS calculation.

Share buybacks have ramped up significantly in recent years both from a prevalence and magnitude standpoint. *Exhibit 1* shows the aggregate dollars spent on quarterly share buybacks over the last 20 years. The level of repurchases in aggregate for Russell 1000 companies hovered around $40 billion from the late 90's through the end of 2004 before ascending rapidly to a peak of almost $179 billion at the end of 2007. Then came the financial crisis, and stock buybacks had plummeted by the middle of 2009. Another surge began in 2010 and has continued through the present time, with buybacks reaching a record $181 billion in the most recent quarter. In fact, share buybacks are estimated to be the largest source of U.S. equity demand this year.

One reason for the surge in buybacks is that post-financial crisis borrowing costs have been enticingly low, a fact which has encouraged companies to borrow even when they have no near term productive use of those funds. Currently companies are sitting on record levels of cash (see "Implications of Excess Cash on the Balance Sheet" from December 2015 Research Perspectives). It is commonplace now for companies taking on debt to use a portion of those funds to buyback shares and/or pay dividends.

At the individual company level, the impact of share repurchases has played a significant role in EPS gains in recent years. At aerospace and defense contractor Northrop Grumman, for example, EPS has skyrocketed 58% over the last five years. Net income over that same period, however, has stayed largely the same (-1%).

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Exhibit #1: Quarterly Stock Purchases ($Bil)
Russell 1000 (aggregate) Q3'96 to Q2'16

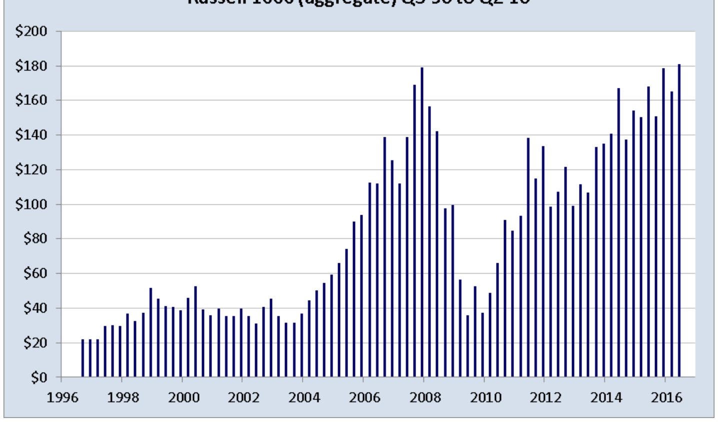
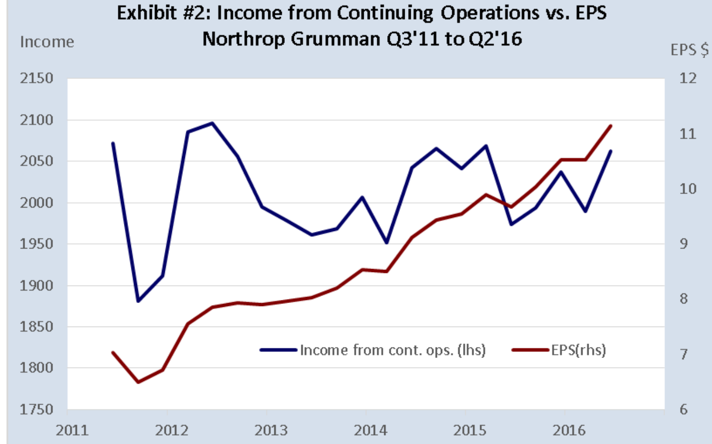


Exhibit #2: Income from Continuing Operations vs. EPS
Northrop Grumman Q3'11 to Q2'16



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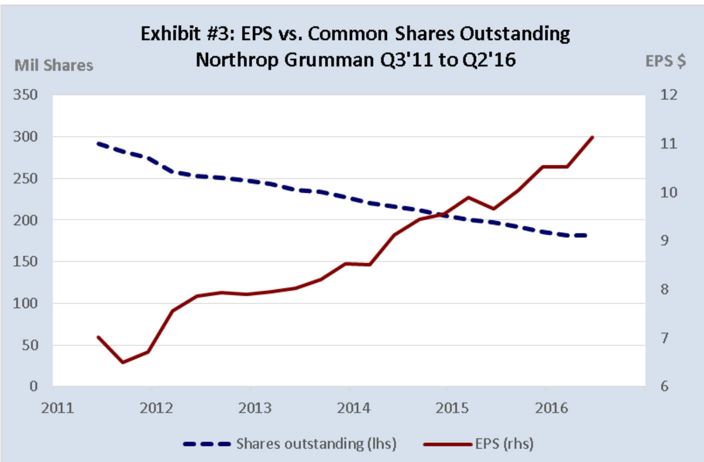
The explanation behind this seeming contradiction becomes clearer once shares outstanding are taken into account (*Exhibit 3*). Over the five years that EPS climbed 58%, the number of shares outstanding contracted sharply (-38%). The change in share count was therefore the primary driver of the EPS gains. Harder to explain is the steep increase in the price investors are willing to pay for NOC shares, which has climbed from 10x to 19x NTM earnings over the last five years.



The market generally has a positive reaction to share repurchases. The willingness of a company's Board of Directors to buy back shares is taken as a signal that they believe the shares are currently undervalued. This move also supports the idea that the company has ample liquidity to cover other commitments (e.g., interest payments, capital expenditures).

Critics of buybacks view this technique as financial engineering, one that does not create true value. From a negative perspective, share buybacks are evidence that management believes there is a shortage of good investment opportunities. Another reason may be that uncertainty is too high (e.g., regulatory, monetary policy). Cash spent buying back shares now is cash that could have been invested in future growth, for example in capital expenditures, R&D, or accretive acquisitions.

Share buybacks do mathematically prop up earnings, but the question is for how long? And at what tradeoff with longer term growth? As is always the case, it is of vital importance to ascertain the true drivers of earnings growth, how sustainable those drivers are, and whether or not the price the market has assigned shares accurately reflects that reality.