Beating the market by buying back stock

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A company just isn't in the swim today unless it's buying its own shares. Are buybacks a fad - or do they pay off for investors? A ground-breaking *Fortune* study shows that buybacks have made a mint for shareholders who stuck with the companies carrying them out.

By Carol Loomis

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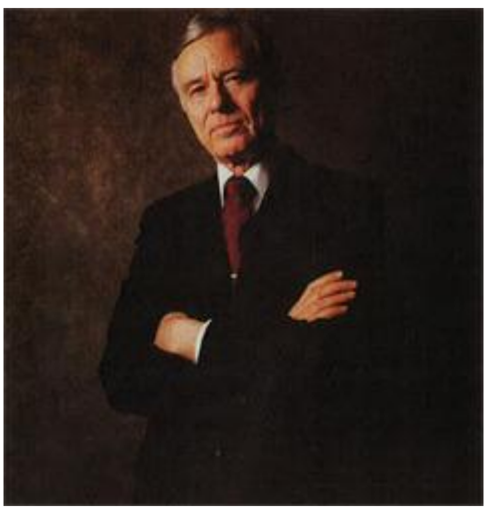


The sultan of buybacks is Henry E. Singleton, 68, chairman of Teledyne, which over the years has repurchased 85% of its shares for about $2.7 billion. A model of flexibility about his stock, Singleton used it as currency when Teledyne was a 1960s highflier, issuing bundles of shares to acquire companies and build his conglomerate. But when Teledyne's price-earnings multiple dived, he switched to repurchases. The first was in 1972 at a price (adjusted for splits and stock dividends) of $8 a share, the last at $200 in May 1984. The shares then leaped to $300 and were recently at $250.

FORTUNE -- Does it pay a company to buy its own stock? A world of companies have come around to thinking that it does. Last year, according to a Merrill Lynch count, about 600 companies announced programs to repurchase their stock -- a record, by a mile. Salomon Brothers estimates that $26 billion went into repurchases during the year, another runaway record. The list of companies in the game includes the large and elite, many among the *Fortune* 500: Exxon (XOM), Standard Oil (Indiana), American Home Products, Coca-Cola (KO), General Foods, on and on.

This burst of activity, however, has taken place in a certain statistical vacuum. No one could say how good stock buybacks have been over the long run for shareholders who stayed with the repurchasing companies. Anyone might marvel at Teledyne, the most celebrated buyback company over the years, whose shareholders have made out smashingly -- achieving a gain, since the buybacks began in 1972, of more than 3,000%. But that standout performance hardly serves as a testimonial to buybacks in general. How about all the other companies that over the years, with somewhat less verve and certainly much less public attention, were buying large chunks of their own stock?

To that question, *Fortune* now has an answer. Working with the 1,660 stocks covered by the Value Line Investment Survey, we identified companies that bought significant amounts of their own common stock in the ten years from 1974 through 1983. Next we reduced this list to voluntary repurchasers -- cutting out, for example, companies that had bought the shares by paying "greenmail" to get rid of a threatening shareholder. Then we measured the total returns (stock appreciation plus dividends) earned by shareholders from the approximate dates of each repurchase "episode" to the end of 1984. For exactly the same periods, we compared the results with total returns earned on Standard & Poor's 500-stock index, a generally accepted indicator of "the stock market."

The outcome is spectacularly decisive. The shareholders in the buyback companies earned superb returns, far exceeding those accruing to investors as a whole. For all episodes measured, the buyback companies showed a median total return, expressed as an annual average, compounded, of 22.6%. The equivalent return for the S&P 500 was only 14.1%. That difference of 8.5 percentage points is enormously significant to an investor: at 22.6%, a stake of $1,000 grows to $7,670 in ten years; at 14.1%, it grows to only $3,740. Clearly, the managers of the buyback companies, in aggregate (though certainly not in every instance), added heroically during these years to the wealth of shareholders who remained in the fold. (For a list of companies that have been big buyers recently, see box at the bottom.)

These findings cannot cheer the critics of buyback programs, who tend to regard them as close to unpatriotic. Why, some skeptics ask, should tax breaks be granted to corporations in the name of "capital formation" when so much money is flowing lazily and unproductively into repurchases? Why, especially, in an age of gigantic government deficits?

Eugene M. Lerner, professor of finance at Northwestern's Kellogg Graduate School of Management and a critic of buybacks, wishes for corporate actions more "socially useful." It's discouraging, he says, to see managers spending so much time "screwing around with the market, instead of finding good business opportunities, competing against the Japanese, and minding the store." Lerner thinks the market should view the announcement of a buyback as a negative signal -- an admission that a company has run out of constructive things to do with its money. But the market, he concedes, doesn't see things that way, and he is unsurprised to hear that the buyback crowd has achieved superior results. He is also unimpressed: "You make a lot of money peddling drugs too, but I'm not in that business either."

Under examination, the arguments against repurchases lose much of their force. If it is wrong for companies to channel money to shareholders instead of retaining it for corporate use, dividends as well as repurchases should be under a cloud. But few people go that far in their criticism -- certainly not Lerner, who regards dividends as "a glorious discipline" to which corporations definitely should be subject. The money paid for repurchases, moreover, does not vaporize once it reaches stockholders and lose its capacity for doing constructive work. Some of it goes for taxes -- assessed at preferential capital-gains rates, rather than the full rates paid on dividends. Once the Internal Revenue Service gets its due, the rest of the money trucks back into the economy, with a part of it unquestionably round-tripping into stocks.

The big positive point about repurchases is that they have showered benefits on stockholders who stayed aboard the buyback companies. For the period covered by *Fortune's* study, repurchases were an intelligent use of money by managers who had, as they always do, a range of alternatives. If the rate of return looks attractive, they can plow funds into the development of new products or into plant and equipment. A second alternative is to buy other companies. A third is payouts to shareholders through dividends or repurchases.

Liking leverage for the boost it can give return on equity, Tandy Corp., home of the Radio Shack chain (see Selling), has been a big buyer of its stock. The man in charge of purchasing, Garland P. Asher, 40, director of financial planning, says Tandy has bought at "horrible times" that initially made it look like "a chump." But the buying done in the 1970s eventually produced rich payoffs. Since late 1983 Tandy has been back in its chump mode: Asher has bought while the stock has sunk. "But that's the point," he says. "You don't want to buy your stock when it's strong."

If a company's stock is undervalued -- as many managers believe theirs is -- a repurchase may offer the best payoff of all. Approaches to determining stock values vary but fundamentally each company judging itself undervalued is saying that its future stream of earnings justifies a higher price than the stock market is willing to accord it. To capitalize on this situation, a company will normally have to expend cash or other assets for its shares, thereby shrinking its total wealth. But because each $1 spent will buy more than $1 of value, the stockholders who retain their shares will emerge with more wealth *per share* than they started with.

Imagine, for example, a company with this financial profile: $200 million in assets, including $38 million of spare cash invested in commercial paper; $120 million in shareholders' equity; projected earnings for the next year of $20 million (after taxes), including about $2 million in interest to be earned on the commercial paper; ten million shares outstanding, which means earnings per share are expected to run $2; and a stock market valuation of $160 million, or eight times expected earnings. But the company's executives are quite sure that the company is worth more like $300 million -- to, say, a private buyer. In other words, they believe the true value of the company to be around $30 a share, rather than the $16 a share that is the stock market's appraisal.

So the company makes a tender for two million of its shares at $19 each, thereby spending $38 million (leaving aside costs for lawyers, investment bankers, and the like). That strips $38 million from assets, which fall to $162 million, and from stockholders' equity, which falls to $82 million. The company thus shrinks and also becomes more leveraged. That is, each dollar of equity is now supporting $1.98 in assets vs. $1.67 previously.

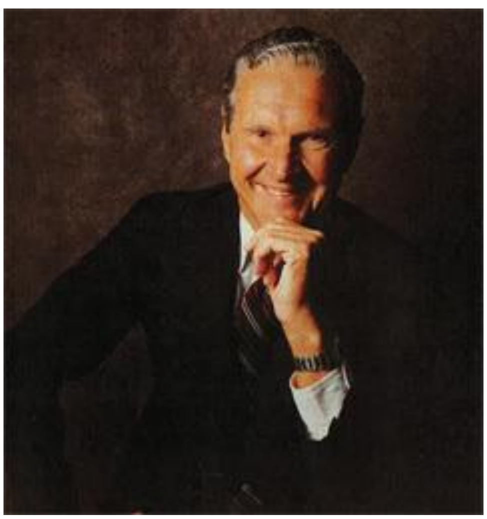
The value of the company to a private buyer also drops, we may assume, by $38 million (to $262 million), and expected earnings fall by the $2 million that will no longer be earned on the commercial paper. But only eight million shares now exist to split the corporate wealth. The forecast for earnings is revised to $2.25 per share, up 12.5%. The true value per share, based on the $262 million the company might bring in a private deal, rises to $32.75, up 9.2% from the original $30.

The stock market will be coping with all these facts in its own independent, unpredictable way. While the tender is in progress, at that premium price of $19 a share, the stock price will undoubtedly rise from its former $16. But it can be argued that if the market remains consistent in its appraisal of the company, its total market value should drop by $38 million -- the shrinkage on both sides of the balance sheet -- once the tender is completed. Were that to happen, the market price of each of the eight million remaining shares would be only $15.25 and their price-earnings multiple less than 7. That multiple could even seem logical because of both the premium paid for the repurchased shares and the added leverage injected into the company. Though leverage can be wonderful in prosperous times, it can be terrible in bad. Bond-rating agencies, in fact, sometimes lower the ratings of repurchasers, as Moody's did recently with both Teledyne and Holiday Inns. Both are among the many companies that have not only pumped up leverage by buying in stock, but have also raised cash to do it by adding debt.

As it turns out, neither the leverage created by buybacks nor much else about them appears to have bothered the stock market. Various academic studies of tenders have shown that the stock seldom slips to $15.25 (to stay with our example) when a tender is completed and instead stays well above the old price of $16. Say the post-tender price is $18. That would mean the market had knocked only $16 million from the company's total market value -- less than half the amount expended to buy shares.

The results of *Fortune's* study are consistent with the academic findings. But they add a whole new body of information about the long-term effects of buybacks. Furthermore, *Fortune's* results, good as they are, present a conservative picture of how well the buyback companies did. For one thing, the study covers only companies still public at the end of 1984. It omits companies that repurchased large quantities of their stock but later were acquired at prices far above the market (Norton Simon, for example) or that bought in all their shares at premium prices and went private in the ultimate buyback (like Metromedia). Were these winners added in, the returns would surely look even more superlative. Second, we did not assume that investors jumped into a buyback situation early. Instead we assumed that they bought in only after a company's repurchases had become a matter of public record -- and after the share prices, in many cases, would have moved up.

To begin with, we identified Value Line companies that, in one or more years from 1974 through 1983, repurchased enough shares to reduce those outstanding by at least 4% (or that, in a few cases, repurchased convertible securities and warrants that are common stock equivalents). The 4% standard limited the study to hard-core buyers. The soft-core sort would be the many companies that buy relatively small amounts of their stock for housekeeping reason -- for example, to supply shares for option and other employee-purchase plans.



Glenn W. Bailey's managerial stripes were earned at ITT under Harold Geneen, whose burning ambitions never included stock buybacks. But after Bailey began running the company now called Bairnco Corp., a maker of lighting fixtures and electronic components, he watched its stock collapse in 1974 to 25% of book value and three times earnings. "Very interesting," he said, and bought until the price hit book seven years later. The stock is up 4,300% since the 1974 low. Bailey, 59, has an 11% stake, recently worth $33 million, that keeps his attention on what's best for stockholders.

The search for 4-percenters turned up about 360. But we wanted only the companies that seemed to be buying on their own initiative, simply because they saw unrecognized value in their stock. So besides weeding out greenmail repurchasers, we excluded other companies that may have been buying because they felt an obligation to do so. For example, purchases made from a former officer or director, or from estates and foundations linked to the buyback company, were disqualified.

In this weeding, we looked at all the companies among the 4-percenters big enough to have made the 1983 *Fortune* lists of the 500 largest industrials and the 500 largest service companies. Of 136 such companies, 87 appeared to be voluntary buyers meeting our criteria. Wanting also to examine the experience of smaller companies, we added a random sample of 100 that seemed to be buying voluntarily. So the total number of buyers included in the final survey was 187. Many of those met the 4% standard in more than one year, and returns to their shareholders were measured, through 1984, for each purchase. In all, the 187 companies accounted for 312 "years," or episodes, of buying.

The result for shareholders had to be measured from a logical time within or after each episode. Fixing that point was easy in the case of cash tender offers and offers to exchange senior securities for common stock. These events are always announced and therefore we began measuring returns from the end of the month in which the announcement was made. By that time the news of the tender or other offer would already have caused the price of the stock to jump in recognition of both the premium to be paid and any other pluses investors saw in the repurchase. Because we began measuring only after such jumps had occurred, the results of the study don't include them.

An after-the-fact procedure was also used for open-market purchases, which are commonly strung out over months and even years. Many companies announce these repurchase programs when they begin. But the Securities and Exchange Commission does not require an announcement and some companies never make one. Word of their repurchases, however, is generally passed along by Wall Street traders and analysts. Quarterly reports to shareholders may confirm that buybacks have taken place. At the latest, a shareholder can discover that a company has bought a significant number of shares when its annual report is published.

Taking all this into account, *Fortune* adopted a compromise approach for openmarket purchases, beginning to measure returns at the end of a fiscal year in which the company experienced a reduction of at least 4% in its outstanding shares. This delayed start means that any help a company's buying gave its stock *in that year* was disregarded in the returns we measured.

But some companies kept on buying their stock. Does that mean their presence in the market could have boosted investors' returns later? The point is important because many people suspect the basic purpose of repurchase programs is to "prop" the stock -- to push up its price or, at the least, keep it from falling. Some companies own up to such intentions. In a 1983 study conducted by the Conference Board, a business research group, 72 companies that had been big repurchasers of stock ranked their reasons for buying. Eleven said one of their objectives was to support their stock's market price, and nine of the 11 ranked that objective first, second, or third. But the Conference Board also asked the 72 companies what impact their repurchases appeared to have had on market prices of their stocks, and only a relative few saw a positive effect. More than 80% discerned no impact at all.

As that suggests, propping is difficult, in part because of an SEC rule, 10b-18, that deals with repurchasing. In the SEC's language, the rule is not "prescriptive." Rather it describes a code of conduct that, if followed by corporations, will provide them a "safe harbor" against charges of manipulating their stocks. The code suggests that companies should: (1) stay out of the market in the early and late moments of the trading day, so as to avoid having an influence on opening and closing prices; (2) follow the market up rather than lead it; and (3) limit their trading volume in any one day to no more than 25% of the average daily volume in their stock over the preceding four weeks. If repurchasers follow those guidelines -- and Wall Street traders say most do -- their opportunities for propping are not bigger than a breadbasket.

Furthermore, a company buying its own stock is simply a single force in the market, seldom more powerful than a large institutional investor, and no more able to stem a tide of selling. Says Kevin M. Gately, a vice president of block trading at Kidder Peabody: "If everybody wants to bail out of a stock at the same time, the company can't hold it up."

Fortune's survey results, in fact, include buybacks that boomeranged. Not many, to be sure -- there were only 32 negative returns in the 312 episodes of buying -- but enough to prove Gately's point. When business in the oil patch began to sag, a good many oil and oil field service companies stepped up to buy their stock, among them Consolidated Oil & Gas, Northwest Industries, and NL Industries. Sellers whipped them. Says a disgruntled NL executive: "Buying our stock is not something we'd be likely to do again." Suave Shoe Corp., a Florida manufacturer that repurchased large quantities of stock in fiscal 1982 and 1983, also stumbled badly. The company began running losses partly attributable to competition from importers helped by the strong U.S. dollar. Following the 1982 episode of buying, Suave's shareholders suffered an annualized loss of 27%, and after the 1983 episode, 38% -- the worst result in the survey.

Exxon has spent more than $3.5 billion since mid-1983 buying 10% of its stock, and it shows no sign of stopping. Architect of the program has been Jack F. Bennett, 61, senior vice president, who has paid an average of $41 a share (against a recent price of $50). Since an average of around 18 barrels of oil and of natural gas equivalents underlay each Exxon share during this period, Bennett in effect bought reserves at $2.28 a barrel -- approximately half the company's worldwide finding costs. Exxon has nevertheless maintained a huge exploration program.

On the other hand, the star performer was Charter Medical, a Macon, Georgia, owner and operator of psychiatric and conventional hospitals. In 1977 Charter twice offered shareholders preferred stock in exchange for common, reducing its common shares outstanding by about 42%. The shareholders who held on to their common -- they include founder and Chief Executive William A. Fickling Jr. -- have since realized average annual returns of 71% (from the date of the first tender) and 79% (from the second).

The exchange offers were obviously classy business decisions -- except that Fickling and Charter have recently been sued by two former common stockholders who accepted preferred stock in the exchanges and think they got taken. They charge that Charter withheld bullish information from the common shareholders (which the company denies doing) and therefore induced them to accept the preferred. Other buyback companies have been sued on similar grounds.

Charter Medical was one of the smaller companies randomly chosen for *Fortune's* survey. The small companies as a group, however, lagged somewhat in performance, racking up a median total return of 21.3% for all episodes measured, vs. 24.1% for the bigger companies studied. And despite Charter Medical's success with exchange offers, one-shot deals -- tenders and exchange offers -- generally brought smaller gains than openmarket purchases. More numerous as well as more successful, the open-market episodes of buying resulted in a median return of 24.1% against 19.6% for the tenders and exchanges. Score one more for the tortoise.

All that, though, is trivia compared with the big general conclusion that buybacks, regardless of who did the purchasing or how, worked superlatively for shareholders. The natural question is why. The most likely answer is that a lot of managers were smart twice over. First, they correctly judged their stock undervalued. Second, they were willing to commit capital to that proposition.

Some managements do not even think of buybacks as an option. The idea of shrinking their equity base repels them. Their inclination instead is to get bigger, and this often leads them to pay rich prices for acquisitions that never earn their keep. Part of the reason for the superior returns of the buyback companies, no doubt, is that they simply did not make as many bad acquisitions. Says Garland P. Asher, director of financial planning at Tandy, a buyback company: "You can argue that at the very least a share-repurchase program keeps people from making mistakes."

A buyback is itself a special kind of acquisition, made at prices that are typically a bargain compared with those a company must pay for an outside purchase. Thomas S. Murphy, Chairman of Capital Cities Communications, has for many years weighed outside acquisitions against the inside variety, sometimes buying other companies, sometimes buying Cap Cities by repurchasing its stock. In the company's 1983 annual report, Murphy describes acquisition opportunities as too highly priced and noted that the company had been a buyer of its own stock during the year. But in March he found an outside megadeal he couldn't refuse, agreeing to acquire ABC for $3.5 billion.

Other companies have seen hard-to-resist advantages in repurchases. Says an executive of a Midwest company:"We looked at what we could buy and decided our own shares were the best value. We know our own company. We didn't know others as well."

His thinking parallels that of investment banker Goldman Sachs (GS), which in a 1983 presentation to client Getty Oil reeled off a string of reasons the company should buy its own stock. Said Goldman, paraphrased: "You will be purchasing crude oil and gas reserves substantially below fair-market value and below what you would pay in a competitive acquisition of another company. The price will also be below finding costs for new reserves. The risks of Getty's business are already well known to management. Repurchases do not disrupt operations. Management time will not be spent on the reallocation of people and resources." Because Getty Oil was then caught up in a fight with the man who controlled 40% of its stock, Gordon P. Getty, the company did not follow Goldman's advice. Texaco, showing no appetite at the time for its own stock, subsequently bought Getty Oil in one of those competitive acquisitions Goldman was talking about, spending more than $10 billion to do so. Later, Texaco got suddenly interested in its own stock as well spending $1.28 billion to buy out the Bass brothers in a greenmail deal.

A buyback enthusiast, Bernard A. Edison, president of Edison Brothers Stores, a chain retailer of shoes, says that its repurchases reflect the wish of those running the company to "manage the stock from the point of view of the stock holder, not that of management." He and other insiders control 37% of Edison's stock which undoubtedly helps them to think like stockholders. Substantial holdings by insiders are, in fact, a feature of many of *Fortune's* buyback companies, and surely a reason these companies substitute repurchases for richly priced acquisitions.

Another buyback enthusiast is Warren E. Buffett, the noted Omaha investor. The company he controls, Berkshire Hathaway (BRKA), is due to acquire 18% of Capital Cities in the ABC deal, and that will become his biggest investment. But right now his four largest commonstock holdings are in corporations that have also repurchased substantial amounts of stock: Geico, General Foods, Exxon, and Washington Post (WPO). The Exxon investment is new, built up only after the company started acquiring its shares in 1983. "A big reason I got in," Buffett says, "is that the company has recognized the value in its stock and been smart enough and pro shareholder enough to repurchase it." On the other hand, Buffett has sold the stocks of certain companies because they would *not* make repurchases.

He is convinced, in fact, that the market discounts the prices of companies that should be making repurchases and don't, instead frittering their money away on acquisitions or other investments of far less value. The corollary, he says, is a markup in prices for companies that do repurchase shares, because investors identify the buybacks as a sign that management will be consistently inclined to act in the interests of shareholders. "All managements *say* they're acting in the shareholders' interests," he observes. "What you'd like to do as an investor is hook them up to a machine and run a polygraph to see whether it's true. Short of a polygraph the best sign of a shareholder-oriented management -- assuming its stock is undervalued -- is repurchases. A polygraph proxy, that's what it is."

A major question for the future is whether buybacks will serve investors as nobly as in the past. *Fortune's* figures suggest they may not. The evidence is in the 1983 data: for episodes of buying that took place in that year, the returns to shareholders have been terrible -- well below results for the S&P 500. That may be because the buybacks need time to bear fruit. It may be also because a large batch of wrong companies -- those whose shares are not really undervalued -- have jumped into the game.

They could be making buybacks simply because these are in fashion. Or perhaps because they fear takeover. Some companies acknowledge that they are buying today to get the price of their stock up, hoping to discourage attacks from raiders looking for cheap merchandise. Though propping doesn't work well, companies that buy shares use up spare cash or untapped debt capacity and thereby presumably make themselves less appealing as takeover candidates.

That whole proposition, however, is controversial, since certain other companies believe that buybacks increase the purchaser's vulnerability by shrinking its size, concentrating stock in the hands of institutions, and making the company generally an easier prize to grab. Harry S. Derbyshire, chief financial officer of Whittaker Corp., is of that persuasion, though Whittaker has nevertheless bought back about 10% of its stock over the past four years. Derbyshire says his company, a Los Angeles-based conglomerate, simply believes itself underleveraged and is buying to cure that condition. The investor relations director at another buyback company says he's sure that repurchases increase the risk of takeover. But his company, he says, is buying its stock anyway "because we're worth more than we're selling for." He might be claiming that even if he didn't believe it. Nevertheless, that's the right kind of reason for repurchases, and it is also a distinct warning to the wrong companies buying for the wrong reasons. The purchase of overvalued stocks won't work any better for companies than it does for investors. But if the players in this game are companies sensitive to values, buybacks may continue to deliver sensational returns to shareholders who hang in for the ride.

CANNIBALS OF THE YEAR

■ FORTUNE's study of buybacks did not include repurchases made in 1984 because not enough time has elapsed to test their success. But here is a sampler of two dozen companies that made major repurchases during the year and might interest anyone inclined to invest in companies following buyback strategies. We've listed voluntary repurchasers only except for Houston Natural Gas, which is a hybrid: to remove a takeover threat, it bought 2.1 million of its shares from Coastal Corp. in a greenmail deal, but then picked up 5.6 million more in the open market. The percentage declines in shares are for calendar 1984 except for Color Tile (fiscal year ended June 30), SCOA (January 28), Levi Strauss (November 25), and Brown-Forman (nine months ended January 31).

The lead company, Teledyne, is an experienced cannibalizer of its shares, and so are Resorts International, Iroquois Brands, Colt, Tandy, Bandag, Color Tile, Crown Cork, International Controls, Levi Strauss, Crane, and Ralston. Among the others, SCOA, an Ohio-based retailer, is thought a candidate to be acquired or go private.

BIG BUYBACKS OF 1984

COMPANY	DECLINE IN SHARES OUTSTANDING
Teledyne	42.5%
Resorts International	31.4%
Iroquois Brands	27.3%
Integrated Resources	23.9%
FMC	23.9%
Houston Natural Gas	21.4%
Ethyl	18.9%
General Dynamics	18.0%
Colt Industries	17.7%
Mark Controls	17.0%
Tandy	15.1%
Celanese	13.8%

COMPANY	DECLINE IN SHARES OUTSTANDING
Bandag	13.4%
Color Tile	13.3%
SCOA	13.2%
Pennzoil	13.2%
Crown Cork & Seal	12.8%
Dart & Kraft	12.7%
Pioneer	12.6%
International Controls	12.5%
Levi Strauss	11.9%
Crane	11.6%
Ralston Purina	11.3%
Brown-Forman Distillers	11.2%

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