Do Buybacks Really Destroy Long-Term Value?

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Published in Economia, September 2019

Share buybacks are one of the most controversial corporate decisions today. US Senator Elizabeth Warren claimed that "buybacks create a sugar high for the corporations. It boosts prices in the short run, but the real way to boost the value of a corporation is to invest in the future, and they are not doing that."

That quote highlights the two main reasons why share repurchases are unpopular. First, they prevent investment – in wages, in new and better products, and in reducing carbon emissions. They seem to split the pie in favour of investors and at the expense of wider society. Second, they increase the short-term stock price, allowing a CEO to benefit by opportunistically cashing out her shares. Moreover, the CEO's personal incentives to undertake repurchases are even broader than in Senator Warren's quote. Buybacks increase not just the stock price but also a company's earnings per share (EPS). That allows a CEO to hit any EPS target in her bonus contract – without boosting revenues or cutting costs, which were presumably the actions that the EPS target hoped to encourage.

The second accusation – the idea that CEOs enrich themselves at the expense of society – incites particular anger. However, in this column I've tried to emphasise two themes. The first is the importance of the pie-growing, rather than pie-splitting mentality. Because the pie can be grown, any gains to the CEO might be a by-product of creating value for society, rather than at the expense of society. If a CEO launches a successful new product, she personally benefits, but so does everyone else. Thus, what matters isn't so much whether the CEO gains from buybacks, but whether buybacks help or harm long-term value – whether they grow or shrink the pie.

And that's where the second theme comes in – the importance of using large-scale, rigorous evidence to critically evaluate common claims. The idea that executives scheme about how they can best line their pockets at the expense of stakeholders is a popular one, since it's consistent with common views of capitalism. But is this actually true? The UK government commissioned PwC and me to study the alleged misuse of share buybacks in the UK. Over 2007-2017, we found that not a single FTSE 350 firm used buybacks to hit an EPS target that it would have otherwise missed.

What about the long-term effects of buybacks? A seminal paper found that firms who buy back stock subsequently outperform their peers by 12.1% over the next four years. This finding is surprisingly robust – while it was on US firms in the 1980s, a study published this year investigates 31 other countries and finds that the results hold in most of them, including the UK. This evidence contradicts the "sugar high" concerns, but is conveniently ignored in claims that buybacks destroy long-term value.

How can these long-term gains arise? It's an indisputable fact that any money spent on a buyback can't be invested elsewhere – you don't need a study to prove that – and reducing investment surely reduces long-term value?

Not always. Investment only increases value if it generates a higher return than the money could earn elsewhere. For example, a homeowner might re-roof his house, build a conservatory, and refurbish his kitchen. But after taking these investments, it may be that

further home improvement isn't worth the cost, or the money is better used for his children's education. Similarly, a great CEO doesn't just spend money willy-nilly, but can discern between good and bad investment opportunities. She shows restraint when she's taken all profitable projects, and pays out the spare cash. This allows shareholders to invest it in other companies with great investment opportunities that otherwise wouldn't be financed.

The idea that the money from share buybacks is redeployed elsewhere isn't just wishful thinking – it's supported by the evidence. Further studies find that buybacks occur when growth opportunities are poor and when companies have excess capital. So companies make investment decisions first and buy back stock out of surplus cash, rather than repurchasing shares first and investing only out of the scraps left over.

But the evidence is not all one-way. Buybacks can destroy value in certain cases. A study finds that buybacks undertaken to meet analyst earnings forecasts lead to cuts in employment and investment. One of my own papers finds that short-term equity encourages a CEO to engage in buybacks and reduces the long-term returns – but she doesn't mind because she cashes out shortly after. Yet in these cases, the root cause of the problem is not share buybacks, but a focus on quarterly earnings and short-term pay schemes. Addressing these problems would address not only the rare instances of myopic buybacks, but other short-termist behaviours such as cutting good investment projects or failing to innovate.