BostonPartners

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The power of stock buybacks for creating shareholder value

Stock repurchase programs are one of the least appreciated means of unlocking long-term value for shareholders. We take a closer look at how they work and where investors can find opportunities now.

After setting a torrid pace in 2022—followed by a somewhat quieter year last year—U.S. companies are back in the business of stock buybacks. S&P Dow Jones Indices expects S&P 500 companies to repurchase some $885 billion in stock in 2024, with more than $155 billion in purchases announced in just the first six weeks of the year. But with lingering uncertainty about the durability of the economy as well as new questions about the future of interest rates, are share buybacks an effective allocation of capital in environments like today's?

Stock buybacks are a time-tested means of increasing shareholder value

> **On a longer-term time frame, the compounding effect of a declining share count can unlock significant value for shareholders.**

There are any number of things a company can do with earnings: organically reinvest, retain the cash, or distribute some of those earnings back to shareholders. The most common means of returning earnings to shareholders is by paying a dividend, but companies can also decide to buy back shares, which increases existing shareholders' proportional ownership.

For example, say an investor owns 1% of a company that repurchases 5% of its shares outstanding annually for five years; the investor's ownership stake would increase by almost 30% without any incremental capital.

There are several reasons why a company would want to deploy capital to buy back shares. For companies that pay out dividends, fewer outstanding shares means the same pool of money can be distributed among a smaller base of shareholders—and that can increase the level of income for individual recipients. Reducing a company's cash on hand through repurchasing shares can also boost certain closely watched financial metrics, such as return on invested capital, as well as earnings and free cash flow on a per-share basis. These types of metrics are essentially fractional calculations: By reducing the denominator in each (through share buybacks), the result increases even though the numerator is unchanged. It might seem academic, but improving these types of financial metrics can act as a tailwind for a stock and ultimately help drive prices higher. On a longer-term time frame, the compounding effect of a declining share count can unlock significant value for shareholders.

CASE STUDY:

How one auto parts retailer turbocharged its stock performance

AutoZone provides an illustration of the potential power behind steady earnings growth paired with consistent share repurchases. In the late 1990s, AutoZone's management team recognized that its capital needs were relatively low, so the team elected to direct all the company's free cash flow to shareholders through repurchases. Since then, the company has reduced its net shares outstanding by more than 90%. While the 6% average revenue growth and 10% net income growth the company has recorded over that time frame haven't exactly been remarkable, the firm has stood out by posting more than 20 consecutive years of positive earnings growth. By continually repurchasing shares while steadily growing the bottom line, the company's earnings per share have expanded over the past 25 years at a compound annual growth rate (CAGR) of around 20%. Similarly, the stock has compounded at approximately 20% annually over those 25 years, resulting in a more than 85-fold cumulative gain.

Had the company not consistently repurchased shares over that period, its earnings per share would have grown at a mere 10% CAGR, according to our calculations. Applying the stock's mid-February 2024 earnings-per-share valuation multiple, the stock would similarly have been almost 90% lower than its share price at that time had the company not engaged in share buybacks.

Stock buybacks can be a better creator of shareholder value

In many cases, share buybacks are a more efficient way to return capital to shareholders than dividends, provided the company appears to have reasonably durable future earnings growth and a reasonable valuation. One reason is the comparative flexibility that buybacks offer. When it comes to dividends, companies are often penalized for cutting or suspending their payments and generally take pains to avoid doing so. Companies that offer a high dividend payout ratio (as a percentage of earnings per share or free cash flow) can find themselves essentially handcuffed to those dividend payments and unable to pursue other options that may deliver higher returns versus a dividend, especially during volatile periods, such as aggressive share repurchases or opportunistic acquisitions.

Dividends have drawbacks for investors as well. They're relatively inefficient from a tax perspective, as dividends are subject to double taxation—first at the corporate level (when the income is earned) and then at the individual level (when it's received). Dividends also introduce reinvestment risk, in that distributions may be able to purchase less and less of a stock that continues to appreciate over time.

What the performance numbers show about buybacks and shareholder yield

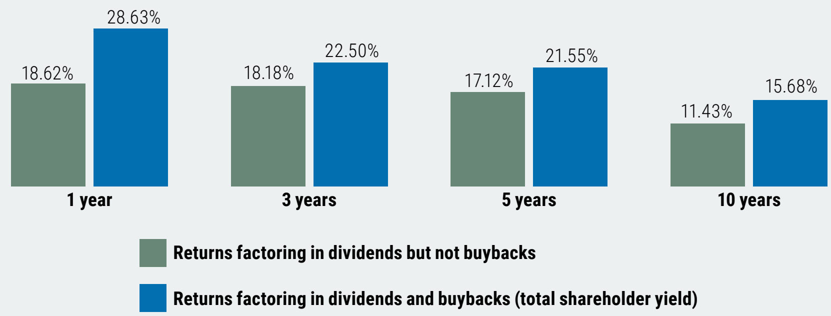
In an effort to quantify the importance of buybacks, we compared the performance of the top quintile of dividend-yielding stocks across the U.S. equity market (as represented by the Russell 3000 Index) with the returns of the top quintile as measured by total shareholder yield, which factors in both dividends and buybacks.

We found that the addition of buybacks alongside dividends significantly enhanced those stocks' total returns over every time period we looked at. Our conclusion: The dividend-paying stocks of companies that are the most active at buying back shares have consistently generated stronger returns than stocks that return most capital solely through dividends.

As for where to find those companies engaged in share buybacks, investors can look at a measure called shareholder yield, which incorporates both dividend payments and repurchase programs. We've found it's not always the case that healthy dividends correlate to an attractive total shareholder yield: Communication Services and Financials, for example, are two of the leading sectors in terms of shareholder yield, but aren't necessarily known for their robust dividend payouts.

Stocks with the greatest shareholder yield have outperformed the highest dividend payers

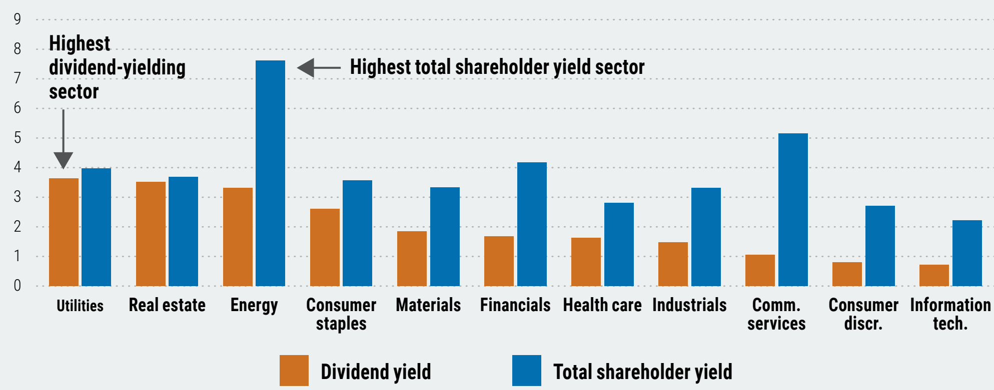
Annualized returns (%) for periods ended 12/31/23



Source: Boston Partners, March 2024. Dividend yield is a dividend expressed as a percentage of a current share price. Total shareholder yield is the sum of the stock's direct payments to shareholders through dividends plus indirect payments such as buybacks as measured by the percentage decrease in a company's outstanding shares. The Russell 3000 Index tracks the performance of 3,000 large-, mid-, and small-cap companies in the United States. It is not possible to invest directly in an index. Past performance is not an indication of future results.

High dividend-yielding sectors aren't necessarily the leaders in total shareholder yield

Dividend yields vs. total shareholder yields for S&P 500 Index sectors as of 12/31/23 (%)



Source: S&P Dow Jones Indices, March 2024. Dividend yield is a dividend expressed as a percentage of a current share price. Total shareholder yield is the sum of the stock's direct payments to shareholders through dividends plus indirect payments such as buybacks as measured by the percentage decrease in a company's outstanding shares. The S&P 500 Index tracks the performance of 500 of the largest publicly traded companies in the United States. It is not possible to invest directly in an index. Past performance is not an indication of future results.

From an investment perspective, we believe it's preferable that businesses with relatively low capital needs return capital to shareholders through share repurchases and/or dividends, absent a higher-returning use of that cash for expansion or acquisition. Typically, the incremental return on capital of expansion or acquisition is less that what's gained through purchasing shares, assuming the valuation of repurchased shares is attractive. Our experience has shown that investing in the stocks of companies that have consistently repurchased shares offers the potential for a powerful compounding effect on returns over the long term, particularly among companies with healthy balance sheets and stable revenue streams.

About Boston Partners

Boston Partners is a value equity manager with a distinctive approach to investing — one that combines attractive valuation characteristics with strong business fundamentals and positive business momentum in every portfolio. The consistent application of this approach over nearly 30 years by an experienced and long-tenured team has created a proven record of performance across economic cycles, market capitalizations, and geographies.

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