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Contents

The Assessment of Share Buybacks

> Elvis is not so difficult as Johnny Cash because his voice is so distinctive, if you try to copy Johnny Cash, it just sounds dumb.
>
> -Brian Setzer

What is a CEO's primary responsibility? Every investor would agree that's an important question, but we doubt many are prepared to render an immediate and confident answer. The more left-brained among us might gravitate towards answers involving operational efficiencies and strategy, while those of us who spend more time in the right half of our heads will focus on the ability to inspire and lead people. Ask William Thorndyke. Jr., though, and he will give you a much more focused answer: ***a CEO's primary responsibility is to allocate capital.***

William Thorndyke is the author of *The Outsiders*, an excellent survey of the eight most effective CEOs in modern history as measured by the increase to shareholder value over their tenures. Interestingly, almost all of them shared the similarity of running very flat organizations in which managers were given extreme autonomy, along with the expectation of maximizing cash flows. These CEO's considered it their most important job to decide what to do with that excess cash generated by their managers, with their options being 1) make acquisitions and internal investments, 2) pay dividends, or 3) buy back shares.

Unless you received too many participation trophies growing up, you probably want to know one thing: who was the best? Well, the following quote goes a long way towards answering that:

> "Henry Singleton has the best operating and capital deployment record in American business…if one took the 100 top business school graduates and made a composite of their triumphs, their record would not be as good as Singleton's."
>
> -Warren Buffett

Henry Singleton was the founder and CEO of Teledyne from 1960 to 1991. The affable Texan with a PhD in engineering from MIT was known for running a bare bones operation. Teledyne had 40,000 employees but fewer than 50 in the home office, which had no human resource or investor relations departments. However, what stood out the most about Singleton was that unlike his peers, he did not choose to use the excess capital his managers generated to pay dividends, but rather to do something few before him had done: buy back shares. In fact, during his tenure, Singleton bought back as astounding 90% of Teledyne. His careful capital allocation would have awarded an initial Teledyne investor an incredible 20.4% compounded annual return during his time at the reigns.

However, keep in mind that Singleton's buyback strategy, like Johnny Cash's voice, was very distinctive. Rather than initiate the never-ending perpetual buyback program that is so common today, he repurchased company shares in large blocks that coincided with low points in the company's stock valuation. Case in point, in 1980, he repurchased 20% of Teledyne in a tender offer when the company's PE ratio was at an all-time low. When Teledyne shares were selling at a premium in the market, he used company stock as a currency to fund acquisitions. Finally, in 1987, when Teledyne shares were at a near-high valuation and Singleton was unable to identify attractive acquisitions or capital projects, Teledyne paid its first-ever dividend to shareholders.

Fast forward to today, and share buybacks have become commonplace. They almost always illicit a positive response from investors and the financial press as a sign that management believes its stock represents a good value. Ask the typical investor (and some Wall Street analysts) why share buybacks are good for shareholders and you are likely to hear oversimplified explanations including:

- Fewer shares outstanding increases earnings per remaining share
- A reduction in assets from paying out cash means an overnight increase in return on assets
- The reduction in shareholders' equity means an immediate increase in return on equity

We recently read an author in the financial press make the following statement: "[Company X] reduced its share count by roughly 5% last year, thus increasing the relative value of each share by the same amount." Seems like sound logic on the surface, but like most things in life and financial analysis, it's just not that simple. Investors must determine the impact on real, intrinsic value of the company, not just the immediate accounting impact. It may be true that investors in Company X may have a 5% larger share of the company, but what if the future earnings power or financial condition of the remaining company has been compromised by a like amount (or more) in the process? Keep in mind that there are other motivations a manager may have for buying back shares other than maximizing shareholder value such as artificially inflating EPS growth to hit bonus targets, or countering the dilutive effect of overly-generous stock option issuance.

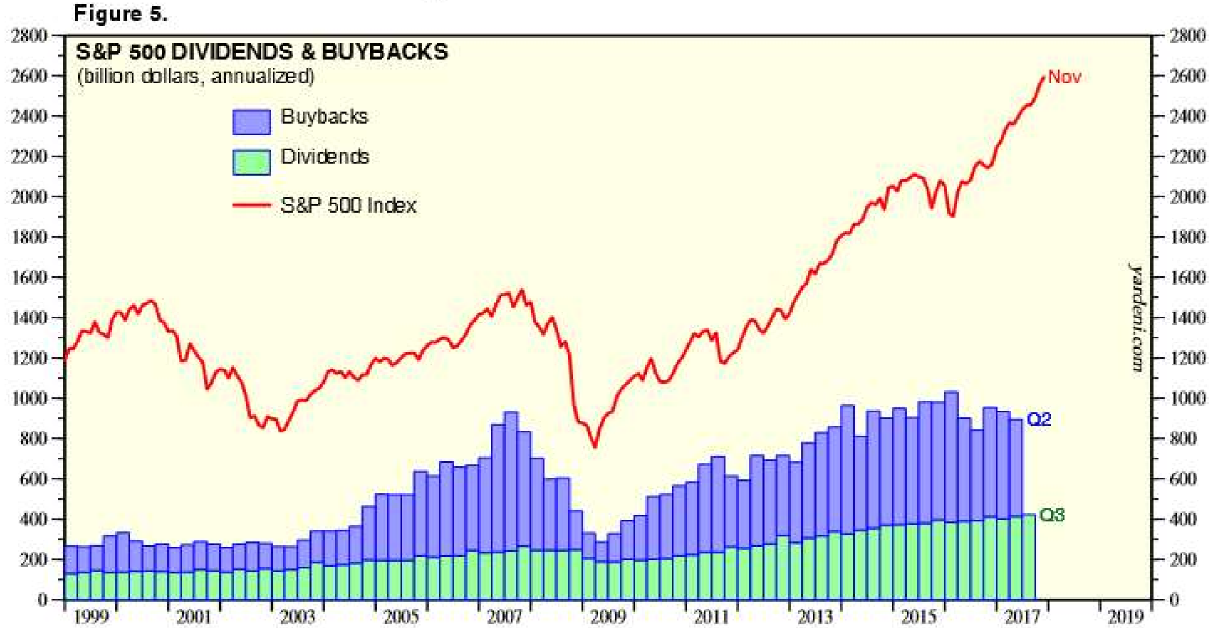
To begin the analysis, an investor should look at how the buyback is funded. **If management chooses to buy back shares with cash, one must consider alternative uses of the cash.** If projects with attractive returns are passed up, or necessary upgrades to assets are neglected in favor of spending the cash on buybacks, the future value of the company is being impaired.

If management chooses to issue debt to fund a buyback, one must consider the impact of the increased leverage on the company's cost of capital and overall risk picture. In some cases, a company may be underlevered and actually benefit from the tax break provided by the debt financing. However, a company with an already sizeable debt load may actually see its cost of capital increase from the increased risk associated with taking on even more debt.

Perhaps the key factor to examine to determine the value of a buyback to remaining shareholders is the price at which management is buying back the shares. Management buying back shares of its stock is not somehow different than an outside investment manager deciding to add shares of that company to its portfolio. If it's a bad investment for the portfolio manager, it's a bad investment for management and its shareholders as well. Still, managements continually demonstrate the inability to exercise disciplined judgement in the timing of share repurchases. Consider the following table complied by Yardeni Research:

Buybacks & Dividends

Figure 5.



Source: Standard & Poor's.

If managements, as a group, were truly focusing on buying back their companies' shares when they were selling at discount, buyback activity should be highest in periods when the markets are down. Unfortunately, managements historically increase their buyback activity when the market is at the top.

Much is made of the tax benefits of share buybacks avoiding the double taxation of dividends. However, we believe this is another overplayed defense of buybacks. Shareholders who tender their shares in a buyback pay capital gains taxes on any gains that are realized in the sale. If the buyback results in share price appreciation, shareholders who choose to stay will not have to pay capital gains taxes unless they sell their shares at a later time. However, as we noted above, the buyback may have actually impaired the intrinsic value of the firm, and buying back shares at historically high valuations is benefitting shareholders who are selling out at the expense of the shareholders who are staying. Investors would do well to keep that in mind the next time a new buyback is announced.

So, managers wishing to follow Henry Singleton's example should only undertake buyback programs that meet the following requirements:

- The buyback should be executed at a price at or preferably below the fair value of the company per share

- The money spent on the buyback should not encroach on projects with returns significantly higher than the firm cost of capital, or lead to the neglect of necessary capital spending and upgrades

- It should only be financed with debt if the company has a low degree of leverage and will therefore benefit from the interest expense tax benefit, and the increased debt will not meaningfully increase its cost of capital or risk profile.

With that in mind, we took at quick look for some examples of higher profile companies that were not following Henry Singleton's examples in their buyback strategies. Please note that we have not done a full review on the below companies. These are simply instances where the numbers would seem to call into question whether buying back shares was the best use of cash to create shareholder value.

Walt Disney Company (DIS)

	Year ended:		
	9/30/2017	9/30/2016	9/30/2015
T12 Operating Cash Flow	$12,343	$13,136	$10,909
T12 Capex	$3,623	$4,773	$4,265
T12 Free Cash Flow	$8,720	$8,363	$6,644
T12 Dividends	$2,445	$2,313	$3,063
T12 Net Stock Repurchases	$9,092	$7,240	$5,766
T12 Cash After Buyback	-$2,817	-$1,190	-$2,185
Shares outstanding	1,578	1,639	1,709
% change	-3.7%	-4.1%	-2.8%
Net Debt	$21,286	$15,580	$13,094
Net Debt/EBITDA	1.3	0.9	0.8

-Walt Disney (DIS) has been consistently buying back shares for years. However, for the last four years, the company's free cash flow after its dividend has not been adequate to cover the buyback, resulting in a gradual increase in net debt levels. Net debt/EBITDA is still under 1.5, which is not yet alarming.

-Note that capital spending was down in fiscal 2017 due to reduced spending at its international parks. However, the company is forecasting capex to increase by roughly $1 billion in 2018, putting it back in line with the last two years. This will be a drain on free cash flow next year.

-The lower share count has been a huge contributor to reported EPS growth in recent periods. EPS adjusted for one-time items was flat for the year ended 9/17. Without the reduced share count, the company would have reported a decline of over 3%.

-While the parks segment posted solid 14% operating income growth in 2017, this was partially driven by reporting a full year of operations at the new Shanghai park and a 25th anniversary celebration at Disneyland Paris. Cable Networks and Broadcasting results continue to struggle with lower viewership at Freeform and flat results at ESPN, which is being hit by higher programming costs. Likewise, Studio Entertainment posted declines. While these segments will be volatile due to the timing of big movie releases and political advertising, over time these segments have not been putting up huge growth numbers. We don't see where the company is going to be able to generate sustainable, strong growth going forward, meaning the reduced share count from the buyback will likely remain material to growth.

-DIS grew its November dividend by 7.7%, down from 9.9% growth in its July dividend. The dividend consumes less than 30% of free cash flow, so it is in no way threatened. With debt levels still in a reasonable range, the company could continue to buy back shares over the next few quarters, but without a significant pickup in cash flows, it can't keep up this pace indefinitely.

-While DIS shares have traded relatively flat over the last couple of years, they have hardly been trading at "fire-sale" levels. All of these factors make us question the value created for shareholders by continuing to take on debt to fund the buyback.

Union Pacific (UNP)

	Trailing 12 months ended:		*Year Ended:*		
	9/30/2017	*9/30/2016*	*12/31/2016*	*12/31/2015*	*12/31/2014*
T12 Operating Cash Flow	$7,456	$7,186	$7,525	$7,344	$7,385
T12 Capex	$3,280	$3,931	$3,505	$4,650	$4,346
T12 Free Cash Flow	$4,176	$3,255	$4,020	$2,694	$3,039
T12 Dividends	$1,957	$1,849	$1,879	$2,344	$1,632
T12 Net Stock Repurchases	$3,887	$2,770	$3,105	$3,465	$3,225
T12 Cash After Buyback	-$1,668	-$1,364	-$964	-$3,115	-$1,818
Shares outstanding	798	832	835	869	901
% change	-4.2%		-3.9%	-3.5%	-3.3%
Net Debt	$14,896	$13,373	$13,670	$12,810	$9,827
Net Debt/EBITDA	1.5	1.5	1.5	1.3	0.9

-Union Pacific (UNP) stock price jumped at the end of November, driven by a higher holiday retail outlook and a tailwind from tax reform. However, core results are still sluggish, as volumes actually declined in the most recent quarter. Higher rates and fuel surcharges helped propel top-line growth. The company remains focused on reducing costs through consolidating its workforce. Nevertheless, uncertain demand in certain end markets such as coal and crude as well as competition in intermodal could make growth more difficult.

-Note that the company's capital spending has been falling for the last two years. After an aggressive capital plan in 2015, UNP has reduced its purchases of new cars and locomotives. The 2017 capital plan target was $3.1 billion. While 2018's target has yet to be officially announced, it will almost certainly be flat to increasing, taking away a key source of recent fee cash flow growth.

-UNP's free cash flow after dividend payments has been insufficient to cover the buyback, resulting in a gradual increase to debt. Debt-to-EBITDA is still in an acceptable range at 1.5 times. However, the company has been growing its dividend by 10% for the last several quarters. The dividend consumes only about 47% of free cash flow, leaving plenty of room to expand the payout ratio to extend growth. Nevertheless, the company appears to be running out of room to continue to reduce the share count at the current pace while still maintaining aggressive dividend growth.

-Additionally, the recent price spike will make buying back shares even more expensive. UNP increased the number of shares purchased by 6.6% in the nine months ended 9/17. However, it took 37% more cash to do so due to share price appreciation. With the price spike in the fourth quarter, not only are the shares less of a value than they were earlier in the year, it will take more cash to get the same impact on EPS from share count reduction.

Mondelez International (MDLZ)

	Trailing 12 mos ended:		*Year Ended:*		
	9/30/2017	*9/30/2016*	*12/31/2016*	*12/31/2015*	*12/31/2014*
T12 Operating Cash Flow	$2,497	$3,454	$2,838	$3,728	$3,562
T12 Capex	$1,069	$1,344	$1,224	$1,514	$1,642
T12 Free Cash Flow	$1,428	$2,110	$1,614	$2,214	$1,920
T12 Dividends	$1,162	$1,073	$1,094	$1,008	$964
T12 Net Stock Repurchases	$2,660	$2,346	$2,601	$3,622	$1,700
T12 Cash After Buyback	-$2,394	-$1,309	-$2,081	-$2,416	-$744
Shares outstanding	1,524	1,576	1,573	1,637	1,709
% change	-3.3%		-3.9%	-4.2%	-4.5%
Net Debt	$17,789	$15,420	$15,458	$13,528	$15,025
Net Debt/EBITDA	3.7	3.8	3.2	2.9	2.8

-Long-time readers of Behind the Numbers will remember our dislike of Kraft Foods and its high-priced acquisitions, followed by almost immediate write-offs and repackaging and spinning off the many acquired assets- which thus formed Mondelez International (MDLZ). Like Kraft, MDLZ's results are perpetually littered with restructuring charges, asset impairments, and unusual one-time items. It is nearing the end of its latest 2014-2018 restructuring program. The plan totals $5.7 billion in severance costs, asset disposals and manufacturing "one-time" costs the company will invite analysts to disregard as non-operational.

-MDLZ is struggling to post positive top-line growth. For the nine months ended 9/17, the company reported revenue growth of 0.3% after adjustment for divestitures, acquisitions and currency translation. However, pricing added 1.2% to growth, meaning volumes fell by almost 1%. The company blamed this on a malware incident in the end of the June quarter that delayed shipments. However, much of this was recovered in the third quarter and we estimate the total negative impact on revenue growth in the nine months ended 9/17 was only about 50 basis points.

-Gross margin fell slightly in the nine-month period, yet the company still reported a 1.1% increase in adjusted operating income margin due largely to lower advertising and consumer promotion costs. Cuts to marketing rarely turn out well for name-brand food companies.

-Cash flow from operations fell in 2016 due to higher pension contributions as well as a lower cash contribution from improvement in working capital. For the first nine-months of 2017, cash flow from operations also declined due to higher tax and VAT-related payments. While the pension and tax factors may reverse, the working capital improvements will likely continue to wane.

-It is worth noting that even when cash from operations was at its peak in 2015, it was not sufficient to cover the dividend and the buyback at its current level.

-Debt is currently over 3 times EBITDA, leaving little running room to continue a debt-fueled buyback. The company's recent rapid dividend growth appears difficult to maintain without a marked uptick in cash flow growth and/or a reduction in the share buyback which has been adding 3-4% to EPS growth the last few years.

Six Flags Entertainment (SIX)

	Trailing 12 months ended:		*Year Ended:*		
	9/30/2017	*9/30/2016*	*12/31/2016*	*12/31/2015*	*12/31/2014*
T12 Operating Cash Flow	$468	$463	$463	$474	$392
T 12 Distributions to Non-Cont. Interests	$39	$38	$38	$38	$38
T12 Capex	$145	$124	$129	$114	$109
T12 Free Cash Flow	$285	$301	$296	$321	$246
T12 Dividends	$227	$215	$220	$201	$184
T12 Net Stock Repurchases	$545	$200	$175	$205	$157
T12 Cash After Buyback	-$487	-$114	-$100	-$84	-$95
Shares outstanding	86	94	94	98	98
% change	-8.8%		-3.7%	-0.2%	-2.2%
Net Debt	$1,938	$1,414	$1,516	$1,406	$1,306

-Six Flags (SIX) posted revenue growth of 4% in the 9/17 quarter on price increases and the impact of opening new parks. The hurricanes took a toll on attendance at several parks, so results will likely see some rebound going forward. Nevertheless, much of the company's growth in recent years has come from price increases and increases in per capita park sales rather than through attendance growth.

-The company also had to recently announce it would be pushing back its goal of reaching $600 million in EBITDA. Investors should also keep in mind that the company's net operating loss carryforwards begin to run out in 2018 and it will begin to gradually experience an increasing cash drag going forward.

-The company has been aggressively repurchasing shares for years, but despite the recent setback in results, it accelerated its buyback in the 9/17 quarter. On a trailing twelve-month basis, the company's dividend and buyback will consume over $480 million more than free cash flow. Dividend growth has been a key part of the bull story at SIX, but the company obviously cannot continue the buyback and the dividend at this pace without significantly ramping up debt, which already exceeds 3 times EBITDA.

Disclosure

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