WAGNER ROAD
CAPITAL MANAGEMENT

Stock Buybacks are Not Always Bad
(I saw it in a video game)

October 11, 2023

From my perspective, if you assume that a company has no major operational or financial stability problems, this is the ideal capital allocation priority:

1. Invest in the company's internal growth
2. Buy other businesses
3. Return capital to shareholders

Most publicly-traded businesses will have a mix of all three. Companies that are still in growth mode will be more focused on the first two, while more mature businesses will return more money to shareholders (through either dividends or share buybacks). Choosing the right mix of those three options is a major part of running a business, and evaluating that choice is a big part of fundamental style investing. But stock buybacks are the most controversial.

There are two major arguments about the value of stock buybacks. One is that it is simply immoral, and this "extra" money should be spent on paying the employees more. The other is that managers generally do a very poor job of deciding when to buy their own stock.

I generally agree with the idea that better-paid employees are better employees, and investment into human capital is something that many large businesses still need to improve. But I don't think that stock buybacks are immoral. I find it more useful to look at it from an investor's perspective, and ask the question without a direct comparison: is this *really* the best use of the company's money?

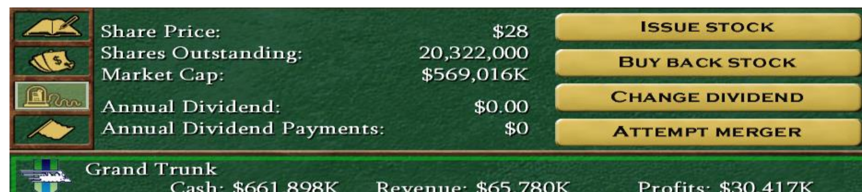
I can't remember when I was first introduced to the idea of stock buybacks, but I do remember where I got it from—a computer game series called railroad tycoon.

The concept of this game is very simple. Start a railroad, build it into a megacorporation, and beat out your competitors. The advantage that this has over learning through a case study or real world experience is that you can experiment with different ways of

doing business, and you can start over if the whole thing blows up. I have done countless business experiments inside this game.

My favorite way of “blowing things up” was through the game’s financial markets, where I could issue shares or buy back stock from the company side, or use my person’s money (or borrow on margin) to buy or sell shares. My goal was always to make as much money as possible, and I experimented on the balance between building a strong business and speculating on the stock. I eventually realized that the game requires a strong business to get a strong stock performance. So I would build a strong operational business and then “blow it up” financially in the same way that toddlers build block towers only to knock them down.

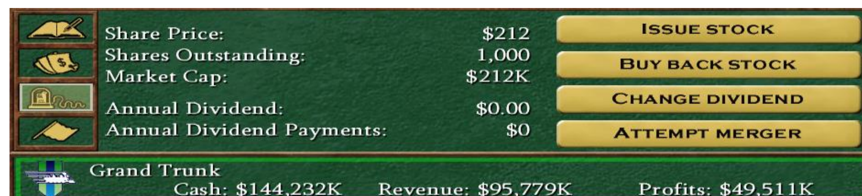
Take a look at this picture from Railroad Tycoon 3. At this point in the game, my (fictional) company had $661 million in the bank and a market cap of $569 million. It had more cash than the value of the entire business, and it happened to be extremely profitable as well.



Screenshot from Railroad Tycoon 3

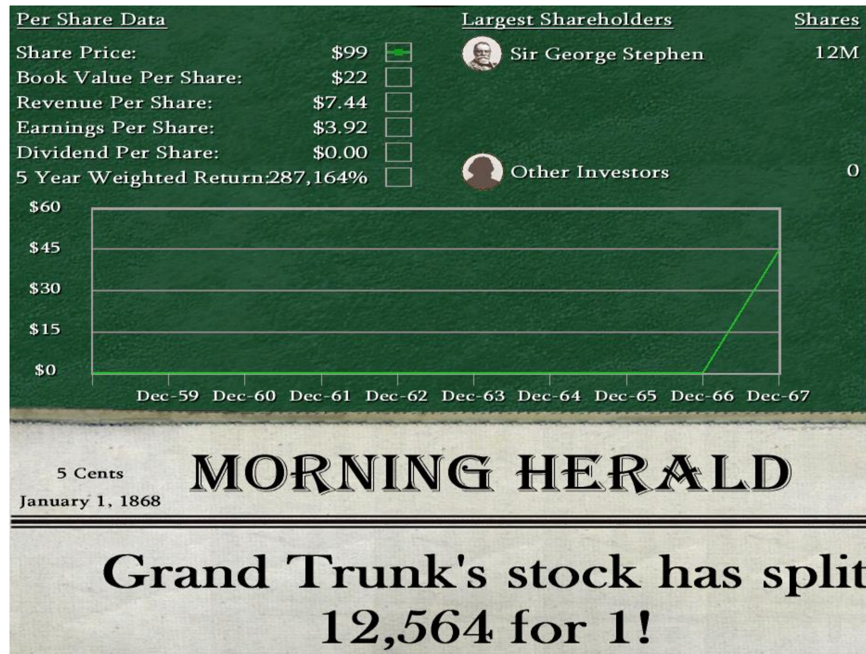
Any halfway intelligent investor would see that buying this company’s stock is an easy decision. And any halfway intelligent manager would easily understand that this company should buy back stock until it disappears into oblivion (the functional equivalent would be taking it private, but the game does not have this option). This is exactly what I did.

The trick was to pause the game to prevent the stock price from properly adjusting. Then buy back as much stock as the game would allow. Here’s a picture of what that looks like, taken at a different time. After an extreme amount of stock buy backs, my company had $144 million cash in the bank and only $212 thousand market cap. And again, it was still extremely profitable. These numbers are insanely unrealistic.



Screenshot from Railroad Tycoon 3

The result was what you would expect. An explosive stock price, and a stock split that might only be achieved by Berkshire Hathaway.



Screenshot from Railroad Tycoon 3

This absurd experiment also made the company's only remaining shareholder, Sir George Stephen, a billionaire!

Screenshot from Railroad Tycoon 3

Buying a company for less than the amount of cash it has in the bank is certainly a value investor's Holy Grail, and every investor dreams of being as lucky as this fictional

version of Sir George Stephen, but this scenario is extremely unlikely to happen in the real world. Modern markets are much more efficient than this, and stock buybacks are not always the obvious answer.

In the real world, the biggest investor complaint is about the timing of stock buybacks. Investors will often agree that if the business cannot grow, then returning money to shareholders is the right decision, but using a buyback at the wrong time is one of the worst management mistakes.

The wrong way to buy back stock

The most outrageous examples are companies that spend everything on stock buybacks only to beg for a bailout during a crisis. This was the complaint against the U.S. airline industry during the pandemic in 2020, which had spent 96% of its free cash flow on stock buybacks over the previous decade. That complaint was both fair and unfair—it was unfair because these companies were mandated to restrict their business to an extreme degree, but it was also fair because that type of cyclical industry requires keeping some extra cash on hand. Even a "normal" crisis could have left some of them looking for bailouts.

Boeing is a better example of a "normal" crisis. While this company also asked for a pandemic bailout, its problems began a couple years earlier. Boeing's latest plane, the 737 Max, crashed in 2018. It crashed a second time in 2019. Before the pandemic even started, it was grounded all over the world.[1]

These disasters were entirely preventable. They were caused by an intentional effort to make development as cheap and as fast as possible (ultimately sacrificing safety). At the same time, Boeing used some of the savings to spend more than $40 billion on share buybacks from 2013 to 2019. Investment priority number one, investing in the company's long-term growth, was cut back in favor of returning cash to shareholders.[2] Returning cash to shareholders was not entirely the wrong choice, but management took it too far.

The story is obviously more complicated. And because of the pandemic, Boeing and the airlines are not the best examples of inappropriate share buybacks. Looking at GE and IBM is much cleaner.

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[1] The story is already well-known, but Frontline PBS has a documentary about the scandal. Some commentators argue that the problems began when Boeing merged with McDonnell Douglas in 1997 and shifted its culture from engineering first to finance first.

[2] Priority number one for a company like Boeing should really be passenger safety, but that's a separate point.

GE is consistently one of my most-referenced companies for a history of bad management.[3] Stock buybacks are part of that story. After the company received a 2008 bailout, it continued to struggle with too much debt and declining businesses. And even as GE faced massive operational and financial shortfalls, management continued to buy back stock. $24 billion was spent on buybacks in 2016 and 2017, at prices that were 50% to 100% higher than what the company sells for five years later (and this is after a strong recovery).[4]

When GE's debt burden became too big to ignore, the company was forced to lay off workers and sell off large business units, and GE is now in the process of breaking up. Cash that was spent buying back stock could have been used to help prevent such a dire outcome. On the other hand, GE management made so many other poor decisions that it might not have made any difference—returning money to shareholders was ironically the right move, because management couldn't be trusted to use it wisely.

IBM is a more mild case of over-paying for stock buybacks. It is more in line with normal management behavior, but it's still bad. The company spent $176 billion on stock buybacks from 1999 to 2019, when it finally suspended the stock buyback program.[5] A mountain of share buybacks were paired with a stock that rose by a total of less than 25% for the entire 20-year time period, with virtually no return from 2010 to 2020 (a decade that included revenue collapsing by almost half). It is not hard to find an investment that outperformed these numbers.

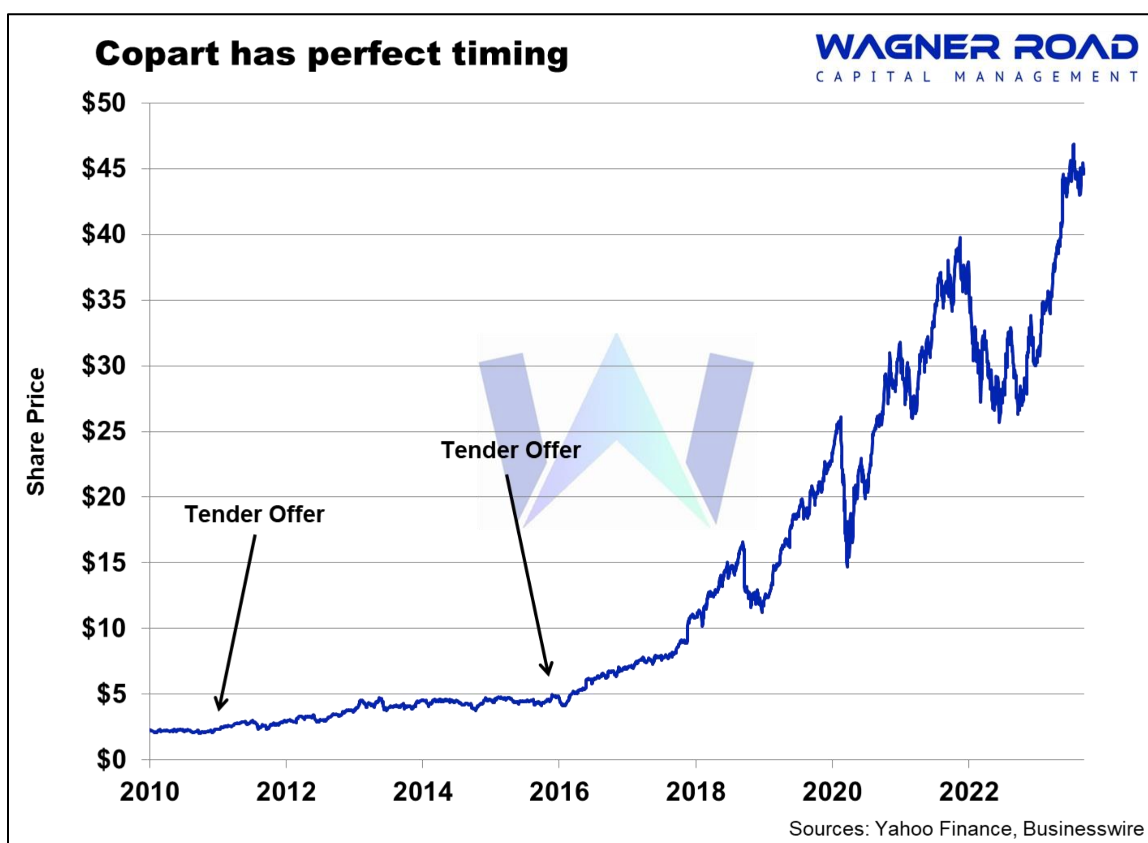
The complaint against IBM is similar to other companies that make share buybacks a matter of routine—the question becomes whether the company is doing it for the right reasons, and why it is not investing more in making the business better. If the management believes that the shares are significantly undervalued, then it might make sense. But buying back stock in the face of significant competition and operational challenges does not make sense over the long term. IBM, at least, has not yet borrowed more money than it can repay. It was not as big of a disaster as GE.

The right way to buy back stock

It is better to be strategic about stock buybacks. Periodic buybacks, timed when the stock is cheap (and the company has no better alternatives), is the ideal that every manager should reach for. Two companies that have shown exceptional discipline in this area are Copart and Berkshire Hathaway. Neither of them pays a dividend.

[3] *Investopedia* has a good summary of GE's recent history, and a 2018 article in *The Week* provides a more detailed and critical look at the company.
[4] A *Fortune* article from 2019 looking back over the previous decade is even more condemning: "GE has wasted a staggering $36.5 billion overpaying for its overpriced stock."
[5] A former IBM employee has done an obsessive amount of research on IBM's financial history. I can't agree with all of his conclusions but I can admire his commitment.

Copart is an extremely unusual case. It has only engaged in two major share buybacks since 2010: In January of 2011, the company completed a tender offer, ultimately reducing the share count by about 25% over 3 years. In December of 2015, the company completed another tender offer, reducing the share count again by about 10% over 2 years.[6] In hindsight, these two tender offers were timed perfectly.



The thought process behind the decision to buy back shares is more important than the timing. It can be summarized by a simple checklist:

- Is the stock cheap?
- Are the company's operations stable?
- Is the company's debt load too big of a burden?
- Is there a better investment inside or outside of the company that is relevant to its growth?

If any of those conditions are not met, then it should not be considered a good decision, even if it the result is impressive. This is, of course, subjective, but it is part of looking at how managers make decisions.

[6] Share count data is available at Macrotrends.

Berkshire Hathaway is another exceptional example of stock buybacks. The company did not buy back any stock or pay any dividends for 40 years, until 2011. That year, Warren Buffett announced that Berkshire Hathaway will buy back stock when the price drops below 1.1 times book value. In 2012, he increased that limit to 1.2 times book value.

This policy clearly signaled what Buffett thought the stock was worth, but it also ensured that the stock would almost never get below 1.2 times book value. As the company's cash pile continued to build, and significant investments became harder to find, Buffett was forced to abandon the strict book value metric. In 2018, the buyback policy was changed to anywhere "below Berkshire's intrinsic value."

After this change, the pandemic enabled Buffett to make massive stock buybacks, investing more than $50 billion over two years. By a rough estimate, Berkshire Hathaway was able to repurchase shares below 1.2 times book value for most of 2020, and close to 1.3 times book value for most of 2021.

Year	Stock Buybacks (Billions)	Average Price/Book Value for Year
2019	$5	1.3
2020	$25	1.2
2021	$27	1.3
2022	$8	1.4

Sources: Barrons, Company Filings, and Macrotrends

This pattern of stock buybacks follows Buffett's philosophy for making any other investment: do it when it makes sense, even if that means doing nothing for decades. As Buffett said in his 2019 annual letter: "Berkshire will buy back its stock only if a) Charlie and I believe that it is selling for less than it is worth and b) the company, upon completing the repurchase, is left with ample cash." This obviously assumes that there isn't any better alternative, and it takes a remarkable amount of patience.

Between the Extremes

Choosing how to spend money is one of the most important management responsibilities. Considering when to buy back shares is a necessary part of this decision (if other options are already exhausted). When stock buybacks are extraordinarily bad, there are often other parts of the business suffering from

management mistakes. But getting it extraordinarily right is rare even among well-managed companies.

The companies that I mentioned here are only at the very edges of how stock buybacks can be the right decision or the wrong decision. Most companies will fall somewhere in the middle: Either buying back stock when it seems to make sense, even if the timing isn't perfect; or buying back stock when it doesn't make sense, but the business is still doing well. Or not buying back any stock at all, when there is nothing else to do.

The big picture on stock buybacks is not measuring the buybacks themselves. It is examining the strategy that management uses when considering an investment. And beyond that, it is thinking about how much management can be trusted to make those decisions in the first place! If an investor can't get past the "trust" part of that question, then they should not invest.

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