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Paying back your shareholders

Successful companies inevitably face that prospect. The only real question is how.

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Most successful companies eventually find themselves generating more cash than they can reasonably reinvest in their businesses at attractive returns on capital. Even in the wake of the recent recession, investors are pressuring companies to distribute a mountain of cash they've accumulated in the past few years. In fact, European and US companies currently hold a total of around $2 trillion in excess cash.[1]

For many companies, that pressure raises several questions. How much cash should they return to shareholders and how much should they retain for investment and for managing volatility? When they do return cash to shareholders, how should they do so—through cash dividends or share repurchases?

Return cash—or invest it?

Some executives and board members argue that returning cash to shareholders reflects a failure of management to find enough value-creating investments. Share repurchases and dividends, these people argue, send a negative signal to the markets that a company can find nothing better to do with its cash. But in most cases, simple math leaves such companies with little choice: if they have moderate growth and high returns on capital, it's functionally impossible for them to reinvest every dollar they earn.

Consider this example: a company earning $1 billion a year in after-tax profits, with a 25 percent return on invested capital (ROIC) and projected

revenue growth of 5 percent a year, needs to invest about $200 million annually[2] to continue growing at the same rate. That leaves $800 million of additional cash flow available for still more investment or returning to shareholders.[3] Yet finding $800 million of new value-creating investment opportunities every year is no simple task—in any sector of the economy. Furthermore, at a 25 percent ROIC, the company would need to increase its revenues by 25 percent a year to absorb all of its cash flow. It has no choice but to return a substantial amount of cash to shareholders (Exhibit 1).

Moreover, concerns about negative signals to the market are misplaced. We've never seen a situation in which the stock market was surprised that a company couldn't reinvest its cash flow. As many companies are currently finding, investors typically anticipate distributions to shareholders long before managers decide to undertake them, since it's obvious that there aren't many alternatives. (What investors don't know is *when* a company will return the cash, so the share price often rises when companies begin share repurchase programs.) It therefore comes as little surprise that, in aggregate, US companies have returned to shareholders around 60 percent of earnings in dividends and share repurchases each year over the past 50 years (Exhibit 2)—even if some individual companies hold on to more cash than they need for operational purposes.

A number of leading companies have adopted the sensible approach of regularly returning to shareholders all unneeded cash and using share repurchases to make up the difference between the total payout and dividends. While these companies don't have formal published policies, you can deduce them from actual practice. Over the five years ending in 2010, for instance, IBM generated $48 billion of cash flow from operations after capital expenditures and acquisitions and returned $56 billion to shareholders[4] in dividends and share repurchases. It's hard to imagine that even a

Exhibit 1

Returning cash is inevitable.

Excess cash flow for $1 billion net income, $ million

Projected return on invested capital (ROIC), %	Projected growth rate, %: 20	15	10	5
50	600	700	800	900
25	200	400	600	800
15	(333)	0	333	667

A company with a 25% ROIC and a projected revenue growth of 5% a year has $800 million of additional cash flow.

company like IBM could have successfully reinvested that much cash in its own businesses over that time, especially since it was already spending $6 billion a year on R&D and more than $1 billion on advertising and promotion.

How to pay it out

While distributions to shareholders, relative to income, have been stable for a long time, the split between dividends and share repurchases has changed significantly. Until the early 1980s, less than 10 percent of distributions involved share repurchases. Now, about 50 to 60 percent do.

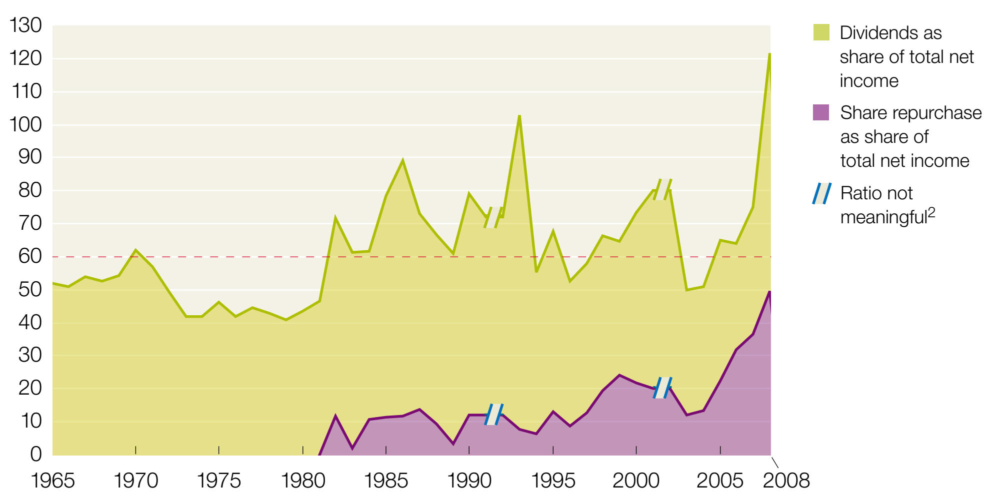
Why the shift? It's primarily about flexibility. Companies, especially in the United States, have conditioned investors to expect that dividends will be cut only in the most dire circumstances. From 2004 to 2008, just 5 percent of US-listed companies with revenues greater than $500 million cut their dividend, and in almost every case the company faced a severe financial crisis. So companies are reluctant to establish a dividend level that they aren't confident of sustaining. They opt, instead, to buy back shares.

Some investors, too, prefer repurchases because they can then choose whether or not to participate. Institutional investors, for example, can maintain their investment in a company without the transaction costs of reinvesting dividends. Individual investors, by not participating in a share repurchase, can defer taxes on the dividends and turn them into capital gains even years in the future.

Exhibit 2

On average, US companies have returned about 60 percent of their net income to shareholders.

US net income payout ratio,[1] %



[1]Sample includes nonfinancial US companies with real revenue >$100 million in any year between 1989 and 2009.
[2]Data for 1991–92, 2001–02 are excluded because of abnormally low net incomes.

Does it matter whether distributions take the form of dividends or share repurchases? Empirically, the answer is no. Whichever method is used, earnings multiples are essentially the same for companies when compared with others that have similar total payouts (Exhibit 3).[5] Total returns to shareholders (TRS) are also the same regardless of the mix of dividends and share repurchases (Exhibit 4).[6] These results should not be surprising. What drives value is the cash flow generated by operations. That cash flow is in turn driven by the combination of growth and returns on capital—not the mix of how excess cash is paid out.

Setting the right mix

So how should a company decide between repurchases and dividends? That depends on how confident management is of future cash flows—and how much flexibility it needs.[7]

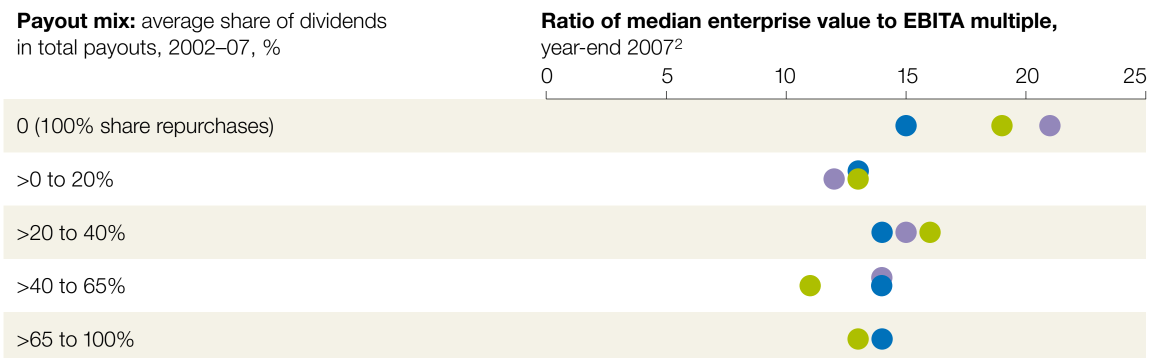
Share repurchases offer companies more flexibility to hold onto cash for unexpected investment opportunities or shifts in a volatile economic environment. In contrast, companies that pay dividends enjoy less flexibility because investors have been conditioned to expect cuts in them only in the most dire circumstances. Thus, managers should employ dividends only when they are certain they can continue to do so. Even increasing a dividend sends signals to investors that managers are confident that they will be able to continue paying the new, higher dividend level. Share repurchases also signal confidence but offer more flexibility because they don’t create a tacit commitment to addi-

Exhibit 3

Earnings multiples are not affected by the payout mix.

Level of total payouts: average annual payouts (dividends + share repurchases) as % of total net income,[1] 2002–07

● 0–65% ● 66–95% ● 96–130%



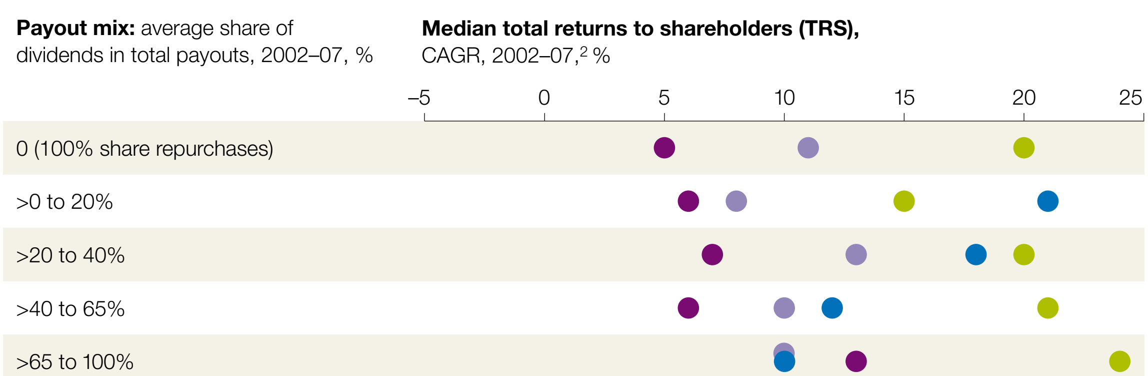
[1]Insufficient data for payout levels of 96–130% at payout mix of >65 to 100% dividends and for payout levels of >130% for all payout mixes.
[2]For 279 nonfinancial companies that were in the S&P 500 at the end of 2009, were continuously in operation since 1999, and paid dividends or repurchased shares. EBITA = earnings before interest, taxes, and amortization.

Exhibit 4

Returns to shareholders are unrelated to the payout mix.

Level of total payouts: average annual payouts (dividends + share repurchases) as % of total net income,[1] 2002–07

● 0–65% ● 66–95% ● 96–130% ● >130%



[1]Insufficient data for payout level of 66–95% at payout mix of zero dividends (100% share repurchase).
[2]For 293 nonfinancial companies that were in the S&P 500 at the end of 2009, were continuously in operation since 1999, and paid dividends or repurchased shares. CAGR = compound annual growth rate.

tional purchases in future years.[8] (As an aside, signaling effects, whether for dividends or share repurchases, do not reflect value creation. They may lift the market's expectations of a company's future cash flows but do not affect the cash flows themselves—and therefore do not create any value.) As you would expect, changing the proportion of dividends to share buybacks has no impact on a company's valuation multiples or TRS, regardless of payout level.

One argument for share repurchases that doesn't hold up to scrutiny: share repurchases increase value because they increase earnings per share. Such an increase is a simple mathematical effect offset by a decline in the price-to-earnings ratio, since a company is more risky as a result of higher leverage. The net effect on share value is zero. Another argument for share repurchases is that companies can repurchase undervalued shares for the benefit of those shareholders who hold on to them. In theory this is correct; however, we've rarely seen companies with a good track record of repurchasing shares when they were undervalued; more often than not, we see companies repurchasing shares when prices are high.

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Successful companies inevitably get around to returning cash to shareholders in some form, if only because they simply can't reinvest their cash as fast as it accumulates. And while there's no fundamental difference in the value of dividends when compared with share repurchases, companies need to balance their approach against the flexibility that management needs.

1 "Excess cash" is defined as the amount of cash outstanding over and above operating cash, which is defined at 2 percent of revenue.
2 Over and above replacement capital expenditures that, we've assumed, equal depreciation. If the company has some debt financing, it could return even more of its profits.
3 The same basic principle applies to different companies, depending on their levels of growth and returns on capital.
4 IBM returned $73 billion to investors and received $17 billion from issuing new shares (primarily the exercise of employee stock options), for net distributions of $56 billion. IBM could pay out more cash than it generated from operations because it also generated cash flows from divestitures, borrowing, and changes in cash balances.
5 We also examined the value of companies by using statistical techniques and found no impact on the dividend or share repurchase mix once we adjusted for differences in total payouts, growth, and returns on invested capital.
6 After adjusting for differences in total payout.
7 See Marc H. Goedhart, Timothy Koller, and Werner Rehm, "Making capital structure support strategy," mckinseyquarterly.com, February 2006.
8 The academic research is not conclusive on whether dividend increases or share repurchases send a stronger signal to investors.

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