

Share buybacks or special dividends?

Buybacks have grown significantly in popularity in recent years compared to special dividends; we seek to uncover the causes driving this trend and whether it is set to continue.

- Share buybacks are currently facing scrutiny, particularly compared to traditional dividends payouts
- Markit's dividend forecasting data indicate that special dividends are dramatically down on 2012 peaks
- Buybacks carry the positive market signals of a pseudo-dividend with no commitment to follow through, compared to a special dividend

Buybacks at any price

From the early 80sⁱ, the increased use of buybacks as preferred vehicles to return capital to investors has divided opinion on their merits. Buybacks are the current *cause celebre* among [activist investors](#) in order to yield more pressure on management teams with surplus cash.

The recent widespread adoption of buybacks in the place of increased dividends can be attributed to a number of factors. The main attraction for management teams and investors seems to be the flexibility and versatility compared to traditional dividend policies. Most executive remuneration packages now include some form of options which were intended to reduce agency risk by aligning incentives, but have maximised focus on share price. Dividends by nature go against share price maximisation all else equal and thus it could be argued buybacks can be used to help reach those all-important strike price levels.

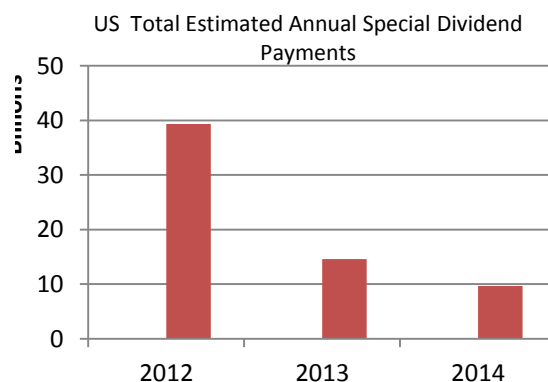
Dividends are notoriously sticky commitments to back out of and the reluctance to increase dividend payments is unsurprising given the current low visibility and economic uncertainty facing large firms.

This is especially true for a technology company such as Apple whose main product

and revenue source did not even exist eight years agoⁱⁱ. Since March 2012, Apple has returned \$94.4bn predominantly ex-shareholders as 72% were in the forms of buybacks and share repurchases.

Companies have displayed a healthy appetite in the past and embraced special dividends to some extent in 2012. This was in lieu of upcoming tax changes that would alter the treatment of dividendsⁱⁱⁱ.

According to Markit dividend data aggregating over the past three years, special dividends last peaked in 2012 and amounted to \$40bn. Currently special dividends look set to reach only a fourth of that in 2014 in an environment of peaking buybacks.



What do buybacks have?

Buybacks are not binding and management is not obliged to actually implement a program.

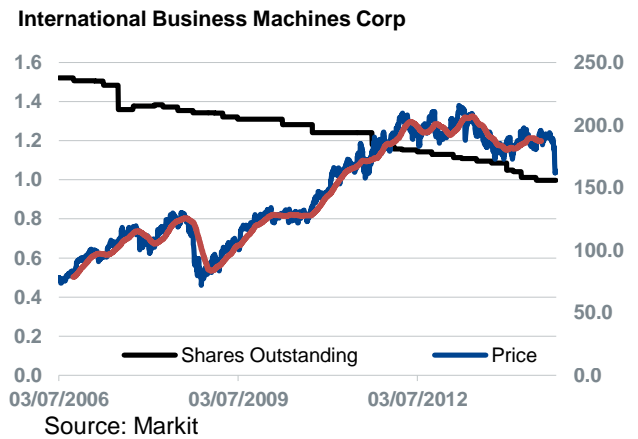
This provides flexibility when times are tough – shielding market reaction to a company divorcing its dividend policy or going on trial separation.

The main positive real affect buybacks have versus dividends is that they lower share count. This increases all per share metrics and most importantly value per share, all else equal, for remaining shareholders.

Dividends are applied to the entire shareholder base whereas buybacks are normally conducted on the open market. Since the shareholder who is selling stock is willing, it follows that the remaining shareholders should be concerned with maximising total returns and remaining tax efficient.

Big Blue, the consistent purchaser

IBM's intentions are to increase shareholder value but against a backdrop of decreased earnings and a changing technology market the company has engaged in large levels of buybacks, mostly at increasing stock prices. The benefits unfortunately may have gone to ex-shareholders.



In IBM's case, more than double has been spent on buybacks than in R&D in the past few years. Apple and IBM are the top two 'buyback' firms of the S&P 500, purchasing \$33bn and \$19bn worth of stock respectively in the 12 months leading up to September 2014.

IBM's share price has performed poorly recently and while not directly related to buybacks had the firm paid dividends, as a shareholder you would have been worse off, *ceteris paribus*.

It seems that the market has not made up its mind regarding buybacks versus dividend, as the amount of buybacks in the S&P [peaked recently, and has since](#) declined slightly.

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ⁱ Professor Damodaran from NYU recently noted in a [post](#) that the initial growth in usage may be attributed to a SEC rule (10b-18) passed in 1982 providing safe harbour to companies executing buyback programmes.

ⁱⁱ Approximately 68% of Apple's 2014 gross profit generated from the iPhone which was first launched in January 2007.

ⁱⁱⁱ Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA). Known as "The Bush Tax Cuts," JGTRRA was signed to improve economic conditions by putting more money in the pockets of individuals and incentivizing businesses to increase investment. Among other measures, the act also decreased the top rate on dividends from 38.6% to 15%. However, the window of relatively low dividend tax rates may soon close with the fiscal cliff. Barring a last-minute Congressional extension, it would benefit shareholders if companies declare and pay special dividends prior to the year-end expiration date. Source: Markit White paper on Spike in Special Dividends Projected in Q4 2012.