Shareholder Payouts and Short-Termism

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Short-Termism in European Corporate Governance (May 2023)

University of Antwerp/HLS/ECGI

Capital Flow Confusion in US

Background: Short-Termism Debate

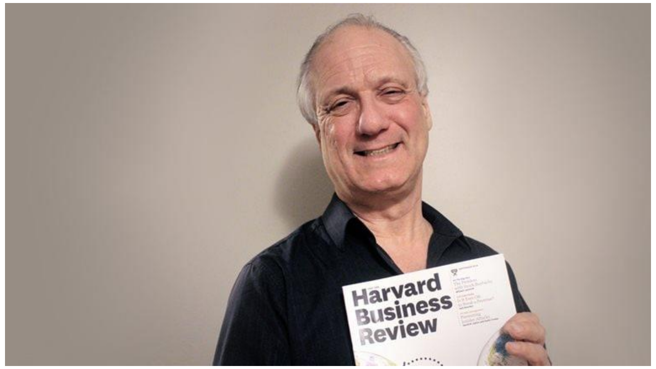
- **Short-termism is a problem:** short-termism (aka "quarterly capitalism"), exacerbated by hedge funds, is a critical problem for US public firms, investors, economy
  - Bratton & Wachter (2010); Coffee & Palia (2015); Lipton (2015); Strine (2010)

- **No, it's not**: hedge funds (and shareholders more generally) play a useful role in ecosystem; concerns over short-termism greatly exaggerated
  - Bebchuk & Jackson (2012); Bebchuk (2013); Gilson & Gordon (2013); Kahan and Rock (2007); Roe (2013, 2018, 2022); Kaplan (2017)

Payouts: Evidence of Short-termism?

- **Since 2015**: focus on *magnitude* of shareholder payouts (dividends + buybacks) as evidence of pervasive and harmful market-induced short-termism

- <u>Claim</u>: activism-induced pressure leads firms to distribute too much cash, **starving firms of capital necessary for innovation, wages, and long-term investment**



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.

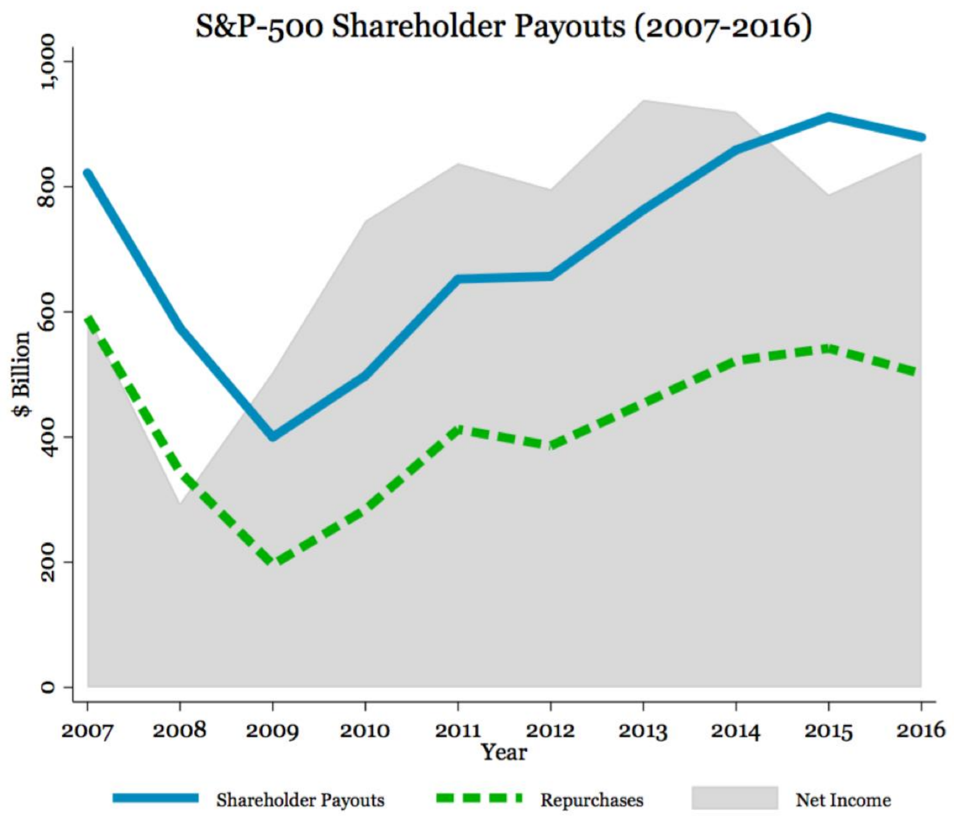
Lazonick's Excessive Shareholder Payout Meme Goes Viral

- think tanks (Brookings Institution, 2015; Roosevelt Institute, 2018)
- asset managers (BlackRock's Larry Fink, 2015; 2016; 2017)
- corporate lawyers (Lipton, 2015)
- politicians (Biden, 2016; Clinton, 2016; Baldwin, 2016; Schumer, 2018; Warren, 2018, 2021; Rubio, 2019; Brown, 2021)
- (even) economists (Kahle & Stulz, 2016)

SP500 Firms

- **2007-2016**
  - $7 trillion in shareholder payouts
    - $4.2 trillion in buybacks
    - $2.8 trillion in dividends
    - 96% of total net income

Figure 1: S&P 500 Shareholder Payouts (2007-2016)



Repurchases of and dividends to common shares are from Compustat. Following Boudoukh et al. (2007), we define repurchases as the purchase of common and preferred shares less any decrease in the value of preferred stock. Market capitalization is the total, year-end market value computed using monthly CRSP data with share and price adjustments.

Policy Proposals to Restrict/Ban Buybacks

- **Democratic Senators Chuck Schumer (New York) and Tammy Baldwin (Wisconsin) introduced a bill to "rein in" buybacks**
  - Allow S.E.C the authority to reject buybacks that, in its judgment, hurt workers
  - Require boards to "certify" that a repurchase is in the "best long-term financial interest of the company"
    - "The surge in corporate buybacks is driving wealth inequality and wage stagnation in our country by hurting long-term economic growth and shared prosperity for workers…"
- **Senators Tammy Baldwin and Elizabeth Warren (Massachusetts) also introduced a bill that <u>bans</u> all open-market repurchases**

Are the claims valid?

- Do buybacks in fact starve companies of capital necessary for investment?
- Is there evidence of pervasive and harmful short-termism in the U.S. market?

People Forget About Equity Issuances…

- Buybacks & dividends = capital moving from firm to shareholders

- Need to account for capital moving to firm from shareholders **via equity issuances**

- In typical repurchasing firm, **many *repurchased* shares later *re-issued (or vice versa)***
  - Share counts tend to remain stable or increase over time
  - … even when repurchases are significant

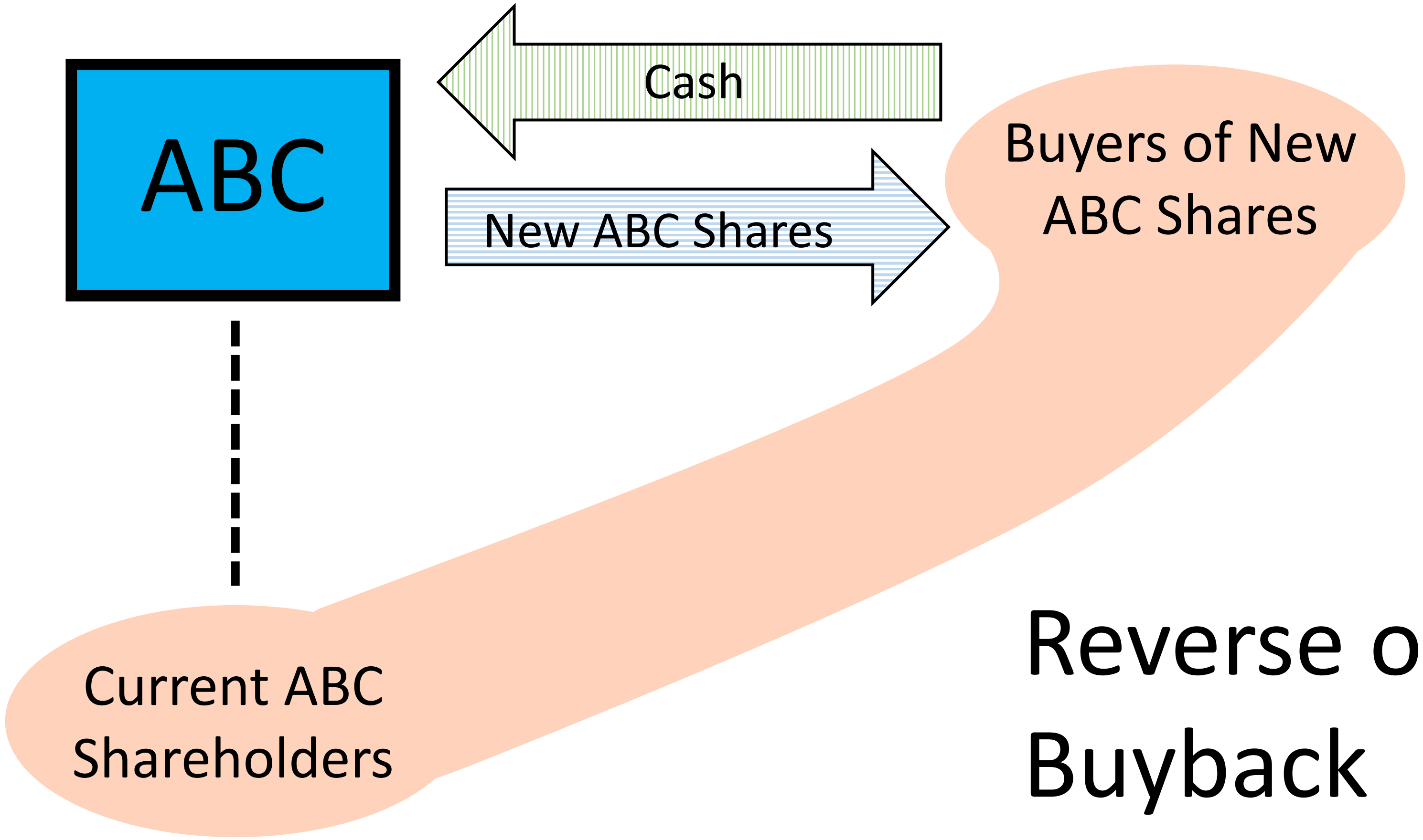
Direct and Indirect Equity Issuances

- **Direct equity issuances to shareholders**
  - **Simple cash-raising**: ~30% of total issuances
    - Seasoned equity offering: firm-commitment or at-the-market
    - Private placement
    - Rights offering
    - Dividend reinvestment plan, direct purchase plan

- **Indirect equity issuances to shareholders**
  - Acquisition-financing: ~20% of total issuances
  - Employee-paying: ~50% of total issuances

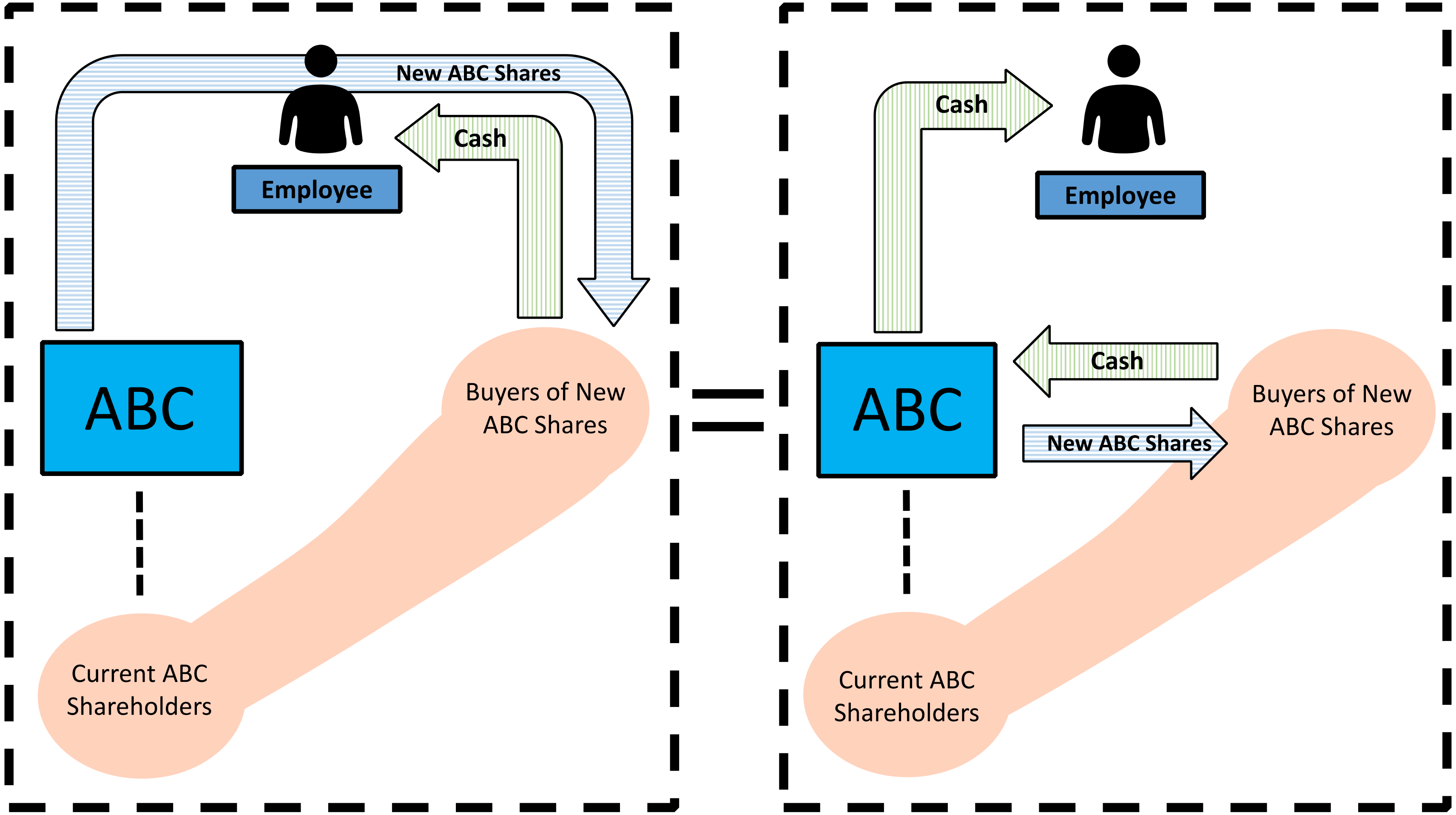
- **All** equity issuances functionally equivalent from a shareholder-firm capital-flow perspective

Simple Cash-Raising Issuance (e.g., SEO)



Reverse of Stock Buyback

Employee-Paying Issuance



Actual Transaction Equivalent Transaction

Better Measurement: Net Shareholder Payouts

- **If shareholder capital flows are important, we should look at <u>net shareholder payouts</u>**

= *Dividends + Equity Repurchases – Equity Issuances*

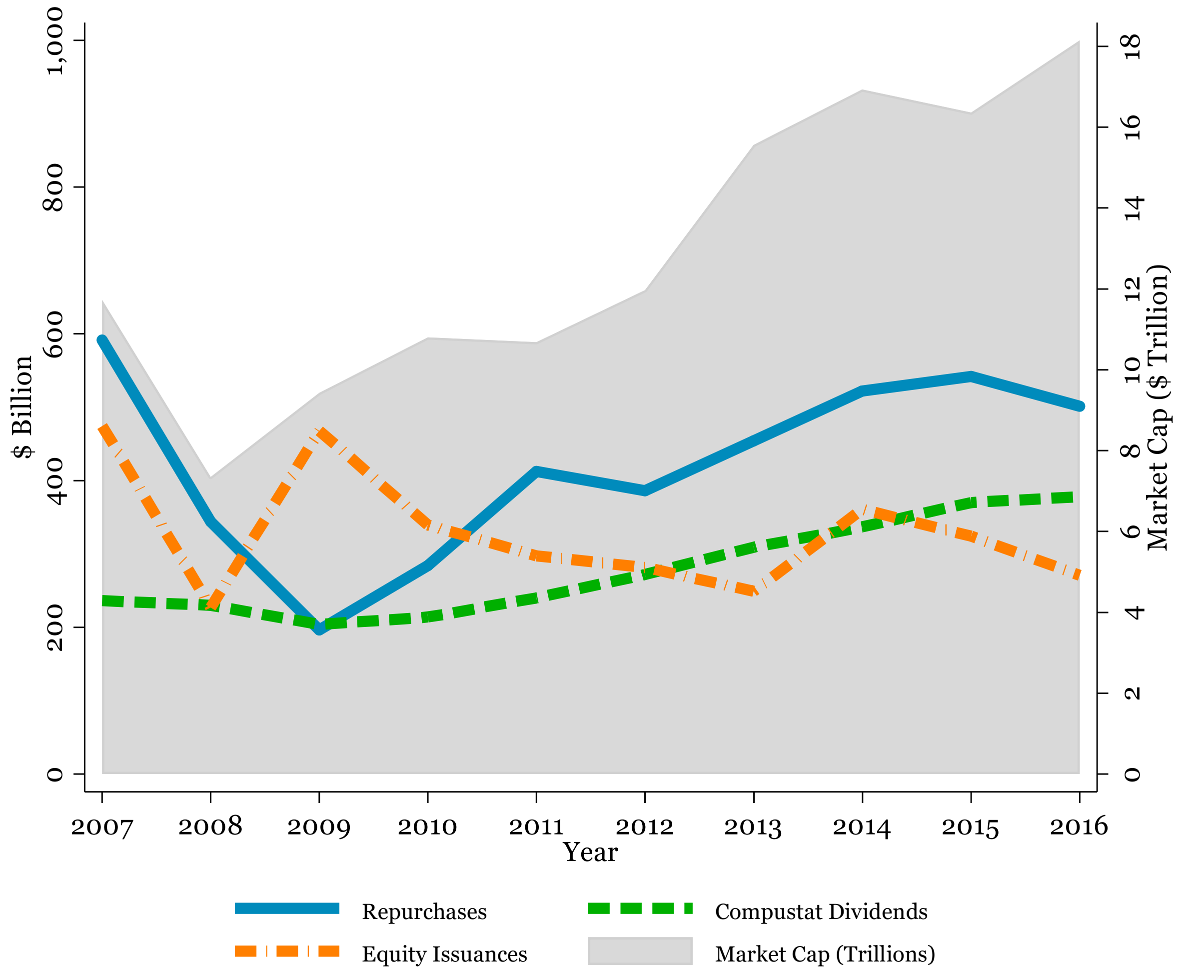
= *Dividends + (Equity Repurchases – Equity Issuances)*

= *Dividends - Net Equity Issuances*

- **Data / Measurement**
  - *Dividends (CRSP)*
  - *Net Equity Issuances = monthly change in share count x average monthly stock price (CRSP)*
  - *(Gross) Equity Issuances = Net Equity Issuances (CRSP) + Repurchases (Compustat)*

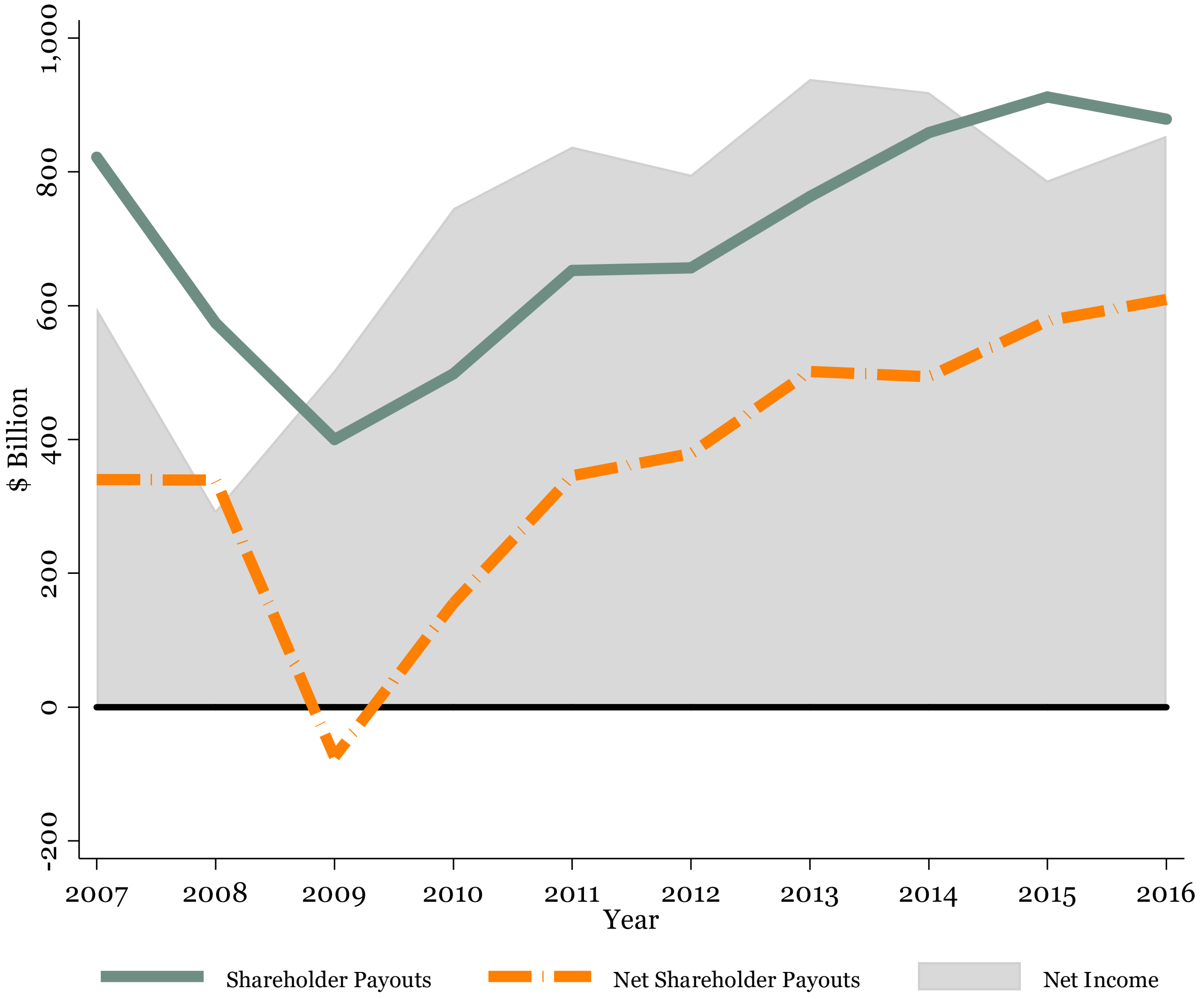
SP500 Repurchases, Dividends, and Equity Issuances

- (2007-2016)
  - Equity issuances significant: **$3.35 trillion**
    - 80% of the $4.2 trillion in buybacks recovered through direct and indirect issuances

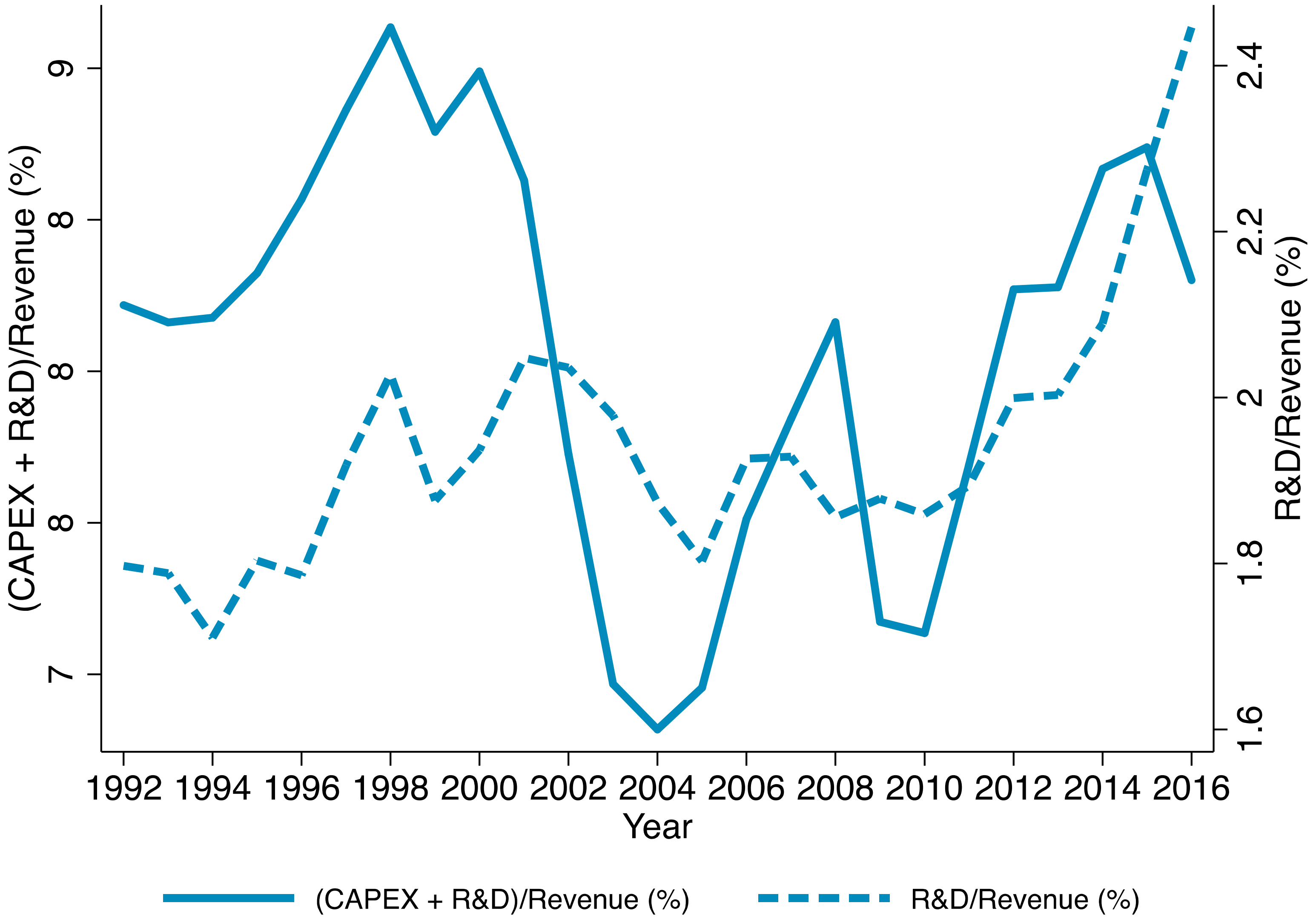


SP500 Shareholder Payouts and Net Sh. Payouts

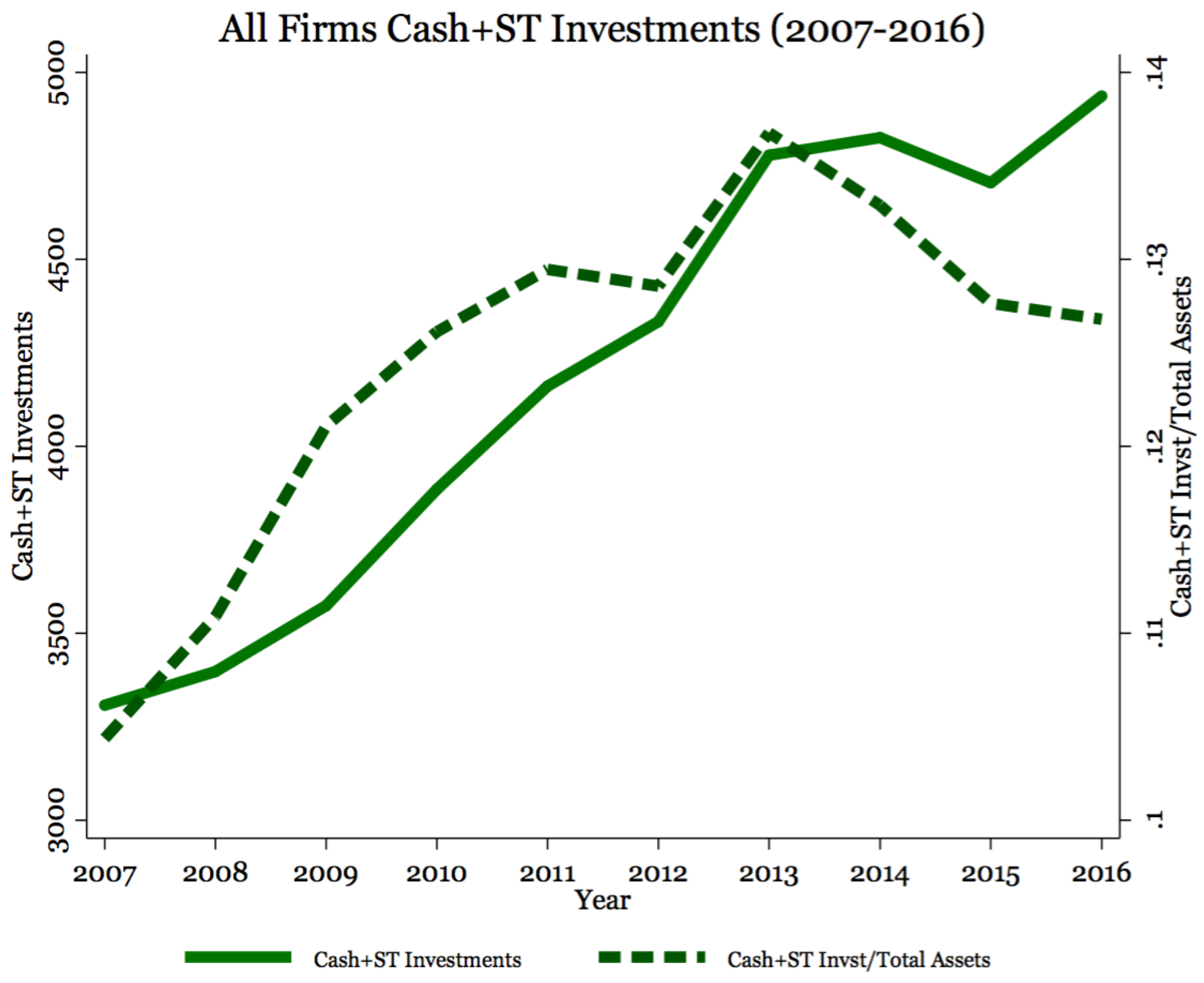
- (2007-2016)
  - Cumulative net shareholder payouts of **$3.7 trillion**
    - 50% of total net income
    - 52% of cumulative shareholder payouts



Public-Firm Investment Intensity (2007-2016)



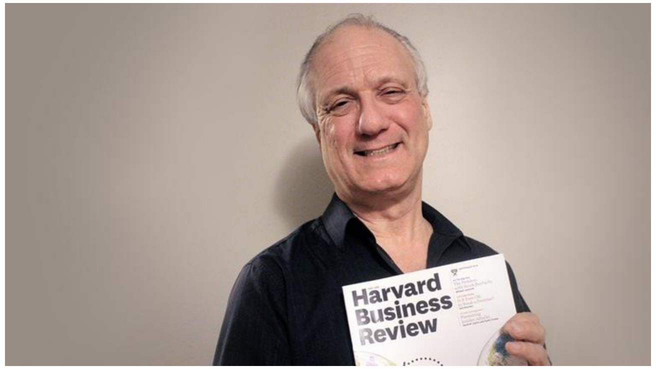
Public-Firm Cash Balances (2007-2016)



Are the claims valid?

- If buyback alarmists are correct, we should expect to observe the collapse of…
  - level of corporate investments -- **NO**
  - corporate investment intensity -- **NO**
  - corporate cash reserves -- **NO**

Capital flow confusion comes to EU thanks to…



European Commission & “Sustainable Capitalism”

- In 2020, EC planned new rules to make European public firms more “sustainable”

- EC adopts as “draft” a commissioned study by EY on sustainable CG that
  - was written by **Lazonick** followers/disciples
  - defines short-termism, purports to find it in EU firms
    - “Excessive” buybacks, falling investment
  - suggests various cures, including radically altering directors’ duties

EC/EY Report’s Main Finding

…companies “focus on short-term benefits of shareholders rather than on the long-term interests of the company”…..

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

(2) CAPEX & R&D intensity has declined

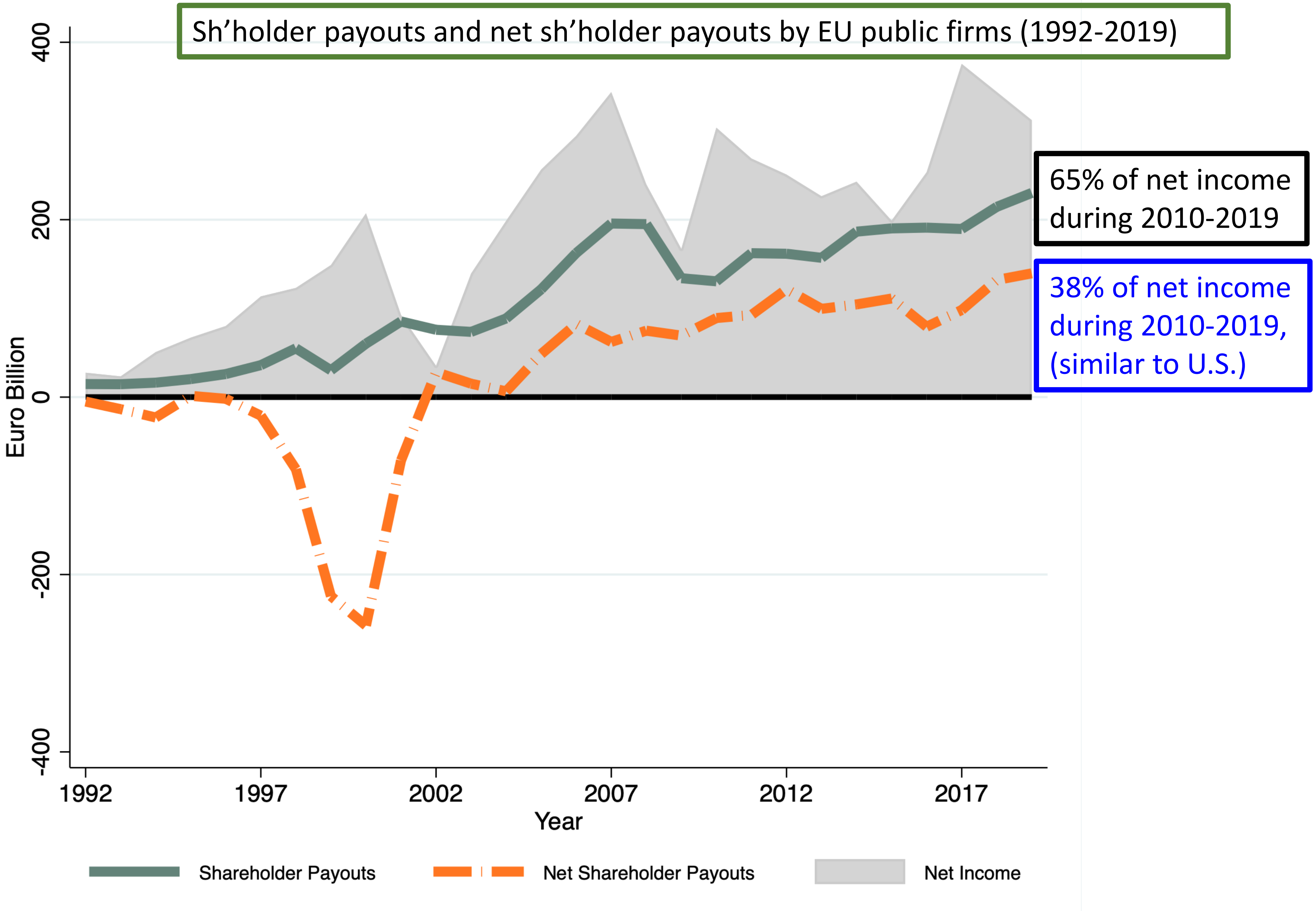
Fact: Investment intensity has increased (EY uses flawed sample).

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

Fact: Cash balances increasing.

(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



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

(2) Properly Measuring Investment

- EY “finds” investment intensity has fallen
  - by arbitrarily and inconsistently dropping firms from its samples
- But looking at <u>all</u> EU public firms..
  - CAPEX, R&D levels each increased over 1992-2019, including 2010-2019
  - Combined CAPEX+R&D intensity increased over these periods

(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

After Fried & Wang, and others submitted comments/reports to EC…

“the Commission’s Regulatory Scrutiny Board (RSB) rejected the European Commission’s draft proposal based on the EY Report not once but twice, stating that it was ‘not sufficiently clear about the need to regulate directors’ duties on top of due diligence requirements’ and that there was ‘[no] convincing evidence that EU businesses [...] do not already sufficiently reflect sustainability aspects or do not have sufficient incentives to do so’.”

Thank you!