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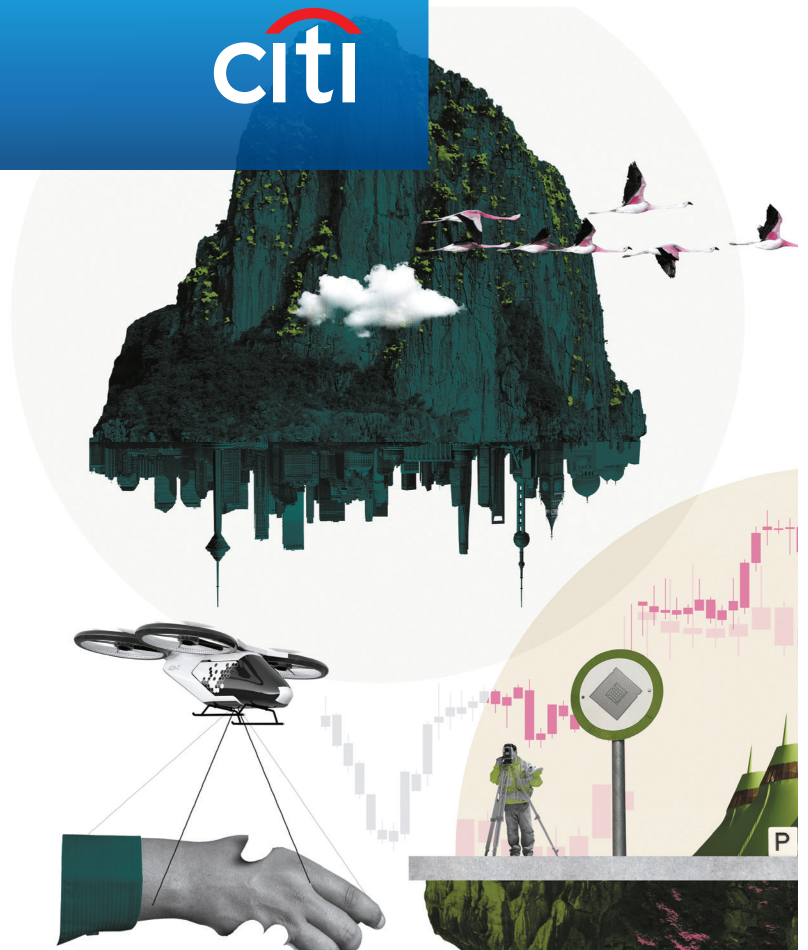

The Mother of All Blackout Periods

COVID-19's Impact on Share Buybacks

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Key Takeaways

- Corporate buyback culture, already a politically sensitive issue in the run up to this year's US presidential elections, is likely to be radically altered by COVID-19. The US, where S&P 500 Index companies have spent $1.6 trillion repurchasing stock over the past two years, is at greatest risk.
- Citi Investment Management's rigorous bottom-up approach and focus on balance sheet strength means we believe our strategies will endure as the buyback debate is reshaped in the months and years ahead. We also consider what impact a vast reduction in repurchase activity means for volatility post COVID-19 as well as how Environmental, Social, and Governance (ESG) scores might encapsulate differing degrees of buyback activity going forward.
- In the US, any companies requiring government assistance under the new CARES Act will be prevented from buying back stock or issuing dividends for 12 months after the debt has been repaid. In Europe, similar restrictions will likely apply. Even firms not in need of bailouts will likely seek to conserve cash, at least until the impact of the current health crisis becomes clearer. Eight of the largest banks in the US have already suspended buybacks through Q2, while companies such as Intel, McDonalds, and AT&T in seemingly less impacted sectors have made similar announcements.

With contributions from Joseph Fiorica, Global Equity Strategy, Citi Private Bank

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Figure 1: Heavy "Buybackers" Starting to Get Punished

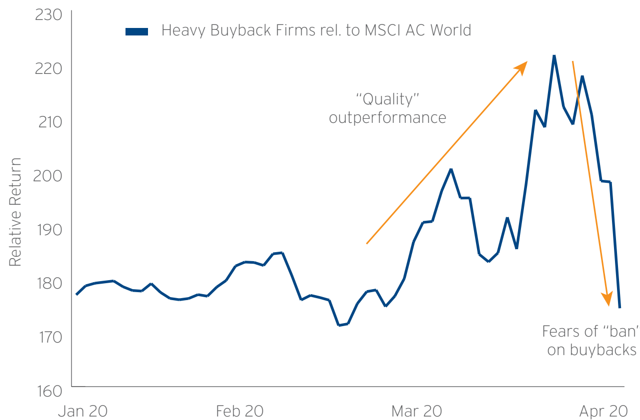
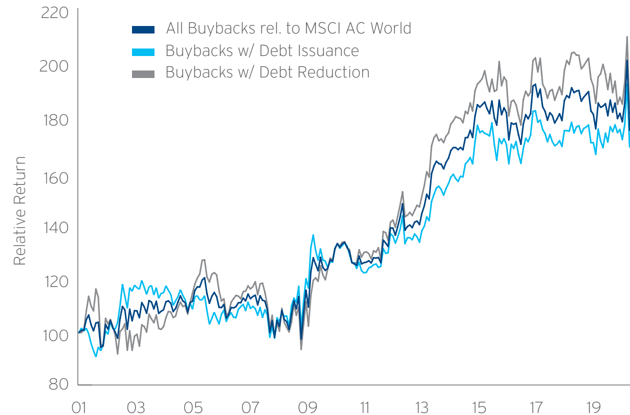


Figure 2: Relative Return of Buyback Strategies



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Source: FactSet and Bloomberg. As of March 31, 2020.

- Investors are beginning to scrutinize companies that have spent the most on stock repurchases and, as a result, are vulnerable to a reduction in repurchase activity (**Figure 1**). While understandable as the market reprices the scope of future buyback activity, in the longer term we believe companies that have grown buybacks while simultaneously taking on debt are at much greater risk (**Figure 2**).

- In Europe, which saw approximately $150bn of buybacks in 2018 versus $800bn in the US, the buyback buffer is already much lower. The preferred European method of returning capital to shareholders is via dividends. We expect to see buyback suspension decisions in the US to be taken on a similar scale as dividend (and buyback) suspensions in Europe. Of course, we anticipate there will be dividend cuts and suspensions in the US. This is already happening, but the extent is likely to be more limited than in Europe.

- Public opinion will also play a role, especially heading into the US presidential elections. As the media spotlight shines on bailed out companies like airlines, other executives will want to avoid similar scrutiny. It could be many years before we see buybacks return to their (tax reform-inflated) 2018 and 2019 levels.

The Rise of Buybacks

Four times a year, generally when earnings season kicks off, investors and analysts alike begin to speculate about equities losing a reliable underlying bid for shares as companies enter their blackout periods – when ad-hoc repurchases of a company's own shares is prohibited. In the US, where the corporate buyback culture is most prevalent, this issue is significant. In recent years, US companies have been responsible for around 75%-80% of global share repurchases. S&P 500 companies alone have spent $1.6 trillion over the past two years buying back their own shares.

The impact of COVID-19 is likely to change this drastically. While politicians, including Democratic presidential hopefuls Bernie Sanders and Elizabeth Warren, were not able to curtail corporate share repurchases despite many years of futile attempts, the fallout from the current health care epidemic managed to do so in a matter weeks.

Critics of buybacks have long argued that this practice incentivizes management to boost earnings per share (EPS) at the expense of capital deepening and employee wages, potentially exacerbating income inequality. Meanwhile, proponents of buybacks argue that equity holders are entitled to receive some portion of earnings once all profitable investment opportunities have been exhausted. Those proceeds can then be invested in other potentially profitable areas of the economy.

We believe the reality exists somewhere in between. In the US, buybacks have not come at the expense of capital expenditures. US companies have become so profitable over the past decade that they were able to buy back vast amounts of shares while simultaneously increasing capital expenditures year after year (**Figure 3**). A large portion of shares are repurchased by companies to offset dilution from employee stock plans. Even accounting for this at 75%-80% of global buyback activity in recent years, US share repurchases appear excessive, especially relative to the country's 55% share of global equity market cap. Cash that might otherwise have been used as a buffer during the COVID-19 epidemic or another future downturn has instead been used to repurchase stock. This, by design or otherwise, has boosted earnings per share.

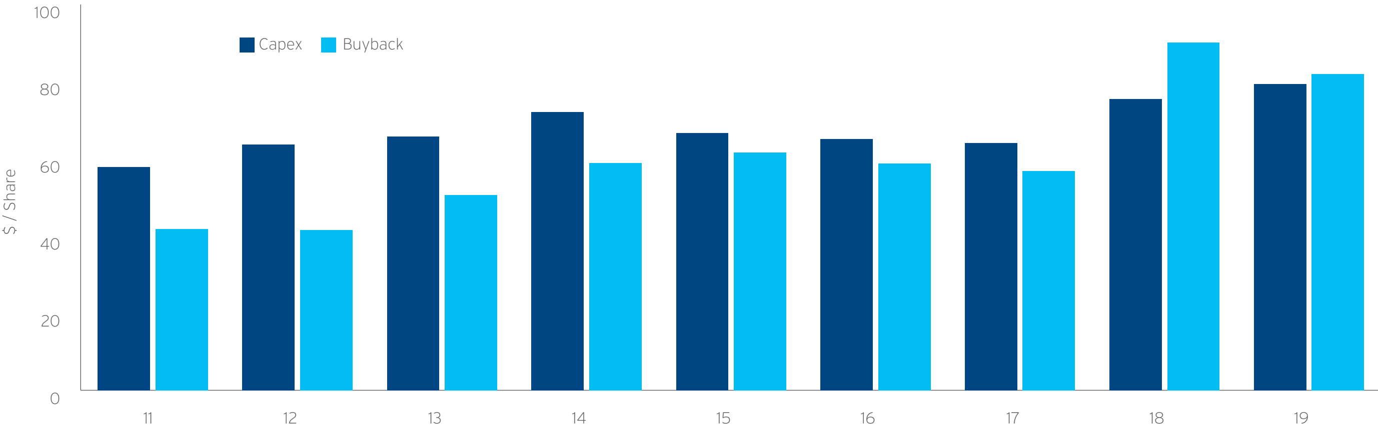
Populism

The airline industry, which spent heavily on buying back their own stock in recent years but now requires government assistance, exemplifies this issue. Any industry is going to struggle when revenues drop 80% amid an unprecedented global economic shutdown. While we do not yet know the full extent of government support needed across the economy, there is potential for industries outside of travel and leisure that will also request assistance, depending on the length and depth of the economic drop.

Given that populist sentiment has been prevalent in recent years, the public appetite for corporate bailouts remains low. It has also forced politicians to denounce and press for share buyback contingencies for companies that receive loans from the government for any fiscal stimulus. We believe the implications of a decline in share buybacks has significant and far-reaching effects on market structure, volatility, and stock selection.

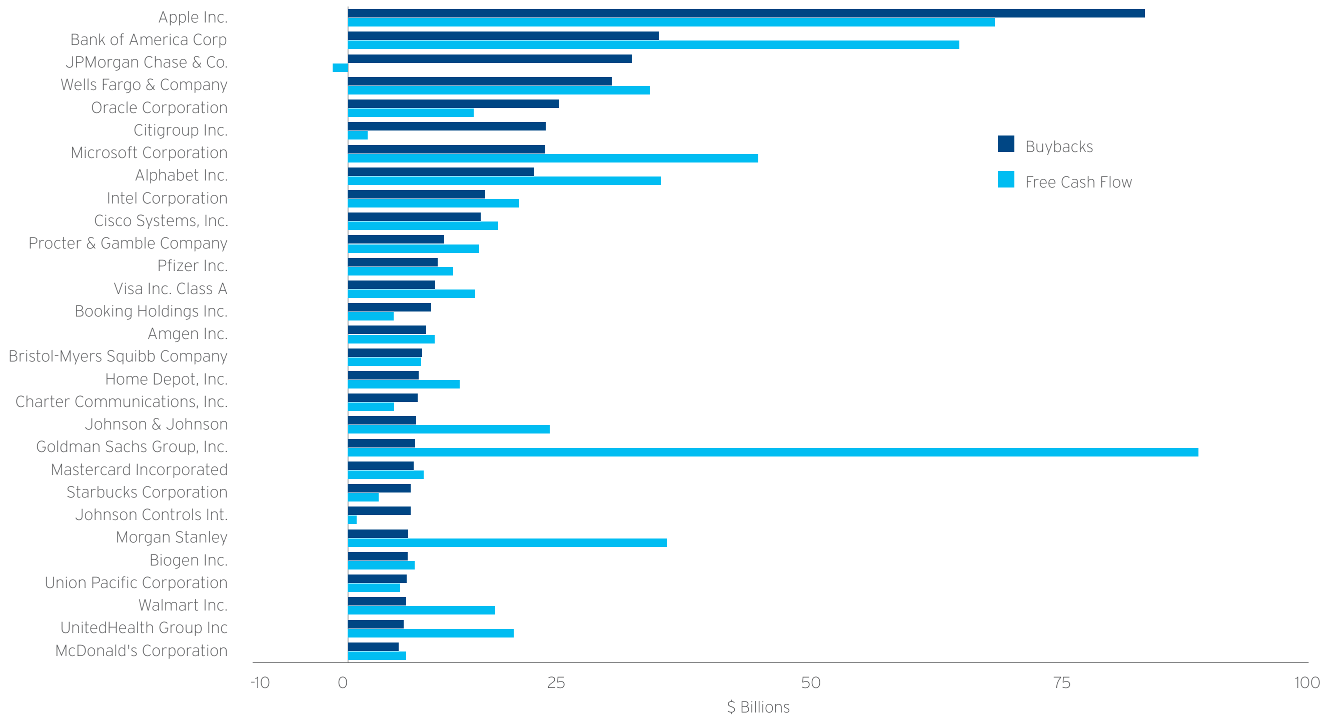
Even outside of the most impacted industries, the scope of buyback activity is being reduced as companies opt to hold back on repurchases in order to assess how the economic backdrop unfolds. Already, we have seen eight of the largest banks in the US suspend buybacks through Q2. After the Technology sector, Financials is the segment of the market that has seen the most share repurchases. Household names in seemingly less affected and varied sectors such as Intel, McDonalds, and AT&T have made similar announcements.

Figure 3: US Buybacks Have Not Been At the Expense of Capex



Source: FactSet and Bloomberg. As of March 31, 2020.

Figure 4: A Ranking of the Largest Corporate "Buybackers"



Source: FactSet and Bloomberg. As of March 31, 2020.

Firms that repurchased the most have outperformed broader global equities over the last two decades, particularly during the most recent economic cycle. However, the financing of buybacks is very important, especially in today's environment. In the post-Global Financial Crisis era, the cheap cost of debt financing helped fuel a surge in buybacks globally. Firms that reduced their debt burden while also sustaining a strong buyback program outperformed those who issued debt to fund these repurchases (**Figure 4**). While we expect buyback activity to slow more broadly following COVID-19, we believe the impact on repurchase activity will be greatest for companies simultaneously issuing debt.

Market Structure & Liquidity

While the post-Global Financial Crisis era has boosted prices across asset classes, market trading volumes declined in the five years following the crisis and have only moderately recovered (**Figure 5**). The rising tide of asset prices, however, has not been beneficial to one significant part of the market: the active investment manager. Historically, the active manager has served as a buyer of last resort. As asset prices declined from time to time, the active manager would step in and purchase assets that they deemed as "value."

Figure 5: Post-Financial Crisis Trading Volume Flat Lining

Source: FactSet and Bloomberg. As of March 31, 2020.

Figure 6: Average $ Share Buyback per $ Trading Volume by Sector

Sector	2019	2018	2017	2016	2015
Financials	3.4%	2.5%	2.3%	2.4%	2.6%
Technology	2.0%	2.3%	1.6%	1.9%	3.1%
Industrials	1.6%	1.7%	1.5%	1.6%	2.7%
Health Care	1.5%	1.7%	1.8%	2.2%	1.4%
Consumer Discretionary	1.4%	1.4%	1.2%	1.5%	1.9%
Materials	1.3%	1.3%	0.8%	1.1%	1.4%
Consumer Staples	1.1%	1.2%	1.6%	1.9%	2.5%
Energy	1.0%	1.4%	1.0%	0.3%	0.6%
Communicate Services	0.8%	0.8%	1.4%	1.6%	1.4%
Real Estate	0.5%	0.6%	0.4%	1.3%	4.3%
Utilities	0.5%	1.5%	0.6%	0.0%	0.9%

Source: FactSet and Bloomberg. As of March 31, 2020.

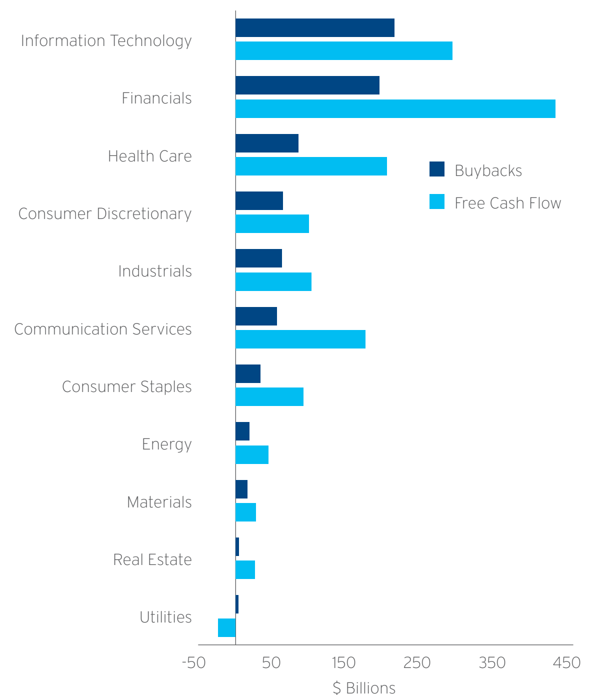
At this stage in the shift from the prevalence of active to passive management and the increasing prevalence of exchange traded funds (ETFs), markets have seen the significant liquidity that the active manager would have provided taken out of the equation and essentially shifted to the hands of rules-based passive managers. The implications of this are nuanced. In periods of market stress, that buyer of last resort, the active manager, has a more limited impact on market liquidity. Periods of panic and stress are exacerbated when investors look to redeem assets all at once without any buyers stepping in to stem the flow of assets.

A second major contributor to market liquidity over the past decade has been share buybacks. There are specific companies that have provided greater than 20% of trading volume from share buybacks. The average company in specific sectors, like Financials and Information Technology, had sourced 3.4% and 2.0%, respectively, of dollar-liquidity specifically from corporate buybacks in 2019 (**Figures 6 and 7**).

This is a concerning trend when one considers that if we were to take corporates out of the calculation of market liquidity, the buyers of last resort — corporates and active managers — have been crowded out.

We believe, however, that it is important to take a bottom-up approach to buyback sustainability. Eight of the largest US banks have already committed to suspending buybacks through Q2 2020. In the UK and Europe the suspension of returning capital to shareholders in any form is likely to go even further. On the flip side, technology companies are more likely to sustain some form of buyback activity. These companies are less affected by social distancing than others and, in many cases, have lower levels of dividends they need to protect and typically are more cash rich than other sectors. When examining vulnerability across sectors, tech looks more resilient from a free cash flow perspective.

Figure 7: US Buybacks by Sector



Source: FactSet and Bloomberg. As of March 31, 2020.

Market Volatility

The implications of fewer buyers in the market implies ceding greater control over liquidity to algorithmic, systematic trading, and trend following strategies. This can have significant implications on market volatility.

One way to analyze this is to look at market volatility over share buyback blackout periods (**Figure 8**). When we compare cross-sectional volatility of S&P 500 companies during blackout periods to year-over-year trading volume growth over the same period since 2015, we see a 12% rise in volatility coupled with a 79% decline in trading volume growth when comparing blackout periods to non-blackout periods.

Looking forward, we believe the implications of this are significant. If corporate buybacks are to decline, then the era of low market volatility is likely over. Furthermore, if volatility is higher than it has been in the recent past, we should also anticipate lower multiples on stocks as well. It is important to note that this analysis is based on blackout periods during which corporates are restricted from buying back their shares tactically, but are still allowed to execute repurchases that are on a pre-set course. The environment ahead of us is one in which share repurchases drop meaningfully altogether, both tactically and pre-set. The impact on volatility is likely to be greater still.

Figure 8: Volatility During Blackout Periods

	Cross-Sectional Volatility	Average YoY Volume Growth
Off-Share Buyback Blackout Months	6.5%	8.2%
Share Buyback Blackout Months	7.3%	1.7%
Percent Difference	12.3%	-79%

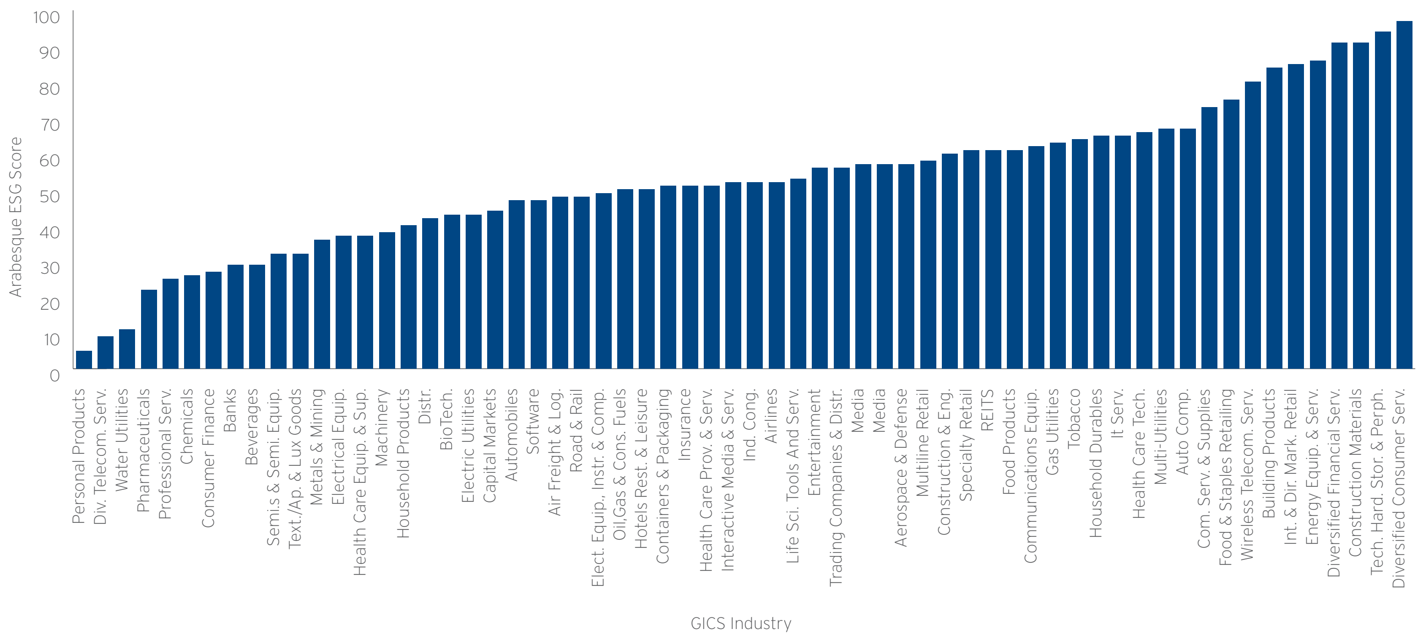
Source: FactSet and Bloomberg. As of March 31, 2020.

The ESG Premium

With ESG era in full force considerations rising in investor popularity, one interesting angle will be the ESG implications of forsaking share buybacks for the greater good. The big money center banks are the epicenter of this. Having spent years in the crosshairs of politicians and the general populace for their behavior in the Global Financial Crisis, banks represent one of the worst industries with regards to the their ESG scores. These institutions have spent years building and proving the sustainability of their balance sheets via stress tests. This has put them in prime position to differentiate themselves in the current crisis. Commenting on the banks' decision to suspend buybacks, a trade group representing large banks has stated that the goal of using their available capital is to "provide maximum support to individuals, small business, and broader economy through lending and other important services."[1]

The suspension of share buybacks by the banks and other companies has the potential to help prevent this recession from evolving into a depression. Because of this, we believe an argument can be made for banks to warrant higher ESG scores. The question will be if improved ESG scores are sufficient to offset the demand for shares that share buybacks no longer provide.

ESG Score



Source: Citi Asset Management, Arabesque. As of March 31, 2020. Rankings are based on a GICS industry weighted average, sector neutral translation of Arabesque ESG scores. Rankings are between 1-100 (worst to best).

There are numerous ESG data providers that evaluate companies on their ESG performance and provide reports and ratings. Report and ratings methodology, scope and coverage, vary greatly among providers.

Arabesque is a global asset management firm and ESG ratings provider. Their S-Ray tool uses self-learning quant models and big data to assess the performance and sustainability of approximately 7,000 companies. S-Ray's provides two types of ratings: The GC score rates companies on the normative principles of the United Nations Global Compact (calculating a GC Score of 1-100). The ESG score provides an industry-specific assessment of companies' performance on financially material sustainability criteria (calculating an ESG Score of 1-100). Although the two scores are correlated, companies may have significantly different values for its GC and ESG Scores.

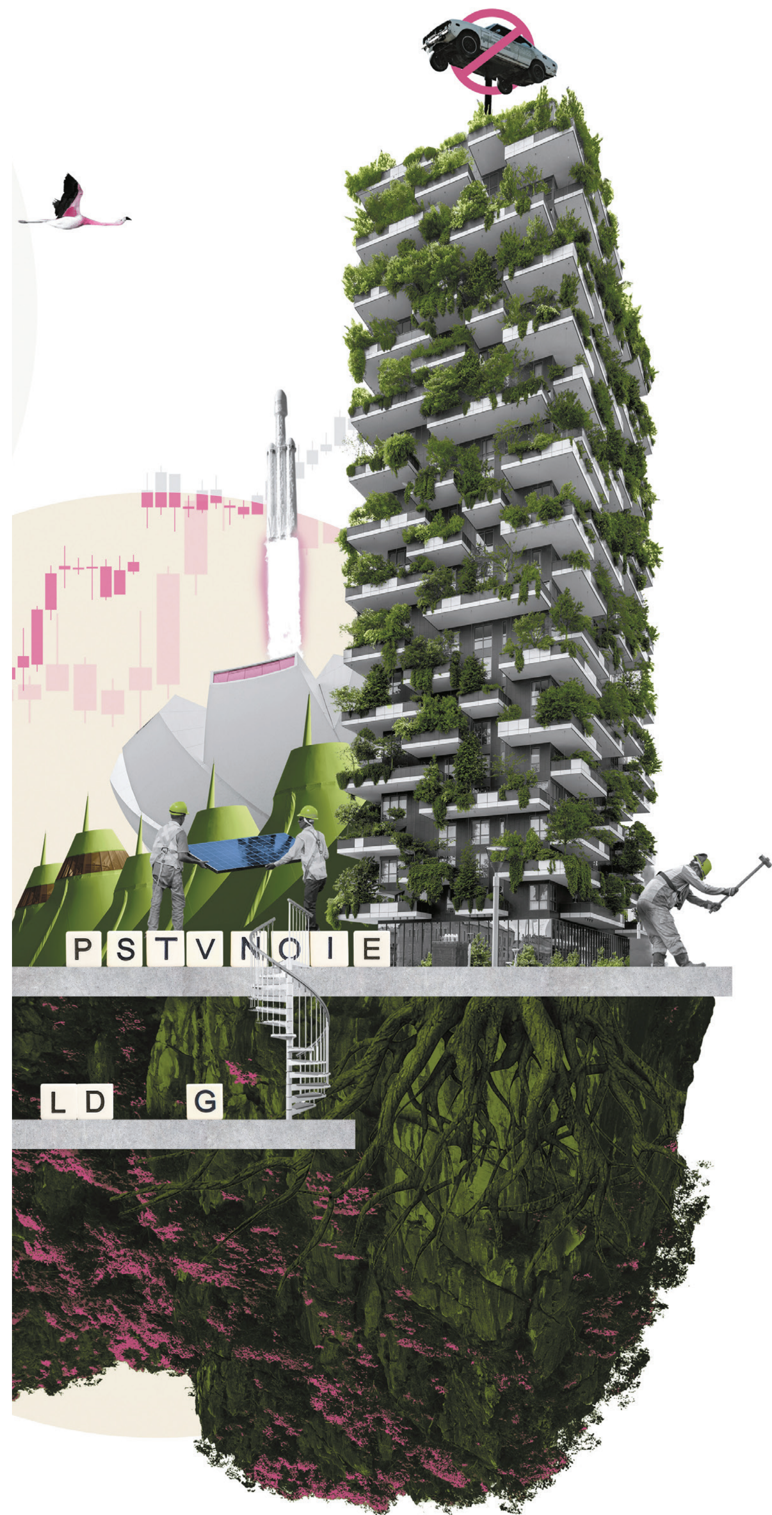
[1] The New York Times: "The Stock Buyback Binge May Be Over. For Now." Accessed 3/24/20

Closing Thoughts

What will be the lasting impact of COVID-19 on society and financial markets? Some companies may choose to continue having a greater portion of their workforce working from home, perhaps as a way to reduce in-office operating expenses. Potentially, a portion of business-related travel will be permanently replaced with videoconferencing. While these outcomes remain to be seen, what does seem increasingly clear is that share repurchases, having grown in favor over the years, should come down drastically.

Understanding how individual stocks are impacted, which are able to sustain repurchases, and which have been borrowing to fund buybacks in recent years will help determine relative winners and losers in the years to come. Positioning one's portfolio to account for the associated rise in volatility and potential impact on ESG metrics requires a rigorous bottom-up approach.

On a bottom-up basis, focusing on the soundness of corporate balance sheets is of utmost importance. Avoiding companies that do not have the balance sheet to weather this marked downturn will be crucial when seeking to avoid a credit event. At a portfolio construction level, diversifying portfolios across sectors, factors, and regions is also important in managing the volatility of the portfolio. The unprecedented nature of this crisis and the fiscal and monetary response leaves the market vulnerable to considerable upside and downside risks. Managing through this uncertain period will require Citi Investment Management's disciplined approach to risk management.



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