Defusing share buyback anxiety

Investors are watching closely to see how companies deploy their cash, wary of schemes that inflate executive pay. But it needn't be stressful, as long as boards get a few things right

By Ken Hugessen with Michelle Tan and John Skinner

The challenges of prioritizing long-term value creation over short-term returns has intensified in recent years and now impacts a wide range of topics, including executive compensation. The significant increase in share buyback activity in the U.S. (US$166 billion in the first quarter of 2016 alone), and well-publicized debates on their utility, has put capital allocation programs and their relationship with compensation program into the spotlight. Critics argue that some companies are undertaking buybacks to both pad returns and stock prices, and raise performance against "per share" performance metrics, at the expense of longer-term corporate health.

There are two key concerns with respect to buybacks and pay.

The first focuses on the expectation that buybacks will increase share prices more than they otherwise would in the very short term. The leverage provided to executives through equity-based awards (e.g., options and performance share units, or PSUs), together with the high proportion that such awards represent in most executive compensation programs, could result in executives benefiting substantially from a short-term pop in share price. This has led some to call into question management's motivation for proposing buybacks.

The second concern is the impact on earnings per share (EPS), a popular measure included in many corporate scorecards and PSU designs. One-quarter of S&P/TSX 60 issuers use EPS as a performance metric in either their short- or long-term incentive program, and it is included in more than half of S&P 500 issuers' annual incentive plans. Since the EPS calculation factors in the number of common shares outstanding, a large-scale buyback could have a material impact.

Long-term shareholders appreciate returns of excess capital when they make good business sense, but also recognize the need to balance short-term returns against prudent reinvestment that supports long-term value creation. At roundtables hosted by Hugessen in both the U.S. and Canada, shareholders repeatedly list capital allocation, performance metrics and linkages to corporate strategy as priority topics of discussion in company engagements. This suggests that shareholders don't have sufficient disclosure to understand how the board-approved corporate strategy is reflected in either the capital allocation or executive compensation programs.

Going one step further, several shareholder proposals have been filed at U.S. issuers that have large buyback programs requesting that financial performance metrics be adjusted to exclude the impact of share repurchases when determining incentive compensation awards and payouts.

When buyback programs are contemplated, there are ways to ensure that shareholders understand the board's process and perspective:

- Committees should be cognizant of the potential relationship between share buybacks and certain incentive frameworks that may reward return but not growth. This may create the implicit, but unintended, incentive to shrink the business to its higher return components.
- Boards need to lead on capital allocation decisions and any potential impact on executive incentives to spare management any real or perceived conflict. This can include adjusting performance targets and/or actual results for material buybacks.

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- Companies can ensure that shareholders have sufficient disclosure to understand the process and rationale for any buyback programs and that appropriate steps are taken to mitigate any unintended consequences on incentive compensation programs.

There are valid reasons for using excess capital to fund buyback program, just as there are reasons why EPS is an appropriate incentive plan performance metric. In the end, it is a board's responsibility to ensure that an efficient capital allocation strategy and effective compensation program that both align with the company's long-term corporate strategy are in place, and are understood by management and shareholders alike.

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