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The Equity Round Trip

Many public companies generate more cash from their operations than reasonably needed for future business investments, and an increasing number have been returning excess cash to shareholders via share buybacks. Hamilton Point's quality-focused investment philosophy leads us to own certain of these publicly-traded companies that are, if you look closely, slowly "going private" by regularly buying back a portion of their shares. The incidence of share repurchases by public companies has been significant in size of late and worth discussing since buybacks can either be a great idea or altogether unwise.

Once Begging for Cash

Backing up a bit, the notion of why private companies become public has changed significantly in the last 30-40 years. Prior to the 1980s, a company needing cash for expansion would first turn to bank financing. Eventually, markets evolved such that additional financial flexibility was available in the form of private placements of equity and high-yielding debt. In either case, at some point when more cash was needed than banks and private capital sources could provide, companies had to raise funds by selling a portion of the company to the public in the form of an initial public offering (IPO).

Typically all proceeds from an IPO, as well as "follow-on" offerings, went to the company for specific growth plans and none to selling shareholders—the logic being, why should a new shareholder buy if the current owners are selling? Investors in public companies naturally preferred that their cash be earmarked for specific projects such as new railroad tracks or cell towers and not legacy shareholders' pockets. Historically, if a family wanted to "cash out" of their public stock, but didn't want to sell the company to a strategic corporate buyer, they could only slowly sell small amounts of personal shares over a period of years.

As our economy and financial markets have matured, there are now thousands of public companies whose original family or other shareholders are long gone and now management and board members, who own small percentages, make the big decisions about how to direct these enterprises. Also reflecting modern times, productive technologies and the opening of the global marketplace to low cost labor have combined to minimize the cash needed to grow businesses (think cloud versus servers in computing).

Now Spewing Cash

As a consequence, there are now plenty of well-established public companies that produce growing gobs of cash annually, even after capital expenditures for both organic growth and maintenance purposes. This has turned upside down the traditional model of growth companies issuing shares to the public. Instead, these companies must decide how to put this excess cash to work for shareholders by making acquisitions, paying down debt, paying dividends and/or buying their own shares on the open market. Worth noting is that, unlike dividends which tend to be repeated quarterly and maintained or steadily grown with time, buybacks are more likely to fluctuate significantly depending on management discretion and market conditions.

Now let's look at a stock buyback "poster child": **Apple**. The company earned a little over $215 billion in net income over their five most recent fiscal years and,

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during that time, bought back almost $130 billion worth of shares while paying out nearly $50 billion in dividends. The rest of the cash was used for capital spending and additions to net cash balances which now total a remarkable $150 billion.[1] Apple's earnings actually decreased some in 2015 relative to the previous year, but estimates are that they continue to have the potential to grow and gush cash in the coming years.

Importantly, Apple has reduced the number of its shares by 18% during this time so investors now own a larger percentage of the company and its cash production. Some argue that companies like Apple should have better places to invest than in share buybacks and higher cash balances, but we believe it is justified for a company to return some excess cash to shareholders rather than feel forced to buy other companies or expand unnecessarily (as lumbering conglomerates like **ITT** did in the 70s and 80s).

Return *On* My Money, or Just Return *Of* It?

As is the case with most corporate finance decisions, stock buybacks can be misguided. We, of course, attempt to invest only in companies who are doing so because they view their stock as a worthy long-term investment. Some untoward companies initiate buybacks primarily to offset the dilutive effects of exorbitant stock option issuance to inside employees and directors. To be especially avoided are those employing buybacks while using growing debt levels to create the appearance of rapid earnings per share growth despite a slowing business model. This latter habit is akin to the neighbor who borrows to buy a fancy car in order to create the impression around the neighborhood that things are going well at work.

The buyback phenomenon is big. Looking at the broad market of the S&P 500, dividends and buybacks totaled around 5% of the total stock market capitalization for the fiscal year ended June 30, 2016. Since dividends comprise around 1.8% of the calculation, it is clear that these companies on average are reducing their publicly traded shares by around 3% per year.[2] Perhaps driven by the combination of a lack of prudent investment opportunities in their businesses and the lure of low cost debt, large companies have increased their expenditures on buybacks from 30% of free cash flow at the end of 2010 to nearly 60% recently. In fact, 28 of the 33 companies currently held in our Global Core Equity Strategy have been net buyers of their own stock in the last five years.[3] Clearly, this buying is significant and has supported stock prices.

Before concluding, we give anonymous credit to our client who sent us an August 2016 *New York Times* article which drew attention to a few name-brand companies that may be behaving badly in terms of how they "manage" their earnings per share using stock repurchases.[4] This illustrates an area where we believe Hamilton Point's in-house research yields important insight, as we seek to separate the companies slowly "going private" with predictable, preferably growing, cash-flow streams from those simply engineering a mirage of earnings growth. We believe our work benefits our clients in the long-run if we properly identify those companies that are as interested as we are in buying their shares — for the right reasons.

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Hamilton Point Investment Advisors, LLC is an independent and independent-minded wealth advisory firm. Please contact us for a complimentary review of your portfolio. In addition, visitors to the firm's website, www.HamiltonPoint.com, can read past investment newsletters.

1) From public filings of financial statements with Securities and Exchange Commission.
2) Birstingl, Andrew. "Buyback Quarterly." FactSet. September 20, 2016.
3) For a free list of all recommendations made by Hamilton Point during the last year, please contact us.
4) Morgenson, Gretchen. "A Simple Test to Dispel the Illusion Behind Stock Buybacks." New York Times. August 12, 2016.