Short-Termism, Shareholder Payouts and Investment in the EU

(https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3706499)

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EY's "evidence" of short-termism, examining listed EU firms 1992-2019

(1) Sh'holder payouts (dividends + repurchases) increasing & high

Fact: EY ignores equity issuances which far exceed repurchases; *net* sh'holder payouts moderate; small EU firms are net equity issuers.

(2) CAPEX & R&D intensity has declined

Fact: Investment intensity has increased (EY uses flawed sample).

(3) Shareholder payouts deprive firms of resources for future investment

Fact: Cash balances increasing.

Facts should matter

Is Harvard partly to blame?

William Lazonick:

"Corporate profitability is not translating into widespread economic prosperity. **The allocation of corporate profits to stock buy-backs deserves much of the blame. Consider the 449 companies in the S&P 500 index that were publicly listed from 2003 through 2012. During that period those companies used 54% of their net income—a total of $2.4 trillion—to buy back their own stock, almost all through purchases on the open market. Dividends absorbed an additional 37% of their net income. That left very little for investments in productive capabilities or higher incomes for employees."**

Harvard Business Review

2014 HBR McKinsey Awards

FIRST PLACE

"Profits Without Prosperity"

SEPTEMBER 2014

A meticulously researched study by **William Lazonick,** a professor at the University of Massachusetts Lowell, suggests that executives are using massive stock buybacks to manipulate share prices and boost their own pay–at great cost to innovation and employment.

(1) Measuring Sh'holder-Firm Capital Flows

- EY looks at *gross* sh'holder payouts (dividends + buybacks)
  - ignoring equity issuances
- But including equity issuances dramatically changes picture

Need to Account for Equity Issuances

- Buybacks & dividends = capital moving <u>from firm</u> to shareholders

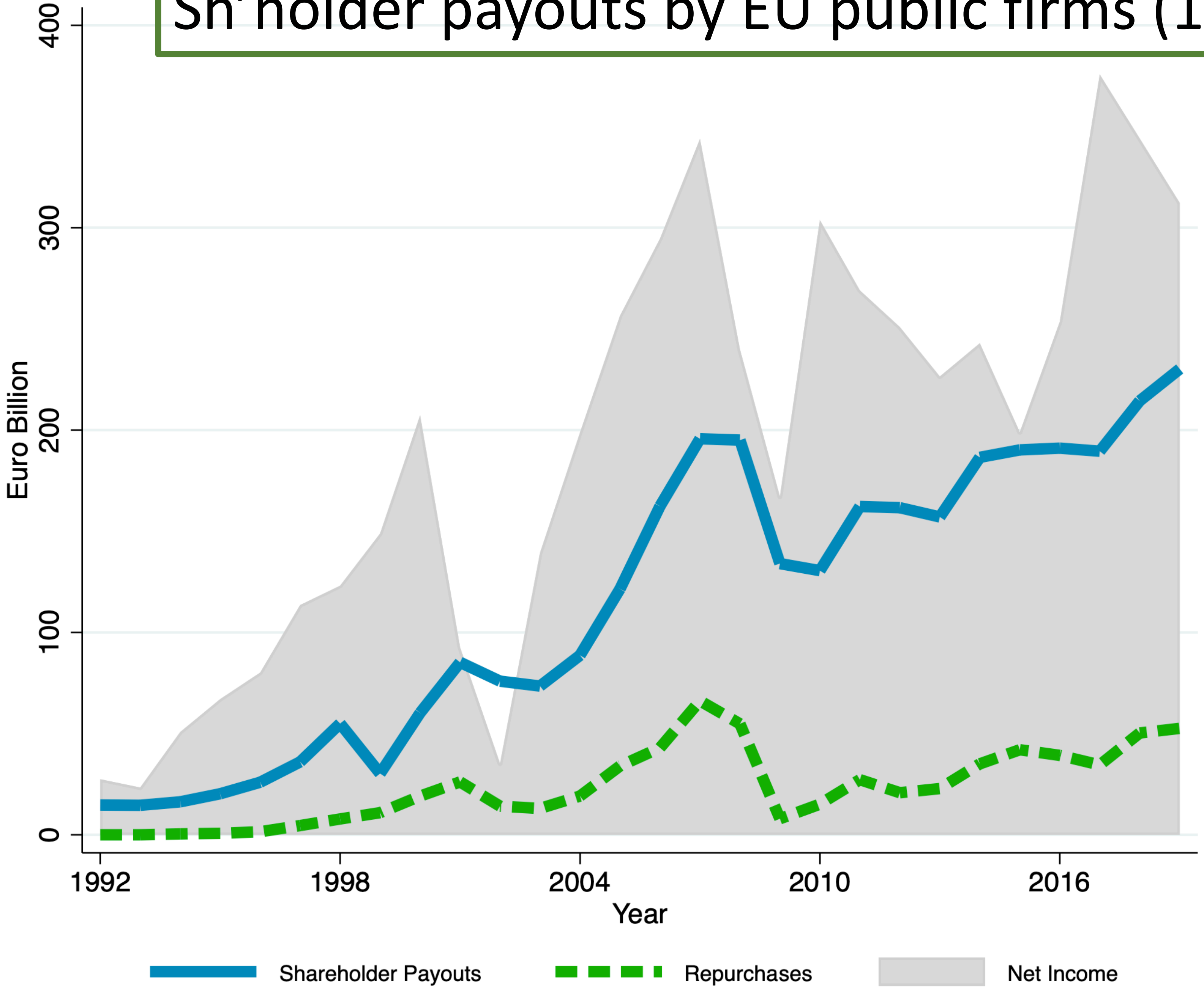
- Must account for capital moving <u>to firm</u> from shareholders **via equity issuances**

- **<u>Direct equity issuances to shareholders</u>**
  - E.g., rights offering

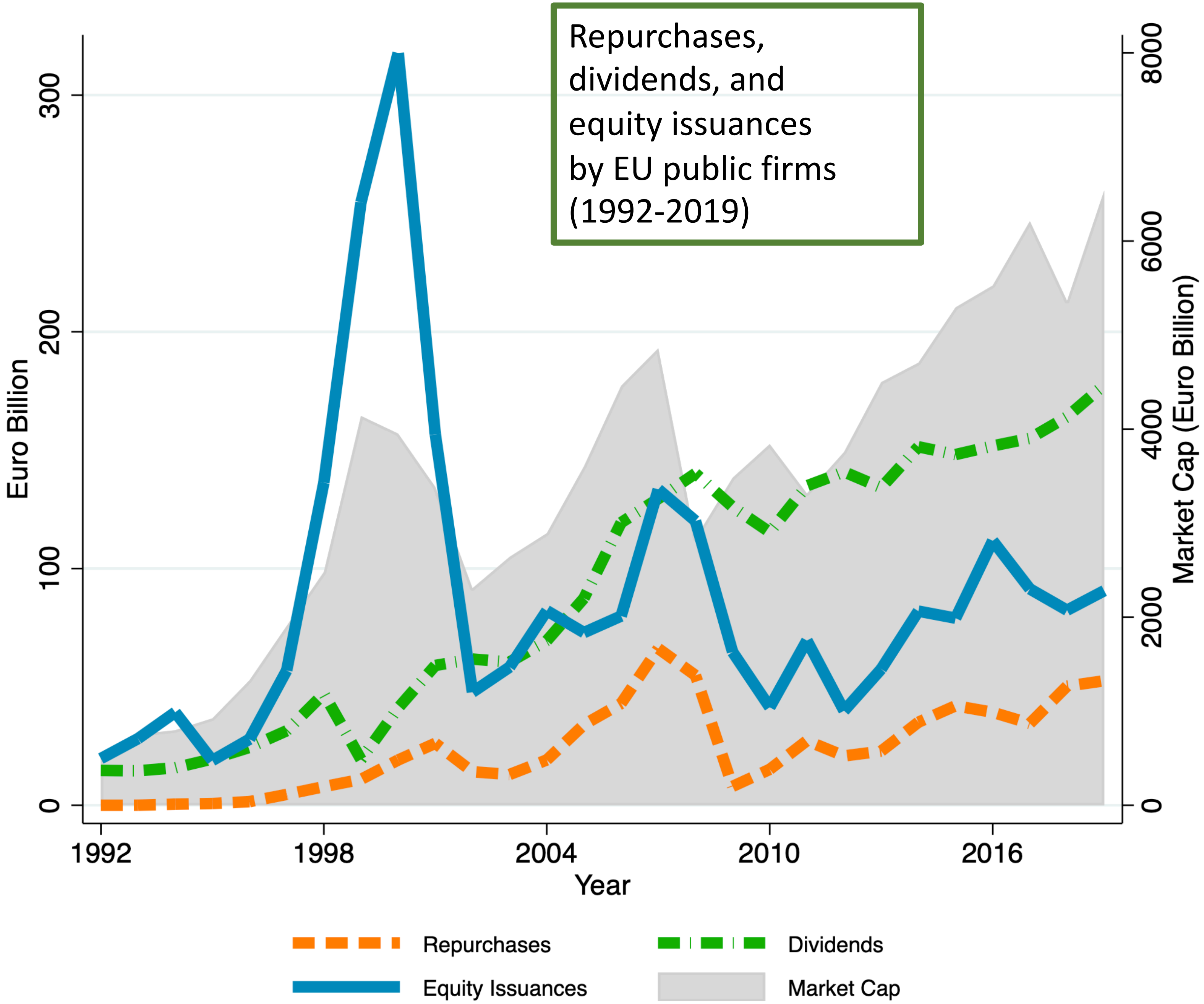
- **<u>Indirect equity issuances to shareholders</u>**
  - E.g., employee-paying

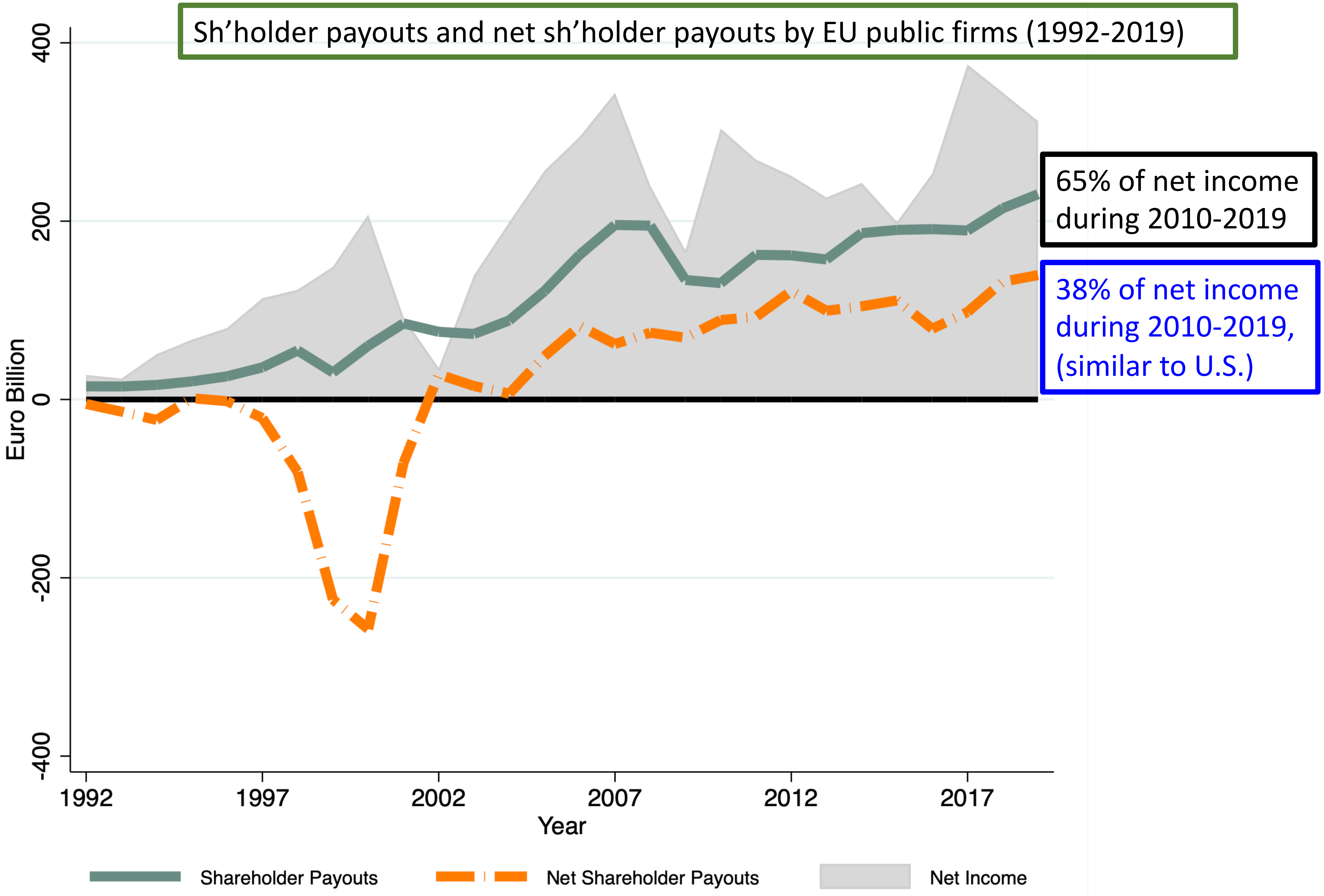
- **<u>All</u>** equity issuances functionally equivalent from sh'holder-firm capital-flow perspective **(Fried & Wang, RCFS 2019)**

Sh’holder payouts by EU public firms (1992-2019)



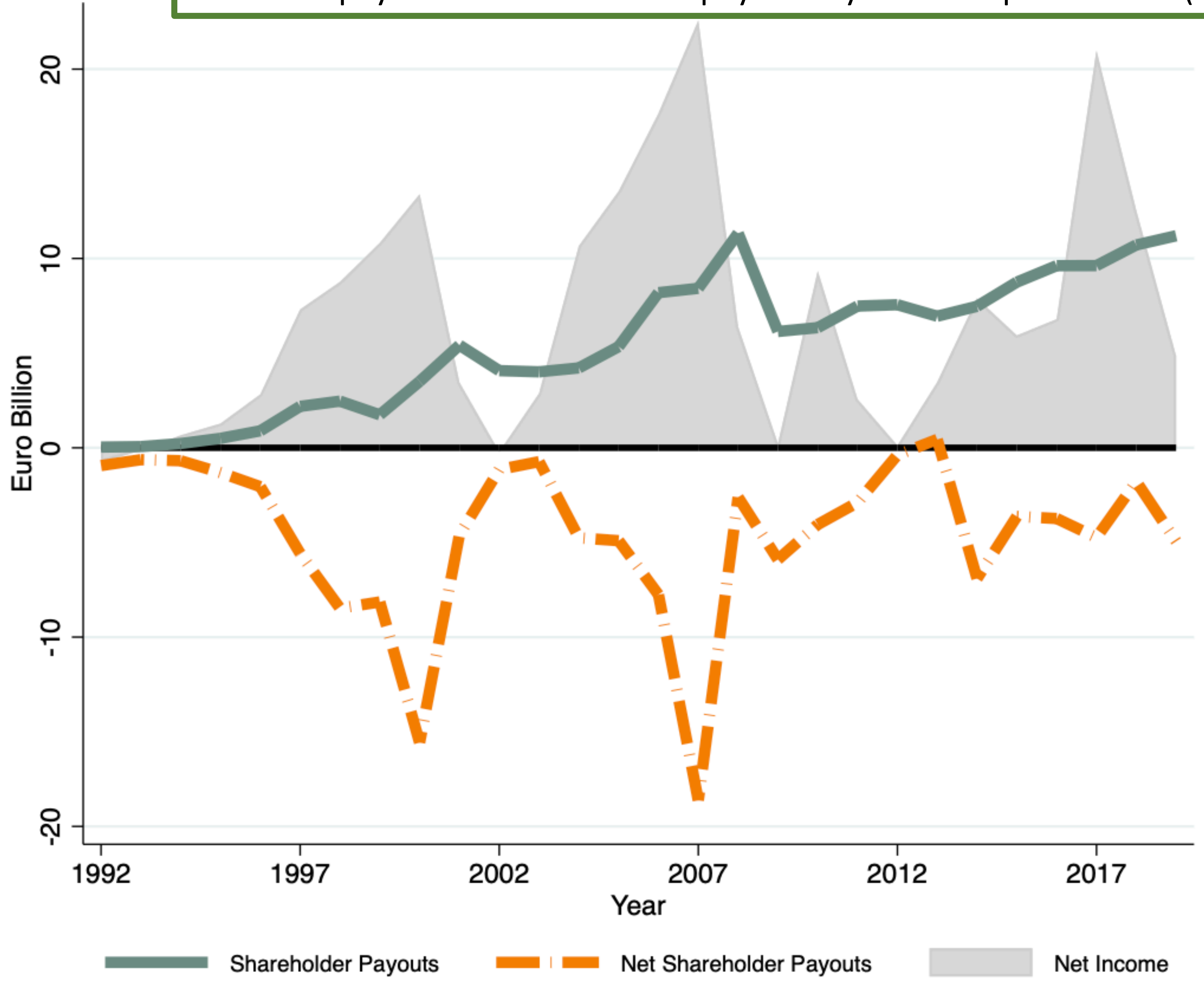
65% of net income during 2010-2019 (like EY finding)

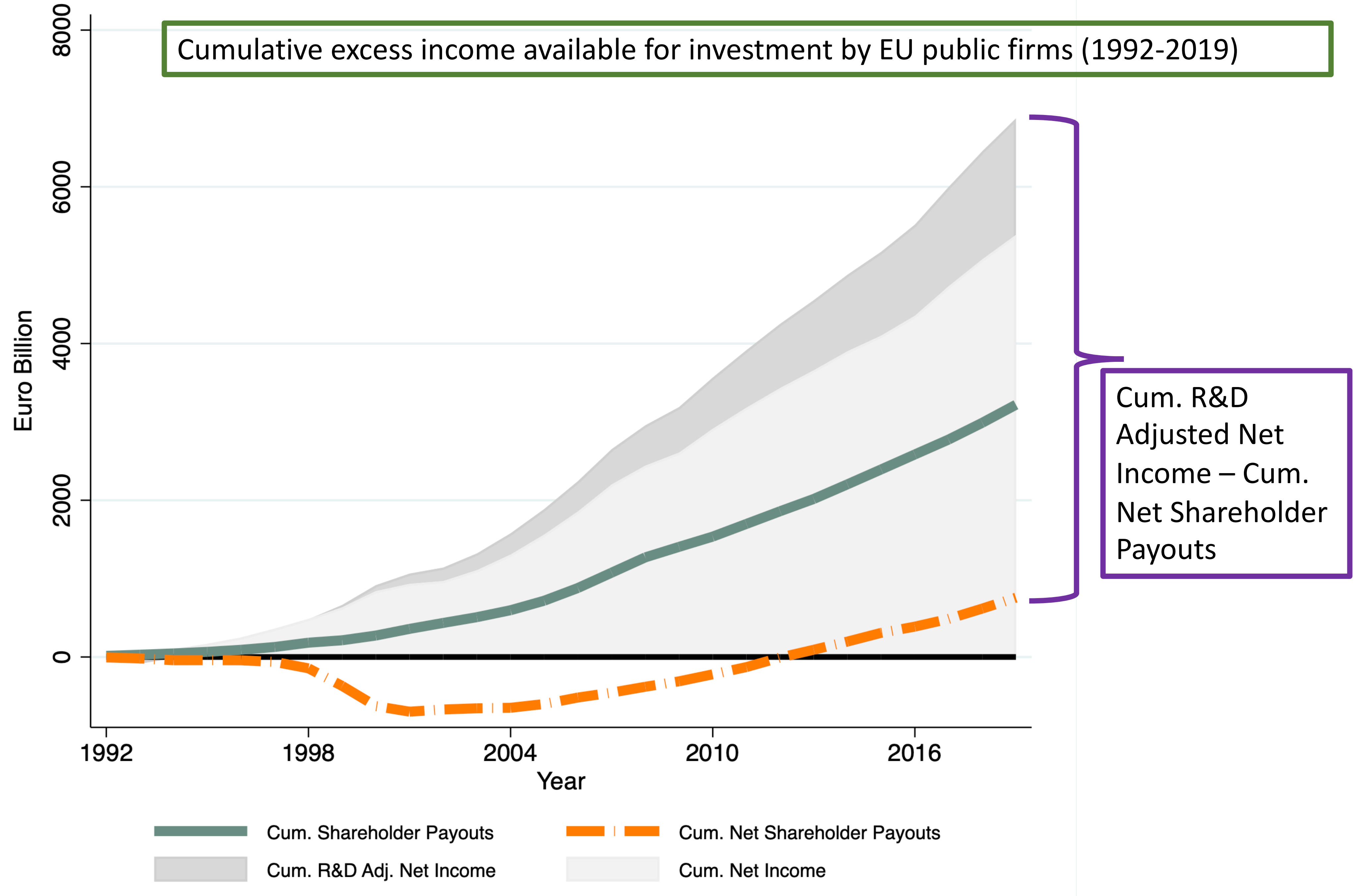

Repurchases, dividends, and equity issuances by EU public firms (1992-2019)
Euro Billion
0
100
200
300
Market Cap (Euro Billion)
0
2000
4000
6000
8000
1992
1998
2004
2010
2016
Year
Repurchases
Dividends
Equity Issuances
Market Cap



Sh’holder payouts and net sh’holder payouts by EU public firms (1992-2019)
65% of net income during 2010-2019
38% of net income during 2010-2019, (similar to U.S.)
Euro Billion
400
200
0
-200
-400
1992
1997
2002
2007
2012
2017
Year
Shareholder Payouts
Net Shareholder Payouts
Net Income

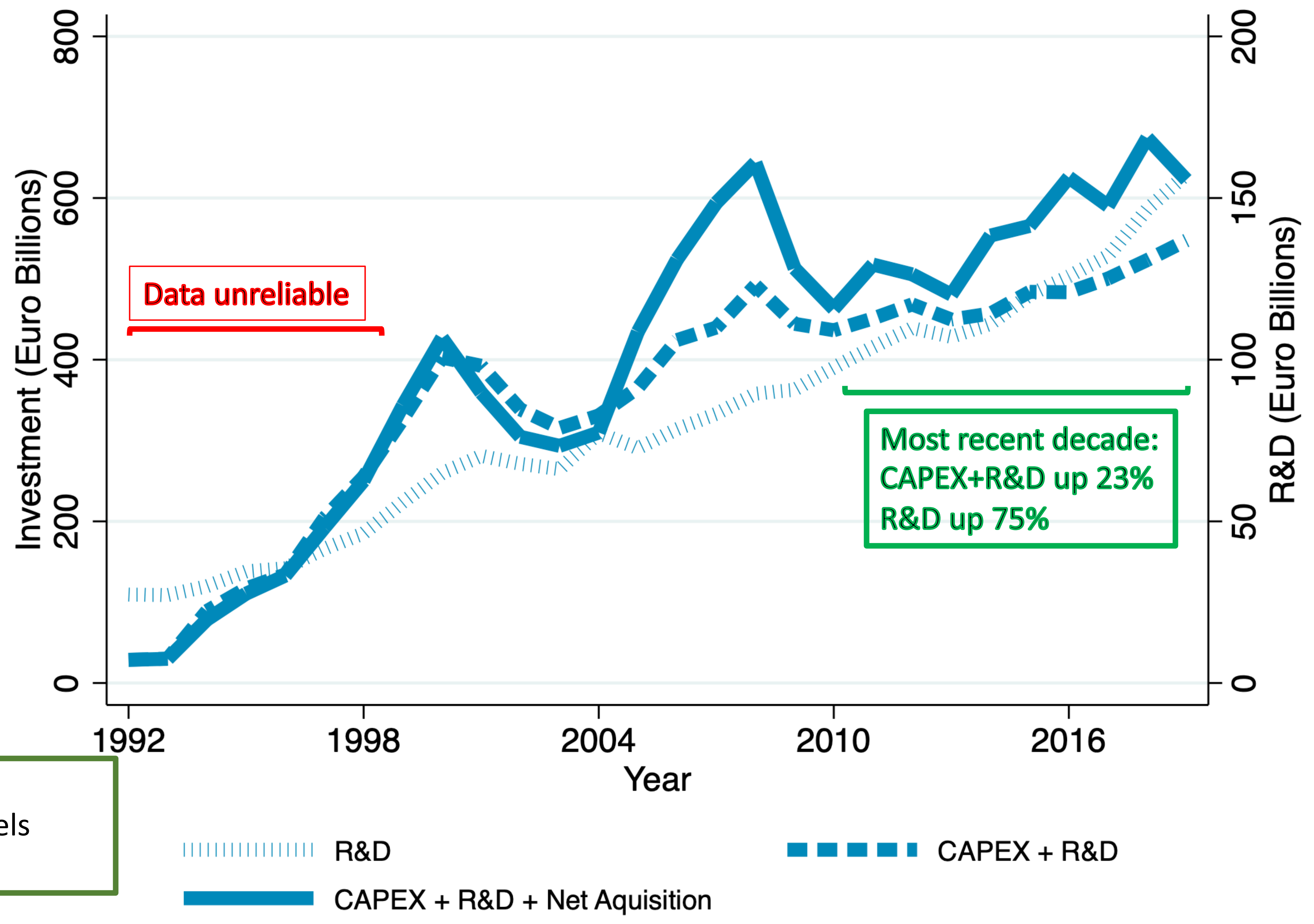
Sh’holder payouts & net sh’holder payouts by small EU public firms (1992-2019)



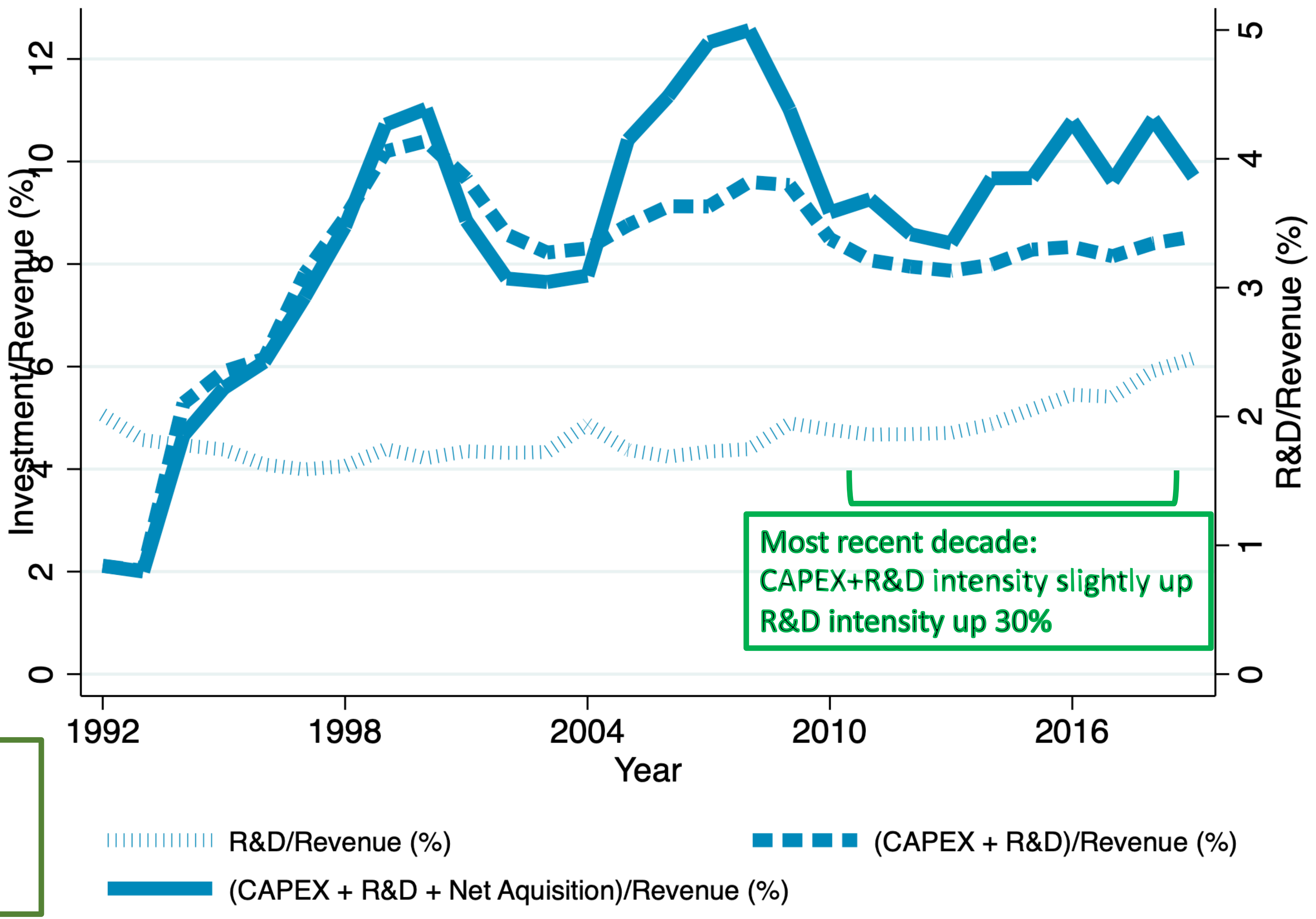

Cumulative excess income available for investment by EU public firms (1992-2019)
Euro Billion
8000
6000
4000
2000
0
1992
1998
2004
2010
2016
Year
Cum. R&D Adjusted Net Income – Cum. Net Shareholder Payouts
Cum. Shareholder Payouts
Cum. Net Shareholder Payouts
Cum. R&D Adj. Net Income
Cum. Net Income

(2) Properly Measuring Investment

- EY "finds" investment intensity has fallen
  - by arbitrarily and inconsistently dropping firms from its samples
- Looking at <u>all</u> EU public firms, we show that
  - CAPEX, R&D levels each increased over 1992-2019, and over 2010-2019
  - Combined CAPEX+R&D intensity increased over these periods
    - CAPEX intensity fell over 2010-2019, but R&D intensity increased by higher amount



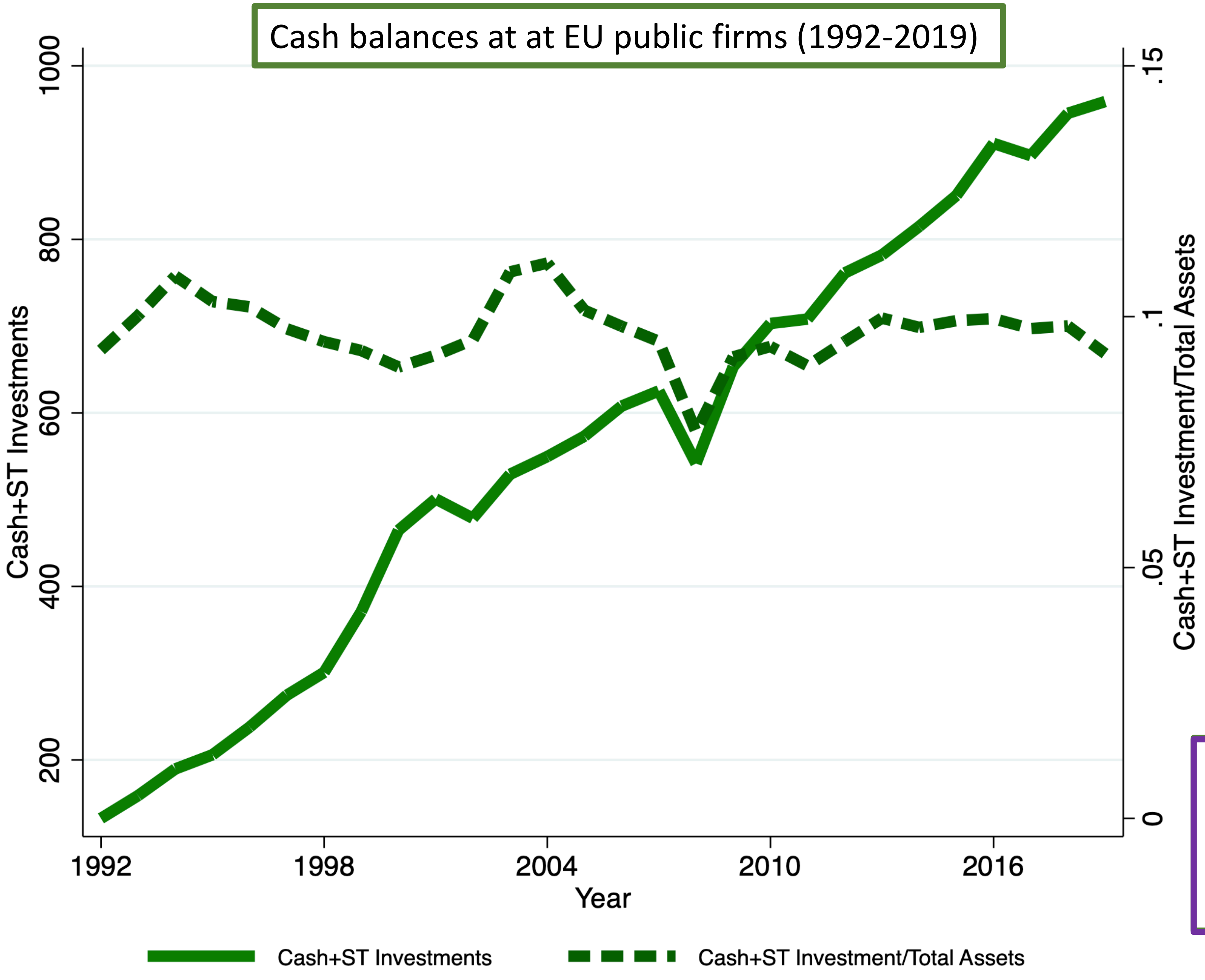
EU public firm investment levels (1992-2019)



Investment intensity at EU public firms (1992-2019)

(3) Properly Measuring Remaining Investment Capacity

- EY Study, at 9
  - “Increasing payments to shareholders will decrease the available resources to invest in R&D, human capital, or other kinds of capital expenditures, thus jeopardizing future productivity growth”
- But cash balances in EU public firms are rising.



Plus, firms can always issue more equity—as many do

Conclusion

- Contrary to EY,
  - actual capital flows to shareholders, net of equity issuances, are modest
  - investment intensity is not declining, but rather rising
  - firms not starved of cash for future investment—cash balances are rising

- EU policymakers should not rely on the EY Study

Thank you!