SHAREHOLDER REWARD - NOT ALL CREATED EQUALLY

Stock Buybacks vs Diversified Dividends
Spurred by the growing role of cheap debt, the stock-market has all but ceased to be a mechanism for capital to be invested in public companies, and become a mechanism where capital is increasingly taken out of them. As aptly summarised by the economist and author, John Kay:

As a source of capital for business, equity markets no longer register on the radar screen. In both Britain and the US, funds withdrawn through acquisitions for cash and share buybacks have recently routinely and considerably exceeded the amounts raised in rights issues and IPOs.

For stock investors, it is important to examine the nature, and the implications, of this capital extraction. More particularly, the growing prevalence of stock buybacks – which has sparked a heated and sometimes fuzzy debate – must be considered carefully. Helpfully, this debate was addressed with customary clarity by Warren Buffett in his 2016 letter to Berkshire Hathaway shareholders:

Repurchases only make sense if the shares are bought at a price below intrinsic value. When that rule is followed, the remaining shares experience an immediate gain in intrinsic value. Ergo, the question of whether a repurchase action is value-enhancing or value-destroying for continuing shareholders is entirely purchase-price dependent. My suggestion: Before even discussing repurchases, a CEO and his or her Board should stand, join hands and in unison declare, “What is smart at one price is stupid at another.”

The growing role of debt has been crucial. According to data from the McKinsey Global Institute, and unarguably encouraged by historically low borrowing costs, the outstanding stock of corporate debt globally has doubled since 2007. Within that growing debt pile, the global value of corporate bonds outstanding has risen 2.7 times, doubling as a share of GDP.

Unsurprisingly, credit quality has deteriorated in tandem. Triple-B rated debt, for example, has more than trebled in size over the past decade, and half of all Investment Grade debt sales in the US this year have come from Triple-B rated companies. Curiously, investor concern at these developments is so far striking by its absence. Indeed, the opposite is arguably more evident. As recently noted by Gillian Tett in the FT:

Demand for risky debt is so high that the spread between safe and hazardous corporate debt (bonds rated triple A and triple B respectively) is a wafer-thin 50 basis points. In 2012 it was 200bp.

A further nuance was highlighted in a recent note by JP Morgan. Driven by US tax reform, US corporations have repatriated $217bn in the year to the end of Q1. Previously, foreign profits were accumulated offshore and generally invested in bonds. In effect, dividends and share buybacks were funded by bond issuance to avoid a punitive repatriation tax bill, and domestic debt was effectively financing offshore bond portfolios.

But as repatriation accelerates, companies have now started to sell their bond portfolios. On the reasonable assumption that debt is not simultaneously repaid, net debt increases. Importantly, the bond portfolios are large enough that movements can have significant effects beyond their owners’ balance sheets. Upward pressure on borrowing rates is thus likely just as corporate balance sheets are becoming riskier.
While stock investors have certainly enjoyed an increasing flow of dividends during the bull market of recent years, the surge in executed buybacks has also been striking. Interestingly however, and contrary to much media commentary, executed buybacks peaked in 2015 and are not at ‘record’ levels. Given the special importance of the US in this debate, our analysis will focus there: (note: the H1 2018 data in the next 2 graphs is for announced buybacks)

### Exhibit 3: Dividends and Buybacks vs. New Debt Issues

![Graph showing dividends, buybacks, and new debt as a percentage of total assets over 30 years.](source: KBIGI/Factset - see disclaimer for description of index information)

Annual cash dividends and share buybacks vs. new debt issues as a percentage of total assets for 610 constituents of the MSCI USA Index as of Dec. 31st 2016. Source: MSCI ESG Research, based on Thomson Reuters data.

While stock investors have certainly enjoyed an increasing flow of dividends during the bull market of recent years, the surge in executed buybacks has also been striking. Interestingly however, and contrary to much media commentary, executed buybacks peaked in 2015 and are not at ‘record’ levels. Given the special importance of the US in this debate, our analysis will focus there: (note: the H1 2018 data in the next 2 graphs is for announced buybacks)

### MSCI USA - BuyBack Vs Dividend

![Graph showing buybacks and dividends for the years 2009 to 1H 2018.](source: KBIGI/Factset - see disclaimer for description of index information)
Focussing on executed buybacks can be misleading. More relevantly, the focus should be on net stock issuance. Although small relative to corporate investment, this has nonetheless been positive in every year since the market trough in 2009 with the single exception of 2013. **Importantly, while a large quantum of buybacks has been executed, share destruction has been non-existent at an index level.** The historic need for equity may be fading, but public companies in aggregate have still been tapping stock investors:

**MSCI USA - Net Issuance**

![Graph showing net issuance in billions of dollars from 2009 to 1H 2018]

When it comes to buybacks, the aggregate picture masks some important industry-group trends. **Most significantly, all discussion of buybacks should underline the huge skew of their incidence to financials, and more strikingly IT:**

**BuyBack**

![Graph showing buybacks in billions of dollars for financials and IT from 2009 to 2017]

Source: KBIGI/Factset
Financials are unsurprisingly responding to the post-crisis restrictions on paying dividends but are clear net issuers in general. In contrast, a handful of IT oligopolies have been extracting significant, if diminishing, amounts of capital:

Clearly, for stock investors buybacks are not necessarily good or bad: most crucially, it depends on the price.

Furthermore, the Buffett comment implicitly assumes that management intent is at least positively aligned to the shareholder, and that buybacks result in actual share destruction. But this assumption does not always hold, and it can prove particularly costly if the true motivation is financial engineering effectively designed to favour management and employees.

In contrast to the transparency and simplicity of dividends, buybacks can be opaque and complex. Consider companies A, B and C who announce their intention to buyback 3% of their respective stock. At face value these 3 buybacks are the same. However, when you look under the bonnet the differences are stark, and potentially costly. For illustration, assume:

<table>
<thead>
<tr>
<th></th>
<th>GOOD Stock A</th>
<th>BAD Stock B</th>
<th>UGLY Stock C</th>
</tr>
</thead>
<tbody>
<tr>
<td>Buyback Announcement % of Market Cap</td>
<td>3%</td>
<td>3%</td>
<td>3%</td>
</tr>
<tr>
<td>Completed Announcement</td>
<td>3%</td>
<td>3%</td>
<td>1.5%</td>
</tr>
<tr>
<td>Change in % Shares Outstanding</td>
<td>-3%</td>
<td>-3%</td>
<td>-1.5%</td>
</tr>
<tr>
<td>Moved to Treasury</td>
<td>0</td>
<td>3%</td>
<td>1.5%</td>
</tr>
<tr>
<td>Net Total Destruction</td>
<td>-3%</td>
<td>0%</td>
<td>0%</td>
</tr>
<tr>
<td>Valuation Premium (Discount) to Peers</td>
<td>-20%</td>
<td>10%</td>
<td>10%</td>
</tr>
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</table>

Company A completes the full buyback announced and destroys the shares. They also buy at a significant valuation discount to their peers. For stock investors, this can be considered a good buyback.

Company B also completes the full buyback announced. However, company management has moved the shares to treasury. While this still improves EPS at first glance, they are potentially keeping the shares in treasury for some ultimately dilutive reason e.g. M&A or to offset the effects of employee option plans - at some point, these shares may well be back in issue - see box (page 6, top) for actual example. In addition, the shares have been bought at a significant valuation premium to their peers. For stock investors, this can be considered a bad buyback.
Company C does not complete the full buyback announced, so company management has effectively reneged on its initial promise. As with Stock B, they’ve also bought at a **premium** to peers. At the very least, this can be considered a questionable if not ugly buyback.

In addition to the illustrative framework above, some further real-world examples - again no names divulged, but examples of actual company accounts shown - may also help.

These examples should further underline the complexity of buybacks, and of the difficult challenge of getting *under the bonnet*:

**STOCK A, a ‘GOOD’ buyback:**
The company is buying stock from the open market. As can be seen from a close examination of the consolidated balance sheet, the company doesn’t hold *treasury shares* and is therefore destroying the shares bought-back.

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### Real-world example -
no names divulged, but example of actual company accounts shown:

- Technology company A acquired the remaining 67.3% of technology company B for approximately $4 billion.
- Under the terms of the agreement, Company B shareholders received US$0.91 per share. This represented a 30% premium to Company B’s closing stock price on 14th December 2015.
- The transaction was financed through equity, debt and cash from Company A’s balance sheet.
- Concurrent to the transaction, Company A also signed a voting and share purchase agreement with Company C, which owns about a 32% stake in Company B, wherein Company A sold new common shares worth US$960 million to Company C. The proceeds from the sale were used to help fund the transaction.
- Looking at the number of shares in the consolidated balance sheet we can see the fall in treasury shares and the consequent shareholder dilution:

#### CONDENSED CONSOLIDATED BALANCE SHEET

<table>
<thead>
<tr>
<th>Liabilities and Equity</th>
<th>Nov. 30th 2017</th>
<th>Dec. 1st 2016</th>
</tr>
</thead>
<tbody>
<tr>
<td>Common Stock, par value (in dollars per share)</td>
<td>$0.10</td>
<td>$0.10</td>
</tr>
<tr>
<td>Common Stock, Authorised Shares (in shares)</td>
<td>3,000</td>
<td>3,000</td>
</tr>
<tr>
<td>Common Stock, issued (in shares)</td>
<td>1,158</td>
<td>1,098</td>
</tr>
<tr>
<td>Common Stock, outstanding (in shares)</td>
<td>1,158</td>
<td>1,098</td>
</tr>
<tr>
<td>Treasury Stock, held (in shares)</td>
<td>0</td>
<td>54</td>
</tr>
</tbody>
</table>

- The company, in the annual Balance Sheet (August 2017), reports the following:
  *Treasury stock in connection with the Company B acquisition, we sold 58 million shares of our common stock to Company C for $986 million in cash, of which 54 million shares were issued from treasury stock. As a result, in 2017, treasury stock decreased by $1.05 billion while retained earnings decreased by $104 million for the difference between the carrying value of the treasury stock and its $925 million fair value.*

**Bottom-line: the acquisition was partially funded with Treasury Shares.**
STOCK B, a ‘BAD’ buyback:
The company in 2017 bought back $2 billion of shares, but this program is used mainly to offset the issuance of shares for its incentive and remuneration program. In fact, deep in the notes, the company reports: The Company does not have a specific policy to repurchase common shares to mitigate the dilutive impact of options; however, the Company has historically made adequate discretionary purchases, based on cash availability, market trends, and other factors, to satisfy stock option exercise activity.

Between 2016 and 2017 the total number of shares issued didn’t change. The shareholders didn’t benefit from the buyback program, but at least the company mitigated the dilutive impact of the remuneration program.

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</thead>
<tbody>
<tr>
<td>Common Stock, par value (in $ per share)</td>
<td>$0.01</td>
<td>$0.01</td>
</tr>
<tr>
<td>Common Stock, shares issued (in shares)</td>
<td>944,033,056.00</td>
<td>944,033,056.00</td>
</tr>
<tr>
<td>Treasury Stock (in shares)</td>
<td>349,148,819.00</td>
<td>347,306,778.00</td>
</tr>
<tr>
<td>Common Stock, shares outstanding (in shares)</td>
<td>594,884,237.00</td>
<td>596,726,278.00</td>
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STOCK C, a ‘QUESTIONABLE’ (arguably ‘UGLY’) buyback:
The company reports: ‘During fiscal year 2017, we repurchased a total of 15 million shares for $739 million and paid $261 million in cash dividends to our shareholders, equivalent to $0.485 per share on an annual basis’.

Given the above statement shareholders may believe that they are getting rewarded from the dividend and from the share repurchase program. However, only the dividend element is returning value to them - the share repurchase program is used only to partially offset the dilutive impact of the new stock issued.

Digging deeper, it looks as if these new shares are largely the result of a convertible bond that had been exercised – a relatively common, if often overlooked event.

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<tbody>
<tr>
<td>Allowance for Doubtful Accounts Receivable</td>
<td>$13</td>
<td>$11</td>
</tr>
<tr>
<td>Preferred Stock, par value</td>
<td>$0.001</td>
<td>$0.001</td>
</tr>
<tr>
<td>Preferred Stock, Shares Authorised</td>
<td>2</td>
<td>2</td>
</tr>
<tr>
<td>Preferred Stock, Shares Issued</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Common Stock, par value</td>
<td>$0.001</td>
<td>$0.001</td>
</tr>
<tr>
<td>Common Stock, Shares Authorised</td>
<td>2,000</td>
<td>2,000</td>
</tr>
<tr>
<td>Common Stock, Shares Issued</td>
<td>868</td>
<td>780</td>
</tr>
<tr>
<td>Common Stock, Shares outstanding</td>
<td>585</td>
<td>539</td>
</tr>
<tr>
<td>Treasury Stock, Shares</td>
<td>283</td>
<td>242</td>
</tr>
</tbody>
</table>

In summary, stock buybacks have been a significant, and growing feature of stock-markets in recent years. Contrary to much conventional thinking, this accelerating capital extraction is by no means a necessarily positive development for stock investors.

Indeed, when funded precariously or done at the wrong price, and/or for reasons that are primarily designed to reward management and employees, buybacks can be significant destroyers of investor wealth.

When assessing buybacks, a thorough analysis of price, funding, skew and execution, over the usual hasty embrace, is to be recommended.

Finally, their opaqueness and complexity contrasts sharply with the generally straightforward cash reward better known as dividends.
Dividends: Growing, Widespread & Under-loved

The growing availability of dividend growth across regions and industry groups is also a significant feature of recent years. Crucially for investors, it's increasingly possible to gain a very diversified exposure to such a positive, and transparent trend:

In contrast to buybacks, the growing availability of this growing dividend-flow offers investors a very diversified exposure to a relatively dependable trend. A trend which historically has been the dominant driver of returns, but has been notably out of favour during the extraordinary monetary environment since the global financial crisis:

For global stock investors, this has produced an historic opportunity. The dividend yield and dividend growth premium on offer from a broadly neutral (regional and industry group) portfolio is at extreme levels. Furthermore, these extreme premia can be harvested at a significant valuation discount with significantly higher quality and having overcome stringent dividend sustainability criteria.
The summary characteristics of the current KBI Global Equity Portfolio underlines this opportunity:

<table>
<thead>
<tr>
<th>HIYDW</th>
<th>Fund</th>
<th>MSCI Index</th>
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<tbody>
<tr>
<td>Dividend Yield</td>
<td>3.7</td>
<td>2.4</td>
</tr>
<tr>
<td>Dividend Payout</td>
<td>58.0</td>
<td>47.3</td>
</tr>
<tr>
<td>Dividend Growth</td>
<td>12.5</td>
<td>8.9</td>
</tr>
<tr>
<td>Total Payout Yield</td>
<td>4.9</td>
<td>2.4</td>
</tr>
<tr>
<td>P/E</td>
<td>14.2</td>
<td>19.4</td>
</tr>
<tr>
<td>P/B</td>
<td>3.8</td>
<td>4.2</td>
</tr>
<tr>
<td>P/C</td>
<td>11.1</td>
<td>16.7</td>
</tr>
<tr>
<td>Weighted Average Market Cap (bn)</td>
<td>94.3</td>
<td>129.5</td>
</tr>
<tr>
<td>Beta</td>
<td></td>
<td></td>
</tr>
<tr>
<td>ROE</td>
<td>23.1</td>
<td>18.5</td>
</tr>
<tr>
<td>ROIC</td>
<td>13.5</td>
<td>11.1</td>
</tr>
<tr>
<td>Net D/E</td>
<td>40.6</td>
<td>46.3</td>
</tr>
</tbody>
</table>

Source: KBIGI/Datastream - data as of end Q2 2018

Free from over-reliance on the opaque and potentially value-destroying complexity of buybacks, investors can instead choose exposure to the more transparent and reliable world of growing, widespread and under-loved dividends.

In addition, as the extraordinary economic and policy environment since the financial crisis continues to normalise, the likelihood of such exposure being handsomely rewarded continues to grow.

### Summary Conclusions

1) Dividends deliver an unambiguous cash reward compared to the often-opaque process of buybacks.
2) Dividends are free of potentially value-destroying financial engineering compared to the often precariously-funded process of buybacks.
3) Dividends announced are generally paid compared to the uncertain outcome of the buyback process.
4) Dividends are solely designed to deliver value to shareholders, compared to a buyback process which may be more focussed on delivering for management and employees.
5) Dividends are widely available, sustainable, and growing across sectors and regions compared to the narrow, concentrated and risky skew of buybacks.
6) Dividends generally represent a strong commitment by management to shareholders compared to the more ambiguous and uncertain signal from buybacks.
7) As the abnormal period of the past decade wanes, dividends & dividend growth are primed to reassert their traditional role as drivers of total shareholder reward.

### References:

Ric Marshall, Panos Seretis, Agnes Grunfeld: ‘Taking Stock-Share Buybacks and Shareholder Value’

Tett, Gillian: ‘Markets might look calm, but they are behaving abnormally’, Financial Times, June 21st, 2018

KBI Global Investors Global Equity Strategies Team, August 2018

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