



STOCK REPURCHASES: MORE MONEY, MORE PROBLEMS?

IDENTIFYING COMPANIES THAT CREATE VALUE THROUGH BUYBACKS

OVERVIEW

- ▶ As the economic recovery continues, S&P 500 companies are reporting record quarterly earnings, with EPS for Q3 2011 at an all-time high. These high earnings help generate excess cash, which may be used to reinvest in the business, pay dividends, make acquisitions, and/or repurchase company stock.
- ▶ Stock repurchase activity is rising to levels unseen since before the financial crisis.
- ▶ S&P 500 companies showed positive correlation between repurchase activity and stock price direction; companies were repurchasing more shares at high prices and fewer shares at lower prices.
- ▶ We therefore examined those companies that bought back shares at low prices, and whose prices subsequently rose. We found that surprisingly few companies were able to repurchase shares at lower prices as well as see future price appreciation within the following 12 months.
- ▶ We used Thomson Reuters Spreadsheet Link to assess which companies have better records of creating value to shareholders through stock repurchases.

BACKGROUND

During the third quarter of 2011, combined EPS of the S&P constituents achieved a very strong 18.0% year-over-year growth rate. Earnings were at a record high as the economy continued its recovery. In aggregate, high net income is accompanied by higher levels of free cash flow. Companies have several options for using this excess cash flow – investing in their businesses, paying dividends to shareholders, making acquisitions, and/or repurchasing company stock.

WHY REPURCHASE STOCK?

Stock repurchases are increasing in popularity as a way to use free cash flow for several reasons. For one, buybacks are popular with investors because they are often a better use of cash if no other attractive uses of cash exist. Stock repurchases are also tax-efficient, as they are a way to return cash to stockholders without triggering taxes on capital gains or dividends. Buybacks, however, don't directly give cash to stockholders; rather they decrease the number of shares outstanding, increasing each stockholder's ownership of the firm. Additionally, since companies are purchasing stock, there is the consideration of what the asset they are purchasing is worth. Since the companies themselves have better information about the business than the market does, stock buybacks could be interpreted as a signal that management believes that the company is undervalued in the market. Stock buybacks can significantly affect the performance of companies if they are able to repurchase stock prior to price increases.

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METHODOLOGY

To identify companies that have a record of timing their stock repurchases to add value to shareholders, we used the Thomson Reuters Spreadsheet Link (TRSL) Excel add-in to pull share repurchase, price, and market capitalization data for the past 10 years for the constituents of the S&P 500 index as of the start of the study. Dividing quarterly share repurchases by market cap normalizes repurchase activity, showing how what percentage of the outstanding stock a company is buying in a given quarter. By comparing quarterly stock repurchase activity with stock price and subsequent performance; we can identify companies which have historically bought low to the benefit of shareholders, and which companies have shown poor timing skills.

Once the data has been populated, we removed companies that bought stock in less than 5 of the 40 quarters during the period reviewed. This eliminated the impact of companies without an active stock repurchase policy and improves the statistical significance of the results, by guaranteeing at least 5 data points. Using the remaining 380 companies in our sample we then calculated 3-month, 6-month, and 1-year forward returns. Next, we ran several correlation analyses for each stock, comparing repurchases with price, and each forward performance measure. We define correlation strength as follows:

EXHIBIT 1. CORRELATION DEFINITIONS

Value	Correlation Type	Strength
0.50 to 1.0	Positive	Strong
0.30 to 0.49		Moderate
0.10 to 0.29		Weak
-0.09 to 0.09	Not Significant	
-0.29 to -0.10	Negative	Weak
-0.49 to -0.30		Moderate
-1.0 to -0.50		Strong

To find companies that add value through stock repurchases, we looked for negative correlation between repurchases and stock price. This allowed us to identify companies that increased their purchases when the stock price was low. Additionally, we also looked for positive correlation between repurchases and future performance.

To find companies that did not add value through stock repurchases, we looked for positive correlation between repurchases and stock price. This allowed us to identify companies that increased their purchases when the stock price was high. Additionally, we also looked for negative correlation between repurchases and future performance.

AGGREGATE S&P 500 PERFORMANCE

Total quarterly stock repurchases for the S&P 500 show a 0.76 correlation coefficient when compared with the level of the index (Exhibit 2). To consider the possibility that this correlation was driven by companies saving cash and reducing stock buybacks during the financial crisis when stock prices were also low, we repeated the analysis excluding the data from Q3 2008 through Q2 2009. Similar results were observed. This high positive correlation indicates that companies in the index as a whole are repurchasing more stock when the price is high and buying less when the price is low. This could be seen as poor market timing by company management. Another explanation for this is that higher cash flows are more likely to come during periods of high stock prices when companies are performing well.

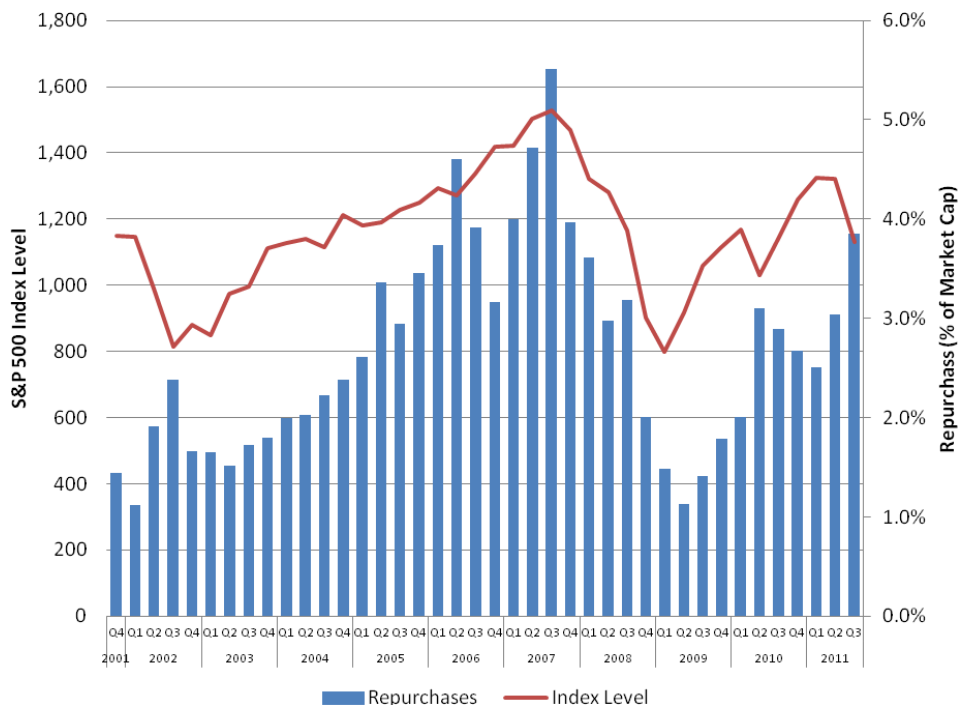
EXHIBIT 2. S&P 500 CORRELATION SUMMARY

	Repurchase Correlation with:			
	Price	3-Mo Ret	6-Mo Ret	1-Yr Ret
S&P 500 Index	0.76	-0.11	-0.18	-0.36
S&P 500 Index (excl Q3 08 – Q2 09)	0.74	0.01	-0.03	-0.30

Source: Thomson One

To evaluate the ability of companies to opportunistically make stock buybacks when share prices are lower, we also calculated the correlations between repurchase activity and stock returns in the periods following the buybacks. For the S&P 500, we find that repurchases were weakly to moderately negatively correlated with future returns as shown in the table above, indicating poor timing of purchases in general.

EXHIBIT 3. QUARTERLY S&P 500 STOCK REPURCHASES VS. INDEX LEVEL



Source: Thomson One

At a company level, we can see this trend continuing when looking at the number of companies at each level of correlation with price and future returns. Of the 380 companies in the S&P 500 that repurchased shares in at least 5 of the quarters examined, 84 of them had moderate or strong positive correlation between buybacks and share price, while 60 companies had moderate or strong negative correlation. Looking forward, more companies show significant negative correlation with future stock returns than show significant positive correlation, again showing poor overall results following share repurchases.

EXHIBIT 4. S&P 500 CORRELATION STRENGTH BREAKDOWN

	Number of Companies Correlated with:			
	Price	3-Mo Ret	6-Mo Ret	1-Yr Ret
Strong Positive Correlation	23	16	12	18
Moderate Positive Correlation	61	27	30	39
Weak or Not Significant Correlation	232	296	280	250
Moderate Negative Correlation	42	28	45	46
Strong Negative Correlation	18	10	10	26

Source: Thomson One

TOP COMPANIES FOR ADDING VALUE THROUGH BUYBACKS

To select the companies with the best records of adding value through share repurchases, we sorted the companies by the correlation between repurchases and price. After sorting to determine the companies with the most significant negative correlation, we further narrowed the field by choosing companies that had positive correlation between buybacks and future returns. This allowed us to identify companies that bought their stock

back when the price was low, but who also made purchases followed by periods of higher stock prices. Results for the top five active companies are summarized in Exhibit 5.

EXHIBIT 5. TOP COMPANIES CORRELATION SUMMARY

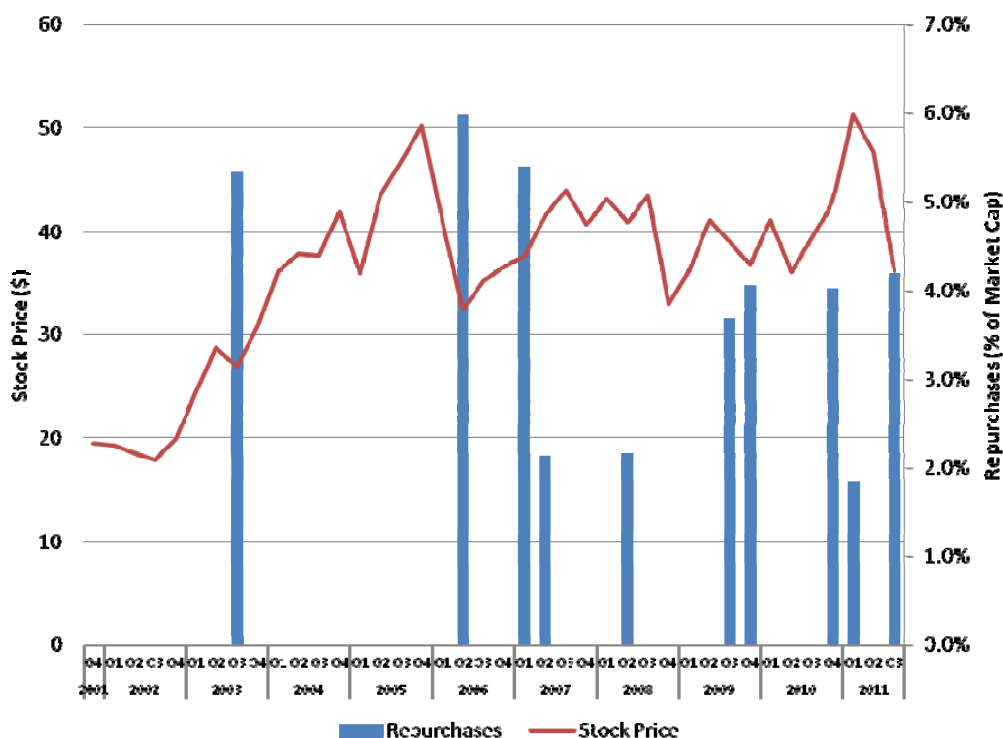
Ticker	Sector	Company Name	Repurchase Correlation with:			
			Price	3-Mo Ret	6-Mo Ret	1-Yr Ret
EOG	Energy	EOG Resources Inc.	-0.83	0.14	0.05	0.03
STJ	Health Care	St Jude Medical, Inc.	-0.79	0.51	0.85	0.83
MOLX	Info. Technology	Molex, Inc.	-0.66	0.06	0.09	0.19
JCP	Consumer Disc	JC Penney Inc.	-0.61	0.43	0.31	0.51
TXU*	Utilities	TXU Corp	-0.58	0.36	0.35	0.27
EDS*	Info. Technology	Electronic Data Systems	-0.56	0.64	0.48	0.65
TIN	Materials	Temple Inland Company	-0.52	0.14	0.31	0.27

Source: Thomson One

* Company is no longer active

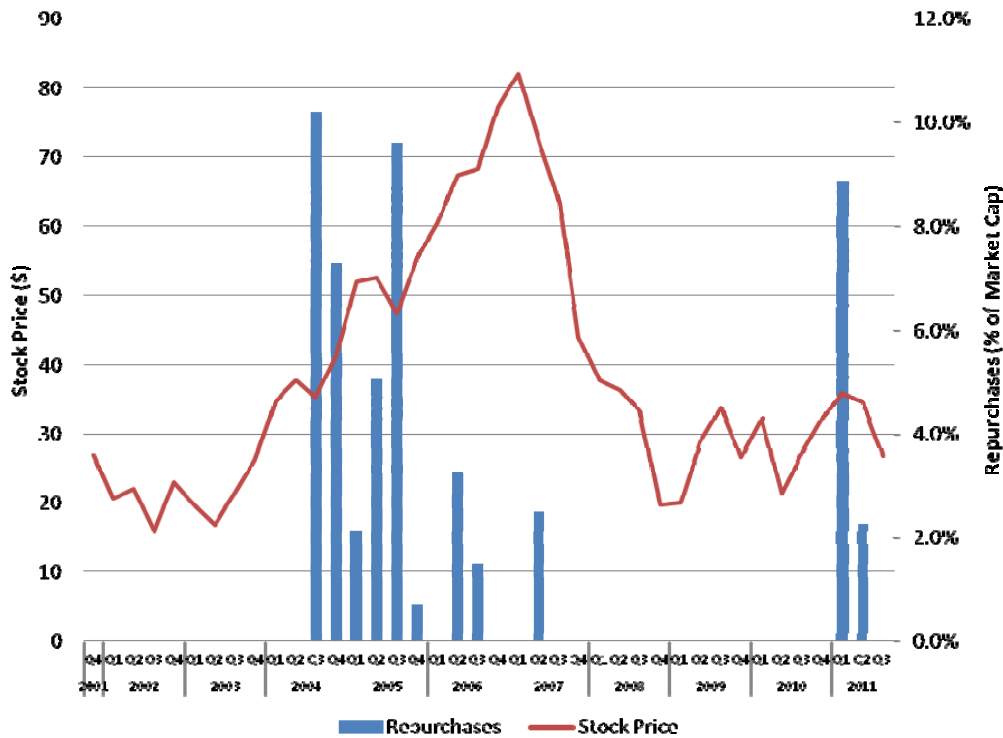
The general repurchase activity pattern for these companies is that they don't necessarily repurchase shares on a regular basis. Rather, they opportunistically purchase shares when the stock price decreases. This is demonstrated by St. Jude Medical, Inc. and JC Penney Inc., shown below in Exhibits 6 and 7, respectively. Both of these companies have successfully bought back stock on price dips and then reduced or stopped buying back stock when the share price recovered. Whether the buybacks sent signals to investors that resulted in increased prices or the companies were simply taking advantage of dips in price to pick up some cheap shares, the actions were beneficial to owners of the stock.

EXHIBIT 6. QUARTERLY ST. JUDE MEDICAL, INC. SHARE REPURCHASES VS. STOCK PRICE



Source: Thomson One

EXHIBIT 7. QUARTERLY JC PENNEY INC. SHARE REPURCHASES VS. STOCK PRICE



Source: Thomson One

WORST COMPANIES FOR ADDING VALUE THROUGH BUYBACKS

By sorting our sample by high correlation between price and repurchase activity, we can identify companies that have historically bought more of their own stock at times when prices were high. Then, we can narrow down this list by selecting companies with negative correlation between repurchases and future returns to find companies that also had price declines after large share repurchases. In Exhibit 11 below are the five active companies with highest correlation between price and buybacks that also had negative correlation with subsequent returns.

EXHIBIT 8. BOTTOM COMPANIES CORRELATION SUMMARY

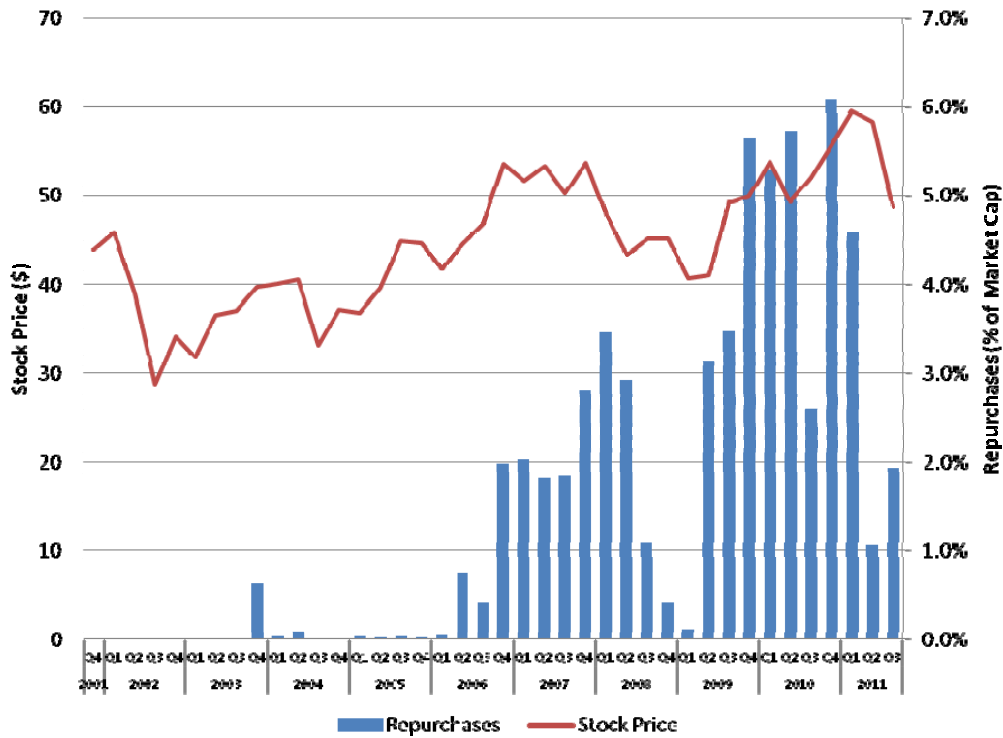
Ticker	Sector	Company Name	Repurchase Correlation with:			
			Price	3-Mo Ret	6-Mo Ret	1-Yr Ret
F	Consumer Disc.	Ford Motor Company	0.90	-0.03	-0.31	-0.35
TRV	Financials	Travelers Companies Inc.	0.63	0.02	-0.08	-0.13
XOM	Energy	Exxon Mobil Corp	0.62	-0.02	-0.33	-0.60
FDX	Industrials	FedEx Corporation	0.59	-0.53	-0.29	-0.07
MER*	Financials	Merrill Lynch & Co	0.58	-0.17	-0.12	-0.53
EXC	Utilities	Excelon Corporation	0.53	0.13	-0.33	-0.58

Source: Thomson One

* Company is no longer active

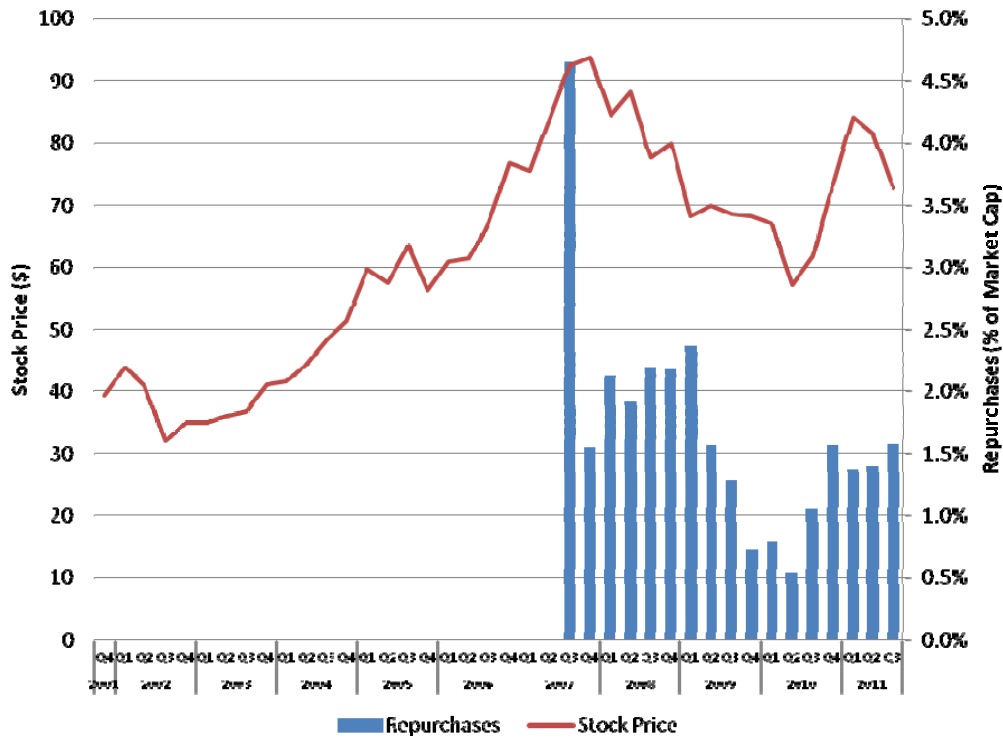
The companies at the bottom of the list for timing their stock repurchases generally follow the pattern of buy high, don't buy low. This is most noticeable when there is a peak in the stock price that coincides with a large stock repurchase. When the stock price declines, buyback activity usually declines with it, as is the case with Travelers Companies, Inc. (Exhibit 9). Travelers' repurchase activity has tended to lag its stock price with buyback activity increasing several quarters after stock price increases, with the opposite happening when the stock price decreases. This can be seen even more dramatically with Exxon Mobil Corporation, which had its first large repurchase one quarter before its all-time stock price peak and then reduced repurchases as its stock price fell.

EXHIBIT 9. QUARTERLY TRAVELERS COMPANIES INC. SHARE REPURCHASES VS. STOCK PRICE



Source: Thomson One

EXHIBIT 10. QUARTERLY EXXON MOBIL CORPORATION SHARE REPURCHASES VS. STOCK PRICE



Source: Thomson One

EXAMPLE: NETFLIX

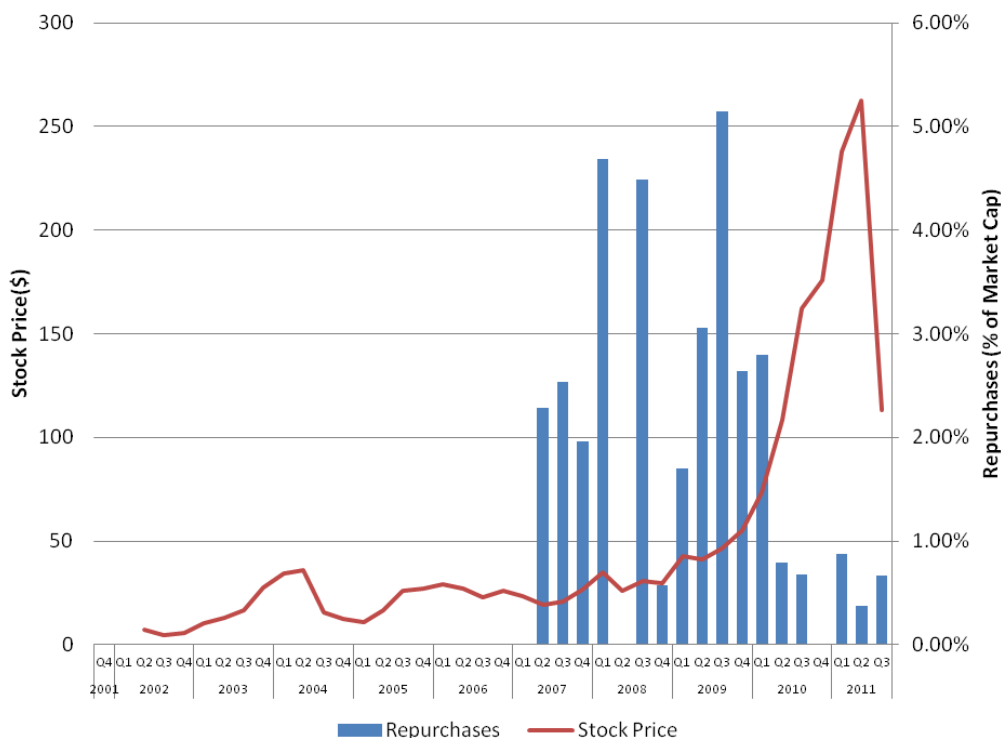
Although Netflix was not in our original sample because it was not in the S&P 500 at the beginning of our study period, its recent activity serves as an instructive example of the risk associated with stock repurchases. As seen in the chart below, Netflix had a good track record of share buybacks at low prices from 2007 – 2009. However, when the stock price increased dramatically throughout 2010 and 2011, the company continued repurchasing shares even as the price approached \$300/share in July, up from \$55.09 at the end of 2009. After Netflix’s share price tumbled throughout September and October, the company was forced to issue \$200 million in common stock at \$70/share and another \$200 million in convertible bonds with a conversion price of \$85.80/share to fund its business expansion.

EXHIBIT 11. NETFLIX CORRELATION SUMMARY

Ticker	Sector	Company Name	Repurchase Correlation with:			
			Price	3-Mo Ret	6-Mo Ret	1-Yr Ret
NFLX	Consumer Disc	Netflix Inc	0.28	-0.14	-0.04	0.09

Source: Thomson One

EXHIBIT 12. QUARTERLY NETFLIX SHARE REPURCHASES VS. STOCK PRICE



Source: Thomson One

CONCLUSION

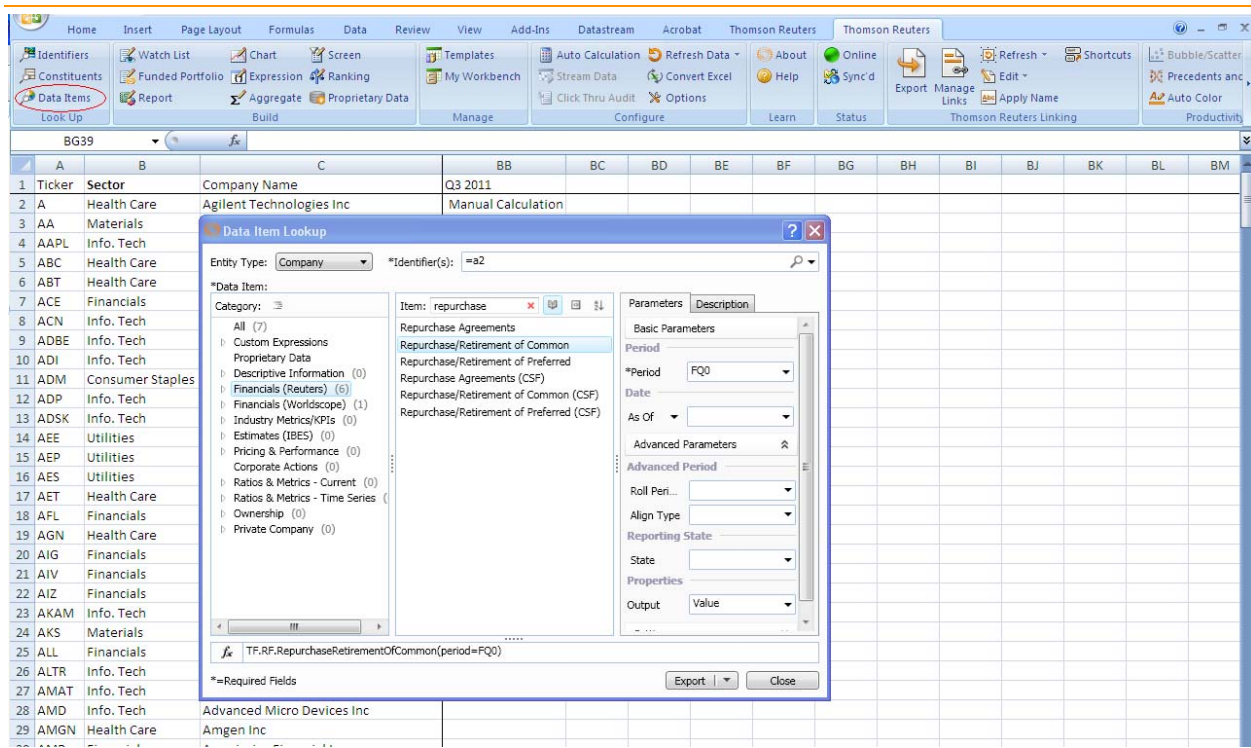
This study suggests that most companies in the S&P 500 index have not been successful in adding value through stock buybacks in the time frames we observed. The positive correlation between buyback activity and price suggests a combination of poor market timing as well as policies that increase repurchases when firms have more free cash flow. This may be partially explained by the need for officers of public companies to make some use of the cash on hand, including keeping less of it due to the possibility of being taken over. The negative correlation between repurchases and forward returns shows that most buybacks did not pay off within the year after purchase. However, we were able to identify firms with a record of strategically

repurchasing shares at low prices. Investors would be well advised to thoroughly analyze a company's share repurchase policy and track record when considering making an investment.

DO IT YOURSELF: RECREATE THIS ANALYSIS USING TRSL

To begin, we opened the Thomson Reuters tab to display the TRSL control buttons. We chose Data Items (circled in the screenshot below), which brings up the Data Item Lookup window. From this window, we referenced the cell that contains the company's ticker. We then used Financials (Reuters) for the category and Repurchase/Retirement of Common for the item and clicked Export. The resulting formula can be copied and pasted throughout the spreadsheet for the different time periods and companies.

EXHIBIT 13. THOMSON REUTERS SPREADSHEET LINK DATA ITEM LOOKUP – REPURCHASES



Source: Thomson Reuters Spreadsheet Link

Similarly, to download historical price data, we used the Data Items tab and selected Close Price, Daily from the Pricing and Performance category. We referenced the ticker as the Identifier and the final date of the quarter in the Parameters tab and clicked export.

EXHIBIT 14. THOMSON REUTERS SPREADSHEET LINK DATA ITEM LOOKUP – PRICES

The screenshot displays the Thomson Reuters Spreadsheet Link interface. A 'Data Item Lookup' dialog box is open, showing the following details:

- Entity Type:** Company
- *Identifier(s):** ==a2
- *Data Item:**
 - Category: Pricing & Performance (35)
 - Item: price
 - Selected Item: Close Price, Daily
- Parameters:**
 - Date: 9/30/2011
 - As Of: =\$BB\$2
 - Output: Value

The background spreadsheet shows a list of companies with columns for Ticker, Sector, Company Name, and Date. The 'Data Items' tab in the software's ribbon is highlighted.

Source: Thomson Reuters Spreadsheet Link

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