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EXECUTIVE COMPENSATION

Executive Compensation and Stock Buybacks: The Pros and the Cons

By James F. Reda

The effect of a stock buyback on an executive incentive program will depend on a variety of factors and is specific to each company and their unique incentive program design. Stock buybacks, which have increased in prevalence following the Tax Cuts and Job Act (2017), continue to be a controversial topic.

A stock buyback (Stock Buyback or Buyback) is when a company purchases its own stock, either on the open market or directly from its shareholders. A Buyback is also known as a "share buyback", or "stock repurchase". Similar to a dividend, a Buyback is a way to return capital to shareholders. Although a dividend is effectively a cash bonus amounting to a percentage of a shareholder's total stock value, however, a stock buyback requires the shareholder to surrender stock to the company to receive cash. Those shares are then pulled out

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 James F. Reda is Managing Director, Executive Compensation Consulting – Benefits & HR Consulting of Gallagher.

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of circulation and taken off the market, thus having a similar effect of returning capital to shareholders.

History of Buybacks

Buybacks are a relatively new concept. Prior to 1982, Buybacks were not common. In fact, they were illegal throughout most of the 20th century because Buybacks were considered a form of stock market manipulation. In 1982, the Securities and Exchange Commission (SEC) passed Rule 10b-18, which created a legal process for executing a Buyback.

In the 2000s, Buybacks became far more frequent. Between 2003 and 2012, the 449 publicly listed companies on the S&P 500 Index allocated $2.4 trillion—some 54 percent of their earnings—to buybacks, according to a Harvard Business Review report.[1]

Today in 2018, more companies than ever are buying back stock. The increase in Buybacks has been fueled by The Tax Cuts and Jobs Act passed on December 27, 2017, which substantially lowered the corporate income tax rate and repatriation tax which encouraged money held abroad to be brought back to the United States. The lowering of these two taxes has allowed companies to re-evaluate their capital allocation profile. Many companies are choosing Buybacks over raising dividends. Forbes Magazine recently reported that S&P 500 Buybacks may exceed $800 billion in 2018. This would exceed the previous 2007 record buybacks of about $650 billion and would be substantially higher than last year's $530 billion. The $800 billion would be about 3.5 percent of the $23 trillion of the S&P 500's market capitalization.[2]

There are three main types of Buybacks: cash-based, loan-based, and a combination of cash and equity. For purposes of simplicity and to illustrate the effect on the financial statements, this article focuses on cash-based Buy Backs. The other two types of Buybacks involving increased debt will work in a similar fashion.

A central decision point in the capital allocation process is to compare the stock price to the intrinsic value of the stock. If a stock is substantially overvalued, a company may sell additional shares, thus increasing the number of outstanding shares. Conversely, if a stock is undervalued, a company may buy back stock.

The Pros and Cons of Buybacks

The Pros

In general, there are many of positive aspects of Buybacks which center on increasing stock price and thus shareholder value. There are a number of valid reasons for why a business might decide to buy back stock, which are as follows:

1. Increase Shareholder Value: Quite often, a company will use a Buyback to pump up the price of its shares when it believes that they have become undervalued. The undervalued stock is brought back at a lower price and is sometimes viewed as a signal by investors that the stock will appreciate in value (even greater than the percent brought back).

2. Return Cash to Shareholders: Buybacks are often used to provide current shareholders with a cash distribution, and this is viewed as a bonus by many investors. Thus, an investor can sell some of the stock held back either to the company or into the open market, which is supported by the strong demand created by the Buyback.

3. Provide Consistent Shareholder Returns: Buybacks provide more consistent return to shareholders vs. special cash or stock dividends that only benefit the current shareholders. This allows Buybacks to complement dividend rates, boosting shareholder return without having to increase a stable dividend rate.

4. Reduce Aggregate Cash Dividends: Buybacks provide a viable way for companies

to reduce their cash outflow, without actually having to cut their dividends. Fewer outstanding shares mean fewer dividends to be paid, and a company may reduce their dividends by a significant amount. The present value of the reduction in aggregate cash dividends may be less than the cost of the Buyback.

5. Increase Earnings per Share (EPS): This fact is based on a simple mathematical formula. If a company removes some of their outstanding shares from the marketplace by buying back stock, it means that their annual earnings will be distributed among fewer shares, and that each of those shares will be entitled to a greater portion of those earnings. The reduction of shares is somewhat counteracted by the interest earned on the cash used for the Buyback.

6. Boost Capital Efficiency Measures: Buybacks can increase financial ratios used to calculate capital efficiency measures such as Return on Equity (ROE), Return on Assets (ROA), or Return on Invested Capital (ROIC). Capital structure plays a large role in how companies (1) optimize opportunities and (2) provide cash for growth and operations. A major factor of capital structure is the debt to equity ratio.

   When a company initiates a Buyback, it effectively changes its capital structure, because fewer outstanding shares equates to less outstanding equity. This change in structure has the benefit of increasing a company's capital efficiency measures simply because its generated returns are now linked to a lower level of equity, assets, and invested capital. Higher ROE, ROA, and ROIC are definitely viewed as positive features in the marketplace.

7. Increase Market Liquidity: Sometimes a large shareholder or seller of a specific stock is looking to liquefy their holdings, and the stock-issuing company may offer to buy back their shares from them.

8. Offset Dilution. A Buyback will offset dilution from issuance of shares as part of a long-term incentive (LTI) program.

The Cons

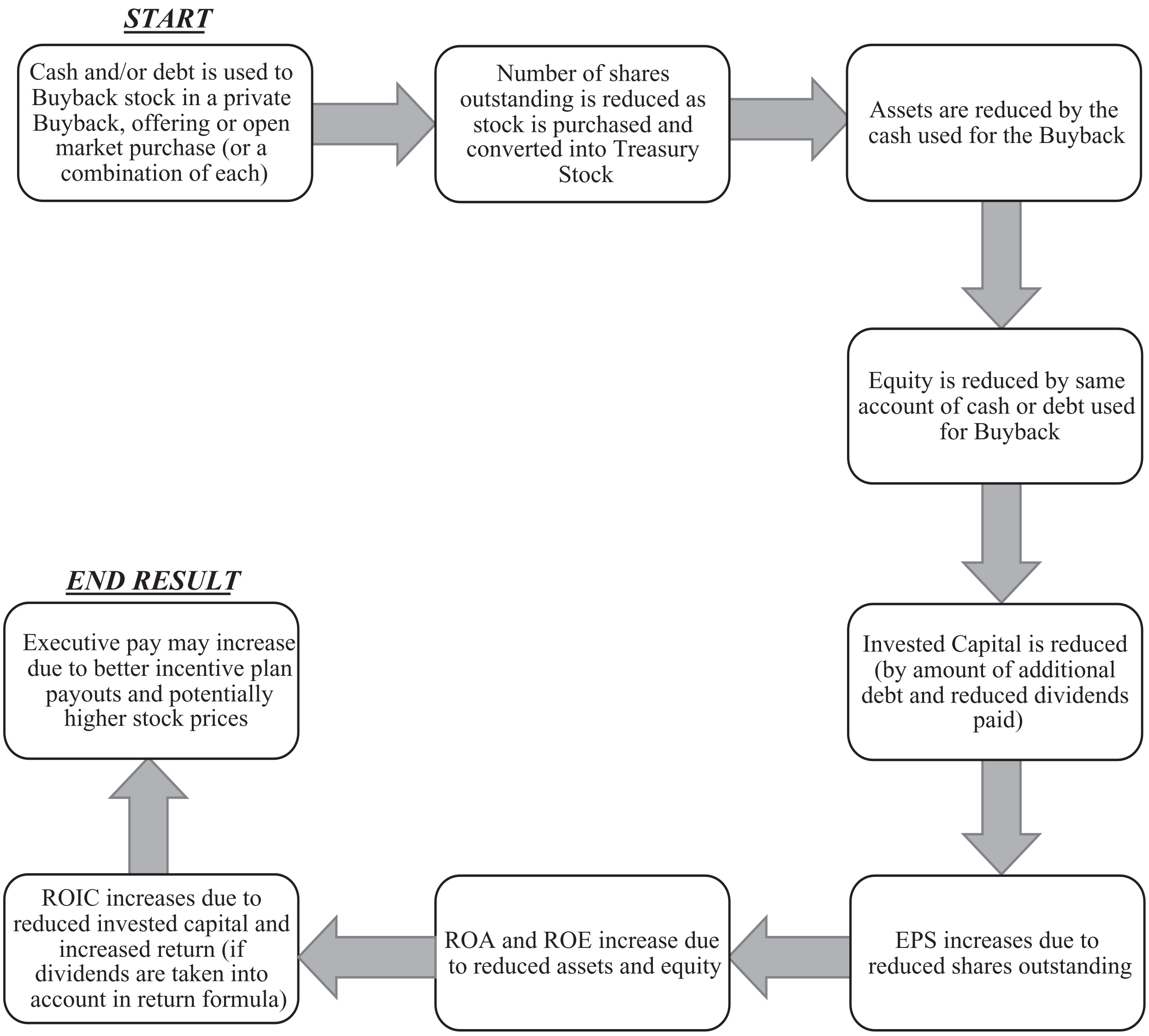
Buybacks may increase executive compensation levels, regardless of the operational success of the company. This is particularly true with the recent reduction in corporate income tax rates. The underlying business model has not really changed or improved, but there is extra cash generated due to the tax savings.

Buybacks directly influence many of the financial ratios used as performance metrics in executive LTI plans. As discussed previously, Buybacks can boost EPS, ROE, ROA, ROIC, or stock price. Although growth in pay levels through the increased value of stock holdings and LTI payouts may benefit executives, there is bound to be criticism from investors, employees, and political factions.

A key connection between buybacks and executive pay is EPS. A Buyback will reduce the number of a company's shares outstanding and thereby increase the earnings per share metric. EPS is often a key benchmark for an executive's performance-based pay—particularly in LTI programs. In addition to EPS, a Buyback also affects other parts of the financial statement. On the balance sheet, a share repurchase will reduce the company's cash holdings, and consequently its total assets base, by the amount of the cash expended in the buyback. The buyback will simultaneously also shrink shareholders' equity on the liabilities side by the same amount. As a result, performance metrics such as ROE, ROA, and ROIC typically improves following a Buyback. Like EPS, each of these capital efficiency measures are commonly used in executive LTI plans.

See Figure 1 for an illustration of how the Buyback lifecycle may lead to increased executive pay levels.

Figure 1. How the Buyback Lifecycle Affects Executive Pay Levels



Another issue when it comes to executive compensation is that a Buyback generally occurs during an LTI award's performance period, and there is no corresponding adjustment to the performance goals to offset the effect of the Buyback. So, it can be said that a Buyback gives the executives a head start in achieving their performance goals.

Some national political factions are using Buybacks as an example of greed, arguing that companies would rather boost the value of shareholders (the few) rather than increasing wages and benefits of the workforce (the many). This is particularly the case where company management is seen to benefit directly from these Buybacks through increased pay.

At a time when institutional investors frequently challenge whether performance targets are rigorous enough, critics of buybacks believe that senior executives should not receive larger pay packages simply for reducing the number of shares outstanding. There is also concern that

Figure 2. Mid-Market Companies Follow the Large Company Trend of Relying on Performance-Based LTI Awards

Top 200	***2016***	***2015***	***2014***	***2013***	***2012***	***2011***	***2010***	***2009***	***2008***
Appreciation Awards		23%	25%	26%	29%	32%	34%	37%	40%
Restricted Stock/Units	NA	18%	18%	18%	21%	22%	23%	22%	19%
Performance-Based Awards		59%	57%	56%	50%	46%	43%	41%	41%
Mid-Market 100									
Appreciation Awards	20%	25%	26%						
Restricted Stock/Units	32%	32%	35%	NA	NA	NA	NA	NA	NA
Performance-Based Awards	48%	44%	39%						

+9 percentage points over 5 year period from 2008 to 2012

use of performance shares in the Mid-Market approaches 50% in 2016, a level first reached in 2012 by the Top 200

+9 percentage points over 3 year period from 2014 to 2016

while buybacks they may boost stock prices in the short term, they can deprive companies of capital necessary for creating long term growth.

A Closer Look at Buybacks and Executive Pay

It is indeed true that executives in the United States will receive larger incentive payouts when measures like EPS, ROE, ROA, ROIC, and stock price show improvement (financially engineered or not). Today's executive pay packages (1) include a significant portion of LTI awards and (2) rely heavily on LTI awards with performance conditions (vs. time-based awards).

Our recent research study[3] (co-authored with The Conference Board) showed that LTI awards occupy a greater portion of total pay than *ever* before, up from 22.8 percent in 2010 to 36.7 percent in 2016 in the Russell 3000 and from 32.0 percent to 47.4 percent in the S&P 500.

Another recent Gallagher study[4] showed that a majority of executive LTI awards at large cap companies are tied to performance measures, including stock-price- or EPS-related measures. Among the Top-200 companies by market capitalization, performance-based LTI awards first averaged 50 percent of the total LTI grant value back in 2012. By 2015, performance-based awards had increased to 59 percent of the total LTI grant value.

Following closely behind top companies, we found that midmarket companies have also moved toward LTI programs focused on performance-based awards.[5] In 2016, performance-based awards made up 48 percent of the total LTI grant value among these companies, up from just 39 percent in 2014. This midmarket sample includes 100 companies selected at random from the Russell 3000 universe and included companies across multiple industry sectors with revenues between $1 billion and $5 billion (non-financial companies) or assets between $1 billion and $10 billion (financial companies) (see Figure 2).

In 2016, the majority of mid-market companies set LTI plans based on income-related measures like EPS (64 percent), followed by total shareholder return (TSR) at 56 percent. Among the top 200 companies, the use of income-related measures in 2015 held strong at 51 percent.

Among the midmarket, capital efficiency measures (where results are divided by capital to assess the quality of the company's receivables) and revenue both grew in usage to 27 percent

Table 1. Top 200 vs. Mid-Market LTI Performance Measures (percent of Cos)

	Top-200			Mid-Market 100		
Performance Measure	**2015**	**2014**	**2013**	**2016**	**2015**	**2014**
Income: EPS, net income, EBIT/EBITDA, operating income, pretax income	51%	49%	53%	64%	61%	54%
Total shareholder return: Stock price appreciation plus dividends (relative and absolute), stock price	56%	57%	55%	56%	46%	43%
Capital efficiency: Return on equity, return on assets, return on investment, return on capital, return on sales, economic value added	47%	46%	44%	27%	23%	22%
Revenue: Revenue, revenue growth	20%	20%	18%	21%	18%	16%
Cash flow: Cash flow, cash flow growth	13%	12%	13%	5%	8%	8%
Other: Milestones, cost savings, market share, etc.	NA	NA	NA	5%	4%	3%

Table 2. Investor Perspectives on LTI Plan Performance Measures

Measure	**Pros**	**Cons**
EPS	• The most commonly used measures by investors	• Can be manipulated by financial engineering such as Buybacks; equity to debt swaps, re-financings and other types of corporate finance actions
ROE	• ISS will be considering a return measure as part of its pay-for-performance review beginning in 2018	• Vulnerable to financial engineering, especially through increase of debt leverage • Does not differentiate between profitability improvement from operational gains and/or added debt leverage
ROIC (if debt is incurred in Buyback and/or less dividends are paid)	• Aligned with shareholder interests • ISS will be considering a return measure as part of its pay-for-performance review beginning in 2018	• Prone to undue influence by financial engineering • A company can achieve high returns by deferring necessary investment or slowing down growth without creating any value for shareholders
ROA	• Captures the fundamentals of business performance in a holistic way, looking at both income statement performance and the assets required to run a business • Less vulnerable to the kind of short-term gaming that can occur on income statements since many assets, such as property, plant, and equipment, and intangibles, involve long-term asset decisions that are more difficult to tamper with in the short term • ISS will be considering a return measure as part of its pay-for-performance review beginning in 2018	• Prone to undue influence by financial engineering • Assets are composed of both debt and equity and interest expense on debt is added back, ignoring the funding of those assets • Difficult comparator to other companies as assumptions vary • Primarily used in financial institutions where capital and debt are used in interchangeable roles to create financial products

and 21 percent, respectively, but remained stagnant over the 3-year period of 2013 to 2015 among top companies (see Table 1).

Common types of capital efficiency metrics include ROE, ROA, and ROIC. Given that Institutional Shareholder Services (ISS) is now considering these "return" measures as part of its pay-for-performance review (beginning January 1, 2018), we expect that the use of capital efficiency measures will increase among both large- and mid-sized companies in the coming years.

Table 2 compares the pros and cons of four popular performance measures.

Conclusion

Boards and senior management have an obligation to maximize long-term shareholder return. As such, the capital allocation process will sometimes result in a decision to buy back stock. At the same time, companies are faced with selecting performance measures that are reasonable, aligned with the business plan and investor communications. The selection of performance measures and corresponding performance levels can be one of the most difficult aspects of designing an incentive compensation program for executives.

We expect that scrutiny to be further complicated as Buybacks continue to increase in prevalence. Companies should be cautious when selecting performance measures that can be manipulated by financial engineering such as Buybacks, equity to debt swaps and other re-financings, and be ready to explain the reasoning behind such choices in the annual proxy statement.

Improving the disclosure of performance measures used, the values associated with those measures, and how they expect to drive performance has been of the upmost importance to avoid unwanted scrutiny.

Notes

1. *https://hbr.org/2014/09/profits-without-prosperity*

2. *https://www.forbes.com/sites/chuckjones/2018/03/16/2018-share-buybacks-could-exceed-800-billion-driven-by-overseas-cash/#b18250239d98*

3. CEO and Executive Compensation Practices: 2017 Edition (*https://www.conference-board.org/ceo-executive-compensation/*)

4. Gallagher's 2015 Study of Short- and Long-Term Incentive Design Criteria Among Top 200 Companies (*https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2916206*)

5. Current Trends in 'Mid-Market' Incentive Plan Design (*https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3152287*)