Gresham House
Specialist investment

How are UK-listed companies using buybacks as a capital allocation tool?

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Following Brexit and the COVID-19 pandemic, investor appetite for UK-listed companies sharply declined.

Allocators pivoted towards 'risk-free' cash products amidst higher interest rates and favoured other global equity markets, particularly the US, as AI momentum stocks delivered supernormal returns. UK-focused funds have since been relentless sellers of domestic shares to meet heightened redemptions, suppressing stock market valuations such that UK equities continue to trade at a c.40% discount to their US peers[1] - a discount even more pronounced in the UK smaller companies space.[2] Macroeconomic challenges simultaneously detracted from consumer and business confidence, contributing to a decrease in appetite for equity exposure. Collectively, these factors created a connected shift in UK corporate behaviour.

In periods of economic and market uncertainty, management teams and investors have used low valuations to legitimise share buybacks

Between 2017 and 2019, companies in the FTSE All Share Index repurchased c.£58bn of their own shares, with a sharp deceleration during the pandemic as businesses conserved capital to ensure survival.[3] Thereafter, as valuation multiples contracted, UK companies bought back c.£140 billion of stock between 1 January 2022 and 30 September 2024 , and the median value of daily repurchases during the year-to-date stands at 9% above 2023 levels.[3]

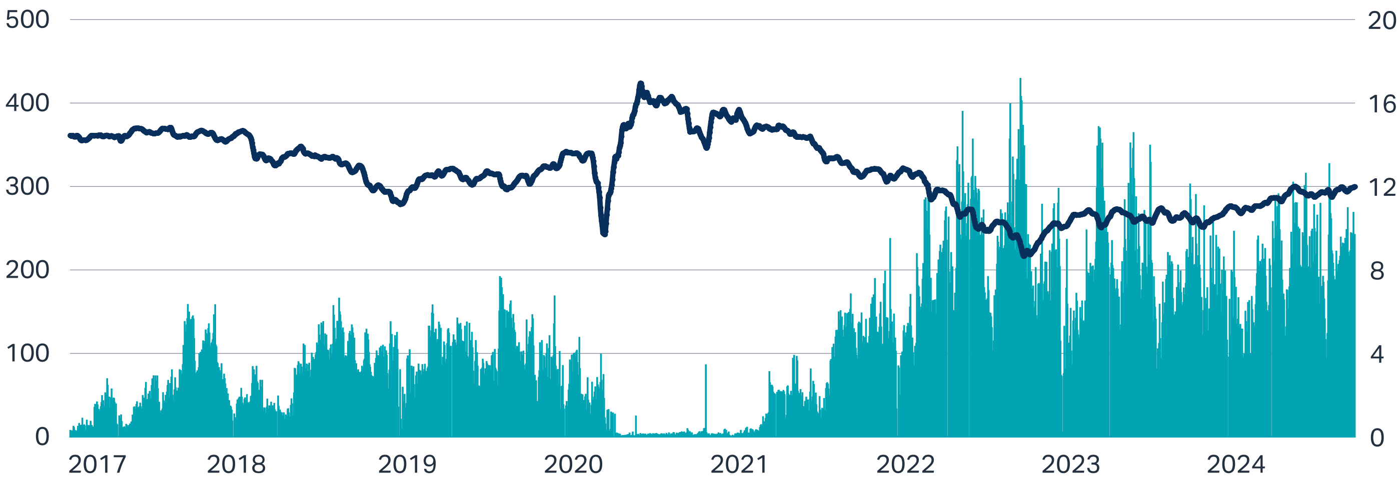
1. Source: Bloomberg, 31 October 2024
2. Source: Berenberg, 30 September 2024
3. Bloomberg Share Buyback Data on FTSE All Share Index Ex Investment Trusts, CACT BBKE function, 30 September 2024

Many investors and commentators have praised this activity as sound capital allocation which exposes the stark undervaluaton of UK equity markets; in their view, management teams that repurchase shares 'below intrinsic value' are acting harmoniously with shareholder interests for three key reasons:

1. Declining share counts induce a positive compounding of earnings per share and dividend yields
2. Repurchasing stock increases the equity ownership of 'patient' or 'long-term' investors at the expense of price-sensitive sellers
3. 'Returning' excess cash through buybacks enhances net shareholder gains by foregoing incremental yet taxable interest income earned on corporate cash, instead diverting shareholder funds to higher yield alternatives: the company's own shares

Indeed, on a surface level, aggregate earnings yields on UK equities became increasingly attractive over the two and a half years between the first COVID lockdown and the October 2022 'mini budget'.

As valuations fell, UK buyback value rose



Source: Bloomberg, 30 September 2024

Assessing buybacks requires investors to look beyond market valuations

Advocates of buybacks in a 'cheap' market often differentiate between 'maintenance', 'growth', and 'excess' capital, emphasising that companies must only repurchase shares after all necessary expenditure to maintain business operations and secure or grow market share.

We think this vital distinction is owed greater investor attention when appraising buyback activity. After all, shareholders necessarily outsource capital allocation to management teams whose actions are guided by a complex interplay of shareholder and board-level influences, management's own value creation plans, and their financial self-interests, often linked to share prices or earnings per share through annual bonuses and long-term incenive plans (LTIPs), both malleable to the effects of buybacks.

The reality is that causation behind management decision-making ebbs and flows with market, macroeconomic, and psychological variables, and we view 'excess' capital as classified by those teams as more at risk of being deployed contrary to 'long-term' shareholder interests.

While buybacks remain a key instrument to return excess capital, they may have as much capacity to destroy long-term shareholder value as to create it.

Capital allocation discipline is key

UK buybacks have risen markedly and inversely to stock market valuations, and in many instances have produced short-term earnings per share or share price accretion.

McKinsey showed that buybacks tend to convey positive short-term signals of perceived stock market undervaluation and confidence in future profitability and cash generation, leading to marginal share price gains.[4]

There is some rationality at play here: a management team that repurchases company shares at a 10x forward P/E will have secured an effective "earnings yield" greater than the current c.5% (pre-tax) interest rate on cash if it remained at the bank, assuming that the company meets its expected earnings forecasts.

This effective yield looks even more attractive if earnings grow over time; thus exploitation of this arbitrage should accrue value to shareholders.

However, and vitally, management teams may have foregone an opportunity to invest in other growth opportunities - organic and/or inorganic - whose projected returns exceed the company's cost of capital and both the cash interest rate and stock earnings yield. In these instances, share buybacks support short-term interests over true long-term shareholder value.

The evidence suggests that in the long-term, this poor capital allocation is gradually built-in to a company's share price and market rating; after all, if future operating earnings and cash generation are not supported through growth investment, this translates to lower growth, weakening market share, and sub-optimal returns on company equity (even if that equity has reduced through share buybacks).[4]

4. R. Dobbs & W. Rehm, 'The value of share buybacks', The McKinsey Quarterly, No.3, 2005

Share price pressure increases the likelihood of inefficient capital allocation

Given the pressurised market and liquidity dynamics of the UK smaller companies space in recent years, we see management teams as more likely to pursue short-term capital allocation decisions, at best out of an irrational reaction to stem downwards price pressure from forced selling of their company's shares, and/or to counteract adverse share price movements following negative earnings announcements, and at worst, due to prioritisation of their own financial compensation above 'long-term' shareholder interests.

While buybacks may signal undervaluation, the UK smaller companies space remains a 'stock pickers' market which requires investors to separate inefficient uses of excess capital with those truly aligned with long-term investor interests. By taking high-conviction equity stakes, we believe that we have an edge in influencing the corporate governance environment in which such capital allocation decisions are made.

Across four portfolios that we manage - Gresham House UK Multi-Cap Income, UK Smaller Companies, UK Micro Cap, and Strategic Equity Capital plc - we found that companies with a net cash position, trading on a median P/E ex cash multiple of 13.6x, could induce an average 1.4% uplift in their forecast return on equity (RoE) by deploying one-third of their net cash balance to repurchase shares. In these instances, the effective earnings yields and wealth transfer into the hands of fewer shareholders would create value in excess of the foregone pre-tax cash interest yield.

Nevertheless, we would not advocate share buyback activity on this basis alone. Using our material equity stakes and strong relationships as an engagement platform, we would first seek to understand management's assessment of the opportunity cost of share buybacks.

If we believe that the company is well-capitalised from internal cash generation, has comprehensively assessed the landscape of organic and inorganic growth opportunities, and concluded that no greater rate of return was achievable with this 'excess' cash, only then would we support the decision to repurchase shares.[5]

Evidence shows that recent UK buybacks have not added value in aggregate

The specific data on UK smaller companies are limited but evidence suggests that companies within the FTSE All Share ex Investment Trusts Index have not uniformly created long-term shareholder value through much-touted buyback activity.

Importantly, market valuations have fallen, cash spent on buybacks has risen starkly, but the aggregate return on equity (RoE) has been broadly static over many years. When share buyback levels were at their peak in late 2022 - simultaneous to trough UK stock market valuations post the 'mini budget' - we can observe a marginal uplift in the return on equity, likely because the earnings yields on shares repurchased outweighed expected returns on any organic growth investment (and/or foregone interest income on cash balances) when those shares were excessively 'cheap'.

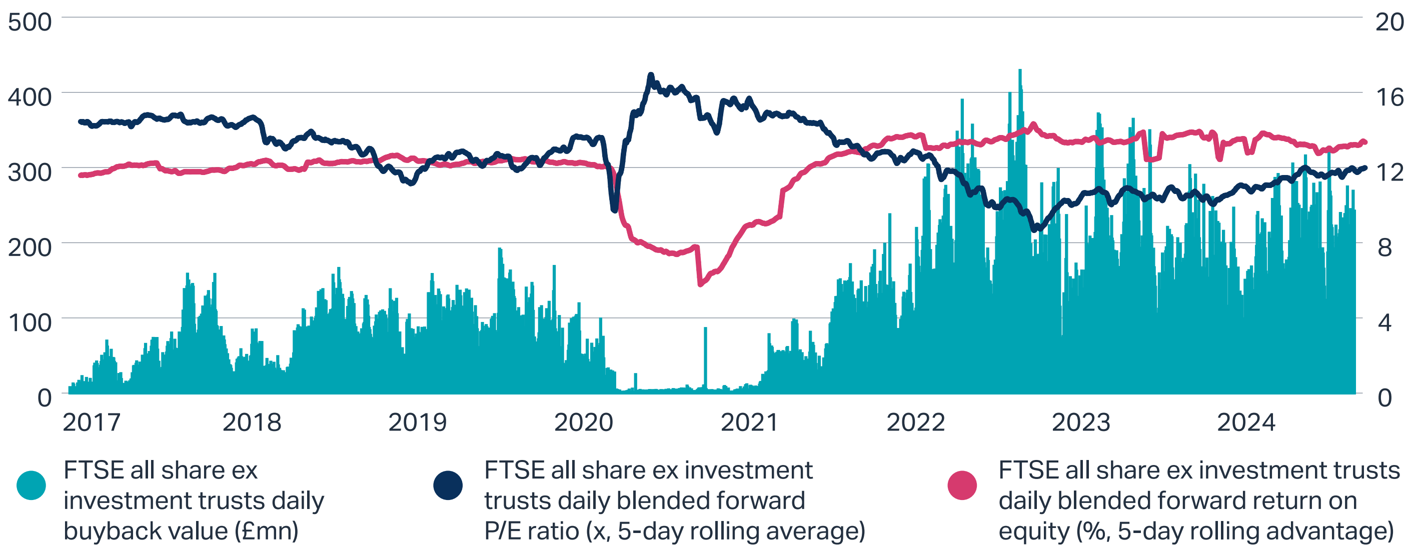
However, as valuations have slowly recovered, the median daily value of UK buybacks has remained high and trended upwards in 2024, whilst the aggregate RoE has marginally declined over that same period (i.e. negative incremental RoE). Although buyback activity is just one component of incremental RoE, it stands to reason that in an environment of rising equity valuations and rising cash interest rates (e.g. late-2022 to today), the case for buybacks becomes less compelling, which contrasts with the elevated buyback activity in that period.

We suggest that management teams have, in select instances, used buybacks to dampen the blow of forced selling of their shares in the short-term and failed to assess the true opportunity cost of share buybacks, both of which harm returns on equity and cause sub-optimal shareholder returns in the long-run.

However, stock pickers have reaped the rewards of some well executed buyback programmes

Whilst the data suggest that, for the market in aggregate, recent buyback activity may not have generated fundamental shareholder value, there are positive case studies to be found on a company-specific basis. Mears Group and Balfour Beatty are just two examples within the Gresham House Public Equity portfolios.

On aggregate, elevated UK buybacks have not clearly created incremental value



Source: Bloomberg, 30 September 2024

5. Gresham House internal research; all median averages, 30 September 2024

Mears Group plc ("Mears")

Mears is a leading maintenance services provider to the UK's affordable housing sector, managing and maintaining c.450,000 homes predominantly through long-term Government contracts.

Having reported net cash of £100mn in December 2022 (an increase from £55mn one year prior), Mears announced a £20mn share buyback programme in May 2023, which resulted in 6.6% of the company's issued share capital being repurchased.[6]

It subsequently executed two further buyback programmes over the following year (with a fourth currently ongoing), which in aggregate (and with the first programme) resulted in c.18% of the company's issued share capital being repurchased (c.16% net of share issuance for Mears' Save As You Earn scheme).

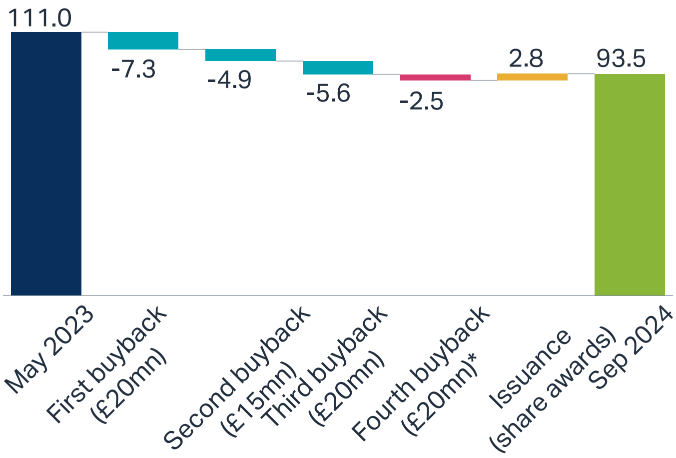
Unlike some other examples of buyback activity in the market, the overwhelming majority of Mears' buyback translated into a net share count reduction, as opposed to just being used to offset dilution from new share issuance (e.g. LTIP vesting).

Despite the c.£55mn deployed on share buybacks over this period (excluding the ongoing fourth programme, of which c.£10mn has been deployed between August and September 2024) and a double digit growth in dividends per share, Mears reported net cash of £107mn at June 2024.[7]

Over the period of the three completed buyback programmes, consensus next-twelve month return on equity rose from c.12% to c.16%, and Mears delivered a Total Shareholder Return (dividends reinvested) of 52%.

Whilst short-term share price developments should not be used to judge the efficacy of a buyback programme, Mears has largely traded at higher share prices post-buyback, a trend which has continued into the ongoing fourth buyback programme.

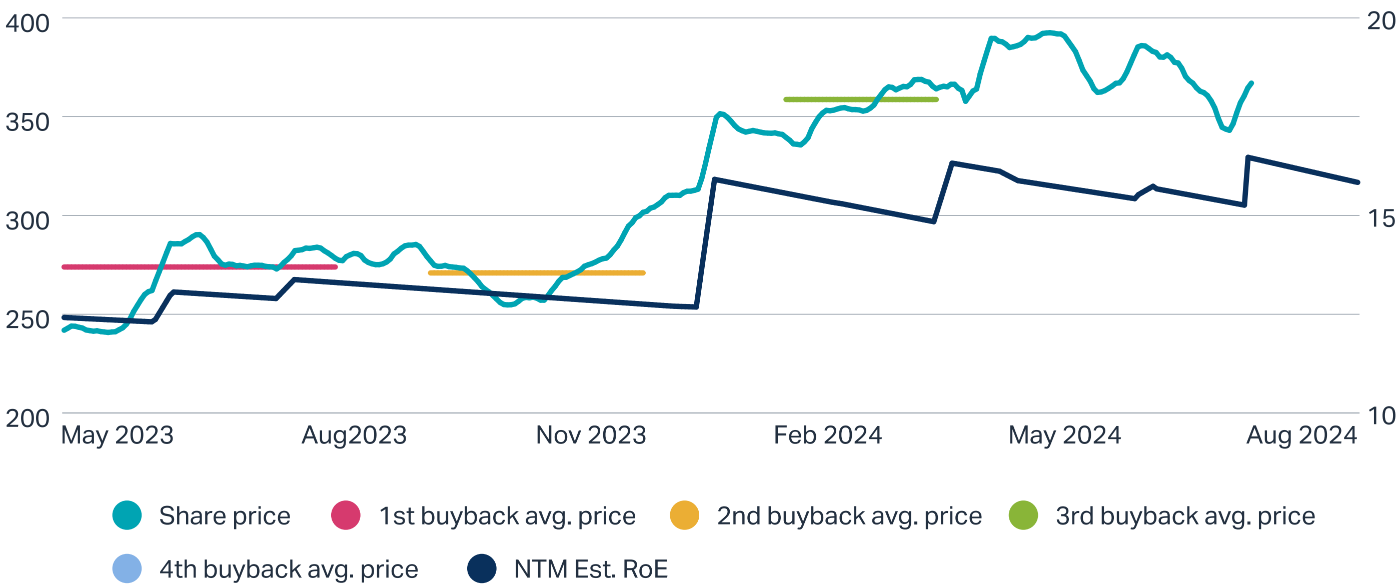
Mears Group impact of share buybacks and issuance on shares outstanding.



*Ongoing

Source: Bloomberg, 30 September 2024

Mears Group evolution of average buyback price, share price and consensus forward return on equity



Source: Bloomberg, 30 September 2024

6. Pre-IFRS 16 lease liabilities
7. Gresham House internal research; all median averages.

Balfour Beatty plc ("Balfour Beatty")

Balfour Beatty is a leading international infrastructure group that develops, delivers, maintains and finances national scale critical infrastructure across the UK, US and Asia.

Emerging from the early part of the COVID pandemic having paid down some of its long-term borrowings and having redeemed its outstanding preference shares, Balfour Beatty concluded the year ended December 2020 with a net cash position of £581mn at which point it began to embark on a multi-year programme to return excess capital to shareholders.[8]

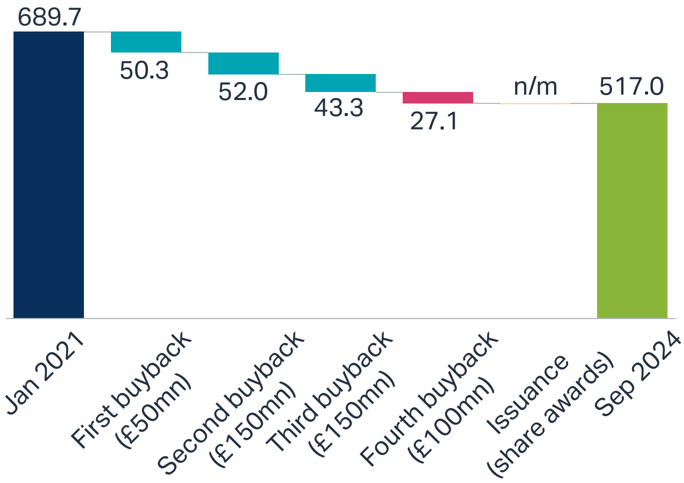
Over the course of the next three years Balfour Beatty returned c.£450mn via buyback, and by the end of 2024 it expects to have returned a total amount of £750mn to shareholders under its 2021 multi-year capital allocation framework.[9]

As with Mears, Balfour Beatty has seen a steady increase in forecast returns on equity throughout its buyback programmes, and its shares today trade at greater prices than those at which the buybacks were executed on average. Perhaps more impressively, Balfour Beatty's buyback programmes have led to a c.25% reduction in its share count since January 2021.

Despite this significant return of capital, Balfour Beatty's net cash[6] at December 2023 (before the fourth, £100mn buyback programme) stood at £842mn, an increase of c.45% from the level immediately prior to the commencement of the first buyback programme in January 2021.[10]

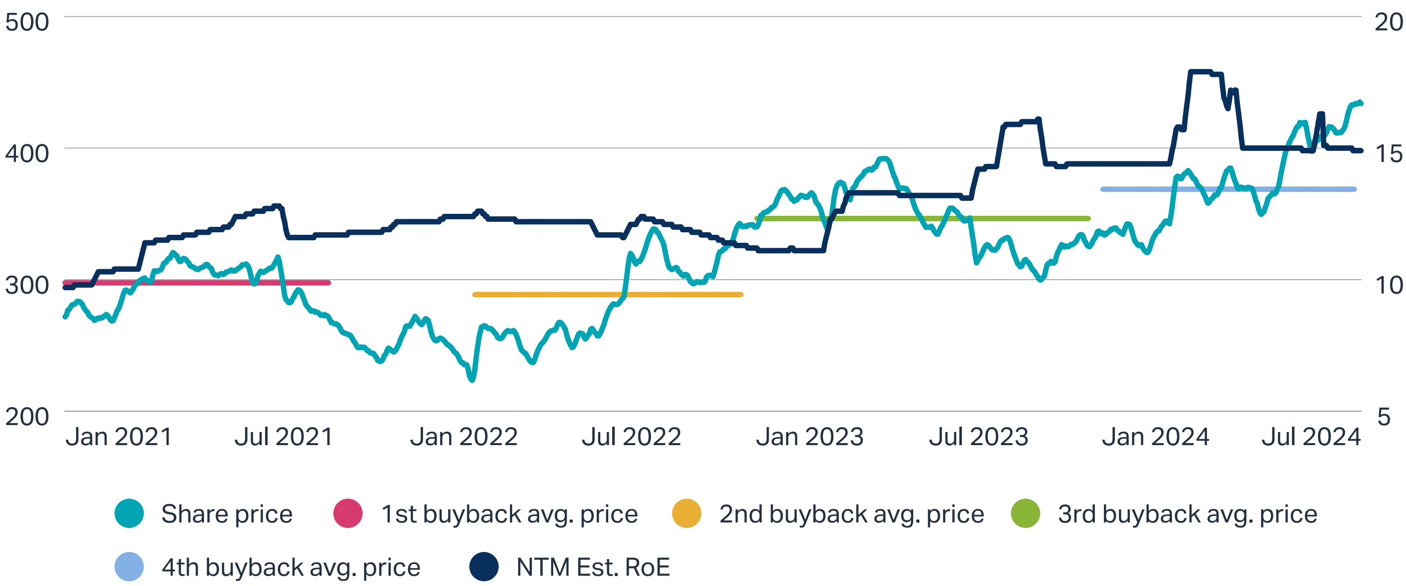
In addition to emphasising the cash generative nature of Balfour Beatty's business, this should bode well for future returns of capital to shareholders.

Balfour Beatty impact of share buybacks and issuance on shares outstanding



Source: Bloomberg, 30 September 2024

Balfour Beatty evolution of average buyback price, share price and consensus forward return on equity



Source: Bloomberg, 30 September 2024

8. Excluding lease liabilities and non-recourse ringfenced funding cash/debt in certain SPVs, and excluding the value of Balfour Beatty's infrastructure investment portfolio.

9. Balfour Beatty Annual Report and Accounts 2023

10. Pre-IFRS 16 lease liabilities

Key takeaways

- Buybacks are one of several capabilities in a company's value creation kit
- The UK market in aggregate has seen a significant uptick in buyback activity post-COVID
- Whilst depressed equity valuations strengthened the case for buybacks in the immediate aftermath of the pandemic, the case since Q4 2022 is less compelling in an environment of rising valuations and rising cash interest rates
- Lacklustre return on equity development in this period calls into question whether elevated buyback activity has led to long-term value creation for the market in aggregate
- In select cases, buybacks may have been deployed to provide short-term share price support in a net outflow environment, and/or have been encouraged by misaligned LTIP incentives
- However, on a company specific basis there are clear examples of sensible buyback programmes which should lead to long-term shareholder value creation
- Disciplined stock selection and active engagement are key to monitoring and shaping companies' capital allocation decisions

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