Corporate Cash Policy and How to Manage it with Stock Repurchases

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Stock repurchases are a flexible way of distributing cash to shareholders. Unlike an increase in dividends, the announcement of an open-market repurchase program does not commit the firm to distribute funds. The management retains the option to start and stop the repurchase program based on the firm's cash needs and other factors. This flexibility is especially valuable to companies facing uncertainty about their performance and market value.

Cash is a buffer for coping with uncertainty. The riskier the business, the higher the expected level of cash reserves. Cash reserves can offset shortfalls in operating cash flows during a general economic or industry downturn. By holding cash, companies avoid the potentially large transactions costs associated with raising capital during tough times and at short notice.

Suppose a company has a highly valuable project but has exhausted its internal sources of funds. Then the company's managers must raise outside capital or forgo the project. For investment-grade companies with unused debt capacity, the project can be funded with debt. But for companies without an investment- grade rating, raising outside capital is likely to be very expensive. Recessions tend to reduce access to external, and particularly public, financing. Companies with limited access to external capital will be more affected by an economic downturn. That is why cash can come handy.

Corporate managers may waste cash by making bad acquisitions or pursuing growth/ market share at the expense of profitability. Managers may also use cash as a pretext for avoiding tough decisions to downsize when necessary.

The value of a dollar of cash to a company with limited access to external capital markets can be as high as $1.15. The premium value effectively assigned to cash in this case reflects the potential value of projects that might otherwise have gone unfunded. At the same time, the market value of a dollar of cash can be as low as $.42 if the market expects value to be lost from the waste of cash reserves.

To send a positive signal, companies can distribute cash to shareholders as regular dividends, special dividends, and stock repurchases. According to

Lintner's model, managers are unlikely to cut dividends. So, companies are reluctant to raise dividends faster than the rate of permanent or sustainable earnings. Thus, one school of thought is that dividends are paid out of permanent earnings. In contrast, repurchases distribute "temporary" or non-recurring earnings. So, dividends and repurchases can be seen as *complementing each other*. Another school of thought is that repurchases may be *substitutes* for dividends—i.e., providing a means of distributing permanent as well as temporary earnings. So, repurchases may be a substitute for dividends (if they pay out permanent earnings) and a complement (if they pay out unexpected earnings).

One of the largest benefits of stock repurchases is their flexibility. In an open market stock repurchase program, a company will announce that its board of directors has authorized the repurchase of a specified number of shares over a certain period of time (typically two-to-four years). But this announcement is only an indication that the firm *may* repurchase stock. It is not a firm commitment and the company is not obligated to buy back stock. Studies have shown that only about 75% of the shares that have been authorized to be repurchased, end up getting repurchased. Moreover, almost 20% of the companies that announce repurchase programs do not repurchase a single share within the next four years, though the majority of companies (about 54%) begin to buy back shares in the quarter following the repurchase announcement.

Companies that make greater use of repurchases than dividends in distributing excess cash tend to have higher levels of non-operating cash flow as well as more volatile cash flows and total distributions. In other words, companies with greater uncertainty about their income are more likely to use repurchases.

Though repurchases provide a flexible mechanism for paying out excess cash, they also appear to be effective in limiting the agency costs that tend to arise from holding too much cash.

Corporate repurchases in the aggregate are not motivated primarily by undervaluation— or at least not by valuation in any absolute sense. And, the same is probably true of M&A and IPOs. Growth in GDP is the most important determinant of repurchase and M&A and equity issuance activity. Economic expansion reduces the cost of equity relative to the cost of debt, which induces some companies, particularly smaller ones needing growth capital, to issue equity. At the same time, it makes companies more willing to use their stock as currency for M&A deals. Economic expansion tends to increase the company's operating cash flow. In the case of larger, more mature companies, such increases are likely to exceed their requirements for new investment. These companies can respond by increasing their dividends. But, given the cyclical character of such earnings, and the increase in risk that comes with it, they may prefer repurchases to dividends.

Companies may repurchase stock to offset the costs of issuing employee stock options as compensation. The issuance of shares in the stock option programs has a dilutive effect on earnings per share. Some companies repurchase stock with the aim of keeping the number of shares outstanding roughly constant. Because executive options are not typically "dividend-protected," the value of such options is effectively reduced by any dividend payments. But if the same amount of cash is instead used to buy back shares, the options effectively participate in the value of the distributions because the firm's stock maintains its value, rather than falling by the amount of the dividend. Studies have shown that companies that use stock options are more likely to repurchase stock. Stock repurchase activity may have increased during the 1990s in part because this form of compensation became increasingly common.

Repurchasing stock increases EPS (and returns on capital) only where the funds used to repurchase stock have no productive alternative use. In such cases, it is essentially the elimination of excess capital that is responsible for the increase in value. If companies were instead to cut back on "productive investment" to fund a repurchase, their value would fall and so eventually would their EPS.

Stock repurchases provide a flexible mechanism to distribute cash to shareholders. Unlike dividend payments, an open market stock repurchase program gives managers the option but not the obligation to distribute funds. This flexibility, particularly valuable during periods of uncertainty, explains much of the apparent substitution of repurchases for dividend income. Repurchases became equal to dividends for the first time in 1998, overtaking dividends in 2005, and then widened the margin significantly in 2006.