How share repurchases boost earnings without improving returns

By Obi Ezekoye, Tim Koller, Ankit Mittal

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Earnings Per Share (EPS) is the most visible measure of a company's financial performance but it may be highly overrated as a barometer of value creation. The fallacy lies in believing that improving EPS in any way will automatically create value and increase the total returns to shareholders (TRS).

EPS can be increased through faster revenue growth, better margins and share repurchases. Each of these strategies has a different impact on value creation.

Revenue growth can improve EPS as long as margins are not sacrificed and the investments made to increase sales, generate more than the cost of capital.

Margin improvements by cutting costs can increase TRS as long as they do not impede future growth by cutting essential marketing and R&D investments.

Share repurchases seldom have any lasting impact on TRS. It is often assumed that a share buyback increases EPS, even as the P/E ratio remains the same and hence the share price increases. There is a correlation between TRS and EPS growth but little of that is due to share repurchases. It is mostly due to revenue and total earnings growth.

It is the generation of cash flow which creates value, not how the cash is distributed to shareholders. Share repurchases are just a reflection of how much cash flow a company generates. The greater the cash flow, the more of it a company will eventually need to return to shareholders as dividends and share repurchases.

Cash has various other uses-paying dividends, repaying debt, investing in new growth opportunities and finally keeping it as it is. What matters is the effect of a share repurchase relative to these other measures, not the effect of share repurchase on its own.

If a company pays dividends, the shareholders receive cash but also retain their shares.

If the company repurchases shares, the selling shareholders receive cash and the remaining shareholders have shares with higher value. Overall, there is no change in value, just a change in the mix of shareholders.

When a company pays down debt, its capital structure, cost of capital and P/E will change. But the enterprise value stays the same and so does the value to shareholders.

Investing at an attractive rate of return will always create more value than repurchasing shares. But this does not happen quickly. There will be a time lag between the time the investment is made and when the returns are realized. With share repurchases, the impact on EPS is immediate. Disciplined managers will not fall for short term benefits at the expense of long term value creation.

In short, increasing EPS can improve the returns for shareholders. But if that increase comes about as a result of a share repurchase, it is unlikely that value will be created.