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BARRON'S COVER

Why the Buyback Boom Is Bullish for Investors

PHOTO: JOSH HOLINATY

By Andrew Bary May 12, 2018

If you need a reason to be in stocks right now, you can look no further than the growing tidal wave of share repurchases.

Buybacks usually support stock prices by reducing share counts and boosting earnings per share. And companies that make announcements of big buybacks—like Apple's (ticker: AAPL) stunning, new, $100 billion program—tend to be brimming with confidence in their C-suites. Indeed, shares of companies with big buybacks have historically outperformed the market.

Standard & Poor's 500 companies are on track to announce $650 billion worth of buybacks this year, according to a Goldman Sachs estimate, smashing the previous record of $589 billion set in 2007.

Buybacks offer investors an effective "yield" of about 3%, calculated by dividing repurchases by the $23 trillion market value of the Standard & Poor's 500 index. Combine that with the 1.9% current dividend yield and investors should get a nearly 5% combined yield this year.

Even as interest rates rise, that combined yield stacks up well against the alternatives, with money-market funds approaching 2% and the benchmark 10-year Treasury note at 3%.

It's this math—and the prospect of higher corporate earnings and dividends—that excites Warren Buffett. "If you had to choose between buying long-term bonds or equities, I would choose equities in a minute," Buffett told CNBC earlier this year.

And expect more announcements of big stock repurchases and dividend increases coming soon from the banks, once the Federal Reserve completes its annual stress tests.

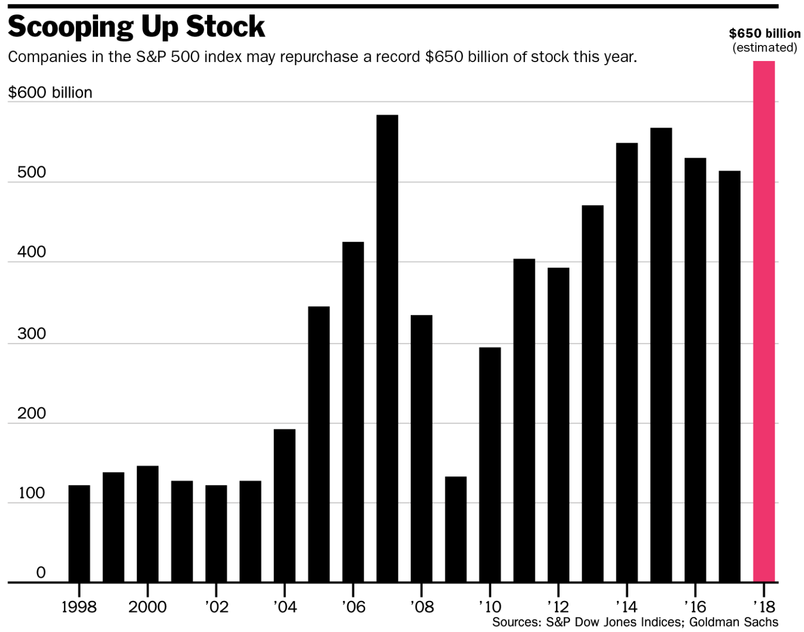
In fact, there are a number of enormous companies that could be doing a lot more to shower cash on shareholders, including Buffett's own company. In addition to Berkshire Hathaway (BRK.A), others companies in the top 10 of the S&P 500 that have been cool to buybacks are Amazon.com (AMZN), Exxon Mobil (XOM), Facebook (FB), and Alphabet (GOOGL).

Berkshire and Alphabet, the parent of Google, have the wherewithal to boost their buyback and ought to do so. Amazon probably should not, because of its attractive investment opportunities and very high equity valuation. Exxon Mobil has focused on its dividend—now a generous 4%—and hasn't had the free cash flow for a meaningful buyback.

Do share repurchases really buoy stock prices in the long term?

There is debate over that question. IBM (IBM) and General Electric (GE) are two prominent examples of companies that executed large buybacks at high prices and have now scaled back or eliminated those programs in the face of earnings pressures.

And there is also the question of whether a company would be better off using its cash to make investments rather than buy back shares. No matter how you answer that, there is little evidence that big



companies making buybacks are skimping on capital spending.

"Investors are constantly evaluating management decisions on the use of capital and judging which uses will offer the best returns," says Anthony DiClemente, a technology analyst with Evercore ISI. "If companies are less innovative or more mature, investors would prefer a buyback. Investors trust [Amazon CEO] Jeff Bezos to invest capital in high-returning businesses. They don't want to see buybacks. Google has more in common with Apple and should be buying back a greater percentage of its stock."

Apple certainly doesn't appear to be starving its operations. It plowed nearly $13 billion into research and development and capital spending in the first six months of its current fiscal year ending on Sept. 30. In the first quarter, Apple made $23.5 billion of stock repurchases—a record for a U.S. company. It has now repurchased $200 billion since its program began in 2012.

Mindful of the political criticism of buybacks as a gift to wealthy shareholders, Apple has emphasized that it plans $30 billion of domestic capital expenditures in the next five years, as well, and will create some 20,000 U.S. jobs.

But it isn't letting up on buybacks. The company won't say how much it plans to repurchase in the coming quarters, other than it aims to move at a "fast pace."

Analysts expect Apple to buy back $70 billion to $80 billion of stock annually in the next few years. That translates into an impressive buyback yield of 7% to 8%. Apple is funding the repurchases with its ample earnings power—now about $60 billion a year—and by gradually bringing down to zero its net cash position of $145 billion. After a 16% increase in the payout recently to 73 cents a share, Apple yields 1.5%.

"What is unique about the Apple situation is that, unlike so many other corporations, it will buy back enough stock to move the needle on earnings per share," says David Rolfe, chief investment officer at Wedgewood Partners in Ladue, Mo., an Apple holder.

The consensus earnings estimate for Apple's fiscal year ending in September 2019 is about $13 a share, but Rolfe thinks it could hit $14, up from an anticipated $12 a share in earnings in the current fiscal year. Rolfe argues that Apple looks appealing at 14 times potential fiscal-year 2019 earnings.

Buybacks are an important part of the reason that Buffett has become such a big fan of Apple. "I'm delighted to see them repurchasing shares," Buffett said at Berkshire's annual meeting last week. "I love the idea of having our 5%, or whatever it is, maybe grow to 6% or 7% without our laying out a dime."

Berkshire has bought 75 million shares of Apple this year, lifting its stake to about 5% and making the company Berkshire's largest equity holding by a wide margin.

Helped by the news of Berkshire's investment, Apple finished at $188 on Friday, up 3% last week after hitting a record $190. Apple's market value now stands at $930 billion, and the company is poised to become the first to hit $1 trillion. To reach that mark, the stock price needs to hit $204.

Apple's share count, which stands at 4.9 billion, could drop by 15% by September 2020, the end of Apple's fiscal year. It already has fallen almost 25% since the repurchase program began.

How the Biggest Fare on Buybacks...

What the top companies in the S&P 500 have spent repurchasing shares.

Company / Ticker	Recent Price	52-Week Change	2018E EPS	2018E P/E	Market Value (bil)	Fiscal 2017 Buybacks (bil)	Buyback Yield	Dividend Yield
Apple / AAPL*	$190.04	24.0%	$11.52	16.5	$934.1	$33.0	3.5%	1.5%
Amazon.com / AMZN	1609.08	69.6	12.07	133.3	780.8	None	None	None
Alphabet / GOOGL	1105.47	15.8	43.65	25.3	764.9	4.8	0.6	None
Microsoft / MSFT**	97.91	41.3	3.82	25.6	752.3	10.3	1.4	1.7
Facebook / FB	185.53	23.5	7.58	24.5	537.2	2.1	0.4	None
Berkshire Hathaway / BRK.A	301,630	22.7	13,415	22.5	496.4	None	None	None
JPMorgan Chase / JPM	114.29	30.7	8.97	12.7	389.1	15.4	4.0	2.0
Exxon Mobil / XOM	81.72	-0.2	4.66	17.5	346.0	0.5	0.1	4.0
Johnson & Johnson / JNJ	125.35	2.1	8.12	15.4	336.2	6.4	1.9	2.9
Bank of America / BAC	30.89	27.9	2.56	12.1	313.2	12.8	4.1	1.6

...And What Some of the Busiest Have Done

Company / Ticker	Recent Price	52-Week Change	2018E EPS	2018E P/E	Market Value (bil)	Fiscal 2017 Buybacks (bil)	Buyback Yield	Dividend Yield
Charter Communications / CHTR	$272.83	-16.2%	$3.92	69.5	$71.8	$11.6	16.2%	None
American International Group / AIG	52.75	-14.1	4.93	10.7	47.4	6.3	13.3	2.4%
General Motors / GM	37.16	8.6	6.36	5.8	52.4	4.5	8.6	4.1
Citigroup / C	72.57	20.2	6.45	11.3	185.0	14.5	7.8	1.8
eBay / EBAY	38.50	13.6	2.29	16.8	38.3	2.7	7.0	None
CVS Health / CVS	62.44	-22.9	6.86	9.1	63.5	4.4	6.9	3.2
Marathon Petroleum / MPC	77.54	48.2	4.67	16.6	35.8	2.4	6.7	2.4
Marriott International / MAR	138.57	34.2	5.45	25.4	49.0	3.0	6.1	1.2
Delta Air Lines / DAL	52.06	4.2	6.20	8.4	36.5	1.7	4.7	2.3
Boeing / BA	344.07	87.8	14.62	23.5	200.5	9.2	4.6	2.0

E=Estimate *Fiscal year ends Sept. **Fiscal year ends June Sources: Bloomberg; company reports

Buffett may be excited about Apple, but another buyback story burned Berkshire in the past. Buffett cited an aggressive IBM repurchase program as a major reason he bought the stock starting in 2011. That investment—$13 billion at its peak—probably was a loser for Berkshire. IBM now trades for $144, below Berkshire's average cost of about $170; Berkshire finished liquidating its IBM holding in the first quarter.

IBM and GE are not the only exceptions to the trend of companies with big buyback programs beating the market. A nearby table shows 10 companies that bought back a high percentage of their shares in 2017. Boeing (BA), Marriott International (MAR), and Marathon Petroleum (MPC) have been big winners, while Charter Communications (CHTR) and American International Group (AIG) have declined. In all five cases, fundamentals—earnings, revenue, and business trends—have been drivers of the stocks.

The two leading candidates for big buybacks, Alphabet and Berkshire Hathaway, are both sitting on roughly $100 billion of cash. But both are controlled by strong-willed leaders who haven't been keen on buying back a lot of their own stock.

Alphabet began a share-repurchase program in late 2015, but it's modest in size and hasn't been enough to offset the large amount of stock-based compensation it hands out. Alphabet bought back $4.8 billion in stock last year, and issued $7.7 billion in shares to employees. Its share count edged up to 705 million at the end of the first quarter, from 702 million a year earlier.

Alphabet could comfortably repurchase $20 billion annually, or 65% of projected 2018 net income.

"Alphabet should be returning more cash to shareholders," says Mark Mahaney, an analyst with RBC Capital Markets. "There's no reason to have $100 billion of cash on the balance sheet. Given all the cash the company has, it should be leaping, not stepping, toward bigger share repurchases."

A more aggressive buyback program could lift Alphabet shares, which trade for $1,103, or 25 times projected 2018 earnings of $44 a share.

As *Barron's* noted in April, Alphabet shares look appealing given the company's growth outlook and a valuation at about 21 times 2018 earnings, excluding net cash of $97 billion. Bulls like Mahaney value Alphabet at about $1,300. "Given the relatively low multiple on the stock, investors would welcome a bigger buyback and shrinking share count at Alphabet," Evercore's DiClemente says.

Alphabet is still growing nicely, with first-quarter revenues up 23% and adjusted earnings per share up 30%. Mahaney says it is reasonable to expect 15% to 20% annualized growth in earnings in the next three years.

Given that prospect and the likelihood that Alphabet shares will be higher in a few years, buying back more stock now seems like a good proposition. Alphabet declined to comment for this article, but the company doesn't put a high priority on share buybacks or dividends—it pays none. Its chief financial officer, Ruth Porat, said on the fourth-quarter conference call that the company favors organic growth, strategic opportunities, and capital expenditures. "And then, finally, that leaves return of capital," she said.

Buffett's reluctance for Berkshire buybacks is harder to understand, given his investment acumen and his support of buybacks elsewhere. Berkshire has a threshold of 1.2 times book value before it will buy back stock. But the stock has rarely, if ever, traded below 1.2 times book value in recent years, and so the company has not repurchased any stock. The Class A shares, now about $300,000 each, fetch 1.4 times book.

Investors stand ready to purchase Berkshire shares if they get anywhere close to 1.2 times book value, figuring that Berkshire is effectively putting a floor under the stock at that level.

"I'd love for Buffett to get rid of that quantitative measure and take a more qualitative approach, given that the company has so much cash," says Rolfe of Wedgewood Partners, which holds Berkshire shares. "Berkshire should buy back stock if it doesn't have alternatives for the cash and the stock is trading below Buffett's calculation of intrinsic value."

Another approach would be to simply lift the cap to 1.25 or 1.3 times book value.

Buffett has said share buybacks make sense at 1.2 times book because that's sufficiently below intrinsic value to make repurchases nicely accretive to intrinsic value. Buffett hasn't disclosed his estimate of intrinsic value other than to say that book value is a "significantly understated tracking measure for Berkshire's intrinsic value."

Book is below intrinsic value because many Berkshire businesses, including Geico and the Burlington Northern railroad, are worth considerably more than the carrying value on Berkshire's balance sheet.

Buffett declined to comment to *Barron's* on the topic. But he told CNBC earlier this year that the cap might be lifted down the road. "If we were going to spend a lot of money to buy in stock at some time in the future, and it was 125% or 127% or something like that, we'd probably go in that direction," he said.

For now, Buffett would rather spend $12 billion or $13 billion to buy Apple shares than repurchase Berkshire's own shares.

But is Apple so much cheaper than Berkshire? While Berkshire reported a loss for the first quarter, it was the result of a decline in the value of the company's $167 billion equity portfolio, reflecting new accounting rules that Buffett has said distort quarterly results. The more important underlying trends at Berkshire's major businesses—insurance, railroad, utilities, and manufacturing—were strong.

For investors looking for aggressive buyback activity, the banking sector stands out. The giant money centers and regional banks should return nearly all of their net income to shareholders in buybacks and dividends in the 12 months starting on July 1, in a roughly two-thirds to one-third split of buybacks and dividends, estimates Barclays analyst Jason Goldberg.

The repurchase "yield" among big banks should average more than 5%, with Citigroup (C) expected to buy back about 10% of its shares, and Bank of America and Wells Fargo, 7% each. The average dividend yield in the group is 2%. "Historically, banks were good total-return stocks, and then the financial crisis hit and they weren't," Goldberg says. "Going forward, they should regain that status with decent dividend yields and stock buyback programs."

Banks are expected to announce their dividend and buyback plans for the next 12 months at the end of June, after the Fed's evaluations. Goldberg favors JPMorgan Chase (JPM) and Citigroup. He likes JPMorgan's peer-leading returns and valuation at about 13 times estimated 2018 earnings. The stock trades at about $114. Citigroup probably has the best buyback story among top banks, which helped attract activist investor ValueAct Partners to take a stake of almost 1% in the company.

Citigroup is targeting earnings of $9 a share in 2020, up from $5.33 last year, in part because of a big reduction in its share count. Citigroup traded on Friday at $73, or 11 times projected 2018 profits and just 1.2 times tangible book.

While it has been cresting for a while, it's not too late to ride the buyback wave. Investors can still catch it through stocks like Apple, JPMorgan, and Citigroup, or by considering Alphabet and Berkshire—two strong fundamental stories—that could benefit from more aggressive buyback programs.

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