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Incredible Shrinking Buybacks

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Last year proved to be a huge repurchasing dog pile as companies jumped into the buyback spending spree in record numbers. According to Standard & Poor's, S&P 500 companies bought back a record $589 billion of their own stock in 2007, up 36% from the $432 billion in 2006--and more than four times the $131 billion in stock buybacks during 2003.

For some perspective, that $589 billion put toward buybacks is more than double the $246 billion in cash dividends that S&P 500 companies paid last year.

Ten companies doing mega-billion-dollar buybacks spent a combined $148 billion on repurchases (all in billions): Exxon Mobil, $31.8; Microsoft, $21; IBM, $18.8; General Electric, $12.3; Hewlett-Packard, $11.8; Home Depot, $10.8; AT&T, $10.3; Transocean, $10.2; Pfizer, $10; and Cisco Systems, $10.

Buybacks in the fourth quarter of 2007 alone were $142 billion, 24% above the fourth quarter in 2006. This is the third largest expenditure of all time, ranking behind the $172 billion spent for third-quarter 2007 and the $158 billion for second-quarter 2007. Over the past 13 quarters, since the buyback boom began in fourth-quarter 2004, S&P 500 companies have spent some $1.44 trillion on stock buybacks, compared with $1.56 trillion on capital expenditures and $721 billion on dividends.

But booms can't--and don't--continue forever.

While 2007 may stand as an awe-inspiring record, that torrid pace cannot last. And there are signs that it has slowed. In the fourth quarter of last year, buybacks declined 18% from the previous quarter, the largest quarter-to-quarter decline in more than five years.

Although the buyback spending spree was undeniably popular and became standard operating procedure for corporations, it was not necessarily good for every company that undertook it. Remember the advice your mother probably told you a million times during your childhood? "Just because your friend is jumping off a cliff doesn't mean it's a great idea for you to do it!"

Everyone's mother had a different version, but they all came to the same conclusion: Before you act, judge for *yourself* whether your actions would be right for *you*.

A few of today's CEOs and boards of directors might have been better off taking that maternal common-sense advice than simply following in repurchasing lockstep with their corporate brethren. In the fourth quarter of 2007, financials accounted for about 13% of all buybacks, down from an impressive 29% of all buybacks in the first quarter of last year.

Would it further surprise you to know that when financials were buying back all that stock, they weren't necessarily making a good investment, at least in the near term? According to data compiled by SNL Financial, shares repurchased by 41 banks and financial service firms have lost more than half their value, while another 147 institutions have seen values drop 25% to 50% below the average repurchase price. And of the more than 600 financial services companies that bought back their own stock last year, it was a losing investment for all but 90 of them.

In fact, a number of cash-strapped banks have essentially reversed their buybacks and have now made plans to offer new shares to raise capital. For example, Washington Mutual said it would issue $7 billion in stock after spending $3.3 billion on buybacks last year, and Lehman Brothers, which in January authorized repurchasing 100 million shares, also plans to issue new stock.

Financial firms were caught off guard by the liquidity crisis caused by defaults by subprime borrowers, and the $109 billion they spent buying back their own stock in 2007 limited their ability to respond to that liquidity crisis. Many companies that have not reversed their buybacks have drastically reduced the pace.

Nobody expects the buyback boom to continue unabated, especially those who track it. Howard Silverblatt, senior index analyst at Standard & Poor's, expects buyback activity to continue at a high but not record-setting pace for 2008, as corporations and investors show continued concern over economic and liquidity problems.

Sure enough, there are far fewer new buybacks being announced as the economy slows this year, compared with what we saw in 2007. Already in the first quarter, stock buybacks dropped to their lowest level in five quarters, to $136.3 billion, according to TrimTabs.

Still, there have been a few big buyback announcements from companies like Qualcomm, Amazon.com, Verizon Communications, Dell, Cisco and Genentech.

It does appear, however, that companies are increasingly looking to raise funds through equity issues instead of debt, and to conserve cash by scaling down on share buybacks.

Excerpted from the May issue of the Buyback Letter. For more of David Fried's specific investment recommendations, click here for a free trial of the Buyback Letter.