The Bitter Truth About Stock Buybacks

by SHAILESH KUMAR on AUGUST 15, 2012

Monster Beverage Corp., (MNST) stock was brought to my attention yesterday as a potentialinvestment due to its fast growth and increased share buyback program. I am going to take this stock as an example to illustrate why company management is often misguided when they buy back their own stock.

Stock Buybacks can Destroy Value

If you are a shareholder, you generally welcome any share repurchase announcement. The math is simple, you think.

If the company remains valued at the same level in the market, the less number of shares this value is divided by, the more the value of the remaining shares. It is a way of engineering a higher share price.
What most investors forget to take into account is that ***the company is using its own cash up to buy these shares back.***
These shares do not magically disappear.

So while the numbers of shares do decline, the intrinsic value of the company also declines.
And not to mention any returns that the company could have generated if it had used that cash in alternative projects.

They are Not Always the Best Use of Cash

A shareholder should demand that the company they have entrusted their capital to uses it wisely. This means investing each dollar in projects that maximize the return on the capital.
When a company decides to buyback their own shares, they are indicating that the valuation is so distressed that investing in own shares are likely to generate better returns for the company (and the shareholders), then pursuing any other projects in their normal course of business.

They better be certain that the stock is undervalued by the market.

And they also need to be certain that there are no other better opportunities to use their cash.

There is no point paying $1.50 or $2 for an asset that is worth just a dollar.

You are better off parking the excess cash in treasuries and your shareholders will be richer for it.

Monster Is Going to Overpay for its Own Stock

Monster stock sells at a Price/Earnings multiple of almost 33 and a Price to Book ratio of 8.7. The P/S ratio is over 5. Not exactly in the value territory.

Put it another way, an investor looking to invest in MNST today is looking at an earnings yield of 3%. To point out my obvious problem with this, it indicates that equity in Monster is less risky (due to the perceived and hoped for growth, no doubt) then the AAA rated Microsoft corporate bonds maturing on Oct 1, 2040 that currently yield 3.961%
Maybe energy drinks are the future and more important for the humanity then a company that creates software and systems that power most of world's governments and businesses.

I doubt it.

The growth argument does not hold water either. If the company expects a continued double digit growth, there is no reason for it to invest in its stock yielding so little. It should invest in growing its business.

You may well ask if a company has excess cash that it doesn't need, why they should not return it to the shareholders?
Fair question. The company does have $870 m in cash and generates more free cash every quarter. If they want to return a part of this to the shareholders (the stock buy back authorization is for $500 million), all the power to them.

Just pay dividends, regular or a special one time dividend.
It is a fair 1-1 exchange. Every $ in dividend payment transfers the same $ in value to the shareholders.

Income Taxes Should have Nothing to Do with Buyback vs Dividends Decision

The argument about the income tax treatment of the return of capital is something the company should not concern itself about. If that is the argument here, the tax impact is still much lower than the value destruction in buying back an overvalued stock (assuming a 10% incremental tax impact on capital gains vs dividend taxes, the over valuation in this case is comfortably more than 10%). The fact is, most investors have their own tax plans, and quite a few own shares in their tax deferred plans where the tax argument has no merit.

A Lot of Other Companies Make this Mistake

The fact is, top management of a company is not impartial. They always overestimate the future prospects of their company and generally tend to believe that their stock is undervalued, *at any price*. Worse, a company maybe under a mistaken belief that their mandate is to support the stock price and not growing shareholder value
It all boils down to whether the management is short term focused or is looking after shareholder's interest for the long term.

Bottomline: Look at Share Repurchases with a Critical Eye

Share repurchases can create value or they can destroy value. They are a great leveler and act as a catalyst to propel the stock price to the true value in the market. If the stock is currently undervalued, it means it will see an appreciation. If the stock is currently over valued, it will eventually decline as the value destruction becomes clear subsequent to the ill-advised stock buy back.

In any case, they also indicate if the management is fully grounded or if they have lost touch with reality.

(In case you are still wondering what my opinion is about investing in MNST, don’t do it)

My comment:

There may be tax reasons for share buy-backs being preferred. Where there is a double taxation of dividends, i.e. the company pay tax and then shareholder are also taxed on their dividends, buy-backs may be more efficient. The buy-back may also favour investors if it triggers capital gains tax rather than perhaps higher rates of income tax that a dividend might attract. Where this double taxation exists there may be a tendency to minimize dividends and keep the cash within the business. This is not a problem provided it is used effectively. With debt attracting tax relief, this may also lead a company to have a preference for debt rather than equity. It may also be that the market is sceptical as to the management’s ability to use the funds effectively in a strategic move such as an acquisition. It may be felt that the return on the money invested, taking into account the risks involved, would be lower than investors could generate in other companies. Accordingly the cash will be distributed to shareholders. Some studies suggest that it is companies that grow the dividend that prove the better long-term investment. Therefore an attractive yield, with a secure and growing dividend, is likely to offer a better total return. (LAS 28.3.2014)