

Global Insight

Focus Article

The power of the buyback

How the effective use of buybacks unlocks shareholder value.

Wu, Dion, & Hardy



For important and required non-U.S. analyst disclosures, see page 6.

All values in Canadian dollars and priced as of April 29, 2016, market close, unless otherwise noted.



Wealth
Management

The power of the buyback



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When companies are sitting on piles of cash, share buybacks—when done right—can create significant value for shareholders. Yet buybacks are often a misunderstood and underappreciated strategy, so we help investors understand how smart buybacks implemented by high-quality companies can work for them.

Successful companies often find themselves generating more free cash flow than can be reinvested in growth initiatives at attractive returns. Dividends and share buybacks are two popular means through which companies can return excess cash to shareholders. While the strong outperformance of consistent dividend growers over time is fairly well understood, we find the benefits of consistent buybacks underappreciated.

For many Canadians, the value of share buybacks could take on added importance after the recent introduction of a new high income federal tax bracket.

This article discusses the rationale for share buybacks, shows that buybacks executed consistently and at sensible prices create long-term shareholder value, and explores the unique subset of Canadian companies that have an established track record of consistent share buybacks.

Creating shareholder value

Highly profitable businesses typically generate significant excess capital over time. Management can choose to invest in growth opportunities, hold cash, pay down debt, or return capital to shareholders through dividends and/or buybacks. Ideally, these decisions should be taken after carefully comparing the expected return on each opportunity relative to the company's cost of capital.

Above-average profitability tends to be driven by some form of competitive advantage, yet many companies find themselves unable to leverage that advantage beyond specific markets or geographies. This highlights the difficulty of deploying increasing amounts of capital at attractive returns. Over time, companies that choose to return some capital to shareholders tend to outperform those that pursue growth at any cost. The historical outperformance of consistent dividend growers speaks to this trend.

Companies that increase their dividend each year generally develop a culture of “capital scarcity,” where less attractive growth projects are shelved and only the most profitable opportunities are pursued. This type of culture is often associated with frugality, which is another key attribute of many successful companies.

Because dividends are often viewed as long-term commitments, share buybacks offer management an additional, and more flexible, means of returning excess capital to shareholders. While the value of a growing dividend is obvious to most investors, we find that the benefits of consistent buybacks are often underappreciated. Buybacks do not increase the total earnings of a company, but reducing the number of shares outstanding can materially enhance shareholder value over time.

Companies that repurchase shares have fared well over the long term

% annualized performance as of March 31, 2016

	YTD	1-year	3-year	5-year	7-year	10-year
S&P/TSX Composite Buyback Index	5.17	-6.53	8.80	7.40	15.03	7.46
S&P/TSX Composite	4.54	-6.55	5.02	2.10	9.59	4.04

Source - Bloomberg

The table above shows how the S&P/TSX Composite Buyback Index—made up of 50 Canadian companies that have returned the highest value to shareholders via repurchases in the past 12 months—has outpaced the S&P/TSX Composite over long time horizons.

But we emphasize that not all share buybacks are created equal.

Buybacks executed consistently, at sensible prices, are most likely to create value for shareholders over time. To further improve the odds of success, we recommend that investors focus on strong businesses and management teams with established track records of disciplined capital allocation. We caution against companies that have a track record of purchasing their shares excessively in good times, which leaves little flexibility to do so in downturns.

Steering away from a rising dividend tax burden

The table below depicts the combined top marginal tax rate applied to different types of investment income for select provinces. A notable gap between the taxability of dividends and capital gains has opened up for high earners over the past few years. The relative tax efficiency of capital gains becomes pronounced when investments are held for long periods of time since taxes are paid only when an investment is sold.

Combined top marginal tax rate applied to different types of investment income for select provinces

	2009		2015		2016	
	Capital Gains	Dividends	Capital Gains	Dividends	Capital Gains	Dividends
Ontario	23.2%	23.0%	24.8%	33.8%	26.8%	39.3%
Quebec	24.1%	29.7%	25.0%	35.2%	26.7%	39.8%
BC	21.9%	19.9%	22.9%	28.7%	23.9%	31.3%
Alberta	19.5%	14.5%	20.1%	21.0%	24.0%	31.7%
Manitoba	23.2%	23.8%	23.2%	32.3%	25.2%	37.8%

Source - RBC Wealth Management

A complete list of tax rates by province is available on request. It is important to note that many Canadians face very different tax situations and we recommend seeking personalized tax advice before making any investments or changes to portfolios.

A short list of Canadian buyback champions

The table provides a list of Canadian companies that have consistently returned capital to shareholders through share buybacks. Our analysis is based on the actual reduction in share count, as opposed to the number of shares repurchased, to get a true measure of the capital returned by a company. We have also focused on companies with resilient business models, solid balance sheets, and favourable outlooks. Most of the companies listed have also managed to regularly increase their dividends over time.

Canadian companies that have consistently repurchased shares

Reduction in share count over specified period as of March 31, 2016

	1-year	3-year	5-year
Metro Inc. (MRU)	-4.7%	-17.1%	-23.1%
Jean Coutu Group PJC Inc. (PJC.A)	-1.2%	-14.7%	-20.9%
Magna International Inc. (MG)	-2.0%	-13.7%	-17.1%
Canadian National Railway Co. (CNR)	-2.7%	-8.1%	-14.3%
WestJet Airlines Ltd. (WJA)	-3.6%	-6.9%	-13.9%
Agrium Inc. (AGU)	-4.2%	-7.4%	-12.7%
Onex Corp. (OCX)	-2.7%	-7.5%	-10.5%
Canadian Tire Corporation Ltd. (CTC.A)	-4.4%	-8.7%	-9.1%
Thomson Reuters Corp. (TRI)	-4.0%	-7.5%	-8.3%
Telus Corp. (T)	-2.4%	-8.8%	-7.8%

Source - RBC Wealth Management, Bloomberg

Research resources

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