Insight

Stock Buybacks for Dummies

DOUGLAS HOLTZ-EAKIN | MARCH 20, 2020

Executive Summary

Stock buybacks are again part of the policy discussion, including the president opining that "we don't want stock buybacks." This assertion presumes that buybacks are in some way undesirable or damaging. A straightforward examination of buybacks indicates:

- Stock buybacks *per se* do not raise share values;
- As a corollary, decisions on firm financial management are not driven by the personal finances of management; and
- It is counterproductive to condition availability of emergency response funds on past or future firm financial policy, including buybacks.

Background

Stock buybacks are in the news once again. In the midst of the economic crisis engendered by the coronavirus pandemic, there are cries to deny assistance to firms – notably airlines – that have engaged in a stock buyback in recent years, to make aid conditional on a commitment not to buy back shares, and more. The presumption is that stock buybacks are harmful or dishonorable, which is completely at odds with any rational assessment of firm financial management.

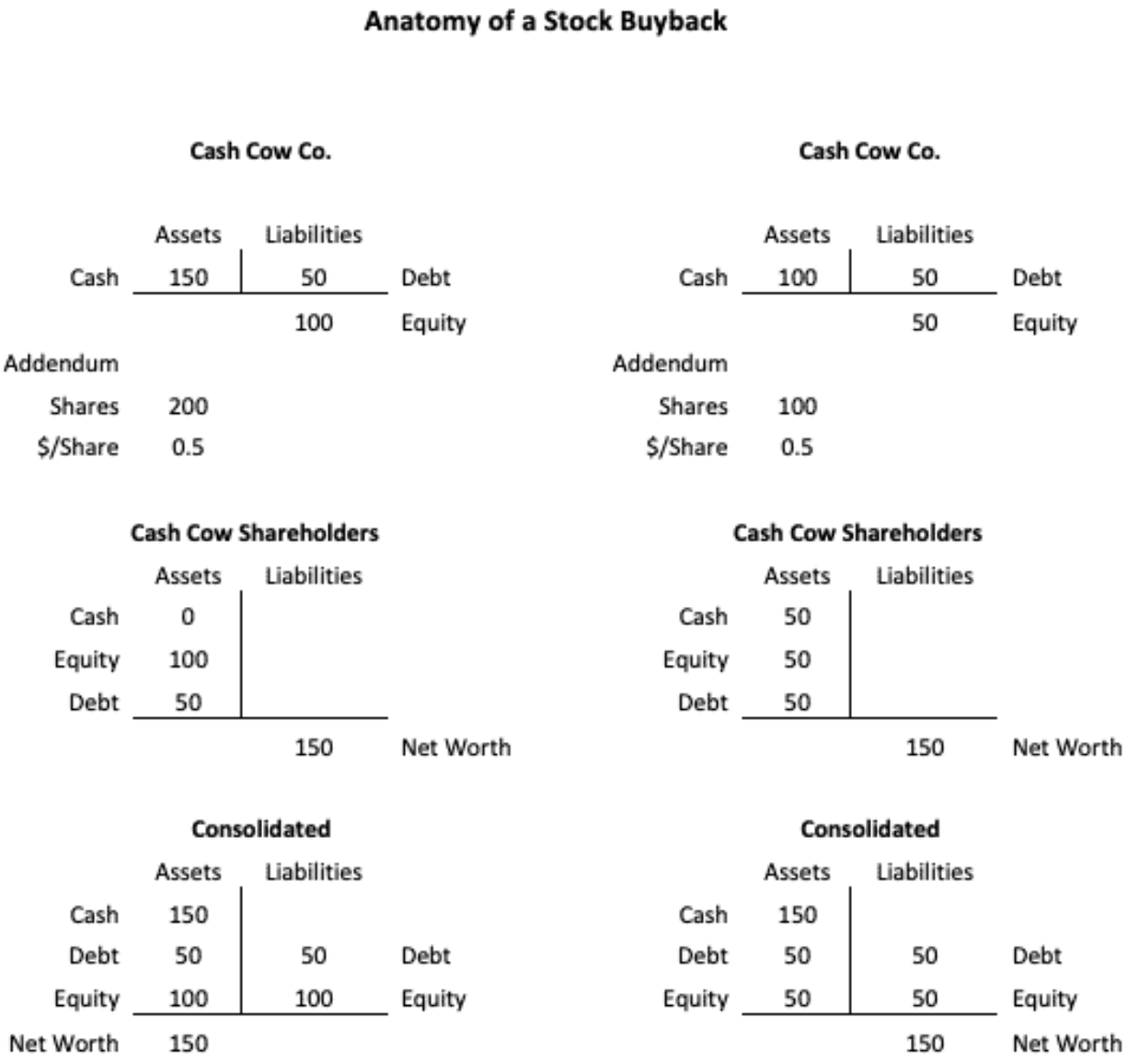
Let's go back to the basics. Shown below is the simple anatomy of a stock buyback.

As shown at the top left, Cash Cow Company has a very simple balance sheet. It has $150 of cash as assets and $50 of debt as liabilities. As a result, the value of the owners' equity is assets minus liabilities, or $100. Notice that if you add up each side of the balance sheet, it totals $150. This is good; balance sheets have to balance!

As an addendum, Cash Cow has 200 shares outstanding. Ownership of all 200 would give the holder a claim to the $100 of equity, which means that each share is valued at $0.50.

Now, look at the top right after Cash Cow uses $50 to buy back shares. Its assets fall by $50, as does the owners' equity, which falls to $50. Note, however, that at $0.50 per share the buyback retires 100 shares. As a result, the remaining 100 shares are a claim on $50; each share has a value of $0.50.

The stock buyback does ***not*** raise the share price.



To see why, consider the balance sheet of Cash Cow's shareholders, shown in the middle row of the diagram. At the start of the transaction, the shareholders had as an asset $100 of owners' equity and $50 of Cash Cow debt (which I assume, for simplicity, they bought). At

the end of the transaction, they hold $50 less in owners' equity, but $50 more in cash. As a result, their net worth is unchanged at $150. The stock buyback does no harm to the financial standing of shareholders.

The key to all of this is shown in the bottom row, which shows the consolidated Cash Cow plus shareholders balance sheet. Both before and after the buyback, the amount of debt and owners' equity offset – they are a liability to the firm and an asset to the shareholders. And in both cases, the only real asset is the cash, which is always worth $150.

This is the key: Cash is the only asset, and the shareholders always own it. They either own it indirectly because it is in the firm and they own the firm, or they own it directly. Moving the cash across the line between the firm and its shareholders is an economic non-event.

Implications

The illustration above is a very simple framework, but dressing it up does not change the core lessons.

1. The value of the firm is determined by its business operations – the quality of its products, marketing efforts, workers' skills, technological advances, and so forth – not the financial transactions that distribute its profits.
2. The stock buyback *per se* does not raise the value of shares. If shares rise at the same time, it must be due to another simultaneous event. For example, if the firm has no good internal investments, the buyback may signal that the firm is not going to waste the shareholders' cash. That is good news. Or the buyback may reflect a sudden popularity in the firm's product. Again, good news.
3. If the stock buyback doesn't matter, why have stock buybacks? This is where a little complication – taxes – matter. If only because shareholders can choose when to sell, capital gains taxes can be deferred. As a result, capital gains are more lightly taxed than dividends. From an overall perspective, then, buybacks are a way to minimize the overall tax liability of the shareholders because an equivalent dividend distribution would be more heavily taxed.

Conclusions

The populist assault on stock buybacks and the managers who initiate them is unmoored from the realities of corporation finance. They are a tell for the betterment of shareholders, not management, and they produce no harm. Especially now, it is counterproductive to condition availability of emergency response funds on past or future firm buybacks.