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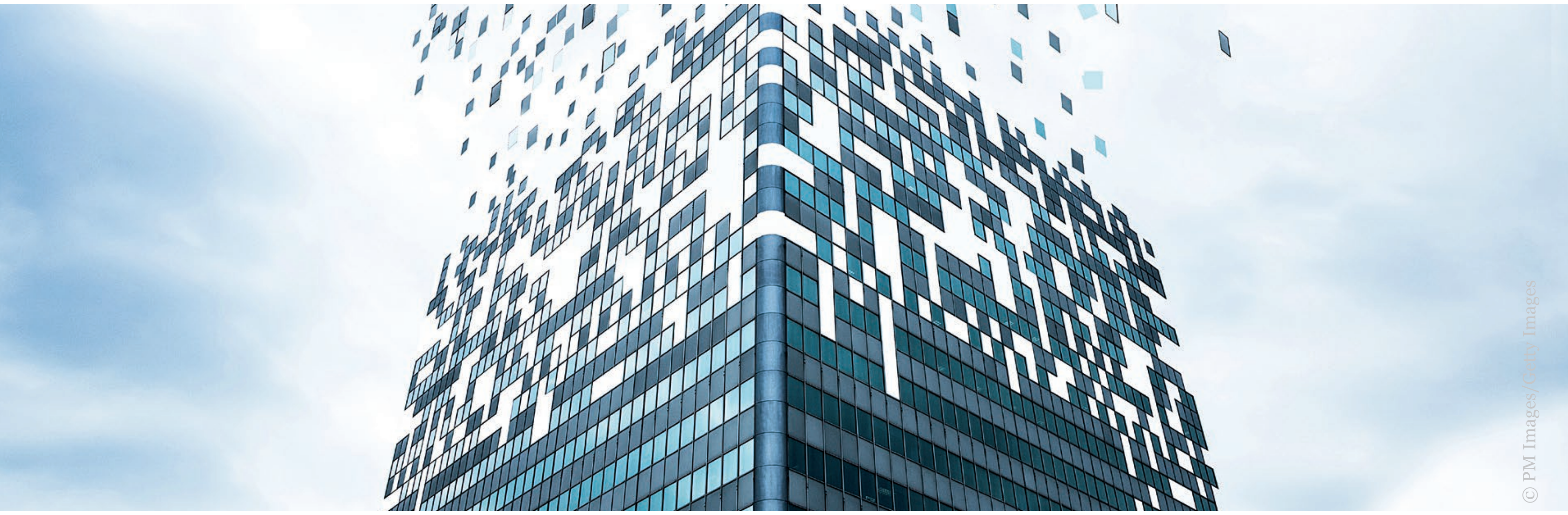


Corporate Finance Practice

Are share buybacks jeopardizing future growth?

Fears that US companies underinvest by paying too much back to shareholders are unfounded. Rather, the rise in buybacks reflects changes in the economy.

Tim Koller

Returning cash to shareholders is on the rise for large US-based companies. By McKinsey's calculations, share buybacks alone have increased to about 47 percent of the market's income since 2011, from about 23 percent in the early 1990s and less than 10 percent in the early 1980s.[1] Some investors and legislators have wondered whether that increase is tantamount to underinvestment in assets and projects that represent future growth.

It isn't. Distributions to shareholders overall, including both buybacks and dividends, are currently around 85 percent of income, about the same as in the early 1990s. Instead, the trend in shareholder distributions reflects a decades-long evolution in the way companies think strategically about dividends and buybacks—and, more broadly, mirrors the growing dominance of sectors that generate high returns with relatively little capital investment.

In fact, ever since the US Securities and Exchange Commission loosened its regulations on buybacks in 1982,[2] companies have been changing the way they distribute excess cash to shareholders. So while dividends accounted for more than 90 percent of aggregated distributions to shareholders[3] before 1982, today they account for less than half—the rest are buybacks (Exhibit 1). The shift makes good sense. Empirically, the value to shareholders is the same,[4] but buybacks afford companies more flexibility. Executives have learned that once they announce dividends, investors tend to expect that the dividends will continue in perpetuity unless a company falls into financial distress. By contrast, a company can easily add or suspend share buybacks without creating such expectations.

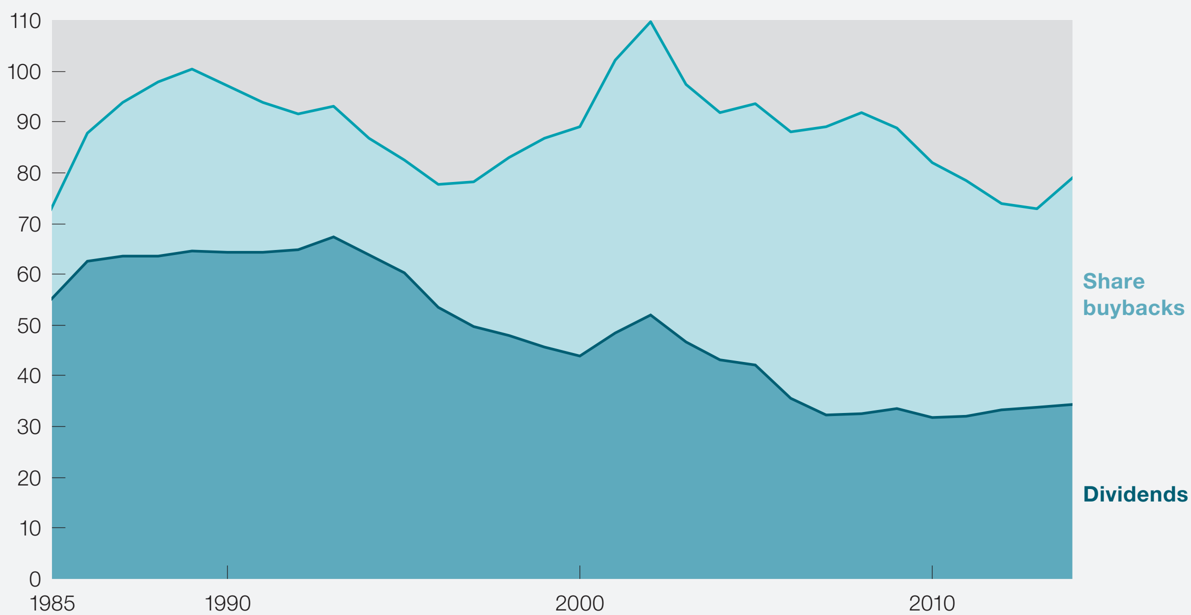
Regardless of the proportion of buybacks to dividends, there's little evidence that distributions to shareholders are what's holding back the economy. In fact, on an absolute basis, US-based companies have increased their global capital investments by an inflation-adjusted average of 3.4 percent annually for the past 25 years[5]—and their US investments by 2.7 percent.[6] That exceeds the average 2.4 percent growth of the US GDP. Furthermore, replacement rates have remained similar. Capital spending was 1.7 times depreciation from 2012 to 2014, compared with 1.6 times from 1989 to 1999.[7] The only apparent decline is in the level of capital expenditures relative to the cash flows that companies generate, which fell to 57 percent over the past three years, from about 75 percent in the 1990s.

That's not surprising, given how much the makeup of the US economy has shifted toward intellectual property–based businesses. Medical-device, pharmaceutical, and technology companies increased their share of corporate profits to 32 percent in 2014,

Exhibit 1

Overall distributions to shareholders have fluctuated cyclically since deregulation in the mid-1980s, though the ratio of buybacks to dividends has grown.

Distributions as % of adjusted net income, 5-year rolling average[1]



[1] For US nonfinancial companies with revenues greater than $500 million (adjusted for inflation).

Source: Corporate Performance Analysis Tool; McKinsey analysis from 13 percent in 1989. Since a company's rate of growth and returns on capital determine how much it needs to invest, these and other high-return enterprises can invest less capital and still achieve the same profit growth as companies with lower returns. Consider two companies growing at 5 percent a year. One earns a 20 percent return on capital, and the other earns 10 percent. The company earning a 20 percent return would need to invest only 25 percent of its profits each year to grow at 5 percent, while the company earning a 10 percent return would need to invest 50 percent of its profits. So a higher return on capital leads to higher cash flows available to disburse to shareholders at the same level of growth.

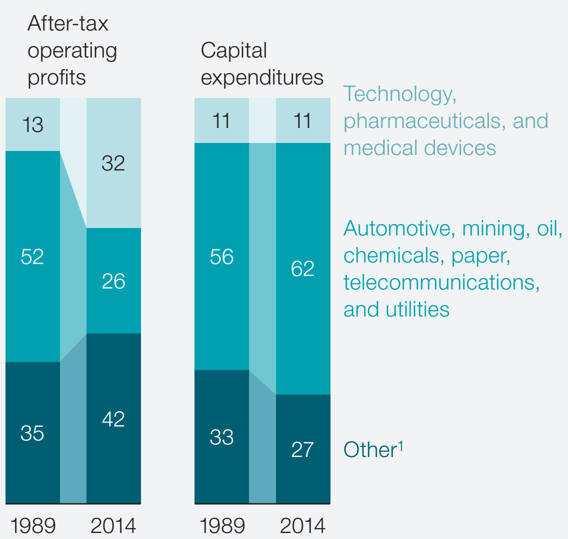
That is what's happened among US businesses as their aggregate return on capital has increased. Intellectual property–based businesses now account for 32 percent of corporate profits but only 11 percent of capital expenditures—around 15 to 30 percent of their cash flows. At the same time, businesses with low returns on capital, including automobiles, chemicals, mining, oil and gas, paper, telecommunications, and utilities, have seen their share of corporate profits decline to 26 percent in 2014, from 52 percent in 1989 (Exhibit 2). While accounting for only 26 percent of profits, these capital-intensive industries account for 62 percent of capital expenditures—amounting to 50 to 100 percent or more of their cash flows.

Here's another way to look at this: while capital spending has outpaced GDP growth by a small amount, investments in intellectual property—research and development—have increased much faster. In inflation-adjusted terms, investments in intellectual property have grown at more than double the rate of GDP growth, 5.4 percent a year versus 2.4 percent. In 2014, these investments amounted to $690 billion.

Exhibit 2

The composition of the US economy has shifted away from capital-intensive industries.

Share of total profits and capital expenditures for US-based companies, %



[1] Other includes capital goods, consumer staples, consumer discretionary, media, retail, and transportation.

Source: Corporate Performance Analysis Tool; McKinsey analysis

Certainly, some individual companies are probably spending too little on growth—just as others spend too much. But in aggregate, it's hard to make a broad case for underinvestment or to blame companies returning cash to shareholders for jeopardizing future growth. ■

[1] For US nonfinancial companies with revenues greater than $500 million (adjusted for inflation). Income is before extraordinary items, goodwill write-downs, and amortization of intangibles associated with acquisitions.

[2] Rule 10b-18 of the US Securities and Exchange Commission "provides companies with a voluntary 'safe harbor' from liability for manipulation under the Securities Exchange Act of 1934."

[3] Among nonfinancial companies in the S&P 500.

[4] Bin Jiang and Tim Koller, "Paying back your shareholders," *McKinsey on Finance*, May 2011, mckinsey.com.

[5] US-based nonfinancial companies with more than $500 million in revenues. Using the aggregate GDP deflator, capital expenditures increased by 2.6 percent, versus 3.4 percent for the capital-expenditure deflator (as a result of lower inflation on capital items).

[6] National Income and Product Accounts Tables, US Department of Commerce Bureau of Economic Analysis, accessed August 2015, bea.gov.

[7] This is lower than it was in the 1970s and 1980s—decades affected by high inflation.

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