Dividends Versus Stock Buybacks – We Have a Preference

Introduction

Many people see these as effectively the same thing. If I pay a 10% dividend to every shareholder, isn't that the same as buying back 10% of all the stock and effectively giving the remaining shareholders 10% more of the company? Well, in one case the shareholder received cash and in the other case 10% of all the shares are eliminated and no one received and extra payment – the risks are not equivalent.

Stock Buybacks Defined

When a publicly traded company repurchases and permanently cancels its own shares (as opposed to holding them for employee benefit programs like stock option and 401-K programs), it is "buying back" its stock. These buybacks are controversial because they:

1. Concentrate ownership in fewer hands;
    a. Can lead to inadvertent changes in voting control and regulatory disclosure requirements.
        i. In practice, some companies use buybacks precisely this way to cement control which is not in the interest of most other shareholders.
2. Replace a dividend **in theory** by systematically raising the amount of the company we own after the buyback;
    a. Buybacks do not really replace dividends because a dividend typically puts real cash in a shareholder's pocket whereas the buyback provides only a theoretical increase in the value of the stock.
    b. Almost always raises the amount of the company we own and not always in a good way.
        i. If the company pays too much for the stock, we own less than we should have if the buyback occurred at a fairer price.
        ii. If the company buys back at a discount, it can lead to a much better benefit but that is not guaranteed if the market does not recognize the value (we have seen companies languish at the same price after buybacks because the market didn't absorb the story behind it.)
3. Do not help the company grow so much as grow the percent of the company owned by the remaining shareholders;
    a. In other words, if a company has profitable projects and opportunities in which to invest and it chooses to buy back its own stock instead, it maybe be decreasing overall returns because good projects tend to perform better than milking the existing business.
    b. There is a sense that companies who tread water by design are companies ripe to be picked off by more aggressive competition.
        i. If opportunities are being ignored, more aggressive competition will likely enter the market.
    c. Can also signal a company with limited prospects or an unattractive market.
        i. We can find diamonds here, but it can also be a company in real decline and to be avoided.
        ii. Buybacks only create theoretical price increases, which when they fail to materialize, argue the company is actually facing decline.

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Dividends

A dividend is simply a method for sharing profits with the shareholders who own the company. Dividends are typically declared four times a year by US companies and twice a year in many foreign businesses. They are typically paid in cash (sometimes companies issue stock as a dividend – the reverse of a stock buyback).

Dividends signal certain benefits:

1. A company's willingness to share profits directly with shareholders;
    a. We applaud this practice since these same companies usually profit share with many employees, management, and even board directors through bonuses so why not the owners, too.
2. Systematically reduces shareholder risk by returning some of our investment to us;
    a. Although not technically reducing what we have invested in most cases, it is putting a profit in our pockets rather than having to time our stock sales based on unpredictable stock price movements.
3. Signals a company's confidence in its future and ability to fund new projects while still sharing profits.

Note: Companies experiencing high growth rates typically do not pay high dividends because reinvestment returns are too high to sacrifice to a dividend. Shareholders can benefit from radical price increases, but timing risk is entirely shifted to shareholders while key employees, managers and others may receive cash bonuses. High growth companies are exciting and also experience the highest failure risk. For every NVIDIA success story there are a bunch more Peloton, Pets.com and MoviePass disasters – companies whose growth dreams turned to ash after finding early success that attracted investors.

While paying a dividend to shareholders reduces the capital a company can invest in any given year, it also keeps shareholders more passive than situations where we see activist shareholders agitating to unlock value. In other words, when a company shifts all the risk to getting the highest stock price rather than profit sharing through dividends, it attracts investors seeking to realize the highest value through any legal means. Those actions can benefit or disadvantage other shareholders; and that increased uncertainty increases risk.

We also get important signals from dividend stocks when the dividend is actually paid by seeing how much of a company's financial report is fluff versus hard cash reality. For example, companies who push into unsustainable dividend payments to maintain appearances signal coming trouble as much as companies paying a sustainable portion of profits signal a healthy business that may be worth our investment.

Let's Discuss

I realize the above is a bit in the weeds, so let's super simplify things to illustrate the issues.

Let's create a company named DOPE that at has only cash in the bank at the end of every day and nothing else. It's a business with no future prospects other than what it can earn each year. Each year, company will need 900K to operate and earn $1MM, giving it an extra $100K to payout in some form like clockwork. Finally, this is a business anyone can enter with $900K to make $1MM in a year.

Now, I have made at least one very unrealistic assumption that our company cannot reinvest in its business to grow, which most companies actually do and deeply complicates this analysis. Because that level of complexity makes any analysis extremely difficult and subtle, let's limit how the company can use its excess cash to see more clearly how the various risk and value levers work for buybacks versus dividends.

Simplified Stock Buyback

Let's skip to December 31st and our super simple company has $1MM in the bank. What is this business worth? If it will produce a $100K profit if one puts up the $900K and anyone off the street could do the same thing on their own, most would argue this business is only worth the cash in the bank and you would not offer a penny more because there is no path to earning that extra penny next year (remember, the business cannot reinvest to grow.)

Let's further assume DOPE has 1MM shares that investors own and each share is worth $1 at the end of the year ($1MM/1MM shares). On December 31st, the DOPE directors have an extra $100K if they choose to operate the next year (the business needs $900K to make $1MM the next year) which can only be used in the following ways:

1. Declare extra bonuses for employees and management;
2. Buyback $100K of shares at $1 per share; or
3. Pay a $0.10 dividend to the 1MM shareholders

Again, please note in the real world, companies typically choose to invest the extra cash to grow the company, which we have taken away for this analysis.

So, with these 3 choices, DOPE's directors vote to promote a higher stock price by buying back 10% of DOPE stock from the market at $1 per share.

After the buyback, DOPE now has $900K in the bank and 900K shares outstanding, so the same $1 per share value has been maintained (the $100K bought back 100K shares that have now been cancelled and no longer exist.) What has changed that is that DOPE will earn $1MM next year, and that $1MM is now divided over the remaining 900K shares, or an 11% increase to $1.11 per share in this very simplified analysis.

This is the theory behind how a stock buyback increases share prices. You do not get the actual extra $0.11 per share in value until you sell some stock when it is trading at $1.11 or higher, assuming the stock price actually increases. In any stock buyback, timing the sale of your stock to get your profits is shifted entirely to the shareholder, and that's an added risk.

Further, it can take 1 year to realize the $0.11 for the shareholders who held their stock over that time.

Simplified Stock Dividend

Instead of buying back the 100K shares, let's assume DOPE declares a $0.10 dividend on December 31st. In this case, every shareholder receives the $0.10, but the remaining cash is lowered to $900K over 1MM shares, or $0.90 per share value after paying the dividend, so have we gained anything?

In this very simplified case, we will gain an extra $0.10 every year DOPE uses the remaining $900K to operate that next year and pay another dividend.

After this next year and one day, we have $0.20 in dividends our pockets and a $0.10 lower stock price because of the most recent dividend payment. This looks like a total $0.01 advantage for the buyback, but is that $0.01 correct compensation for carrying all that extra risk?

Simplified Conclusions

While both strategies return about the same amount to shareholders, the stock buyback shifts all the timing risk to the shareholder. That makes a buyback a theoretical return until sales actually occur. Further, dividend stock shareholders receive their first dividend as much as a year before the buyback value has been theoretically created.

We conclude dividends factually reduce risk whereas stock buybacks only theoretically achieve the same result (you have to sell enough stock at a fair price each year to equal the dividend that was paid.) Further, the scheme only works if the average stock buyback was completed at some favorable price. With so many moving parts, stock buybacks are far riskier than holding a dividend stock in our simplified world.

But what about in the real world where our super simplifications no longer limit how companies act?

Real World Stock Buybacks

In the real world, companies typically reinvest their profits to grow their businesses in alignment with whatever reward program a company has in place. For example, some companies reward managers for growing market share (how much of the overall business segment they control) whereas others may reward cash flow increases. To make it even more complex, companies typically chase multiple targets across multiple operating divisions. For example, Sempra (an energy utility company we like) has prioritized renewable energy projects in California while working to harden its Texas grid against storm damage. One division is growing while the other is working to stabilize performance against increased weather-related risks; and Sempra has many more divisions, each chasing its own priorities.

When we evaluate the effectiveness of any stock buyback, we have to know:

1. The fair value of any share today and on each day shares were bought back;
2. What are the company's growth prospects after the buyback;
3. Is there a motive beyond an increasing stock price behind the program;
4. Is there a very liquid market for the stock;
    a. If the stock doesn't trade well or is not followed by Wall St. analysts, the share price can stay disconnected from its actual value for very long periods of time; and
5. Does the stock trade in a way that allows shareholders to realize the increased value of their shares.

Each of these issues gets very complicated and we will really only know after the fact what actually happened. In our opinion, stock buybacks may or may not reduce the risk in any investment and we have no way to know ahead of time whether it will work.

There have been academic studies that attempt to get at these issues in the real world, but using their averages to predict company specific outcomes is dangerous when each company is unique in so many respects. Thus, we will not consider these sorts of studies when evaluating any specific investment.

Instead, we can observe from press releases that Companies in the real world who view their stock price as being too low often vote to buy back some portion of its stock as a confidence statement and as a projected superior investment. Ironically, it is also the typical first response to a hostile takeover offer – takeovers are often launched when a target company's stock price is depressed, so the target promises to correct the situation through buybacks. By announcing the buyback, the target company hopes existing shareholders believe the price will increase, even when that result is a far from certain.

For a real-world example, Mark indirectly owns stock in a very illiquid public company that tried this and it did not work because no analysts covered the stock and no one was around to understand how the value had changed. The buyback did succeed, however, in increasing control over the company which was big part of the plan (Mark was a board director at the time and very involved in the process.)

Real World Stock Dividends

In the real world, we see dividends typically reducing risk, but not always. Some dividends actually deplete a company's future because it cuts into vital cash flow needed to maintain the business. We sometimes see this in tax pass-through entities like Real Estate Investment Trusts (REITs) and Business Development Companies (BDCs) where those companies have committed to distribute 90% of income to maintain their favorable tax status.

When we see the dividend take up a reasonable portion of cash flow that allows the company to sustain or thrive, we perceive an attractive situation. Sometimes we see higher dividends with fewer growth prospects and other times lower dividends with an emphasis on growth. It is not clear which might be the riskier course because each company has its own issues, opportunities and priorities even when they are in the same business segment.

What is clear is that each time a company distributes cash to shareholders, investment risk has most likely gone down.

Real World Conclusions

Just as in our simplified world, we vastly prefer paid dividends to stock buyback programs because the risk reduction is far easier to see up front. Measuring cash in our pockets against forecasting how a buyback will provide the opportunities to sell over time at favorable prices is a pretty clear risk trade off – we'll take the dividend, please.