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Stock buybacks: some old norm should remain new

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11. Stock buybacks: some old norm should remain new

Zhang Wei[281]

Corporate payouts, especially through stock buybacks, are never short of critics. COVID-19 has simply energized them further. From the energy industry to airlines and banks, US public companies are blamed for ensnaring themselves into the abysmal crisis in the midst of COVID-19 by handing out cashes extravagantly to buy back stocks years before.

However, as astutely pointed out by Professors Jesse Fried and Charles Wang, the critics did not get the facts right even before COVID-19. After taking into consideration the amount of newly raised capital through equity or debt issuances, the cumulative net payouts by US public companies between 2007 and 2016 totalled just above 40% of their net income, not reaching even a half of what the critics claimed to be.

At the same time, studies on motivations and impacts of stock buybacks are legion before COVID-19. More often than not, empirical evidence points to the benign effects of buybacks. For instance, buybacks are predominantly deemed by the market as a credible signal of undervaluation of stock price of listed companies, which patently contributes to the efficiency of the capital market. Similarly, draining the free cash flow under the control of the management removes an important source of agency costs, a point well-known to the students of corporate governance since Professor Jensen's profound insight presented in the mid-1980s. Again, empirical data bear out buyback's constructive role anticipated by the theory.

On the other hand, the claimed pernicious inducement of buybacks finds much weaker, if any, empirical support. For example, the suspected motives of informed-trading are debunked by the fact that buybacks are conducted overwhelmingly through public market and avoiding the disclosure windows of sensitive information. Since tender offers at fixed prices entail less risk of being perceived as manipulation and can be launched at much larger scales than public market purchases under the regulatory safe harbours, insiders would reap substantially more benefits through tender offers should buying back stocks are mainly to facilitate informed-trading.

Moreover, while earnings management is apparently associated with stock buybacks, the direction of the causality is controversial, and may well be flowing from buybacks toward management. In other words, earnings are managed months before announcement of buybacks in order to facilitate the buyback plan under consideration. In any event, investors appear to be smart enough to call

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out such management mischiefs by discounting their stock prices after firms have made clear their intention to buy stocks back.

Fierce criticism has been laid on stock buybacks for siphoning funds out of the corporate reserve for R&D investments. As rightfully noted by commentators, however, the cashflow going back to shareholders of public companies has turned into a source of capital supporting energetic R&D research in private companies, startups in particular. It is well conceivable that the R&D money is likely to be employed more efficiently in the private companies seeing a robust growth than in established ones whose stocks have been floating publicly for a long time. The theory goes, therefore, stock buybacks by public companies will promote, rather than suffocate, R&D efforts in our society.

Admittedly, empirical evidence on this latter regard is sparse. Some rudimentary observation of the changes in total factor productivity (TFP), a measure of contribution of technology development to aggregate economic growth, in US and Japan, however, establishes a prima facie case that stock buybacks are unlikely to have caused a sacrifice to the overall technological development. The amount of stock buybacks started to surge in US since the SEC adopted Rule 10b-18 to relax buybacks in 1982, yet the TFP in US rises in tandem thereafter. Similarly, in Japan the Companies Act was revised in 2001 and then 2003 to substantially loosen the restrictions on stock buybacks. However, the TFP in Japan shows no sign of declining in the wake of the changes in law.

The financial fallout of American companies at the height of COVID-19 cannot be convincingly attributed to the abundance of cash returned to shareholders through buybacks, either. As Professor Charles Elson of the University of Delaware stated, even if companies had not bought back their stocks, they would not have had enough cash on hand to support the kinds of revenue declines we are seeing. The latest research by Professors Fahlenbrach, Rageth, and Stulz confirms that “had firms not had payouts in the last three years, their financial flexibility would not have been very different on average and their average improvement in stock returns would have been smaller than 2%”.

Hence, the idea of hoarding cash in preparation for such an unpredictable risk resulting in such a large scale financial loss appears to be a highly inefficient type of self-insurance. Social security network and governmental grants could be more cost-effective to deal with catastrophes of small probabilities like COVID-19. On the other hand, the costs of cash hoarding could be extremely high, both because of the slack it encourages in corporate governance and the misallocation of capital contributing to macroeconomic stagnation. We are unlikely to see disasters or plagues of a similar scale at least in the near future, but we are almost certain to see managerial opportunism on daily basis if indulgence in cash is unbridled.

In the Asian-Pacific region, stock buybacks by public companies do not seem to be generating a great amount of concern. If anything, there is a consistent relaxation in rules of buybacks. In the wake of the 1997 Asian financial crisis, for example, Singapore amended its Companies Act to allow companies to purchase up to 10% of their own stocks out of distributable profits. It is considered a step to address the issue of lack of good investment opportunities by a number of cash rich companies during the crisis. In 2013, the cap on stock buybacks was further raised to 20%. Similarly, Japan eased its long-standing restriction on stock buybacks first in 2001, with even greater discretion of buying back stocks granted to corporate boards in 2003. Most recently, China followed suit in 2018 to permit stock buybacks by listed companies to maintain corporate and equity value generally.

Considering the highly concentrated ownership structure and the risk of tunnelling often observed in many countries in the region, the legal blessing on stock buybacks is probably a right movement to enhance corporate governance and upgrade market efficiency, both of which are essential to sustainable capital formation. While some new norms may settle down in the aftermath of COVID-19, we also have every reason to believe that, many fundamental human behaviours will remain unchanged. Therefore, those old norms that helped resist our temptations in the past will perhaps continue to be effective after the virus is subdued.