Friday Morning Coffee

Nr. 6 — Share buybacks: Is US CEO’s most popular drug coming to Europe?

In Cocaine, Eric Clapton is famously singing "*If your thing is gone and you wanna ride on. Cocaine. Don't forget this fact, you can't get it back*".

These lyrics come to my mind when thinking about the share buybacks trend in the US. **Without turbo-charging returns by aggressively buying back shares, earnings growth in the US would indeed have been negative over the last 2 years!**

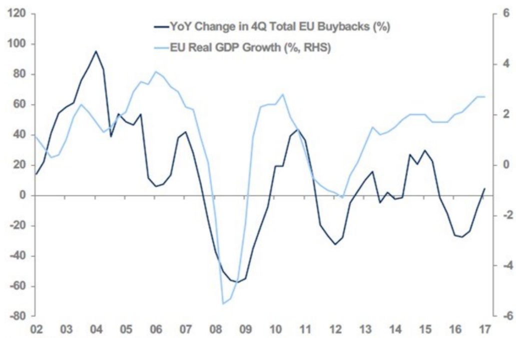
The main incentives of US companies to take the route of share buyback are threefold:

- Firstly, management wants to create shareholder value as 80% of companies have linked their CEO’s salaries to share price performance,
- Secondly, the cost of funding is historically low, and
- Lastly, Cash flows have been strong.

By buying back shares, companies mechanically reduce the number of outstanding shares and hence increase the earnings per share. Société Générale estimates that over the last 6 years 17.5% of the US market capitalization has been bought back. **Interestingly enough, it is not always the most solid companies buying back shares. Indeed, there is a tendency to the weaker, more cyclical and highly leveraged companies to buyback shares.**

As value investors, we do not feel fully comfortable with the underlying logic of companies financing share buyback programs by debt, especially when they operate in volatile businesses. They may sacrifice their long-term financial flexibility in their quest for yield. In addition, we find it difficult to understand why a company would buy back its shares at high valuation multiples. A dividend payout would technically make more sense if the balance sheet is solid.

The old continent has not seen these excesses yet, but European companies are slowly waking up to the mathematics of share buybacks as shown in this graph from Morgan Stanley.



Source: MSCI, Bloomberg, Morgan Stanley Research

The following note gives the opinion of the Investment team at the time of the publication. Please refer to important notice at the end of the document.

Friday Morning Coffee - Nr. 6 — Share buybacks: Is US CEO's most popular drug coming to Europe?

The question that can legitimately be asked is whether Europe will follow the American trend or whether European stock repurchase programs will remain within reasonable limits.

Our view is that the European background is not the same as in the US. For example, in Spain only 15% of CEO's salaries are linked to share prices. Moreover, since the trough 2009 earnings seen in corporate Europe after the financial crisis, the equity gap (capital increases minus buy-backs) have actually had a negative impact on earnings per share (Source: Goldman Sachs Portfolio Strategy Research, 'Strategy Matters: Time to buy(back)?', 5 July 2017).

In a nutshell, **we believe the situation in Europe remains healthy as the earnings recovery we are seeing is based on fundamentals, not financial engineering.** Profitability in Europe is going up, driven by sales growth and by margin expansion due to self-help measures taken by companies who have been disciplined in keeping costs under control.

Roughly 25% of the companies we hold in our portfolios are currently performing share buy-backs. They are spread amongst all sectors, but most in Consumer Discretionary. However, the businesses are all sharing common characteristics: they are generating strong cash flows and have strong balance sheets. As value investors holding these names in our portfolio with the required margin of safety, we are also confident they are not buying back their own shares at elevated valuations.

Have a great weekend,

Léon Kirch, CFA
Partner & Chief Investment Officer
April 13th, 2018