In direct contradiction to efficient market theory or modern corporate finance, **capital structure is critical** and often an indicator of management skill. After the article from Michael Milken, stock buy-backs will be discussed.

Wall Street Journal APRIL 21, 2009

Why Capital Structure Matters: Companies that repurchased stock two years ago are in a world of hurt.

By MICHAEL MILKEN

Thirty-five years ago business publications were writing that major money-center banks would fail, and quoted investors who said, "I'll never own a stock again!" Meanwhile, some state and local governments as well as utilities seemed on the brink of collapse. Corporate debt often sold for pennies on the dollar while profitable, growing companies were starved for capital.

Chad Crowe

If that all sounds familiar today, it's worth remembering that 1974 was also a turning point. With financial institutions weakened by the recession, public and private markets began displacing banks as the source of most corporate financing. Bonds rallied strongly in 1975-76, providing underpinning for the stock market, which rose 75%. Some high-yield funds achieved unleveraged, two-year rates of return approaching 100%.

The accessibility of capital markets has grown continuously since 1974. Businesses are not as dependent on banks, which now own less than a third of the loans they originate. In the first quarter of 2009, many corporations took advantage of low absolute levels of interest rates to raise $840 billion in the global bond market. That's 100% more than in the first quarter of 2008, and is a typical increase at this stage of a market cycle. Just as in the 1974 recession, investment-grade companies have started to reliquify. Once that happens, the market begins to open for lower-rated bonds. Thus BB- and B-rated corporations are now raising capital through new issues of equity, debt and convertibles.

This cyclical process today appears to be where it was in early 1975, when balance sheets began to improve and corporations with strong capital structures started acquiring others. In a single recent week, Roche raised more than $40 billion in the public markets to help finance its merger with Genentech. Other companies such as Altria, HCA, Staples and Dole Foods, have used bond proceeds to pay off short-term bank debt, strengthening their balance sheets and helping restore bank liquidity. These new corporate bond issues have provided investors with positive returns this year even as other asset groups declined.

The late Nobel laureate Merton Miller and I, although good friends, long debated whether this kind of capital-structure management is an essential job of corporate leaders. Miller believed that capital structure was not important in valuing a company's securities or the risk of investing in them.

My belief -- first stated 40 years ago in a graduate thesis and later confirmed by experience -- is that capital structure significantly affects both value and risk. The optimal capital structure evolves constantly, and successful corporate leaders must constantly consider six factors -- the company and its management, industry dynamics, the state of capital markets, the economy, government regulation and social trends. When these six factors indicate rising business risk, even a dollar of debt may be too much for some companies.

Over the past four decades, many companies have struggled with the wrong capital structures. During cycles of credit expansion, companies have often failed to build enough liquidity to survive the inevitable contractions. Especially vulnerable are enterprises with unpredictable revenue streams that end up with too much debt during business slowdowns. It happened 40 years ago, it happened 20 years ago, and it's happening again.

Overleveraging in many industries -- especially airlines, aerospace and technology -- started in the late 1960s. As the perceived risk of investing in such businesses grew in the 1970s, the price at which their debt securities traded fell sharply. But by using the capital markets to deleverage -- by paying off these securities at lower, discounted prices through tax-free exchanges of equity for debt, debt for debt, assets for debt and cash for debt -- most companies avoided default and saved jobs. (Congress later imposed a tax on the difference between the tax basis of the debt and the discounted price at which it was retired.)

Issuing new equity can of course depress a stock's value in two ways: It increases the supply, thus lowering the price; and it "signals" that management thinks the stock price is high relative to its true value. Conversely, a company that repurchases some of its own stock signals an undervalued stock. Buying stock back, the theory goes, will reduce the supply and increase the price. Dozens of finance students have earned Ph.D.s by describing such signaling dynamics. But history has shown that both theories about lowering and raising stock prices are wrong with regard to deleveraging by companies that are seen as credit risks.

Two recent examples are Alcoa and Johnson Controls each of which saw its stock price increase sharply after a new equity issue last month. This has happened repeatedly over the past 40 years. When a company uses the proceeds from issuance of stock or an equity-linked security to deleverage by paying off debt, the perception of credit risk declines, and the stock price generally rises.

The decision to increase or decrease leverage depends on market conditions and investors' receptivity to debt. The period from the late-1970s to the mid-1980s generally favored debt financing. Then, in the late '80s, equity market values rose above the replacement costs of such balance-sheet assets as plants and equipment for the first time in 15 years. It was a signal to deleverage.

In this decade, many companies, financial institutions and governments again started to overleverage, a concern we noted in several Milken Institute forums. Along with others, including the U.S. Chamber of Commerce, we also pointed out that when companies reduce fixed obligations through asset exchanges, any tax on the discount ultimately costs jobs. Congress responded in the recent stimulus bill by deferring the tax for five years and spreading the liability over an additional five years. As a result, companies have already moved to repurchase or exchange more than $100 billion in debt to strengthen their balance sheets. That has helped save jobs.

The new law is also helpful for companies that made the mistake of buying back their stock with new debt or cash in the years before the market's recent fall. These purchases peaked at more than $700 billion in 2007 near the market top -- and in many cases, the value of the repurchased stock has dropped by more than half and has led to ratings downgrades. Particularly hard hit were some of the world's largest companies (i.e., General Electric, AIG, Merrill Lynch); financial institutions (Hartford Financial, Lincoln National, Washington Mutual); retailers (Macy's, Home Depot); media companies (CBS, Gannett); and industrial manufacturers (Eastman Kodak, Motorola, Xerox).

Without stock buybacks, many such companies would have little debt and would have greater flexibility during this period of increased credit constraints. In other words, their current financial problems are self-imposed. Instead of entering the recession with adequate liquidity and less debt with long maturities, they had the wrong capital structure for the time.

The current recession started in real estate, just as in 1974. Back then, many real-estate investment trusts lost as much as 90% of their value in less than a year because they were too highly leveraged and too dependent on commercial paper at a time when interest rates were doubling. This time around it was a combination of excessive leverage in real-estate-related financial instruments, a serious lowering of underwriting standards, and ratings that bore little relationship to reality. The experience of both periods highlights two fallacies that seem to recur in 20-year cycles: that any loan to real estate is a good loan, and that property values always rise. Fact: Over the past 120 years, home prices have declined about 40% of the time.

History isn't a sine wave of endlessly repeated patterns. It's more like a helix that brings similar events around in a different orbit. But what we see today does echo the 1970s, as companies use the capital markets to push out debt maturities and pay off loans. That gives them breathing room and provides hope that history will repeat itself in a strong economic recovery.

It doesn't matter whether a company is big or small. Capital structure matters. It always has and always will.

Mr. Milken is chairman of the Milken Institute.

A Study on Capital Allocation-Share Buy-Backs

INTRODUCTION

This chapter will give the reader many different case histories on **share repurchase**. How management allocates capital both within the business through maintaining its competitive position and/or to grow will be crucial in normalizing earnings and determining intrinsic value. A key question to ask is what becomes of the firm's free cash flow and excess cash? The investor must estimate what might happen to that cash—will it be paid out as a dividend, will shares be repurchased (outstanding shares might decline net of share issuance and option conversion) and at what estimated price? Will management buy back shares below intrinsic value with excess cash? Or will excess cash be squandered in foolish acquisitions that won't earn their cost of capital? If management does not pay down debt in strong economic times, will the company be imperiled during a recession? How might management's skill or lack thereof in capital allocation effect an investor's downside, base case and upside scenarios? Try to understand how your qualitative assessment of management might effect your quantitative estimation of intrinsic value.

Share repurchase programs should be an integral part of a company's capital allocation process, one in which management weighs reinvestment opportunities not only against the alternative of **cash dividends** but also both of those alternatives against a third alternative, the **buyback of common stock**. Management has several capital allocation alternatives:

Business Needs: Working capital, Capital expenditures, and Mergers & acquisitions

Return Capital to Shareholders: Dividends, Share buybacks, and Debt repayment

Many view shares repurchases as a form of dividend because money is distributed to selling shareholders. The company, however, has not paid out cash directly to all shareholders, but has received its stock in return for its cash. A company shrinks the company's assets by the amount of cash paid out. It reduces the company's borrowing base, and it reduces the shareholders' aggregate equity.

Some companies fund stock repurchases with cash on hand, some use borrowed money and some who borrow have as their primary goal a reconfiguration of the company's capital structure so as to increase the proportion of debt to equity. Unfortunately, many companies during the late 1990's bull market have used share buy-backs to sop up excess shares issued from option grants being exercised by management and employees, and as a method to support the share price of the firm. Those types of share buybacks are value destroying and simply transfer wealth from shareholders' pockets to management.

EXAMPLE:

What about the argument that companies can put spare cash to better use by buying back their own shares? When a company repurchases some of its stock, that action reduces the number of its shares outstanding. Even if its net income stays flat, the company's earnings per share will rise, since its total earnings will be spread across fewer shares. That, in turn, should lift the stock price *(all else being equal)*. Better yet, unlike a dividend, a buyback is tax free to investors who don't sell their shares. Thus it increases the value of their stock without raising their tax bill. And if the shares are cheap, then spending spare cash to repurchase them is an excellent use of the company's capital.

Company XYZ	**Today**	**Post Buy-Back**
Net Income	$1,000	$1,000
Fully Diluted Outstanding Shares	200	100
Equity	$10,000	$5,000
EPS	$5.00	$10.00
P/E Multiple *all else remains the same*	10x	10x
Price	$50.00	$100.00

A stock repurchase shrinks the company's assets by the amount of cash paid out, it reduces the company's borrowing base, and it reduces the shareholders' aggregate equity. One might say that a buyback resembles a lizard lunching on its own tail.

This chapter will start with buy backs from a corporate finance perspective as described by *Mr. Louis Lowenstein*, the CEO of *Supermarkets General* and a Law Professor at *Columbia University*. Then you will read what the masters, *Buffett* and *Graham* had to say on the subject. If, when and how a company buys back its shares says a lot about the business and capital allocation skills of management as the Case Studies of *Teledyne Corporation* and others will show. You will learn the importance of context and circumstance as the principles of good and bad capital allocation are applied. I hope you find the lessons instructive.

Louis Lowenstein on Share Repurchases from the book, *Sense & Nonsense in Corporate Finance* (1991)

People remember the 1920s when banks and investment companies desperately tried to shore up confidence and the price of their stocks by buying their own shares in the open market. (See Section by Benjamin Graham on pages 23-26). Beyond that, many investors wondered why there was nothing better to do with the money. But fashions change.

Managements have enormous difficulties to reinvest the retained earnings of a good business successfully. With rare exceptions, managers fall victim to the unrealistic expectation that they can find another business just as good as one they now have, or that they can make it as good, or that having found a good one, it does not much matter what price they pay. Share repurchases often offer them the opportunity to buy more of a good business, the one they already own, at a price that makes the purchase either attractive by any standard or at least better than the next available alternative.

BARGAIN PURCHASES

The most obvious reason is to buy stock at a substantial discount from intrinsic value. Intrinsic value, of course, is a slippery concept not easily agreed upon and not a precise figure. Along with "maximizing shareholder value" and "strategic planning," "intrinsic value" is one of the most abused phrases in the financial vocabulary. It has nothing to do with the next move in the stock market. It has nothing to do with industry averages. If the airline industry is selling at twenty times current earnings, it does not mean that *Delta Airline's* stock is selling below intrinsic value because its price earnings ratio is somewhat less. Such discounts may be important to traders who hope to capture them in the next few days or weeks but not to companies considering whether to retire stock.

All of those so called discounts are based either on where the stock market has just been or on expectations of where it is about to go. They have nothing to do with intrinsic value because they look to the stock market not just for a good opportunity to buy, which is sensible, but for the ultimate reward, which is not. The stock may in fact rise, but for a stock buyback that is about as meaningful as saying that the investment in the East Asian market by our fictitious company, *Middle American*, was a brilliant move because ultimately the common stock went up. It confuses cause and effect. It confuses the real success of an investment with the mirror of it in the stock market.

CALCULATING THE INVESTMENT VALUE OF REPURCHASED SHARES

A stock repurchase should be analyzed, just as any other investment would be, on the basis of the projected stream of income and cash flow over time. On that basis, there are sometimes splendid opportunities. In the late 1970s, for example, when I *(Louis Lowenstein)* was president of *Supermarkets General*, a leading food chain, its stock was selling at about five times its current earnings and at an even lower multiple of projected earnings for the next three to five years. Even at five times earnings, the buyback promised a return after taxes of 20 percent a year, well above the company's internal benchmark for investments in the business itself. Better yet, the company had sufficient capital resources so that there were no hard choices to make. It could build and support whatever new stores were available—good sites are hard to find—and it could (and did) also buy back over 5 percent of its shares. In buying those shares, the company was capturing for the continuing shareholders a stream of income, much as it would in a tangible investment. And unlike some of the other "opportunities" available to the company, this one was in an already profitable business, the one that management knew best. It already knew that the accounting was honest, and the bills had all been paid on time.

In the 1980s, when I *(Louis Lowenstein)* was no longer at the company—which may have been the reason—*Supermarkets General's* stock rose sharply. Everyone was delighted, but that is not why the earlier decision to shrink the number of shares was a good idea.

It is true, of course, that shares of its own common stock were not an "investment" for *Supermarkets General* in the usual sense. They could not be booked as an asset. (Once upon a time the accountants allowed such tricks, but no more.) *Supermarkets General*, the company, was poorer, not richer, for having made this "great" investment. (A cynic might have said that too many such successes would have undone the company.) Still, a buyback should be analyzed as an advantageous investment, if—and it is a big if—management is looking at the long-term welfare of all the shareholders and if it can increase the intrinsic value per share outstanding after the transaction. For the continuing shareholders, a share repurchase is often a particularly exciting concept, with high prospects for advantage.[1]

BARGAIN PRICES: FAIR OR UNFAIR?

Buying back stock for 50 cents on the dollar of intrinsic value may not seem controversial, but like everything else about buybacks it is. One fear is that what is good for the continuing shareholders is, by definition, bad for those who have sold their shares back to the company. Why would anyone knowingly sell "dollars" for 50 cents? There must have been some deception, or else the sellers would not have sold. In short, the critics suspect that at the heart of any bargain purchase there inevitably lies an unfair advantage.

The implicit assumption is that a stock repurchase program is a zero-sum game; whatever one group gains, the other loses. And behind that assumption lies another important one: in substance a company's shareholders all have the same investment goals or horizons. If *Middle American* were privately owned, with only twenty or so shareholders, that second assumption would be essentially correct. None of the twenty could trade in and out of the stock. The shareholders would have little choice but to measure their personal profits in terms of the company's profits and dividends. But for a public company, the assumption that all the shareholders are patient holders who have held the stock for years and expect, or at least are willing, to leave it to their children is obviously unrealistic. Trading has soared since 1960, when a pokey 3 million shares a day changed hands on the NYSE. Now the turnover is 150 million shares of more a day (in 1990). It is not Uncle Bill in Peoria who is doing all that trading. Many of *Middle America's* shares are held at any given time by a wide array of professionals with hyperactive tendencies:

1. Traders who are in the stock for a few hours and who never pay attention to the fundamentals.
2. Money managers who are buying a stock because it is in a specific sector like the drug industry and they believe this sector will outperform the market.
3. Program traders who buy and sell stocks in the *Standard and Poor's 500* stock index because of an arbitrage opportunity.

In fact, even among professionals, very little money is managed on patient, *Graham-and-Dodd* fundamental-value principles. Five (5) percent is one estimate as to the amount of money being managed on a genuine long-term basis.

[1] Compare Van Horne, Financial Management, page 380 (rejecting the treatment of a share repurchase as an investment).

Most business people already know that intuitively. They have all seen security analysts sell off their company's stock in a near panic anytime a quarter's earnings disappoint them.

Because shareholders come in so many different versions, with such different interests, a share buy-back is not a zero-sum game but rather one that everyone can win, according to individual goals. Because their goals are so different, it is not true that a company can capture a bargain on behalf of the continuing, non-selling shareholders only at the expense of those who do sell. An example may help clarify the concept. In a bid for tenders in May 1984, ***Teledyne*** was offering $200 a share for five million shares of its common stock—about 25 percent of the total then outstanding. Before the announcement, the stock was selling at about $156 per share. Those who did not tender, including management (which already owned about 12 percent of the stock), were presumably holding *Teledyne* for the long pull. Obviously they thought the intrinsic value of their investment would benefit. But those who were in *Teledyne* for the short run were apparently ecstatic at the prospect of over a quick 29 percent gain. The five million share offer was promptly oversubscribed, and the company ultimately bought all 8.7 million shares that were tendered at a total cost of over $1.7 billion.[2]

Teledyne, which had bought back stock all during the 1970s and early 1980s, had some long term, value, value investors who were unwilling to sell a "dollar: at a discount. Investors who held their shares throughout those years saw the stock rise from $8 per share (adjusted for splits) in the early 1970s to over $425 in the second half of 1984. Those who sold into those buybacks all did well, but the non-sellers did even better.

In a leveraged buyout ("LBO"), the shareholders are given no meaningful choice—either tender your shares now or see them redeemed in a freeze-out merger three months later. But in a buyback there is a choice, at least where management makes adequate disclosure of business developments and prospects. The issue for a shareholder is whether to take the money and run or be patient. Not everyone can be patient; not everyone wants to be.

What is adequate disclosure? In a share buyback, a company should reverse the usual emphasis. Instead of being especially candid about negative information, the company should be absolutely sure to disclose all the potentially cheery news. Nor should management stop at disclosure only of the hard news. There are often a variety of so called soft data relating to plans, appraisals, or prospects that may be quite problematic but are capable of having a significant impact. Managements do not usually like to release these cheery projections. There is an ingrained tendency to be cautious about these matters because ordinarily they are reluctant to disappoint investors. But this is not the ordinary case. That is particularly true for companies where management owns a substantial part of the stock and therefore has a palpable conflict of interest.

SHOULD SHAREHOLDERS DO THEIR OWN BARGAIN HUNTING?

It is sometime said that, taxes aside, a self-tender is neither better nor worse than a cash dividend. *Teledyne* could simply have paid that $1.7 billion as a cash dividend—the equivalent of $200 a share for the over 8 million shares acquired in the 1984 tender offer—and let shareholders buy additional stock for themselves. Tax exempt investors, in particular, could have increased their proportionate ownership exactly as did those who elected not to tender.

What is overlooked is that there are some unique benefits to a properly conceived share repurchase plan. First, while it is no doubt correct that shareholders, on receiving a cash dividend, could reinvest in the company, the reality is that they don't – or at least there is no reason to expect that they will. Shareholders—particularly individual shareholders who, after all, still own most of the shares—do not get up every morning, or even every Monday morning, and reassess each of their holdings. True, a sinking stock price should stimulate investors to consider buying additional shares. Often, however, it has the reverse effect of inducing them to sell and cut their losses. By repurchasing shares, a conscientious and loyal management, aware that the stock is at a discount, in effect is capturing the bargain for all rather than for the few. It should be congratulated for doing so.

[2] James W. Wansley and Elayan Fayez, "Stock Repurchases and Security holder Returns: A case study of Teledyne," Journal of Financial Research (1986): 179.

The more basic flaw in the "taxes aside" argument against share repurchases is that for most shareholders, taxes do count. It is a mystery, in fact, why so many thoughtful finance books open the discussion of a problem by saying "taxes aside." In a discussion of finances, it is a bit like saying "money aside." A shareholder is taxed fully on a dividend but on a sale of stock only to the extent that he or she had a gain. Won't a combined federal and state income tax rate of, say, 35 percent, taxes count a whole lot? And for long-term holders who do not tender any of their shares back to the company, there is another additional tax advantage: all taxes are deferred for an indefinite period, a superb result whose benefits are not often recognized, and about the best that a tax planner could hope to do.

SHARE REPURCHASES: GOOD SENSE EVEN WITHOUT A BAGAIN PRICE

Fifty-cent dollars are not always lying around for the asking, and as the discount shrinks, so do some of the unique attractions of a stock buyback. But bargain or no bargain, the basic issue remains the same. **What can management do with the money as compared with what shareholders can do with it for themselves? We saw that same tension in the discussion of cash dividends, and it applies fully as much to a share repurchase.** My (*Louis Lowenstein, CEO of Supermarkets General)* own experience was that once some cash began to accumulate, the urge to be creative with it was almost irresistible. What peerless leader wants to admit to managerial impotence? A former executive of *American Standard, John Grant*, captured that urge marvelously well. Picture yourself, he said, in the executive suite and imagine how the boss is likely to regard a buildup of cash in the company's coffers. He should, *Grant* said, consider repurchasing stock, but the thoughts really going through his mind are the following:

- "If we don't find more investment opportunities and show we can grow, our excessive liquidity will make us a takeover candidate, and all my plans for the future may be shattered. *(Excess cash will attract activist like bears to honey.)*

- We need growth to maintain a good image in the investment community, as well as to attract and hold able employees."

- Our cash gives us a means of diversifying and making our business less subject to the ups and downs of the business cycle."

- We need to grow because there is a higher margin of safety in bigness. Also, it is nice to see your name rising on the Fortune 500 list."

- It may not sound very bold to walk down the hall at corporate headquarters and tell people that we are giving money back to the shareholders. How will that help to attract and hold good managers? As *Grant* suggested, the shareholder response ought to be simple: we don't need you to diversify or buffer the business cycle. We expect mature companies such as this one to generate cash rather than spending it on extraneous acquisitions, which do not assist present businesses, have only average potential, considering the prices paid, and requires new business skills for wise control. The response of a thoughtful employee ought not to be very different because companies that waste money rarely provide either long term opportunity or security. In short, it is not immoral to hold cash until you have something useful to do with it, and it is not a shameful retreat to pay dividends or repurchase stock.

Audio/Video Affiliates is a case in point. In the late 1980s the company operated over a hundred consumer electronics stores, primarily in small cities. It was conservatively capitalized and could have continued to open new outlets, but with VCR sales flattening out and no new products coming on stream, most electronics retailers were doing poorly. The company's sales fell by 15 percent during the two years ended January 1989, to $195 million; profits fell by more than 50 percent. A proposed buyout of the company failed, and although it had the resources, the company decided not to invest further in the business at that time. Instead it offered to all shareholders an opportunity to sell back to the company, pursuant to a tender offer, about 30% of the outstanding shares at a price well above the market. As one director put it, **the company decided to return its excess capital to shareholders and to do so in a tax efficient way.**

A critic might have said that *Audio/Video* should have found better uses for the money. But in reality, with the industry marking time, the only alternative was to diversify. When one company buys another, it often ends up in a bidding contest, with the so-called winner paying top dollar *(the "winner's curse".)* The buyer's shareholders lose. In a well conceived plain vanilla share repurchase, there need be no losers.

THE BASELINE CASE

Even so, at some point the market price may be so high that a share repurchase plan does not make sense. The "return" on the investment in treasury stock may become so low that any excess cash or untapped borrowing power might better be used to pay cash dividends. But the price at which that happens is higher than is usually realized. Assume, for example, that a few years from now the stock of our fictitious drug company, *Middle American*, is earning about 20 percent on shareholder equity---down from 25 or so percent previously but still excellent—and that it is paying out 40 percent of its earnings as dividends. Earnings would be growing at a 12 percent compound annual rate. (With a 20 percent return on equity and with dividends equal to eight percentage points, the equity would grow by 12 percent a year and so, therefore, would earnings.) That's not bad, but let's assume that by then the company has available to it fewer attractive opportunities for new business investments. Let's assume also that the stock is selling at three times its book value—roughly normal for a good drug company. At that price, and given our assumptions about profits and the dividend payout ratio the company's stock would be selling at a price that would produce an earnings yield of slightly more than 6 percent, or about one third of the 20 percent yield on book value. Stated the usual way, the price-earnings ratio would be 16—the reciprocal of 6+ percent—and the company would be paying annual cash dividends amounting to 2.67 percent of the market price.

For a company to buy back its stock at a price that produces an earnings yield of less than seven percent on the investment seems too low to make it worthwhile. Certainly the stock would not look like a 50 cent dollar. But wait. If that 12 percent growth rate and the price earnings ratio are <u>sustainable</u>—an extremely important "if"—a share repurchase program may still be attractive. If the company continues to earn 20 percent on equity, which in turn is growing 12 percent annually, the non selling shareholders will enjoy a total return of 14.67 percent annually, consisting of 12 percent in stock price appreciation and 2.67 percent in cash dividends, as the following figures show:

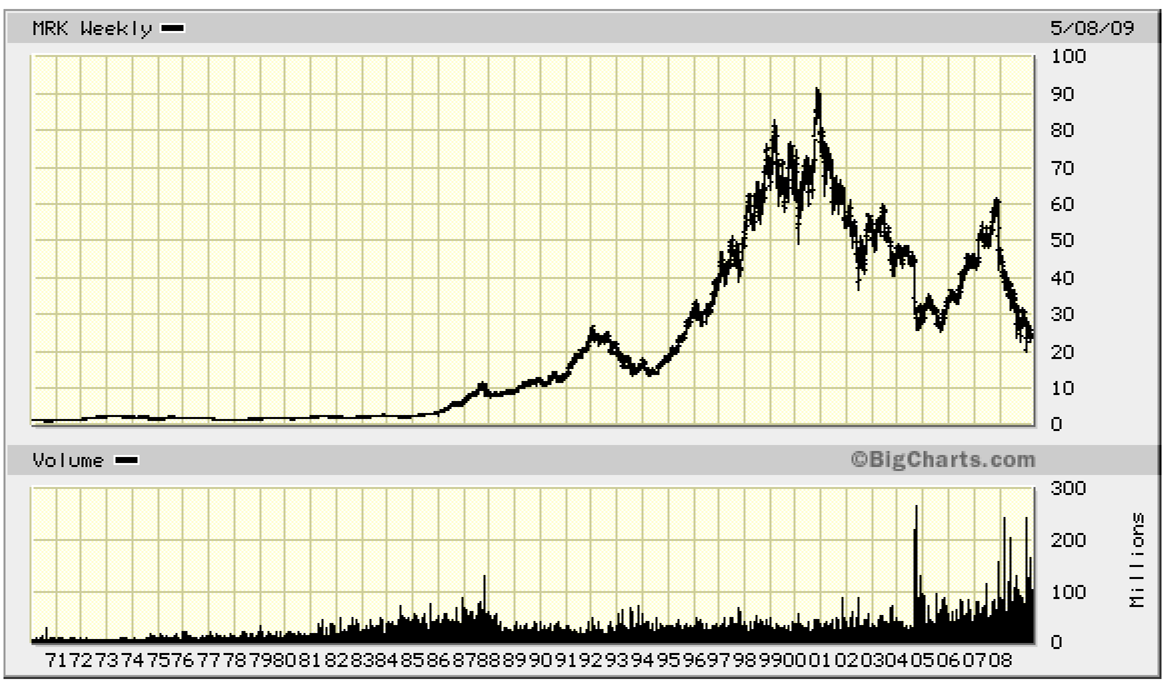
Return on equity (book value)	20%
Dividend payout ratio	40%
Annual growth in book value and earnings = (20% ROE) x (1- 40% tax Rate) =	12%
Ratio of market price to book value	3x
Average annual growth in market price per share	12%
Average annual dividend yield on market price	2.67%
Total annual return to shareholders (market appreciation plus dividends)	14.67%

Of course, such assumptions, on average, tend to be <u>too</u> good to be true. Over a fifty year period, stocks (including stocks that started out at high price reflecting the high returns then being earned on equity) have earned for investors a total return of about 10 percent compounded annually. But even an annual return of 10 percent from a share repurchase program may be acceptable for a nontaxable investor, such as a pension fund. After all, such an investor demonstrates, by holding on to a company's shares, that it prefers investment in this company, at its present share price, to investment in the marketable shares of other available companies. And the continuing, <u>fully taxable shareholder</u> should have a much better result from share repurchases. **The taxable shareholders, by forgoing a dividend in exchange for corporate use in share repurchases of the same funds, gets to earn money on the taxes that would have been paid currently on a cash dividend**—taxes that are put off until, much later, the sale price for the shares is enhanced by the, say, 10 percent—return investment the company made on his or her behalf when it repurchased stock.

The arithmetic can get interesting when repurchases continue over a long period, allowing large effects from compound interest; if you earn 10 percent per year on your money, pay taxes each year at a 33.3 percent rate, and invest the balance at 10 percent before taxes, you will earn 6.67 percent per year after taxes and will, after compounding, increase a $10,000 investment to about $100,000 after taxes over thirty-six years. If I, on the other hand, invest $10,000 at a 10 percent compounded annual rate, before taxes, and pay no tax until cash-in time, thirty-six years later, when I will pay taxes at the same 33.3 percent rate, then I realize $309,000, pay $103,000 in taxes, and have left $206,000, more than twice as much as you have. My $206,000 has given me an annual, compounded rate, after tax return of 8.77 percent, compared with yours of only 6.67. The difference is entirely due to my pay later arrangement with the income tax collector. And, besides, under current tax law, neither I nor my transferees may ever pay any income tax on my gain because I may die with my stock, give it to my favorite charity (in ways that avoid the alternative minimum tax) or others who can use its full economic value without taxation.

Thus, buying in shares of *Middle American* at sixteen times current earnings might not be a great bargain for nontaxable shareholders, but it can provide a satisfactory result for them, and a great result for taxable shareholders, even if *Middle American* cools down enough to provide only a 10 percent return for existing investors. Moreover, the result, even if modest, may be a great deal better than that available from throwing money at acquisitions stimulated by fee-receiving advisers.

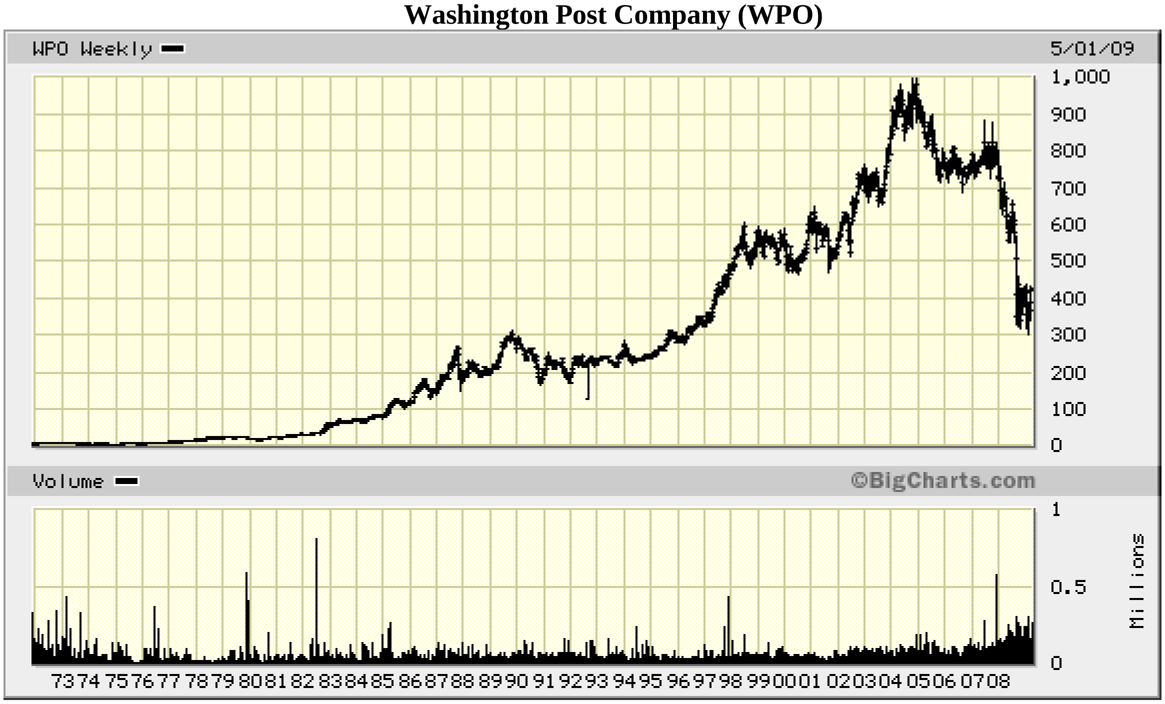
This description of *Middle American* resembles somewhat the experience of *Merck*. Over the years 1984-87, *Merck* bought back about 11 percent of its common shares for about $1.9 billion, reducing the number of shares from 444 million to 394 million (adjusted for a stock split in 1988). While the company's return on book value and price-earnings ratio were somewhat different, the averages were about the same as those of *Middle American*.



SOME BETTER-THAN-BASELINE CASES

If from time to time bargains are available and if a company is willing to buy stock aggressively, the rewards will far exceed the baseline case. During the 1970s, the *Washington Post* company bought in stock, shrinking the number of shares outstanding from about 19 million at the end of 1974 to about 14 million at the end of 1981—more than 25 percent. The company's net earnings grew from $145 million in 1974 to $33 million in 1981, compounding at an annual rate of 11.89 percent. But the earnings per share grew over that period from $0.78 to $2.32, a compounded annual increase of 16.85 percent. **What would have been in any event an excellent result for shareholders was transformed into a superb one.** The extra ingredients were the substantial amounts of stock that the company was willing to buy, plus the fact that during the mid-to late 1970s, it was able to do so at "discount" prices of seven to eight current earnings *(a 14% to 12.5% "earnings yield".)* For a shareholder who had 1,000 shares at the beginning of 1975 and did not sell, an investment of about $12,500 became one of about $125,000, which, because it had never been taxed, was still there seven years later. In a good company, in a good industry, augmenting important assets *per share* is the key.

Washington Post Company (WPO)



Now, continuing our little study of the effects of compound interest, consider a taxable shareholder who also bought 1,000 shares of the *Washington Post* company in 1975 for $12,500 but instead of holding them sold out at year-end and reinvested the after-tax proceeds in a company just as successful as the *Washington Post*. Assume, being astute, that she repeated the process each year, and assume further that this pattern continued not for seven years but for a somewhat longer period of fifteen years. In short, assume that she defied the odds and found each successive year, fifteen times over, still another equally good company. Assume, too, that her federal and state capital gains tax averaged 28 percent a year. By mid-1989, ignoring dividends and commissions, she would have had $355,000 worth of stock, which is not bad but not nearly so good as the **$1.2 million that a do-nothing, non-selling, continuing shareholder would have had.** When we speak of someone having the patience of Job, we forget how profitable it can be.

THE FINANCIAL TIGER AT EXXON

Exxon (XOM) has had the largest repurchase program of all. During the six years, 1983-1988, it bought back (net of resales and adjusted for a stock split) 524 million shares at an aggregate cost of $14.5 billion (or an average price of $27.67)--$4.1 billion in 1988 alone. Everything that *Exxon* does, of course, is on a larger-than-life scale, but the scale here was large even for *Exxon*. By the end of 1988, the company had retired 28 percent of the 1.81 billion shares that had once been outstanding. *Exxon* generates large cash flows from operations—about $10 billion a year from 1983 to 1988. *Jack F. Bennett*, the senior vice-president of finance during those years, would later say that compared to the alternatives, share repurchases had been the most advantageous use of excess cash flow for shareholders. The company was already paying substantial dividends, he said, and shareholders are reluctant to see the dividend rate fluctuate. They are much readier "to accept volatility in share repurchases than dividends," so if a major opportunity had come along, the company would have felt free to stop buying stock. In addition, the company took into account the tax advantages for many shareholders of a share repurchase program over cash dividends.

It is tempting to see *Exxon* as simply having bought back oil on the cheap, but *Bennett* rejected that. **The program was conceived, he said, on essentially the same return on investment basis as any other capital expenditure**—the same basis recommended all through this chapter.

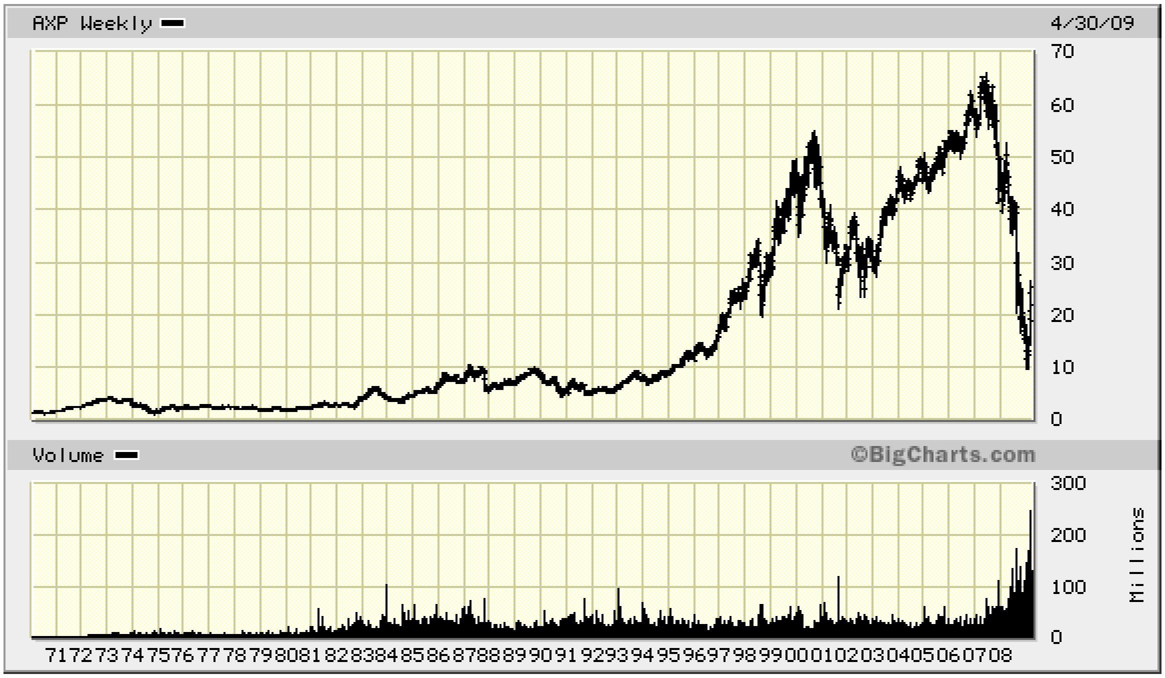
Stated differently, while the company continued to invest about $6 billion to $9 billion a year in its oil exploration and other operations, it was unable to invest more-by buying oil reserves, for example—without dropping below the company's hurdle rate. **Since it refused to do that, buying back stock was a happy alternative. (How many other companies have fudged the numbers just to invest in dubious projects or acquisitions?)** The price of oil had dropped sharply in the early 1980s, depressing the price of all oil company stocks, and as *Bennett* drily observed, the company presumably had higher expectations about the company's eventual prospects than did the marginal seller of stock. (For years, the stock of *Exxon*, a company with huge oil reserves and established market positions, sold at six times earning or less.)

Bennett apparently felt free to halt the program from time to time, depending on market conditions, but he sought board approval for continued purchases each quarter.

SHARE REPURCHASES VERSUS DIVERSIFICATION: *EXXON (XOM)* VERSUS *AMERICAN EXPRESS (AXP)*

Charles R. Sitter, Bennett's successor at *Exxon*, rightly fears, as he has said, that companies with strong cash flows will "let the money burn a hold in (their) pockets" if they don't distribute the excess. Diversification is a seductive trap. The fact that you can run one type of business well, he explained, doesn't prove that you can also run something else—or, he might have added, overcome the burden of having paid too high an entry price.

Sitter did not name any companies that had embarked on misguided diversification programs, but one that fits the description marvelously well is *American Express*, a company that dissipated more than half of its likely value in this fashion. *American Express* owned a great business, better than *Exxon's* called *Travel Related Services (TRS)*, which included the company's credit card and traveler's check operation. The *American Express* credit card was the prestige card in the industry and commanded a loyal following despite its higher charges. Traveler's checks were an even more attractive operation because customers received no interest for depositing large amounts of money with the company--$24 billion of checks were issued in 1989—which the company could then lend out at high rates. During the 1980s, *TRS*'s net income (after taxes) grew at a 20 percent compounded annual rate—from $177 million in 1980 to $830 million in 1989. *TRS* consistently earned 27 percent or more on shareholders' equity. *Exxon*, on the other hand, deals in a commodity, which pricing is erratic and subject to political and other factors over which *Exxon* has no control.



In a sense, the success at *TRS* may have been the problem because it emboldened management to suppose that it could repeat it elsewhere. The company used the entire stream of profits from *TRS*, and much more, to stitch together the pieces of what became *Shearson Lehman Hutton*, hoping to make of it the keystone of a diversified financial services supermarket, a global one at that. *American Express* bought other businesses, too. But the *Shearson* operation was by far the largest and most grandiose. As of June 30, 1990, company had invested about $4 billion in *Shearson*, not including capital raised directly by Shearson itself. It began with the purchase of *Shearson* for $1 billion in shares of *American Express* in 1981 and concluded with more than $1 billion of additional investments in late 1989 and early 1990 to staunch the hemorrhaging at *Shearson*. To put that $4 billion in scale, at the beginning of 1981, the year the first segment of *Shearson* was acquired; *American Express's* entire net worth was $2.2 billion. *Shearson* built lavish offices around the world, including a $25 million conference center—ski resort in Colorado, but the so-called synergy from a global financial services business was never more than a mirage; it shone brightly in the prose of *American Express's* annual reports but then disappeared on a closer look. **Even in the salad years 1987-1988, *Shearson* failed to earn a return of more than 6 percent on equity.** From 1981 through mid-1990, taken as a whole, and after allocating corporate overhead expenses, the business did not make so much as a single dollar. In the language of an *Exxon*, it was a dry hole.

American Express bought a variety of other businesses, and on some of them it made money, but overall the results there too were mixed at best. In 1987 and 1988, for example, a banking subsidiary, *Trade Development Bank* (now merged with *American Express Bank*), took huge losses on $1.6 billion of Third World country loans, and half again as much remained on the books. At the end of the 1980s, all of the major businesses it had bought under the incumbent management, only one was still there *and profitable*. *IDS Financial Services*, a business that was earning about 14 percent on shareholders' equity but which will always be for *American Express* a relatively small one. It would be difficult to unravel all of these bold moves to see what *American Express* would have looked like today if it had possessed the discipline of an Exxon, except, of course, that it would have been a great company. But it is not too difficult to do so just with *Shearson*, to see what *American Express* might have looked like in June 1990 if it had reinvested the *TRS* profits back into the well managed *TRS* business by buying back stock, instead of ploughing money into a historically troubled industry in pursuit of an imperial dream.

The company began the decade with 285 million shares outstanding. Using the *Shearson* monies to buy back stock would have reduced that to perhaps a little as 188 million. Instead, management allowed the outstanding shares to balloon to 445 million by mid-1990. *James D. Robinson III*, the chairman, seemed oblivious to the fact that each newly issued share represented a dilution of the shareholders' stake in its existing businesses, including the wonderful *TRS*. Almost all those shares, including the 27 million sold in June 1990 to make good the losses at *Shearson*, were sold at low multiples of earnings. It was little short of criminal. *American Express*, which owned the outstanding *TRS* business, was selling (parts of) it on the cheap. (*Peter Lynch*, who ran the *Fidelity Magellan Fund*, has coined a crude but apt term for such acquisition programs, ***diworseificantion***.)[3]

It is true that Wall Street, at least, applauded the purchase of the first segments of *Shearson Lehman* Hutton. And it is surely possible that if *American Express* had not been so taken with the ambitious model of a financial supermarket and if *Shearson* had continued to be run in the same penny-pinching, prudent style as before the acquisition, the outcome would have been acceptable. But as much as half of the ultimate investment in the *Shearson* financial supermarket came as part of, or in the wake of, the purchase of *Hutton*, and by then the applause had dried up.

More telling than any cheers or boos from the gallery was an incident that took place in the summer of 1985. *Sanford I. Weill* had been the CEO of Shearson when it was acquired in 1981, and in 1983 he became the president of *American Express* itself. By 1985, having left the company, he offered to buy its insurance subsidiary, *Fireman's Fund*. At a meeting of the *American Express* board of directors to consider his offer, *Weill* appeared and so, too, did *Warren Buffett*, the chairman of *Berkshire Hathaway*, who was to have provided some of *Weill's* capital. Buffett had once been a substantial investor in *American Express* and knew the company well. He was sitting on Weill's side of the table but, even so, offered the board some advice. Regardless of whether they sold *Fireman's Fund* to *Weill*, he said, they should sell it to someone. *Buffett* described *TRS* as an exquisite franchise, which to him meant that *TRS* operated in a market and with products that, like few others, did not have to compete primarily on price. *American Express* should sell all its other businesses, because, he said, they were fuzzying up this great franchise. According to one of the participants, *Buffett's* comments had an "electric impact" on the board, particularly on *Howard L. Clark, Sr.*, the retired CEO of *American Express*. It might have been hoped that these comments would stimulate some reexamination of the *American Express* diversification program, and for a time they seemed to have had some effect. The company sold off portions of *Fireman's Fund*, not to *Weill* but as part of public offerings in October 1985 and May 1986. But by 1987 *Robinson* was back on the diworsification trail in a serious way, throwing the ill-fated *Hutton* log on the *Shearson* pile.

The Table on the next page gives values for *American Express*—both actual and as it might have looked had it never heard of *Shearson*. Let's assume that *American Express* had not issued the 85 million shares of stock (adjusted for stock splits) used to buy *Shearson* in 1981. Assume, too, that using the $3 billion in cash it later invested in *Shearson*, it had retired stock at a price equal to the highest price in each of the years those monies were disbursed. Valued at the same multiple of twelve times current earnings at which it was actually selling in mid-1990, the stock of this "what if" *American Express* would have traded at over twice the price at which it was in fact trading. True, the actual price previously paid to repurchase shares in the open market might have been higher, but then too the price-earnings ratio for the "what if" company might also have been higher. Assuming that those two factors balance each other out, it seems altogether likely that the shareholders would have been at least two times richer. An *American Express* reconstituted without *Shearson* and with a greater focus on *TRS*, and with a far stronger balance sheet too, would have been a much more attractive company. Instead of selling, as it did in mid-1990, at twelve times its earnings, a below-market multiple, the stock might well have sold above fourteen times earnings, the market average.

[3] See Peter Lynch's One Up on Wall Street, (1989) Page 146.

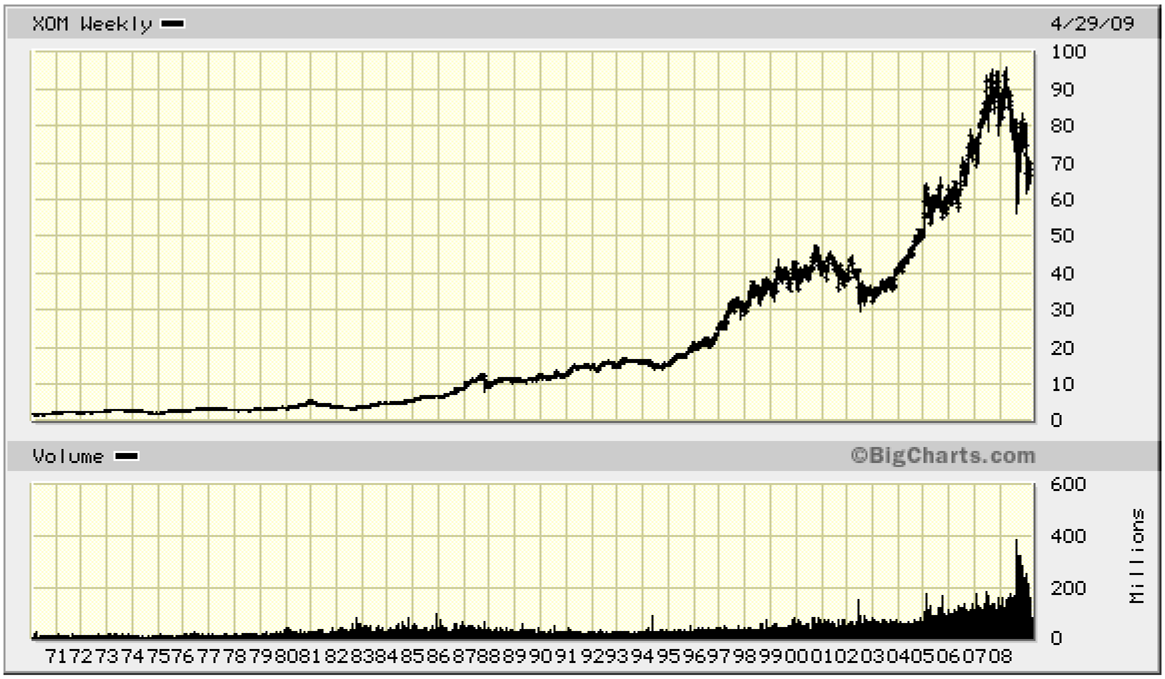
Amex: What Was and What If *(Amex didn't make poor acquisitions)*	**Actual AMEX**	**"What If" AMEX**
EPS		
12 months ended June 20, 1990	$2.49*	$5.74
Average for 3 years, 1987-1989	$2.11	$3.82
***TRS* contribution (three-year average) to**		
Revenues	45%**	65%
Earnings	79%	85%
***TRS* compounded annual earnings growth rate, 1980-89**	20%	20%
Shares of AMEX issued to buy Shearson (millions, adjusted for stock splits	85	n.a.
Dollars invested in Shearson/dollars used to buy back shares ($ millions)* **	$3,024	$3,024
Shares Outstanding (millions		
December 31, 1980	285	285
June 30, 1990	445***	188
Stock Price at June 30, 1990		
At 12 times current earnings	$30.75	$68.87
*Excused charges in first quarter of 1990 for restructuring and change in accounting practices		
**Shearson revenues exclude interest.		
***Does not reflect either the public sale of a portion of the *Shearson* stock by the company in 1987 or the retirement of those shares in exchange for additional shares of *American Express* in August 1990		

There is a slightly different way of looking at *American Express*, but it confirms our conclusion that the diversification program was a fiasco. In 1981, on a per-share basis, the earnings from businesses other than *TRS* accounted for about 80 cents per share of the company's earnings. By 1989, adjusted for stock splits, the per share earnings accounted for by the *TRS* division were three and a half times what they had been eight years earlier. But the earnings of all the rest, including *Shearson*, still represented only about 80 cents per share. All that money and nothing to show for it. In the meantime, the company's long-term debt had mushroomed from $1.1 billion to $11.7 billion, more than half of which—precisely how much more is unclear—had been incurred to finance *diworsification*. Long-term debt, once modest, now far exceeded shareholders' equity. *(Amex essentially leveraged up to buy poorly performing and bad assets instead of returning the money to shareholders.)* This company, which should have been awash in the earnings and (except to finance credit card receivables) the cash flow from *TRS*, was instead forced to issue new shares in June 1990 to bolster its weakened credit.

NO FREE LUNCH HERE?

If you happened to be passing through *Yale*, the *University of Chicago*, *MIT*, or most any other B-school or economics department, you could probably hear a don argue that, even with buybacks on the scale of $15 billion, *Exxon* was spinning its wheels. They worry that the increases earnings per share enjoyed by the remaining shareholders as a result of such a program do not add real value to their holdings because the improvement is offset by added risk. The contention is that while the earnings per share may rise, ordinarily the improvement can be achieved only by increasing debt and therefore risk. The financial markets, it is said, will compensate for that added risk by reducing the price earnings ratio (and therefore the value) of the common stock. In short, there is no free lunch. The company is what it is, and value cannot be added simply by jiggling the capital structure. *This is the Capital Asset Pricing Model ("CAPM") which states that capital structure does not matter. Editor: CAPM might work in a world where human incentives and taxes do not matter.)*

Whatever its conceptual appeal, however, the theory misses a lot. Some companies have cash on hand and so do not have to borrow at all. Their cash and net worth will shrink by the amount of the buyback, but the cash was not earning much and the stock market rarely values cash dollar for dollar in the price of the company shares. For still others, those that must borrow, the tilt in the debt to equity ratio, the added leverage, may be temporary because they have substantial continuing, cash flows and will quickly pay down the added debt. During the relevant years, *Exxon*, for example, had sufficient earnings to pay all interest charges at least 8.5 times. For a company so conservatively capitalized, where was the added risk, or if there was more, what was the harm from it? During the years 1986 to 1988, when the oil industry's average return on equity was a modest 10.8 percent, *Exxon (XOM)* was reporting 17.8 percent, very high for the industry. For the decade 1980-90, *Exxon's* shareholders enjoyed a sparkling total return (dividends plus price appreciation) of 18 percent a year—more than twice the industry median. Realistically, the company and its continuing shareholders did enjoy a free lunch on their share repurchases, or at least they ate haute cuisine at *McDonald's* prices.



It is true that not all companies are like *Exxon*. *Ralston Purina*[4] also bought back a great deal of stock but was unable to do so without a major increase in corporate debt. Having spent over $2 billion to buy in shares, the company's earnings before interest and taxes (from continuing operations), which had covered interest charges nine times in 1982, covered them only three and a half times in 1989. According to the risk/reward, no-free-lunch theory, the company's share price should have reflected the added risk, which was significant. In the debt tolerant climate of the 1980s, however, the stock rose from about $12 in the first quarter of the 1982 fiscal year to about $80 at the end of fiscal 1989, and the price-earnings ratio more than doubled. The 1980s were a good time for food companies but not that good. It was a time when leveraged restructurings were being rewarded, not penalized.

More fundamentally, however, the debate about whether share repurchases can directly affect the market value of an enterprise is simply beside the point. While share repurchases, it is true, do take place in the stock market, properly conceived they are a company operation, not a stock market one. Why do so many people—in and out of academia—miss the point? ***It is the business effects that matter not the near-term stock market effects.*** If the business decision is correct, if the "investment" in the retired shares has been well conceived, the stock market—often wise, often not—will eventually sort itself out.

4 On December 12, 2001 *Ralston Purina Company* merged with *Nestlé Holdings, Inc.* Pursuant to this merger, shares of *Ralston Purina Company* were exchanged for a cash settlement of USD33.50 for each share of common stock. *Ralston Purina Company* is no longer a public company and most of its businesses are now known as *Nestlé Purina PetCare Company*, which is a fully owned subsidiary of *Nestlé Holdings, Inc.*, which is a fully owned subsidiary of *Nestlé S.A.*

Who cares if share repurchase "signals" better profits, as so many Wall Street analysts and others, obsessed with market performance, like to ask? For twelve years *Teledyne (See case study in appendix to this chapter)* bought back its stock, paying over $2.7 billion. Stock repurchases on such a scale are not primarily a signal to the market of some other event, such as higher profits. Buybacks are the "event," a major event, with a direct impact of their own, and should be scrutinized as such.

A MODEL WITHOUT A MODEL

The lessons at *Exxon* and elsewhere are that buybacks are sometimes clearly better than either the available reinvestment opportunities or a cash dividend. Still, a good many questions remain. Suppose there is not enough capital to approve all good projects and also to buy back shares. Which comes first? Should a company forgo profitable business investments in order to make even more "profitable" investments in its shares: If the shares are very cheap, does that mean that the company should forgo or even eliminate cash dividends? I don't have answers to such questions, and I am wary of analyses that assume there are single-best, definitive responses.

The reasons I am so wary may help to explain the inherent fallacy of many of the algebraic formulas that delight B-school people. If a company has available a large number of excellent projects with a projected return of 16 percent or better, should it abandon some of them in favor of buying back shares on which it will expect to "earn" 25 percent? The most sensible answer, I suggest, is that **the answer is unclear**. Sometimes, yes, it should postpone the investment in tangible assets in favor of a buyback. The latter might be an opportunity that is unlikely to last very long. Perhaps the business opportunity—the ability to build a new alumina reduction plant--will still be there in a year, and that year's delay will not matter. By allowing additional time for research on the refining process, the delay might even help. On the other hand, for a local retailer rejecting six terrific new store sites may be downright foolish if those stores would be occupied by a competitor[5]. And on the further hand,**--**I wish I had three hands—perhaps the tension is not all that great, either because the company can do some of both or because it can borrow. Companies with a wealth of good projects are often already successful ones. Such companies usually have a good measure of untapped borrowing power, in part because they know that rare good opportunities sometime do come along—particularly for well-run, successful companies. By utilizing that borrowing capacity, the hard choice between business projects and buybacks may not be very hard at all.

This process of complicating the issues could go on and on, but I hope the point is clear. True, it is difficult to imagine circumstances in which a company would disregard the expectations of shareholders and suddenly omit its cash dividend in order to buy back stock, but I have no formula. Anyone who does may be missing the main point.

THE RECENT SURGE IN SHARE REPURCHASES: NOT ALL TO THE GOOD

At the beginning of this chapter, we saw that share repurchases soared in the 1980s. Some part of the increase can be explained by a generally better understanding of the benefits of plain vanilla buybacks. Call it "maximizing shareholder values," one of the catchy phrases of the day. As recently as 1982, *Exxon's* management was saying that it had no plans to retire shares, but by the end of the decade it had repurchased $15 billion worth. Still, there have not been enough plain vanilla buybacks to account for anything like the more than $140 billion of stock that corporations bought back over 1986-1988. It would be nice to report that everyone at the *Business Roundtable* and *American Manufacturers Association* has been thinking about shareholder value, assiduously taking notes, but it isn't so.

Of the tens of billions of equities repurchased in recent years *(1980-1990)*, fear of takeovers was the most important factor. To thwart a bid, for example, *Carter Hale*[6], owner of a mediocre collection of retailing business,

[5] Capital expenditures needed to maintain a competitive position in the industry are required and not discretionary if a company wishes to maintain its normal earnings power. Thus, a share buyback decision would have to be considered only after such maintenance capital expenditures ("MCX") are made.

[6] **Broadway Stores, Inc.** was an American retailer based in Southern California. Known through its history as ***Carter Hawley Hale Stores*** and

bought stock in the open market at prices 50 percent higher than they had been a few weeks before. Seeing how frightened they were, investment bankers regularly beseeched corporate clients to buy back shares in order, as one said, to "close the value gap between current market value and 'break-up' value before the company becomes a target." In short, many share repurchases had little to do with the creation of long-term business values and the judicious use of cash flows.

The surge in share repurchases closely followed the surge in mergers and acquisitions. Only now that the threat of takeovers has visibly subsided will we begin to see to what extent corporate managers have learned to think, like *Exxon*, of share repurchases as a recurring, normal, non-defensive part of their corporate strategy. The belief here is that some of those lessons have been learned. Bigger is not always better. Managers speak more comfortably now about the need for a focused mission and many of them no longer see acquisitions as the obvious use of excess cash flows. Perhaps even *American Express* has learned a thing or two.

A WORD OF CAUTION

At the outset of this chapter, I said that plain vanilla buybacks are not for everyone. But I then went on to explore how attractive they can sometimes be. In the general prosperity of the 1980s, it often seemed easy to borrow money, buy back shares, and soon after see that decision vindicated in the stock market. But the combination of a share repurchase program and added leverage is like driving water through a small nozzle at high speed. **It is dangerous and in any event works well only in strong hands.**

It behooves outside directors to adopt an independent posture toward share buybacks. The board should review any proposals with particular care, but it should also encourage management to consider one when the circumstances seem propitious. It is difficult to think of many other issues on which outside directors can so clearly earn their keep.

In a share repurchase program, the company is inescapably **making a judgment about the value of its business.** It is trying to buy in a portion of its equity at a bargain price but without the unfair, illegal advantage of trading on inside information. By definition, the company may be rejecting the current valuation of its stock on Wall Street, not because it has better information but rather because it has a more thoughtful, longer-term view of values. At the least, it is saying that the price is reasonable; it is not paying more than a dollar for a dollar's worth of stock, measured by business values. For many businesses, these are little better than guesses—guesses made more difficult by the natural optimism of the CEOs who are accustomed to challenges and expect to win. If they were cautious by nature, if the future didn't usually look good to them, they would probably be elsewhere.

Tempting as it may be to swing into action, management often needs to be patient, and that can be very difficult. Analysts and others will criticize the company for sitting on cash, as if it were indecent to expose any significant amount of money to public view. But in a stock market that swings from **manic to depressive**, from pricing a la *Tiffany's* to *Filene's Basement*, with remarkable frequency, opportunities will arise. **History tells us that, as someone said, stability itself may eventually be destabilizing by encouraging a false sense of confidence and renewed speculation.** It is the inability to know when those opportunities will arise that makes waiting so painful; particularly if in the interim the stock moves higher rather than lower. Given the temptation to use the money sooner than later, given too the temptation to use buybacks for a variety of inappropriate purposes, the operation may easily turn out badly.

No doubt the management of *Comprehensive Care*, for example, had great expectations when the company shrunk its stock by over 25 percent in fiscal 1987, buying back over 4 million shares at $13 a share. The company develops and manages programs for drug abuse and psychiatric treatment. Patient days in existing units had declined sharply; profits were falling and unfortunately they continued to fall. The balance sheet eroded with them. Debt, more than half of it attributable to the buyback, soon exceeded shareholders' equity. The banks imposed

Broadway Hale Stores over time, it acquired other retail store chains in regions outside California home base, and became in certain retail sectors a regional and national retailer in the 1970s and 1980s. It entered into Chapter 11 bankruptcy in 1991, and eventually its assets were completely sold off.

credit constraints. A year and a half later, the dividend was omitted, and a loss was reported. Not long after that, in 1990, the company, which by then had lost financial flexibility, saw its stock fall below $2 a share.

Price Communications retired over $100 million worth of common stock in 1986-1988, shrinking its stock by more than half. Why it did that is something of a mystery, given the company's poor prospects. *Price*, whose total revenues were only about $90 million, lost $12 million to $24 million in each of those three years. The company owned various broadcast and newspaper properties, but it had paid top dollar and was soon liquidating asset to stay a step or so ahead of the sheriff. By the fall of 1989, with a smaller revenue base, the company had $400 million of debt. With annual interest charges of over $45 million, over half its total revenues were dedicated to interest payments. The company acknowledged the obvious: its current levels of operations would not generate sufficient cash flow to cover interest payments ($50 Million 10% Conv. Debs.) Despite the continuing losses, the company had split its stock five-for-five at least once every year beginning in 1985. One possible explanation for the share repurchases was that the president and CEO, *Robert Price*, held a class of junior stock that would become convertible into common stock if the price of the common rose above a stipulated level for a period of time. It is impossible to say whether *Price*, a former investment banker and former deputy mayor of New York, had that in mind and in any event the conversion privilege was not triggered. **But for a company awash in hard-to-service debt, it was reckless to spend $100 million on buybacks.**

In the fall of 1990, with *Price Communications* hovering on the edge of bankruptcy, the president blamed the company's problems on the credit crunch. No mention was made of the company's own lack of judgment.

Buybacks are not for everyone. It is hard to separate the saints and sinners, however. Even when we tell the saints to line up on the right and the sinners on the left, everyone in the class moves in the same direction. What to do? In the United States, we leave the issue to the business discretion of corporate managements and directors. The courts are reluctant to intervene. Perhaps, somewhat like the British, we should insist that whenever a company intends to buy back shares posed for repurchase is from a particular, designated seller (rather than by tender offer or open market transactions), the matter should be put to a vote of the shareholders. The mere fact of such a requirement, together with the accompanying disclosures, would make at least choirboys, if not saints, out of a few sinners.

As if that were not enough, one further note of caution needs to be struck. Most stocks, including our fictitious *Middle American*, usually sell at prices well above their book values. For a company to buy back a share of stock, therefore, means that the **excess of the purchase price above book value of that share reduces the book value of the remaining shares.** The buyback may be beneficial for the continuing shareholders, but the book value of their shares will suffer as a result. Still, most shareholders probably would not notice or care.

Book value as such may not matter, but buybacks by companies whose stocks are selling above their book value can significantly **distort some of the usual yardsticks for measuring the profitability of the business and management's compensation.** In this respect, buybacks are very much like the extraordinary write-downs that some companies take to reduce the balance sheet values of operations whose prospects have soured. Net worth is reduced in the one case by the amount of the buyback and in the other by the amount of the write-down. The result is that a financial operation, such as a buy-back, can make the business henceforth seem more profitable and efficient than is the fact the case because it will inflate the company's return on equity for future periods. And it will do that long after the buyback itself has been forgotten.

EXAMPLE:

Returns on equity (ROE) for the S&P 500 companies have averaged between 10 percent and 15 percent for most of this century, but they rose sharply in the 1990s. Indeed, one of the reasons U.S. companies traded at such premiums to their book values in the mid-1990s was that they enjoyed historically high returns on equity. Under such conditions, rich stock valuations are justified—as long as companies can maintain these high returns. Unfortunately, **profit margins are highly mean reverting.**

The difficulty in maintaining high ROEs can be seen in this hypothetical example of a company earning $10 million initially and attaining a consistent 25% percent ROE[7]

Year	Base Equity	Net Income	Ending Equity	ROE
1998	$35,000,000	$10,000,000	$45,000,000	25%
1999	$45,000,000	$12,855,000	$57,855,000	25%
2000	$57,855,000	$16,525,000	$74,380,000	25%
2001	$74,380,000	$21,242,888	$95,622,888	25%
2002	$95,622,888	$27,307,733	$122,930,621	25%
2003	$122,930,621	$35,104,090	$158,034,711	25%
2004	$158,034,711	$45,126,308	$203,161,019	25%
2005	$203,161,019	$58,009,869	$261,170,887	25%
2006	$261,170,887	$74,571,686	$335,742,574	25%
2007	$335,742,574	$95,861,903	$431,604,477	25%
2008	$431,604,477	$123,230,476	$554,834,953	25%

Because each year's net income is added into equity and becomes a component of net year's calculation, it becomes considerably more difficult to generate sufficient net income to keep the ROE at 25 percent. In fact, our hypothetical company must increase its net income and equity by 28.6% annually to maintain a 25% ROE. High returns on equity should be accompanied by even higher increases in net income. Look what happens to our hypothetical company's ROE when net income grows by only 15% annually. The ROE calculation is made by dividing net income by the average of the base equity and the ending equity so for 1998 we have $10 million net income divided by (base equity of $35 million + ending equity of $45 million/2) = $10 million/$40 million = 25%.

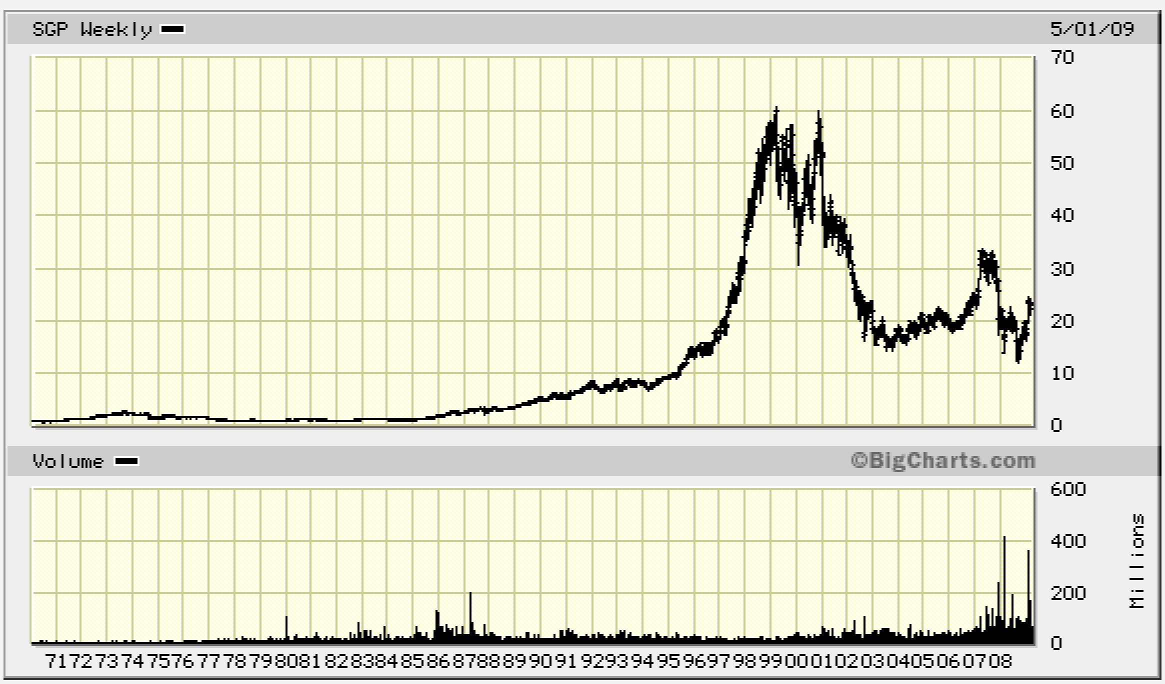
Year	Base Equity	Net Income	Ending Equity	ROE
1998	$35,000,000	$10,000,000	$45,000,000	25%
1999	$45,000,000	$11,500,000	$56,500,000	23%
2000	$56,500,000	$13,225,000	$69,725,000	21%
2001	$69,725,000	$15,208,000	$84,933,750	20%
2002	$84,933,750	$17,490,063	$102,423,813	19%
2003	$102,423,813	$20,113,572	$122,537,384	18%
2004	$122,537,384	$23,130,608	$145,667,992	17%
2005	$145,161,019	$26,600,199	$172,268,191	17%
2006	$172,268,191	$30,590,229	$202,858,419	16%
2007	$202,858,419	$35,178,763	$238,037,182	16%
2008	$238,037,182	$40,455,577	$278,492,760	16%

Wall Street clearly favors stable earnings growth, but as you can see, it leads to a gradual decline in ROE and a decline in the growth rate of shareholders' equity. If management wishes to maintain a company's ROE at 25%, it must find ways to create more than $1 in shareholder equity for every dollar of net income produced. Indeed, when net income does not grow as fast as equity, management has not maximized use of the extra resources given it.

A high ROE maybe the result of stock buybacks. Companies can greatly manipulate ROEs through buybacks, ESOPs (Employee Stock Option Programs) and the granting of options. *General Electric (GE)* pioneered new territory in November 1989 when it announced a $10 billion share buyback program with the stated intention of improving return on equity. Since then, hundreds of companies have used repurchases to their advantage. By retiring shares, companies reduce shareholders' equity, and improve per-share earnings, a double bonus to ROE.

[7] Wall Street on Sale by Timothy Vick pages 163-166

Schering-Plough, the pharmaceutical company, posted an unusually high ROE of 65.9 percent in 1996. The figure seems astonishing given that *Schering-Plough* had virtually no debt. Schering-Plough bought back 142 million shares that were sitting in the treasury for reissue. The cost basis of the shares ($3.56 billion at the end of 1996) was subtracted from shareholders' equity, thereby inflating ROE. Had *Schering-Plough* had not been buying back stock, its 1996 ROE would have been 23.3 percent, more in line with competitors. Hoarding shares is not necessarily bad for shareholders. Companies rich enough to buy back substantial blocks of stock are better able to boost ROE and earnings over time. *Schering-Plough* was experiencing strong sales trends, improving profit margins, and its capex represented just a fraction of net income (free cash flow was strong.) The company was well situated for repurchasing shares each year to improve ROE.



Stock buybacks (if done at appropriate valuations) and nice, fat dividends *(may)* create shareholder value. Often overlooked, they reduce the risk a company has to take to produce a total return for shareholders as it accelerates earnings per share and dividend growth. In other words, absent a dividend or share buyback, to achieve 12 percent total return (assuming P/E doesn't change) EPS needs to increase 12 percent. However, if the company paid a 3 percent dividend and bought back 2 percent of its shares, it would only have to grow earnings at 7 percent (the first 5% coming from dividend and share buyback) to achieve the same 12 percent total return. Usually a company has to take less risk to grow earnings 7 percent versus 12 percent. **Share buybacks are not a substitute for organic growth, but are often an underappreciated bonus.** *(This example ignores compounding).*

A company that is able to buy back a meaningful amount of its stock and pay a dividend while growing earnings needs to have significant free cash flows (not be in a capital intensive business) and/or generate high return on capital. And it also needs to trade at an attractive valuation, as dividend yield and the amount needed to buy back stock are also influenced by the stock's valuation.

Stock Buybacks Distort the Balance Sheet[8]

Stock buybacks inadvertently distort the appearance of the balance sheet when market-value transactions such as this are mixed with historical entries on the balance sheet, such as issuance of common stock and retained earnings. In the frequent case where the market value of equity substantially exceeded its book value, share repurchases may actually lead to negative equity on the balance sheet.

To gauge a company's true indebtedness and the risk that comes with it, you should utilize debt and interest coverage ratios in relation to net income; earnings before interest, taxes, depreciation, and amortization EBITDA); operating cash flows; and/or free cash flows. These ratios tell a more accurate story about the balance sheet (debt) risk and not distorted by share buybacks. Here are some examples of these ratios: debt/EBITDA; debt/operating cash flows; EBITDA/interest expense; operating cash flows/interest expense; and many others).

CASE STUDY: *Colgate-Palmolive's* Capital Structure

If you solely used debt-to-assets or equity-to-debt to analyze *Colgate-Palmolive Company's* indebtedness from 1999 to 2002, you would come to the wrong conclusion on the company's financial risk. As shown in Exhibit 1, over the four year period 1999-2002, you would come to the wrong conclusion on the company's financial risk

Exhibit 1: Snapshot of Colgate-Palmolive's Balance Sheet in $ Millions

	Dec. 2002	**Dec. 2001**	**Dec. 2000**	**Dec. 1999**
Retained Earnings	4,653	4,148	3,624	3,076
Common Stock	1,867	1,902	1,878	1,796
Less: Treasury Stock	6,152	5,204	4,043	3,056
Total Equity	**367**	**851**	**1,458**	**1,816**
Total Interest Bearing Debt	**3,604**	**3,239**	**2,978**	**2,790**
Total Assets	**7,087**	**6,985**	**7,252**	**7,423**

Exhibit 2: Colgate-Palmolive's Traditional Capital Structure Ratios

	Dec. 2002	**Dec. 2001**	**Dec. 2000**	**Dec. 1999**
Total Equity	367	851	1,458	1,816
Total Assets *(divided)*	7,087	6,985	7,252	7,423
Total Equity to Total Assets	***5.2%***	***12.2%***	***20.1%***	***24.5%***
Interest Bearing Debt	3,604	3,239	2,978	2,790
Total Assets *(divided)*	7,087	6,985	7,252	7,423
Total Debt to Total Assets	***50.9%***	***46.4%***	***41.1%***	***37.6%***

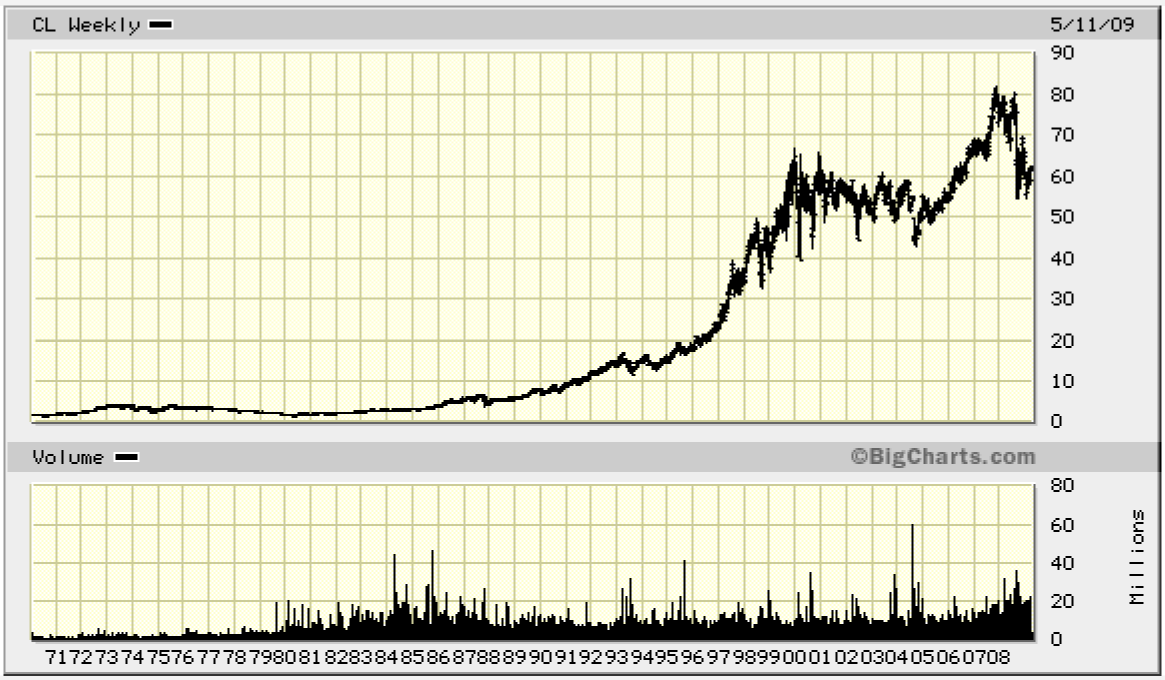
Exhibit 3: Colgate-Palmolive's Debt and Interest Coverage ($ Millions)

	Dec. 2002	**Dec. 2001**	**Dec. 2000**	**Dec. 1999**
Operating Cash Flow	**1,611**	**1,600**	**1,536**	**1,293**
Interest Expense	**158**	**192**	**204**	**224**

[8] Active Value Investing, Making Money in Range-Bound Markets by Vitaliy N. Katsenelson (2007) pages 91-95

Operating Cash Flows Interest Coverage (x covered)	***10.2***	***8.3***	***7.5***	***5.8***
Free Cash Flows	**1,268**	**1,259**	**1,170**	**920**
Interest Expense	**158**	**192**	**204**	**224**
Free Cash Flows Interest Coverage (x Times)	***8.0***	***6.5***	***5.7***	***4.1***
Total Interest-Bearing Debt	*3,604*	*3,239*	*2,978*	*2,790*
Operating Cash Flow	*1,611*	*1,600*	*1,536*	*1,293*
Debt Payoff from Operating Cash Flows (yrs. To payoff)	***2.2***	***2.0***	***1.9***	***2.2***
EBIT	*2,024*	*1,861*	*1,721*	*1,564*
Interest Expenses	*158*	*192*	*204*	*224*
EBIT Interest Coverage *(x Times)*	***16.3***	***17.5***	***16.2***	***12.8***
Total Interest-Bearing Debt	*3,604*	*3,239*	*2,978*	*2,790*
Free Cash Flows	1,268	1,259	1,170	920
Debt Payoff from Free Cash Flows (Yrs. To Payoff)	***2.8***	***2.6***	***2.5***	***3.0***

Colgate-Palmolive, Inc. (CL) Chart



--

Gillette is a good example. It happens to be a very profitable company, but in the process of buying back about 22 percent of its stock in the 1980's it completely eliminated shareholders' equity. With a book value per share of less than $8, the company bought back stock in 1986 at $29 a share and subsequently in 1988 at $45 a share. As a result, shareholders' equity became a minus $133 million. Net income for 1987 (adjusted for the buyback) declined, of course, but only by about 17 percent—from $230 million to $192 million. With the company's equity rapidly disappearing, however, return on equity rose from about 18 percent in 1985 to about 39 percent in 1987. Then it leaped to infinity in 1989. *Gillette's* business was very good but it was not infinitely good.

Similarly, compare two companies in the food industry, *Ralston Purina* and *H.J. Heinz*. Ordinarily one might have assumed that *Ralston Purina*, which showed a much higher return on equity in the late 1980s, was the more profitable company. Wrong. *Heintz* was the stronger of the two, with generally better market positions and higher profit margins. *Ralston Purina*, however, had bought back much more stock than *Heintz*, thus boosting its return on equity. **The usually good yardstick didn't work.** As one thoughtful money manager, *Seth Klarman (Baupost Group)*, has said, not every company that seems to be earning a 25 percent return on equity is equally profitable.

LEGAL AND ACCOUNTING CONSTRAINTS OF SHARE REPURCHASES

While the legal restrictions on plain vanilla buybacks in the United States are relatively few, there are some. Moreover, there are significant tax implications for shareholders. For a corporate manager, rather than a lawyer or banker, these factors can be summarized without doing them much injustice.

The central business question is whether to buy stock in the open market or by a tender offer. Open market purchases will be at prevailing market prices, and while the announcement of a repurchase program will have some positive effect on the market, it is often minor and ephemeral. Open market purchases are usually the least expensive route; the mechanics are relatively simple and inexpensive. An investment bank or brokerage firm buys stock for the company within the company's price guidelines, at about the same commissions applicable to institutional investors. Although there is no explicit requirement that a company disclose its buyback program, the antifraud rules, particularly the rules against insider trading, apply. Because the buyback itself may constitute significant information, it would be the rare company that did not announce its intentions. And if the company has material inside information apart from the buyback itself, that should also be disclosed. Earnings projections that the company had intended for use only in capital budgeting or for other internal purposed should be examined for the assumptions on which they were written. If the company expects a banner year, better than the Street expects, some further disclosure might be required.

The federal securities laws also restrict the manner in which shares are acquired. To prevent manipulation, the SEC has established a *safe-harbor rule (Rule 10b-18)* under which, in general, company purchases may not exceed 25 percent of the average daily trading volume, may not be made at the beginning or end of the day, and may not be made at prices over the market. Although the rule is nominally only a safe-harbor provision and therefore not mandatory, adherence to it is close to universal.

Open market purchases are low cost, usually sensible route. But for companies eager to buy back large amounts of their stock and to do so quickly, or for companies that fear the price may soon move up, they may not be the answer. Depending on the level of trading in the company's stock, the volume limitations under Rule 10b-18 may be too restrictive. Block purchases are exempt from those limitations, but they cannot be used as mere conduits for circumventing volume limitations. Companies seeking to buy back in a short time a large portion of their shares should consider a tender offer *(See Teledyne Case Study in Appendix)*.

In a self tender, the company commits to buy a minimum, typically substantial, number of shares pursuant to a formal tender offer document that it files with the SEC and distributes to shareholders. In a conventional tender offer, the company offers to buy shares at a fixed price. Recently, however, there has increasingly appeared the modified Dutch auction in which shareholders are asked to set the price, within limits set by the company, at which they individually are ready to sell. The offer states the quantity of shares to be bought. Assuming the requisite number of shares are tendered, there will be a lowest price at which the company can purchase that quantity. All those who tendered stock at or below that price will have their shares purchased at that one price. The shares of those whose offers were at a price higher than the purchase price will not be bought in the tender offer.

In 1981 *Todd Shipyards* was the first to use a Dutch auction in this way. The advantage to the company is clear: shareholders interested in selling are forced to compete. Concerned about the possibility of manipulation, however, the SEC has set some limitations, notably by insisting that the company state beforehand the number of shares to be purchased.

A still more recent invention is the "put-rights" used by *Gillette* and others. In 1988 *Gillette* was under pressure from a hostile group to sell the company and thereby to realize values that supposedly were not being reflected currently in the stock price. A bargain was struck under which *Gillette* agreed to repurchase one-seventh of the company's outstanding shares at a price 40 to 50 percent over the market price that had prevailed shortly before. The concern was that the price might be "too fair," that is, too high, which would have been unfair to those who, as some inevitably would do, failed to tender. The company solved the problem by issuing to all shareholders tights to sell stock to the company at $45 a share, at the rate of one share for each seven owned. Being transferable, the rights traded at the value the stock market fixed as the difference between the $45 put price and the expected value of the stock after the offer expired. Thus, even those who did not sell any shares could capture their prorate portion of the premium by selling off their rights.

Put rights are interesting, but as the *Gillette* case suggests, they are intended for situations where the repurchase price may represent a premium over intrinsic value and, rather than accede to a hostile bidder's greenmail demands for a premium for one shareholder, the company pays a "premium"—in effect, a dividend—to all.

TAX CONSIDERATIONS

For shareholders, a corporate stock redemption raises the possibility that the proceeds will be taxed as a dividend. Although the federal tax rate for the moment is the same for both ordinary income capital gains, there is a substantial difference in the overall result because a dividend is taxed in its entirety (to the extent of the corporation's current and accumulated earnings and profits and a capital gain only to the extent of the gain. The argument has sometimes been made that stock redemptions should be universally treated as if the company had paid a cash dividend to all the shareholders, with the continuing shareholders then deemed to have bought the shares of those who, in fact, sold their stock back to the company. Whatever the theoretical merits, the law does not treat buybacks generally as the equivalent of a dividend. Instead, only shareholders whose proportionate interest in the company is essentially unaffected by the distribution are taxed on sales of stock to the company as if the company had paid a dividend. Control shareholders who have sold their entire holdings or reduced their proportionate interest by more than 20 percent, and those non-control shareholders of a widely held corporation who reduce their percentage ownership by any amount, are taxed only to the extent of the gain.

For shareholders that are themselves corporations, the issues are the same, but here it is usually a benefit to have the transaction treated as a dividend because of the preferential treatment accorded under the tax laws to inter corporate dividend payments.

While there are some arcane aspects, the fundamentals of the tax law are such that noncorporate investors should be able to ensure themselves of capital gains treatment, and corporate investors should be able to ensure themselves of capital gains treatment, and corporate investors of dividend treatment, if they so desire.

ACCOUNTING EFFECTS

Years ago, when a substantial number of companies were still acquiring other companies in exchange for common stock of the purchaser, it was common to remind people that the ability to account for the acquisition on the acquiring company's books as a so-called *pooling of interests* might be jeopardized by a significant buyback program within two years of the acquisition. That could be important if the acquired company was being purchased for more than its asset values. For example, unless pooling treatment was available, a substantial goodwill item might be added to the books of the purchaser, and under the applicable accounting rules, that goodwill would be charged off against future earnings although it would not be deductible for tax purposes. The pressure of hostile takeovers in recent years, however, has made the leisurely pace of acquisitions for stock almost an anachronism.

This brief summary of legal and other factors affecting buybacks applies only to the more limited, plain vanilla versions. For share repurchases that involve a drastic corporate restructuring, the greenmailing of a hostile bidder, or a freeze-out, there are significant other issues under both state and federal law.
--

Warren Buffet on Share Repurchases

Mr. Warren E. Buffett succinctly captured the excitement of share repurchases in the 1984 annual report of *Berkshire Hathaway*. The stock market, he said, is not as efficient as many economists and business school professors would have us believe; sometimes bargains do exist. Companies that seize those opportunities have demonstrated their "pro shareholders leanings" more directly than any glossy four-color annual report or handout.

1984 Berkshire Hathaway's Shareholder Letter, Pages: 5-9

The companies in which we have our largest investments have all engaged in significant stock repurchases at times when wide discrepancies existed between price and value. As shareholders, we find this encouraging and rewarding for two important reasons - one that is obvious, and one that is subtle and not always understood. The obvious point involves basic arithmetic: major repurchases at prices well below per-share intrinsic business value immediately increase, in a highly significant way, that value. When companies purchase their own stock, they often find it easy to get $2 of present value for $1. Corporate acquisition programs almost never do as well and, in a discouragingly large number of cases, fail to get anything close to $1 of value for each $1 expended.

The other benefit of repurchases is less subject to precise measurement but can be fully as important over time. By making repurchases when a company's market value is well below its business value, management clearly demonstrates that it is given to actions that enhance the wealth of shareholders, rather than to actions that expand management's domain but that do nothing for (or even harm) shareholders. Seeing this, shareholders and potential shareholders increase their estimates of future returns from the business. This upward revision, in turn, produces market prices more in line with intrinsic business value. These prices are entirely rational. Investors should pay more for a business that is lodged in the hands of a manager with demonstrated pro-shareholder leanings than for one in the hands of a self-interested manager marching to a different drummer. (To make the point extreme, how much would you pay to be a minority shareholder of a company controlled by *Robert Vesco*[9]?)

The key word is "demonstrated". A manager, who consistently turns his back on repurchases, when these clearly are in the interests of owners, reveals more than he knows of his motivations. No matter how often or how eloquently he mouths some public relations-inspired phrase such as "maximizing shareholder wealth" (this season's favorite), the market correctly discounts assets lodged with him. His heart is not listening to his mouth - and, after a while, neither will the market.

We have prospered in a very major way - as have other shareholders - by the large share repurchases of *GEICO, Washington Post,* and *General Foods*, our three largest holdings. (*Exxon*, in which we have our fourth largest holding, has also wisely and aggressively repurchased shares but, in this case, we have only recently established our position.) In each of these companies, shareholders have had their interests in outstanding businesses materially enhanced by repurchases made at bargain prices. We feel very comfortable owning interests in businesses such as these that offer excellent economics combined with shareholder-conscious managements.

1999 Berkshire Hathaway Shareholder Letter

9 **Robert Lee Vesco** (December 4, 1935-November 23, 2007) was a fugitive United States financier. After several years of high stakes investments and seedy credit dealings, Vesco was alleged guilty of securities fraud. He immediately fled the ensuing U.S. Securities and Exchange Commission investigation by living in a number of Central American and Caribbean countries that did not have extradition laws. Charges emerged following the Watergate scandal that linked Vesco with illegal funding for a company owned by Donald A. Nixon (Richard Nixon's brother).

Recently, a number of shareholders have suggested to us that Berkshire repurchase its shares. Usually the requests were rationally based, but a few leaned on spurious logic.

There is only one combination of facts that makes it advisable for a company to repurchase its shares: First, the company has **available funds** -- cash plus sensible borrowing capacity -- beyond the near-term needs of the business and, second, finds **its stock selling in the market below its intrinsic value**, conservatively-calculated. To this we add a caveat: **Shareholders should have been supplied all the information they need for estimating that value**. Otherwise, insiders could take advantage of their uninformed partners and buy out their interests at a fraction of true worth. We have, on rare occasions, seen that happen. Usually, of course, chicanery is employed to drive stock prices up, not down.

The business "needs" that I speak of are of two kinds: First, **expenditures that a company must make to maintain its competitive position** (e.g., the remodeling of stores at *Helzberg's*) and, second, optional outlays, aimed at **business growth, that management expects will produce more than a dollar of value for each dollar spent** (*R. C. Willey's* expansion into Idaho). When available funds exceed needs of those kinds, a company with a growth-oriented shareholder population can buy new businesses or repurchase shares. **If a company's stock is selling well below <u>intrinsic value</u>, repurchases usually make the most sense.** In the mid-1970s, the wisdom of making these was virtually screaming at managements, but few responded. In most cases, those that did made their owners much wealthier than if alternative courses of action had been pursued. Indeed, during the 1970s (and, spasmodically, for some years thereafter) we searched for companies that were large repurchasers of their shares. This often was a tipoff that the company was both undervalued and run by a shareholder-oriented management.

That day is past. Now, **repurchases are all the rage**, but are all too often made for an unstated and, in our view, ignoble reason: to pump or <u>support</u> the stock price. The shareholder who chooses to sell today, of course, is benefitted by any buyer, whatever his origin or motives. But the *continuing* shareholder is penalized by repurchases above intrinsic value. Buying dollar bills for $1.10 is not good business for those who stick around.

Charlie and I admit that we feel confident in estimating intrinsic value for <u>only a portion</u> of traded equities and then only when we employ a <u>range of values</u>, rather than some pseudo-precise figure. Nevertheless, it appears to us that many companies now making repurchases are overpaying departing shareholders at the expense of those who stay. In defense of those companies, I would say that it is natural for CEOs to be optimistic about their own businesses. They also know a whole lot more about them than I do. However, I can't help but feel that too often today's repurchases are dictated by management's desire to "show confidence" or be in fashion rather than by a desire to enhance per-share value.

Sometimes, too, companies say they are repurchasing shares to offset the shares issued when stock options granted at much lower prices are exercised. This "buy high, sell low" strategy is one many unfortunate investors have employed -- but never intentionally! Managements, however, seem to follow this perverse activity very cheerfully.

Of course, both option grants and repurchases may make sense -- but if that's the case, it's not because the two activities are logically related. Rationally, a company's decision to repurchase shares or to issue them should stand on its own feet. Just because stock has been issued to satisfy options -- or for any other reason -- does not mean that stock should be repurchased at a price above intrinsic value. Correspondingly, a stock that sells well below intrinsic value should be repurchased whether or not stock has previously been issued (or may be because of outstanding options).

You should be aware that, at certain times in the past, I have erred in *not* making repurchases. My appraisal of Berkshire's value was then too conservative or I was too enthused about some alternative use of funds. We have therefore missed some opportunities -- though Berkshire's trading volume at these points was too light for us to have done much buying, which means that the gain in our per-share value would have been minimal. (A repurchase of, say, 2% of a company's shares at a 25% discount from per-share intrinsic value produces only a ½% gain in that value at most -- and even less if the funds could alternatively have been deployed in value-building moves.)

Some of the letters we've received clearly imply that the writer is unconcerned about intrinsic value considerations but instead wants us to trumpet an intention to repurchase so that the stock will rise (or quit going down). If the writer wants to sell tomorrow, his thinking makes sense -- for him! -- But if he intends to hold, he should instead hope the stock falls and trades in enough volume for us to buy a lot of it. That's the only way a repurchase program can have any real benefit for a continuing shareholder.

We will not repurchase shares unless we believe Berkshire stock is selling well below intrinsic value, conservatively calculated. Nor will we attempt to talk the stock up or down. (Neither publicly or privately have I ever told anyone to buy or sell Berkshire shares.) Instead we will give all shareholders -- and potential shareholders--the same valuation-related information we would wish to have if our positions were reversed.

Recently, when the A **shares fell below $45,000, we considered making repurchases**. We decided, however, to delay buying, if indeed we elect to do *any*, until shareholders have had the chance to review this report. If we do find that repurchases make sense, we will only rarely place bids on the New York Stock Exchange ("NYSE"). Instead, we will respond to offers made directly to us at or below the NYSE bid. If you wish to offer stock, have your broker call Mark Millard at 402-346-1400. When a trade occurs, the broker can either record it in the "third market" or on the NYSE. We will favor purchase of the B shares if they are selling at more than a 2% discount to the A. We will not engage in transactions involving fewer than 10 shares of A or 50 shares of B.

Please be clear about one point: We will *never* make purchases with the intention of stemming a decline in Berkshire's price. Rather we will make them if and when we believe that they represent an attractive use of the Company's money. At best, repurchases are likely to have only a very minor effect on the future rate of gain in our stock's intrinsic value.

2009 Annual Meeting of Berkshire Hathaway Shareholders

Mr. Warren E. Buffett is asked about **Berkshire buying back its own shares**. Buffett says most of repurchasing of shares recently has been foolish because the stocks were too expensive."

--

Benjamin Graham in Security Analysis (1940), Chapter XLIV, pages 605-610.

IMPLICATIONS OF LIQUIDATING VALUE. STOCK-HOLDER-MANAGEMENT RELATIONSHIPS.

Repurchase of Shares Pro Rata from Shareholders.

The *Hamilton Woolen* management is also to be commended for its action during 1932 and 1933 in employing excess cash capital to repurchase pro rata a substantial number of shares at a reasonable price. This reversed the procedure followed in 1929 when additional shares were offered for subscription to the stockholders. The contraction in business that accompanied the depression made this additional capital no longer necessary, and it was therefore a logical move to give most of it back to the stockholders, to whom it was of greater benefit when in their own pockets than in the treasury of the corporation.

Hamilton Woolen sold 13,000 shares pro rata to stockholders at $50 per share in 1929. It repurchased, pro rata, 6,500 shares at $65 in 1932 and 1,200 shares at $50 in 1933. *Faultless Rubber Company* followed a similar procedure in 1934. *Simms Petroleum Company* reacquired stock both directly from the shareholders on a pro rata basis and in the open market. Its repurchases by both means between 1930 and 1933 aggregated nearly 45% of the shares outstanding at the end of 1929. *Julian and Kokenge (Shoe) Company* made pro rata repurchases of common stock in 1932, 1934 and 1939.

Abuse of Shareholders through Open-market Purchase of Shares.

During the 1930–1933 depression repurchases of their own shares were made by many industrial companies out of their surplus cash assets (the Figures published by the New York Stock Exchange in February 1934 revealed that 259 corporations with shares listed thereon had reacquired portions of their own stock), but the procedure generally followed was open to grave objection. The stock was bought in the open market <u>without notice</u> to the shareholders. This method introduced a number of unwholesome elements into the situation. It was thought to be "in the interest of the corporation" to acquire the stock at the lowest possible price. The consequence of this idea is that those stockholders who sell their shares back to the company are made to suffer as large a loss as possible, for the presumable benefit of those who hold on. Although this is a proper viewpoint to follow in purchasing other kinds of assets for the business, there is no warrant in logic or in ethics for applying it to the acquisition of shares of stock from the company's own stockholders. The management is the more obligated to act fairly toward the sellers because the company is itself on the buying side.

But, in fact, the desire to buy back shares cheaply may lead to a determination to reduce or pass the dividend, especially in times of general uncertainty. Such conduct would be injurious to nearly all the stockholders, whether they sell or not, and it is for that reason that we spoke of the repurchase of shares at an unconscionably low price as only presumably to the advantage of those who <u>retained</u> their interest.

Example: White Motor Company.

In the previous chapter attention was called to the extraordinary discrepancy between the market level of *White Motor's* stock in 1931–1932 and the minimum liquidating value of the shares. It will be instructive to see how the policies followed by the management contributed mightily to the creation of a state of affairs so unfortunate for the stockholders.

White Motor Company paid dividends of $4 per share (8%) practically from its incorporation in 1916 through 1926. This period included the depression year 1921, in which the company reported a loss of nearly $5,000,000. It drew, however, upon its accumulated surplus to maintain the full dividend, a policy that prevented the price of the shares from declining below 29. With the return of prosperity the quotation advanced to 721/2 in 1924 and 1041/2 in 1925. In 1926 stockholders were offered 200,000 shares at par ($50), increasing the company's capital by $10,000,000. A stock dividend of 20% was paid at the same time.

Hardly had the owners of the business paid in this additional cash, when the earnings began to shrink, and the dividend was reduced. In 1928 about $3 were earned (consolidated basis), but only $1 was disbursed. In the 12 months ending June 30, 1931 the company lost about $2,500,000. The next dividend payment was omitted entirely, and the price of the stock collapsed to 71/2.

The contrast between 1931 and 1921 is striking. In the earlier year the losses were larger, the profit-and-loss surplus was smaller and the cash holdings far lower than in 1931. But in 1921 the dividend was maintained, and the price thereby supported. A decade later, despite redundant holdings of cash and the presence of substantial undistributed profits, a single year's operating losses sufficed to persuade the management to suspend the dividend and permit the establishment of a grotesquely low market price for the shares.

During the period before and after the omission of the dividend the company was active in buying its own shares in the open market. These purchases began in 1929 under a plan adopted for the benefit of "those filling certain managerial positions." By June 1931 about 100,000 shares had been bought in at a cost of $2,800,000. With the passing of the dividend, the officers and employees were relieved of whatever obligations they had assumed to pay for these shares, and the plan was dropped. In the next six months, aided by the collapse in the market price, the company acquired 50,000 additional shares in the market at an average cost of about $11 per share. The total holdings of 150,000 shares were then retired and cancelled.

These facts, thus briefly stated, illustrate the **vicious possibilities** inherent in permitting managements to exercise discretionary powers to purchase shares with the company's funds. We note first the painful contrast between the treatment accorded to the *White Motor* managerial employees and to its stockholders. An extraordinarily large amount of stock was bought for the benefit of these employees at what seemed to be an attractive price. All the money to carry these shares was supplied by the stockholders. If the business had improved, the value of the stock would have advanced greatly, and all the benefits would have gone to the employees. When things became worse, "those in managerial positions" were relieved of any loss, and the entire burden fell upon the stockholders. (In the sale to *Studebaker* in 1933 the directors set aside 15,000 shares of treasury stock as a donation to key men in the organization. Some *White* stockholders brought suit to set aside this donation, and the suit was settled by payment of 31 cents per share on *White* stock not acquired by *Studebaker*.)

In its transactions *directly with its stockholders,* we see *White Motor* soliciting $10,000,000 in new capital in 1926. We see some of this additional capital (not needed to finance sales) employed to buy back many of these very shares at one-fifth of the subscription price. **The passing of the dividend was a major factor in making possible these repurchases at such low quotations.** The facts just related without further evidence might well raise a suspicion in the mind of a stockholder that the omission of the dividend was in some way related to a desire to depress the price of the shares. If the reason for the passing of the dividend was a desire to preserve cash, then it is not easy to see why, since there was money available to buy in stock, there was not money available to continue a dividend previously paid without interruption for 15 years.

The spectacle of a company over rich in cash passing its dividend, in order to impel desperate stockholders to sell out at a ruinous price, is not pleasant to contemplate.

Westmoreland Coal Company: Another Example.

A more recent illustration of the dubious advantage accruing to stockholders from a policy of open-market repurchases of common stock is supplied by the case of *Westmoreland Coal*. In the ten years 1929–1938 this company reported a net loss in the aggregate amounting to $309,000, or $1.70 per share. However, these losses resulted after deduction of depreciation and depletion allowances totaling $2,658,000, which was largely in excess of new capital expenditures. Thus the company's cash position actually improved considerably during this period, despite payment of very irregular dividends aggregating $4.10 per share.

In 1935, according to its annual reports, the company began to repurchase its own stock in the open market. By the end of 1938 it had thus acquired 44,634 shares, which were more than 22% of the entire issue. The average price paid for this stock was $8.67 per share. Note here the extraordinary fact that this average price paid was less than one-half the cash-asset holdings alone per share, without counting the very large other tangible assets. Note also that at no time between 1930 and 1939 did the stock sell so high as its cash assets alone. (At the end of 1938 the company reported cash and marketable securities totaling $2,772,000, while the entire stock issue was selling for $1,400,000.)

If this situation is analyzed, the following facts appear clear:

1. The low market price of the stock was due to the absence of earnings and the irregular dividend. Under such conditions the quoted price would not reflect the very large cash holding theoretically available for the shares. Stocks sell on earnings and dividends and not on cash-asset values—unless distribution of these cash assets is in prospect.

2. The true obligation of managements is to recognize the realities of such a situation and to do all in their power to protect every stockholder against unwarranted depreciation of his investment, and particularly against unnecessary sacrifice of a large part of the true value of his shares. Such sacrifices are likely to be widespread under conditions

of this kind, because many stockholders will be moved by necessity or the desire for steady income or by a discouraged view of the coal industry to sell their shares for what they can get.

3. The anomaly presented by exceptionally large cash holdings and an absurdly low market price was obviously preventable. That the company had more cash than it needed is confessed by the fact that it had money available to buy in cheap stock—even if it were not evident from a study of the unusual relationship between cash holdings and annual business done.

4. All cash that could possibly be spared should have been returned to the stockholders on a pro rata basis. The use of some of it to buy in shares as cheaply as possible is unjust to the many stockholders induced by need or ignorance to sell. It favors those strong enough to hold their shares indefinitely. It particularly advantages those in control of the company, for in their case the company's cash applicable to their stock is readily available to them if they should need it (since they could then bring about a distribution). Just because this situation is distinctly not true of the rank and file of the stockholders, the market discounts so cruelly the value of their cash when held by the company instead of themselves.

Two additional factors in this situation deserve brief mention. The company had a rental obligation of 10 cents per ton, but not less than $189,000 annually, for mining coal from leased lands. This liability was an additional consideration, besides the ordinary ones, which argued for maintenance of a comfortable cash position, but it could not justify the immobilizing of far more cash than the whole company appeared to be worth at any time between 1930 and 1939.

In October 1939 the company made application to the S.E.C. to terminate trading in its shares on the Philadelphia Stock Exchange and the New York Curb Exchange, intimating that the infrequency of transactions might be responsible for their unduly low price. The reader may judge whether or not, in the circumstances, the plight of the stockholders would be relieved in any wise by destroying the established market for their shares. (The application was later withdrawn.)

Summary and Conclusion.

The relationship between stockholders and their managements, after undergoing many unsound developments during the hectic years from 1928 to 1933, have since been subjected to salutary controls—emanating both from S.E.C. regulation and from a more critical viewpoint generally. Certain elementary facts, once well nigh forgotten, might well be emphasized here: Corporations are in law the mere creatures and property of the stockholders who own them; the officers are only the paid employees of the stockholders; the **directors, however chosen, are virtually trustees, whose legal duty it is to act solely in behalf of the owners of the business.**

To make these general truths more effective in practice, it is necessary that the stock-owning public be educated to a clearer idea of what are the true interests of the stockholders in such matters as:

- dividend policies,
- expansion policies, and
- the use of corporate cash to repurchase shares,

the various methods of compensating management, and the fundamental question of whether the owners' capital shall remain in the business or be taken out by them in whole or in part.
The management of *American Telephone and Telegraph Company* has repeatedly asserted that it considers itself a trustee for the interests of stockholders, employees and the public, in equal measure. A policy of this kind, if frankly announced and sincerely followed, can scarcely be criticized in the case of a quasi-civic enterprise. But given the ordinary business company, **the issue is more likely to be whether the management is acting as trustees for the stockholders or as trustees for the management.**

END

See case studies on the following pages to test your understanding and provoke your thinking.

Case Study #1: LandAmerica, Inc., a nation-wide title insurer both paid a dividend and bought back stock at over $70 per share and even close to $80 per share. The last 10-K and 10-Q filed before the company announced their insolvency are presented on the following pages. Can you describe how the company allocated capital? What decisions did management make? Management's incentive compensation was based on return on equity; how did that effect how the company's capital was managed? The company eventually had to file for bankruptcy due to the inability to fund its operations and repay debt. What might you have done differently if you were the CEO?


LFGRQ Daily
4/24/2009
110
100
90
80
70
60
50
40
30
20
10
0
Volume
© BigCharts.com
10
8
6
4
2
0
Millions
99
00
01
02
03
04
05
06
07
08
09

LANDAMERICA FINANCIAL GROUP, INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS, DECEMBER 31

(In millions)

	2007	2006
ASSETS		
INVESTMENTS:		
Fixed maturities available-for-sale – at fair value (amortized cost: 2007 – $1,005.3; 2006 – $1,267.2)	$ 1,019.1	$ 1,275.8
Equity securities available-for-sale – at fair value (cost: 2007 – $85.6; 2006 – $111.3)	81.1	129.8
Fixed maturities trading – at fair value	124.5	—
Federal funds sold	59.6	50.4
Short-term investments	160.3	403.0
Total Investments	1,444.6	1,859.0
CASH	98.2	82.5
LOANS RECEIVABLE	638.4	535.8
ACCRUED INTEREST RECEIVABLE	16.8	20.2
NOTES AND ACCOUNTS RECEIVABLE;		
Notes (less allowance for doubtful accounts: 2007 – $1.8; 2006 – $1.5)	22.7	19.3
Trade accounts receivable (less allowance for doubtful accounts: 2007 – $11.1; 2006 – $10.2)	127.9	139.2
Total Notes and Accounts Receivable	150.6	158.5
INCOME TAXES RECEIVABLE	22.7	60.4
PROPERTY AND EQUIPMENT—at cost (less accumulated depreciation and amortization: 2007 – $233.6; 2006 – $224.5)	133.4	164.2
TITLE PLANTS	102.4	105.0
GOODWILL	809.9	783.4
INTANGIBLE ASSETS (less accumulated amortization: 2007 – $100.1; 2006 – $78.2)	94.4	135.2
DEFERRED INCOME TAXES	120.1	84.1
OTHER ASSETS	222.2	186.5
Total Assets	$ 3,853.7	$ 4,174.8

	2007	2006
LIABILITIES		
POLICY AND CONTRACT CLAIMS	$ 876.5	$ 789.1
DEPOSITS	564.5	618.2

ACCOUNTS PAYABLE AND ACCRUED LIABILITIES	365.3	400.0
NOTES PAYABLE	579.5	685.3
DEFERRED SERVICE ARRANGEMENTS	199.9	218.6
OTHER	67.3	67.8
Total Liabilities	2,653.0	2,779.0
SHAREHOLDERS' EQUITY		
Common stock, no par value, 45,000,000 shares authorized, shares issued and outstanding: 2007 – 15,351,550; 2006 – 17,604,632	335.4	465.3
Accumulated other comprehensive loss	(26.2)	(32.2)
Retained earnings	891.5	962.7
Total Shareholders' Equity	1,200.7	1,395.8
Total Liabilities and Shareholders' Equity	$ 3,853.7	$ 4,174.8

LANDAMERICA FINANCIAL GROUP, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS
YEARS ENDED DECEMBER 31

(In millions, except per share amounts)

	2007	2006	2005
REVENUES			
Operating revenue	$ 3,569.4	$ 3,885.2	$ 3,853.6
Investment and other income, net	121.2	123.6	101.8
Net realized investment gains	15.2	7.1	4.2
	3,705.8	4,015.9	3,959.6
EXPENSES			
Agents' commissions	1,420.9	1,585.1	1,561.8
Salaries and employee benefits	1,146.9	1,182.7	1,118.3
General, administrative and other	783.7	731.8	676.6
Provision for policy and contract claims	288.5	231.3	197.2
Premium taxes	43.5	45.2	42.7
Interest expense	50.3	45.2	33.8
Amortization of intangible assets	21.9	25.9	28.8
Impairment of intangible and long-lived assets	25.3	14.7	39.1
Early extinguishment of debt	6.4	—	—
	3,787.4	3,861.9	3,698.3
(LOSS) INCOME BEFORE INCOME TAXES	(81.6)	154.0	261.3
INCOME TAX (BENEFIT) EXPENSE	(27.5)	55.2	95.7
NET (LOSS) INCOME	$ (54.1)	$ 98.8	$ 165.6
NET (LOSS) INCOME PER SHARE	$ (3.31)	$ 5.80	$ 9.45
WEIGHTED AVERAGE NUMBER OF SHARES OUTSTANDING	16.3	17.0	17.5

NET (LOSS) INCOME PER SHARE ASSUMING DILUTION	$	(3.31)	$	5.61	$	9.29
WEIGHTED AVERAGE NUMBER OF SHARES OUTSTANDING ASSUMING DILUTION		16.3		17.6		17.8

LANDAMERICA FINANCIAL GROUP, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS
YEARS ENDED DECEMBER 31

(In millions)

	2007	2006	2005
Cash flows from operating activities:			
Net (loss) income	$ (54.1)	$ 98.8	$ 165.6
Adjustments to reconcile net (loss) income to cash provided by operating activities:			
Depreciation and amortization	69.1	60.5	58.8
Amortization of bond premium	5.8	6.6	6.2
Impairment of intangible and long-lived assets	25.3	14.7	39.1
Early extinguishment of debt	6.4	—	—
Net realized investment gains	(15.2)	(7.1)	(4.2)
Net change in fair value of trading securities	20.5	—	—
Deferred income tax (benefit) expense	(38.5)	36.5	(27.8)
Loss on disposal of property and equipment	10.6	2.0	1.0
Change in assets and liabilities, net of businesses acquired:			
Accounts and notes receivable	21.4	(3.4)	(16.3)
Income taxes receivable/payable	30.9	(77.2)	65.3
Accounts payable and accrued expenses	(23.7)	(31.6)	62.7
Policy and contract claims	87.4	69.5	53.8
Deferred service arrangements	(18.7)	4.0	8.8
Other	(13.0)	5.3	9.5
Net cash provided by operating activities	114.2	178.6	422.5
Cash flows from investing activities:			
Purchases of title plants, property and equipment	(24.5)	(66.2)	(39.7)
Purchases of business, net of cash acquired	(27.7)	(213.1)	(24.0)
Change in short-term investments, net of businesses acquired	242.9	107.9	(208.1)
Cost of investments acquired:			
Fixed maturities available-for sale	(251.0)	(394.0)	(450.4)
Equity securities available-for sale	(83.0)	(66.6)	(77.0)
Proceeds from investment sales or maturities:			
Fixed maturities available-for-sale	359.6	314.3	366.1
Equity securities available-for sale	124.8	61.3	18.8
Net change in federal funds sold	(9.2)	(46.2)	0.3
Change in loans receivable	(108.6)	(98.4)	(94.1)
Other	(6.1)	14.4	(18.3)
Net cash provided by (used in) investing activities	217.2	(386.6)	(526.4)
Cash flows from financing activities:			
Net change in deposits	(53.7)	71.0	174.1
Proceeds from the exercise of options and incentive plans	2.8	1.4	7.9
Tax benefit of stock options exercised	1.8	1.2	—
Cost of shares repurchased	(143.6)	(40.1)	(64.0)
Dividends paid	(17.1)	(13.8)	(11.7)
Proceeds from issuance of notes payable	165.2	304.2	45.7
Payments on notes payable	(271.1)	(122.5)	(32.0)
Net cash (used in) provided by financing activities	(315.7)	201.4	120.0
Net increase (decrease) in cash	15.7	(6.6)	16.1
Cash at beginning of year	82.5	89.1	73.0

Cash at end of year	$ 98.2	$ 82.5	$ 89.1
Supplemental cash flow information:			
Non cash investing activities – transfer of fixed maturities from available-for-sale to trading	$ 142.6	$ —	$ —
Non cash financing activities – common shares issued for Capital Title merger	$ —	$ 49.7	$ —

LANDAMERICA FINANCIAL GROUP, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY
YEARS ENDED DECEMBER 31, 2007, 2006 AND 2005

(In millions, except per share amounts)

	Common Stock		Accumulated Other Comprehensive Income (Loss)	Retained Earnings	Total Shareholders' Equity
	Shares	Amounts			
BALANCE – December 31, 2004	18.0	$ 491.5	$ (17.6)	$ 723.8	$ 1,197.7
Comprehensive income:					
Net income	—	—	—	165.6	165.6
Other comprehensive loss					
Net unrealized loss on securities, net of tax benefit of $10.8	—	—	(20.1)	—	(20.1)
Pension liability adjustment, net of tax benefit of $2.6	—	—	(4.6)	—	(4.6)
					140.9
Purchase of call options, net of tax	—	(1.0)	—	—	(1.0)
Common stock retired	(1.1)	(64.0)	—	—	(64.0)
Stock options and incentive plans	0.4	16.6	—	—	16.6
Common dividends ($0.66/share)	—	—	—	(11.7)	(11.7)
BALANCE – December 31, 2005	17.3	443.1	(42.3)	877.7	1,278.5
Comprehensive income:					
Net income	—	—	—	98.8	98.8
Other comprehensive income (loss)					
Net unrealized gain on securities, net of tax expense of $(3.5)	—	—	6.1	—	6.1
Pension liability adjustment, net of tax expense of $(4.0)	—	—	8.4	—	8.4
SFAS 158 adoption adjustment, net of tax benefit of $2.7	—	—	(4.4)	—	(4.4)
					108.9
Common stock retired	(0.6)	(40.1)	—	—	(40.1)
Common stock issued	0.8	49.7	—	—	49.7
Stock options and incentive plans	0.1	12.6	—	—	12.6
Common dividends ($0.80/share)	—	—	—	(13.8)	(13.8)
BALANCE – December 31, 2006	17.6	465.3	(32.2)	962.7	1,395.8

Comprehensive loss:					
Net loss	—	—	—	(54.1)	(54.1)
Other comprehensive income (loss)					
Net unrealized loss on securities, net of tax benefit of $6.2	—	—	(11.2)	—	(11.2)
Postretirement benefits liability adjustment, net of tax expense of $(10.3)	—	—	17.5	—	17.5
Foreign currency translation	—	—	(0.3)	—	(0.3)
					(48.1)
Common stock retired	(2.5)	(143.6)	—	—	(143.6)
Stock options and incentive plans	0.2	13.7	—	—	13.7
Common dividends ($1.04/share)	—	—	—	(17.1)	(17.1)
BALANCE – December 31, 2007	15.3	$ 335.4	$ (26.2)	$ 891.5	$ 1,200.7

Last 10Q filed 11/2008

PART I. FINANCIAL INFORMATION

ITEM 1. CONSOLIDATED FINANCIAL STATEMENTS

LANDAMERICA FINANCIAL GROUP, INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS
(In millions)

	September 30, 2008 (Unaudited)	December 31, 2007
ASSETS		
INVESTMENTS:		
Fixed maturities available-for-sale - at fair value (amortized cost: 2008 - $749.2; 2007 - $1,005.3)	$ 724.0	$ 1,019.1
Equity securities available-for-sale - at fair value (cost: 2008 - $77.4; 2007 - $85.6)	70.7	81.1
Fixed maturities trading – at fair value	107.5	124.5
Federal funds sold	118.8	59.6
Short-term investments	235.5	160.3
Total Investments	1,256.5	1,444.6
CASH	63.2	98.2
LOANS RECEIVABLE	720.8	638.4
ACCRUED INTEREST RECEIVABLE	12.4	16.8
NOTES AND ACCOUNTS RECEIVABLE;		
Notes (less allowance for doubtful accounts: 2008 - $2.9; 2007 - $1.8)	20.0	22.7
Trade accounts receivable (less allowance for doubtful accounts: 2008 - $12.7; 2007 - $11.1)	103.7	127.9
Total Notes and Accounts Receivable	123.7	150.6
INCOME TAXES RECEIVABLE	33.7	22.7

PROPERTY AND EQUIPMENT - at cost (less accumulated depreciation and amortization: 2008 - $247.4; 2007 - $233.6)	108.9	133.4
TITLE PLANTS	101.4	102.4
GOODWILL	614.6	809.9
INTANGIBLE ASSETS (less accumulated amortization: 2008 - $115.1; 2007 - $100.1)	59.4	94.4
DEFERRED INCOME TAXES	-	120.1
OTHER ASSETS	230.5	222.2
Total Assets	$ 3,325.1	$ 3,853.7

	September 30, 2008 (Unaudited)	December 31, 2007
LIABILITIES		
POLICY AND CONTRACT CLAIMS	$ 982.5	$ 876.5
DEPOSITS	707.9	564.5
ACCOUNTS PAYABLE AND ACCRUED LIABILITIES	309.2	365.3
NOTES PAYABLE	569.4	579.5
DEFERRED SERVICE ARRANGEMENTS	184.4	199.9
OTHER LIABILITIES	86.4	67.3
Total Liabilities	2,839.8	2,653.0
SHAREHOLDERS' EQUITY		
Common stock, no par value, 45,000,000 shares authorized, shares issued and outstanding: 2008 - 15,476,306; 2007 – 15,351,550	339.2	335.4
Accumulated other comprehensive loss	(61.6)	(26.2)
Retained earnings	207.7	891.5
Total Shareholders' Equity	485.3	1,200.7
Total Liabilities and Shareholders' Equity	$ 3,325.1	$ 3,853.7

LANDAMERICA FINANCIAL GROUP, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS
THREE MONTHS AND NINE MONTHS ENDED SEPTEMBER 30, 2008 AND 2007
(In millions, except per share amounts)
(Unaudited)

	Three Months Ended September 30, 2008	Three Months Ended September 30, 2007	Nine Months Ended September 30, 2008	Nine Months Ended September 30, 2007
REVENUE				
Operating revenue	$ 630.1	$ 874.0	$ 1,974.1	$ 2,756.8
Investment and other income	20.9	26.6	77.9	89.0
Net realized investment (losses) gains	(19.2)	6.2	(21.4)	14.6
	631.8	906.8	2,030.6	2,860.4
EXPENSES				
Agents' commissions	277.3	357.4	825.1	1,062.4
Salaries and employee benefits	197.2	272.2	636.9	896.0
General, administrative and other	214.5	196.1	526.4	580.2
Provision for policy and contract claims	132.9	80.4	288.9	221.6
Depreciation and amortization	15.8	16.5	47.2	52.3
Interest expense	13.1	12.6	37.4	36.5
Impairment of intangible and long-lived assets	224.9	-	224.9	20.8
	1,075.7	935.2	2,586.8	2,869.8
LOSS BEFORE INCOME TAXES	(443.9)	(28.4)	(556.2)	(9.4)
INCOME TAX EXPENSE (BENEFIT)	155.7	(7.6)	117.6	(1.2)
NET LOSS	$ (599.6)	$ (20.8)	$ (673.8)	$ (8.2)
NET LOSS PER SHARE	$ (39.45)	$ (1.28)	$ (44.33)	$ (0.49)
WEIGHTED AVG NUMBER OF SHS. OUTSTANDING	15.2	16.2	15.2	16.7
NET LOSS PER SHARE ASSUMING DILUTION	$ (39.45)	$ (1.28)	$ (44.33)	$ (0.49)
WEIGHTED AVERAGE NUMBER OF SHARES OUTSTANDING ASSUMING DILUTION	15.2	16.2	15.2	16.7
CASH DIVIDENDS DECLARED PER SHARE	$ 0.05	$ 0.30	$ 0.65	$ 0.74

LANDAMERICA FINANCIAL GROUP, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS
NINE MONTHS ENDED SEPTEMBER 30, 2008 AND 2007
(In millions)
(Unaudited)

	2008	2007
Cash flows from operating activities:		
Net loss	$ (673.8)	$ (8.2)
Adjustments to reconcile net loss to cash provided by operating activities:		
Depreciation and amortization	47.2	52.3
Amortization of bond premium	3.0	4.7
Impairment of intangible and long-lived assets	224.9	20.8
Net realized investment losses (gains)	21.4	(14.6)
Net change in fair value of trading securities	8.5	5.4
Deferred income tax (benefit)	193.0	(29.7)
Change in assets and liabilities, net of businesses acquired:		
Accounts and notes receivable	23.7	(6.2)
Income taxes receivable/payable	(83.8)	60.0
Accounts payable and accrued expenses	(47.4)	(57.0)
Pending trades of trading securities, net	(3.1)	(1.0)
Policy and contract claims	106.0	73.2
Deferred service arrangements	(15.5)	(14.1)
Other	24.4	(1.6)
Net cash (used in) provided by operating activities	(171.5)	84.0
Cash flows from investing activities:		
Purchases of title plant, property and equipment	(15.3)	(15.2)
Purchases of businesses, net of cash acquired	(3.7)	(27.1)
Change in short-term investments	(75.5)	237.1
Cost of investments acquired:		
Fixed maturities available-for-sale	(165.6)	(226.6)
Equity securities available-for-sale	(28.6)	(65.3)
Proceeds from investment sales or maturities:		
Fixed maturities available-for-sale	418.6	304.1
Equity securities available-for-sale	27.1	73.2
Net change in federal funds sold	(59.2)	46.6
Change in loans receivable	(83.1)	(71.5)
Other	(0.4)	(3.2)
Net cash provided by investing activities	14.3	252.1
Cash flows from financing activities:		
Net change in deposits	143.4	(120.3)
Proceeds from the exercise of stock options and incentive plans	-	2.8
Tax benefit of stock options exercised	-	1.8
Cost of shares repurchased	-	(126.7)
Dividends paid	(10.0)	(12.5)
Proceeds from issuance of notes payable	99.7	37.2
Payments on notes payable	(109.9)	(136.0)
Deferred financing costs	(1.0)	-
Net cash provided by (used in) financing activities	122.2	(353.7)
Net decrease in cash	(35.0)	(17.6)
Cash at beginning of period	98.2	82.5
Cash at end of period	$ 63.2	$ 64.9
Supplemental cash flow information:		
Non-cash investing activities – transfer of fixed maturities from available-for-sale to trading	$ -	$ 142.6

LANDAMERICA FINANCIAL GROUP, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY
NINE MONTHS ENDED SEPTEMBER 30, 2008 AND 2007
(In millions, except per share amounts)
(Unaudited)

	Common Stock Shares	Common Stock Amounts	Accumulated Other Comprehensive Income (Loss)	Retained Earnings	Total Shareholders' Equity
BALANCE – December 31, 2006	17.6	$ 465.3	$ (32.2)	$ 962.7	$ 1,395.8
Comprehensive loss:					
Net loss	-	-	-	(8.2)	(8.2)
Other comprehensive (loss) income, net of tax:					
Net unrealized loss on securities	-	-	(11.9)	-	(11.9)
Postretirement benefits liability adjustment	-	-	5.4	-	5.4
					(14.7)
Common stock retired	(2.0)	(126.7)	-	-	(126.7)
Stock options and incentive plans	0.2	12.4	-	-	12.4
Common dividends ($0.74/share)	-	-	-	(12.5)	(12.5)
BALANCE – September 30, 2007	15.8	$ 351.0	$ (38.7)	$ 942.0	$ 1,254.3
BALANCE – December 31, 2007	15.3	$ 335.4	$ (26.2)	$ 891.5	$ 1,200.7
Comprehensive loss:					
Net loss	-	-	-	(673.8)	(673.8)
Other comprehensive (loss) income, net of tax:					
Net unrealized loss on securities	-	-	(41.8)	-	(41.8)
Postretirement benefits liability adjustment	-	-	8.4	-	8.4
Foreign currency translation	-	-	(2.0)	-	(2.0)
					(709.2)
Stock options and incentive plans	0.2	3.8	-	-	3.8
Common dividends ($0.65/share)	-	-	-	(10.0)	(10.0)
BALANCE – September 30, 2008	15.5	$ 339.2	$ (61.6)	$ 207.7	$ 485.3

Case Study #2: Conflicting Shareholder Needs Regarding Share Buybacks.

An activist investment fund may pressure a company to increase its debt load and use the resulting cash to complete a stock buyback or issue a special shareholder dividend. Those kinds of dissident demands place a spotlight on fundamental differences between institutions and activist hedge funds. "Activist shareholders might have different time horizons and different objectives than other investors, particularly institutional investors that often can not buy or sell their stakes," says the *U.S. Chamber of Commerce's David Chaven.*

Chavern points out that observers have to be careful not to immediately draw parallels between the interests of activist hedge fund and institutions. While an activist may want to press for a short-term cash out, such as a special dividend or stock buyback, most institutions have much longer investment horizons to consider, and worry about what removal of cash and passive securities reserves will mean for the future of the corporation. Many institutions may prefer to have that cash remain on the balance sheet, ready to be reinvested in the company at an appropriate time or used to buy a critical asset that may be available only at a later date. "The quick return of a stock buyback can be fleeting and not worthwhile for many investors that have a much bigger picture, long term outlook," Chavern says.

The *University of Delaware's Charles Elson* puts it even more strongly. Corporate cash on the balance sheet in many cases can be used for better things than the stock buybacks typically sought by activist hedge funds, he says. In many cases, corporations hold that cash, anticipating specific expenses that need to be paid for in the short-term. "Having a stock buyback or special dividend paid to investors is probably not in the long-term interest of most institutional investors," Elson says. *(To learn more about Mr. Elson and governance of corporate boards with many other useful links go to http://www.be.udel.edu/ccg/InterestingLinks.htm)*

But to the possible detriment of the long-term investment plans of institutions, companies have been making more stock buybacks than ever before. According to the Standard & Poor's (S&P) 500 Stock Index, a listing of large publicly held corporation, executives approved roughly $432 billion in stock buybacks in 2006, up from $349 billion in 2005 and $131 billion in 2003.

Howard Silverblatt, an analyst at S&P, points out that the dramatic increase in stock buybacks and short term returns in recent years can be attributed in part to the surge in activist hedge fund managers' pressing companies to complete recapitalizations. But, he adds, other institutions have also contributed to that phenomenon. "A lot of times companies that are under pressure for M&A by institutions and activist will agree to a stock buyback in the short-term as a compromise to increase share growth instead of a merger or other transaction," Silverblatt says.

In 2004 and parts of 2005, *Charles Jones*, the CEO of Toronto-based enterprise software business *GEAC*, found himself the target of a Greenwich, Connecticut-based activist investor *(Silver Point Capital)* who was pressing for just that kind of stock buyback. The activist wanted the company raise its debt levels and use the proceeds and its cash on hand to buy back shares.*

In response, Jones immediately began his own campaign targeted at engaging the institutions that owned stakes in *GEAC*. He explained to them that much of the company's cash reserves were the result of its customers paying advance payments at the beginning of the year. That <u>cash</u>, Jones says, was reserved to pay for customer maintenance and service. In essences, the presence of a large amount of cash on the balance sheet was an illusion, because by the end of the year it typically was gone. Getting rid of the cash would hurt the company in the long term as it struggled to find cash to fund routine maintenance and service costs. **This was a situation that the insurgent either was not aware of or didn't care about because by the time the stock buyback was completed they would have been gone, leaving the company and its longer-term investors in a mess of trouble.** Jones's campaign was successful. The institutions ultimately didn't support the activist's efforts. "We were not going to solve our strategic long-term value problem by buying back shares," Jones says. "It would have been great for the activist because would have left with the additional value, but all the other institutional investors would have been left with a hard future."[10]

**Editor*: Whether a company should buy back shares is dependent upon a host of issues. If the company buys back stock, the first consideration is whether the shares are <u>below</u> intrinsic value. To determine intrinsic value, the analyst must understand the company within its industry well enough to assess the competitive position of the company and what are the true capital requirements and other uses of surplus cash (or borrowing capacity) to normalize earnings. In this real-life example, if *GEAC* bought back its stock (even if it had "surplus cash"), the

[10] <u>Extreme Value Hedging: How Activist Hedge Fund Managers Are Taking On The World</u> by Ronald D. Orol (2008)

company might have reduced its attractiveness in being acquired at a premium and/or reduced its financial flexibility to be able to take advantage of a consolidating industry. Many corporate finance decisions have trade-offs and are neither black nor white. *GEAC* was eventually acquired at a premium to its public market price. See article on next page.

Silver Lake Partners request for the company to buyback shares would have made an acquisition more difficult because of the following factors:

- Share repurchase can divert shares away from another bidder. Once *GEAC* acquired shares there would be fewer for another buyer.
- Share repurchases can divert shares away from arbitrageurs who can be of assistance to a bidder because they acquire shares with the explicit purpose of earning high returns by selling them to the highest bidder.
- The acquisition of the target's (*GEAC*) own shares can allow *GEAC* to use up its own resources to reduce its cash or *GEAC* can use up its borrowing capacity making the acquisition process more difficult.
- The acquisition of shares can be a necessary first stop in implementing a white squire defense. If the target has enough SEC-authorized shares available, it must first acquire them through share repurchases.[11]

However, with fewer shares outstanding withdrawn from the market it may be easier for a hostile acquirer to obtain control because the bidder has to buy a smaller number of shares to acquire 51% of the target. A solution to this dilemma is to use targeted share repurchases. This strategy takes the shares out of the hands of those who would most likely sell them to the hostile bidder. If, at the same time, these shares are placed in friendly hands, the strategy can be successful. For example, in 1984 when *Carter Hawley* combined a buyback of 17.5 million shares in 1984 with a sale of stock to *General Cinema Corporation*, it was implementing a similar strategy to prevent *The Limited* from obtaining control of *Carter Hawley Hale*.

A target can implement a share repurchase plan in three ways:

1. General non-targeted purchase
2. Targeted share repurchases
3. Self-tender offer.

News Story: Monday, November 07, 2005 5:50:00 PM

Abstract: ERP company receives sizable markup on its per-share price, cites industry consolidation and all-cash deal as reasons for sale.

Geac Computer Corp., a developer of enterprise resource planning and other software, said today that it has agreed to be acquired for $1 billion by the private equity firm that also backs Infor Global Solutions (Alpharetta, GA), a software company that has acquired more than a dozen applications providers in the past two years.

During a conference call today, *Geac* president and chief executive Charles S. Jones said that more than 25 companies had bid for *Geac*, with five entering a "confidentiality" stage in the process. The winning bidder was *Golden Gate Capital*, a San Francisco-based private equity firm that has funded *Infor* and several other software companies.

The price for *Geac*, which claims that 18,500 organizations use its various software product lines, is $11.10 per share, or $1 billion, a 27% premium over the $8.77 share price as of last Friday. The deal requires regulatory approval as well as an affirmative vote by two-thirds of *Geac* shareholders. *Geac* is based in Markham, Ontario, Canada.

[11] Mergers, Acquisitions, and Corporate Restructurings, Second Edition by Patric A. Gaughan (1999) pages 226-227.

Jones said there were a number of reasons for the sale to *Golden Gate*. He cited the all-cash nature of the acquisition, the premium over the share price and industry consolidation. He said that in order for *Geac* to continue to grow it would have had to acquire additional companies.

Judy Sweeney, a research director at *AMR Research*, said the acquisition part of *Geac*'s strategy was becoming problematic. "The whole *Geac* model was built on acquisition," Sweeny said in an interview. "They were finding it harder and harder, and they were watching revenues decline. They still had cash in the bank and wanted to cash out at a premium rather than wait."

In its first fiscal quarter 2006, *Geac* had revenues of $103.7 million, down from $106.9 million in the like 2005 fiscal period. Net income was $11.3 million, down from $13.5 million. At the end of the first quarter, *Geac* had $192 million in cash, which will be used to help finance the acquisition by Golden Gate.

Upon completion of the acquisition, which *Geac* said it expects in the first quarter of calendar 2006, some *Geac* products will be transferred to Infor, and the rest of the company will be reorganized into two separate Golden Gate Capital portfolio units.

Infor will acquire five ERP product lines. They are: System21, which is designed for the mid-market; *s*, a German ERP product; Streamline, a Microsoft technology-based product for the small and medium-size market; Runtime, an IBM iSeries-based line, and Management Data, described as a services offering.

Geac's financial applications as well as its industry-specific software products will be organized as two business groups under a new Golden Gate company preliminarily called NEWCO. One unit will house financial applications, including *Geac*'s Enterprise Server, SmartStream, Anael, Extensity and Comshare products. The other will handle *Geac*'s products for local government, restaurants and libraries, among others.

Infor, which has acquired such companies as Brain, Lilly and MAPICS, stands to add between 1,800 and 2,000 customers as a result of the acquisition, said Infor president and chief operating officer Ken Walters. Infor, which closed its fiscal year on May 30 with $360 million in revenue, currently has about 17,500 customers.

In an interview, Walters said that the addition of *Geac*'s product lines supports Infor's vertical market strategy in manufacturing and distribution. "We will be very consistent with what we've done in the past," Walters said. "We will continue to support and develop the *Geac* products and look at ways to leverage them in geographies and vertical markets."

Walters also said he was particularly excited about the addition of the Runtime iSeries-based product, which provides ERP as well as product lifecycle management and product data management capabilities to the apparel industry. The Runtime product line, he said, integrates with *Geac*'s System21 line and also is a fit with a segment of the former Brain customer base.

Walters estimated that the addition of the *Geac* products will result in Infor having about a $300 million business in iSeries-related software, which will be a challenge to such other iSeries software competitors as SSA Global and Oracle. "We are going to rival anyone for the top," he said.

Infor will also look at ways to leverage the *Geac* products with Corestone, its standards-based development and integration environment announced in June. Walters said he would announce "a clear product roadmap" for the *Geac* products after the acquisition is completed.

***GEAC* Computer Corp. Press Release: SAN FRANCISCO, California, MARKHAM, Ontario and WALTHAM, Massachusetts** – November 7, 2005 – Golden Gate Capital, a private equity firm focused on investing in high-growth businesses in change intensive industries, and *Geac* Computer Corporation Limited (TSX:

GAC and NASDAQ: *GEAC*) today announced that they have reached a definitive agreement for Golden Gate Capital to acquire *Geac* in an all-cash transaction valued at US$11.10 per share (which, based on Friday's Bank of Canada exchange rate, was CDN$13.11), or approximately US$1.0 billion, pursuant to a plan of arrangement.

Commenting on the transaction, Charles S. Jones, President and CEO of *Geac* said, "Today's announcement provides outstanding opportunity for all of our key stakeholders. For shareholders, we have achieved an offered price of US$11.10, a per share value which represents a 27.0% premium over Friday's trading price and a 38.7% premium to enterprise value. For our customers and employees, this proposed transaction and the resources available through it provide a long-term future for our business. *Geac* has capitalized on its industry-specific focus and expertise in the Manufacturing, Government, Financial Services, Healthcare and Retail sectors. Our vertical market success should be enhanced by the current initiatives and momentum within the Golden Gate portfolio." With today's transaction price, *Geac*'s share price, in US dollar terms, has increased by nearly 276.0%, since Mr. Jones became Chairman of the company five years ago, compared to the NASDAQ Index Composite decrease of 38.6% and the TSX Index increase of 6.8%, during the same period. "At the annual meeting, we noted the most important trend in our industry is consolidation. This economic paradigm cannot be ignored. The unique combination of our business with several of Golden Gate's software investments provides the extraordinary opportunity to deliver the greatest value to each and every stakeholder group. Importantly, success in the software industry today derives from the strength of size and scale – the scale to invest in new products, in marketing and in a global sales force," Mr. Jones continued.

"The technology businesses we acquire are carefully selected based on their growth potential and ability to deliver vertically specific enterprise software offerings and deep market expertise to their customers. Golden Gate Capital views *Geac* as a natural addition to this successful strategy," said *David Dominik*, Managing Director of *Golden Gate Capital*, which has more than $2.5 billion under management. "*Golden Gate Capital* looks at acquisitions with a different perspective than most private equity firms. We seek to integrate companies that can grow significantly faster together than they could on their own. This strategy has been implemented successfully by *Concerto/Aspect Software*, *AttachmateWRQ*, *Inovis* and *Infor*. We will aggressively support the *Geac* business units with our 'assembler' acquisition strategy. Upon completion of the acquisition, *Geac* will be reorganized into two separate *Golden Gate Capital* portfolio companies."

Jones also noted that one of *Geac*'s largest shareholders, *Crescendo Partners*, has expressed its full support for this transaction and has agreed to vote in favor of the plan of arrangement. *Eric Rosenfeld*, President and CEO of *Crescendo Partners*, is a member of *Geac*'s Board of Directors.

Case Study #3 Westwood One's Share Buybacks *(Source: Active Value Investing pages 110-111 by Vitaly N. Katsenelson—I highly recommend this book)*

Westwood One (WWON-OTB) is an example of a company that bought back stock at a high valuation and for the wrong reasons.

"Westwood One is a creator of content like traffic updates and radio shows, selling the content to both terrestrial and satellite radio stations. It showed little revenue growth from 2001 to 2005. Actually, little doesn't do it justice—there has been zero revenue growth since 2002. In real terms (after inflation), revenues actually declined.

Instead of reinvesting money and growing the business, Westwood One bought back stock as if it was going out of style *(Westwood bought back stock over the past ten years—obviously at prices above intrinsic value)*. Unfortunately, the stock itself has been declining for a while, from $35 (a P/E of 35) in 2002 to $7 in January (a P/E of 13), and earnings also declined over that time. Sadly, the company was buying the stock all the way from the top to the bottom, paying an incredibly high P/E multiple in the process.

I can understand when a company buys back undervalued stock and it subsequently gets cheaper; timing those things is difficult. However, buying back stock that is trading at a high valuation—and, I would argue that 25 to 35 times earnings is high, especially for a company that isn't growing revenues—and leveraging its balance sheet (debt increased from $232 million to $406 million by Sept. 2006) to support those purchases shows management misallocation of capital. All EPS growth from 2002 to the first half of 2006 came from share buybacks—none of it was organic (until the earnings took a dive in the second half of 2006).

I can not fault management for this no-growth company's ridiculous prior valuation; investors had everything to do with that. But I can fault management for buying back stock at very high valuations, instead of reinvesting earnings to grow its core business or paying a dividend (the company started to pay a dividend only in 2005). (See full article after the case data on pages 44-45)"
--

Suggestions for Case: on the next few pages are the financial summary and management discussion from *Westwood One*. Do you agree or disagree with the analysis provided above? Would you as the CEO of this company invested more in the business? What analysis would you need to do in determining whether to invest in the business? Has management in their discussion explained the reasons for the buyback of shares? Is the disclosure adequate? Why or why not?

Item 6. Selected Financial Data from the Dec. 31, 2006 10-K Westwood One, Inc.

(In thousands except per share data)

	2006	2005(1)	2004(1)	2003(1)	2002(1)
OPERATING RESULTS FOR YEAR ENDED DECEMBER 31:					
Net Revenues	$ 493,995	$ 557,830	$ 562,246	$ 539,226	$ 550,751
Operating and Corporate Costs, Excluding Depreciation and Amortization and Goodwill Impairment	393,303	393,026	392,693	371,206	373,577
Goodwill Impairment	515,916	—	—	—	—
Depreciation and Amortization	20,756	20,826	18,429	11,513	11,464
Operating (Loss) Income	(435,980)	143,978	151,124	156,507	165,710
Net (Loss) Income	$ (469,453)	$ 77,886	$ 86,955	$ 91,983	$ 101,717
(Loss) Income Per Basic Share					
Common stock	$ (5.46)	$ 0.86	$ 0.90	$ 0.91	$ 0.97
Class B stock	$ 0.26	$ 0.24	$ —	$ —	$ —
(Loss) Income Per Diluted Share					
Common stock	$ (5.46)	$ 0.85	$ 0.88	$ 0.86	$ 0.93
Class B stock	$ 0.26	$ 0.24	$ —	$ —	$ —
Dividends Declared					
Common stock	$ 0.32	$ 0.30	$ —	$ —	$ —
Class B stock	$ 0.26	$ 0.24	$ —	$ —	$ —
BALANCE SHEET DATA AT DECEMBER 31:					
Current Assets	$ 149,222	$ 172,245	$ 174,346	$ 165,495	$ 153,628
Working Capital	29,313	72,094	93,005	86,484	68,314
Total Assets	696,701	1,239,646	1,262,495	1,280,737	1,281,205
Long-Term Debt	366,860	427,514	359,439	300,366	232,135

Total Shareholders' Equity	202,931	704,029	800,709	859,704	922,705

Management discussion of:

Earnings per share

Weighted average shares outstanding for purposes of computing basic earnings per Common share were 86,013,000, 90,714,000 and 96,722,000 in 2006, 2005 and 2004, respectively. The decreases in each of the previous two periods were primarily attributable to Common stock repurchases under the Company's stock repurchase program partially offset by additional share issuances as a result of stock option exercises. Weighted average shares outstanding for purposes of computing diluted earnings per Common share were 86,013,000, 91,519,000 and 99,009,000 in 2006, 2005 and 2004, respectively. The changes in weighted average diluted Common shares are due principally to the decrease in basic shares and the effect of the decrease in the Company's share price, partially offset by the effect of stock option and restricted stock unit grants. Weighted average shares outstanding for purposes of computing basic and diluted earnings per Class B share were 292,000 in 2006 and 2005 and 395,000 in 2004. The decrease in weighted average Class B shares from 2004 to 2005 reflects the conversion of Class B shares to Common shares in 2004.

Liquidity and Capital Resources

The Company continually projects anticipated cash requirements, which include share repurchases, dividends, potential acquisitions, capital expenditures, and principal and interest payments on its outstanding and future indebtedness. Funding requirements have been financed through cash flow from operations and the issuance of long-term debt.

At December 31, 2006, the Company's principal sources of liquidity were its cash and cash equivalents of $11,528 and available borrowings under its bank facility as further described below.

The Company has and continues to expect to generate significant cash flows from operating activities. For the years ended December 31, 2006, 2005 and 2004, net cash provided by operating activities were $104,251, $118,290 and $117,456, respectively. The decrease in 2006 is primarily attributable to a decrease in net income, offset by changes in working capital. For 2005, the increase is primarily attributable to a decrease in cash taxes paid resulting from higher tax benefits from the exercise of stock options in 2005.

On October 31, 2006 the Company amended its existing senior loan agreement with a syndicate of banks led by JP Morgan Chase Bank and Bank of America. The facility, as amended, is comprised of an unsecured five-year $120,000 term loan and a five-year $150,000 revolving credit facility which shall be automatically reduced to $125,000 effective September 28, 2007 (collectively the "Facility"). In connection with the original closing of the Facility on March 3, 2004, the Company borrowed the full amount of the term loan, the proceeds of which were used to repay the outstanding borrowings under a prior facility. As of December 31, 2006, the Company had available borrowings of $100,000 under the Facility. Interest on the Facility is variable and is payable at a maximum of the prime rate plus an applicable margin of up to .25% or LIBOR plus an applicable margin of up to 1.25%, at the Company's option. The applicable margin is determined by the Company's Total Debt Ratio, as defined. The Facility contains covenants relating to dividends, liens, indebtedness, capital expenditures and restricted payments, as defined, interest coverage and leverage ratios. The Company also has issued, through a private placement, $150,000 of ten year Senior Unsecured Notes due November 30, 2012 (interest at a fixed rate of 5.26%) and $50,000 of seven year Senior Unsecured Notes due November 30, 2009 (interest at a fixed rate of 4.64%). In addition, the Company entered into a seven-year interest rate swap agreement covering $25,000 notional value of its outstanding borrowing to effectively float the interest rate at three-month LIBOR plus 74 basis points and two ten-year interest rate swap agreements covering $75,000 notional value of its outstanding borrowing to effectively float the interest rate at three-month LIBOR plus 80 basis points. In total, the swaps cover $100,000 which represents 50% of the notional amount of Senior Unsecured Notes. The Senior Unsecured Notes contain covenants relating to dividends, liens, indebtedness, capital expenditures, and interest coverage and leverage ratios. None of the Facility or Senior Unsecured Note covenants are expected to have an impact on the Company's ability to operate and manage its business.

In conjunction with the Company's objective of enhancing shareholder value, the Company's Board of Directors authorized a stock repurchase program in 1999. Most recently, on April 29, 2005, the Company's Board of Directors authorized an additional $300,000 for such stock repurchase program, which gave the Company, as of April 29, 2005, authorization to repurchase up to $402,023 of its Common stock. Under its stock repurchase program, the Company purchased approximately: 750,000 shares of the Company's Common stock, at a total cost of $11,044, in 2006; 8,015,000 shares of the Company's Common stock, at a total cost of $160,604, in 2005 and 8,456,000 shares of the Company's Common stock, at a total cost of $216,503, in 2004. The Company has not repurchased any of its Common stock since February 2006. At the end of December 2006, the Company had authorization to repurchase up to an additional $290,490 of its Common stock.

On April 29, 2005, the Board of Directors declared the Company's first cash dividend of $0.10 per share of issued and outstanding Common stock and $0.08 per share of issued and outstanding Class B stock. The Board declared additional dividends for all issued and outstanding Common stock and Class B stock on the same terms on August 3, 2005 and November 2, 2005. Dividend payments totaling $27,032 were made in 2005. On February 2, 2006, April 18, 2006 and August 7, 2006, the Company's Board of Directors declared cash dividends of $.10 per share for every issued and outstanding share of Common stock and $.08 per share for every issued and outstanding share of Class B stock. On November 7, 2006, the Company's Board of Directors declared a cash dividend of $0.02 per share for every issued and outstanding share of Common stock and $0.016 per share for every issued and outstanding share of Class B stock. Dividend payments totaling $27,640 were made in 2006.

The Company's business does not require, and is not expected to require, significant cash outlays for capital expenditures.

The Company believes that its cash, other liquid assets, operating cash flows, ability to cease issuing a dividend, and existing and available bank borrowings, taken together, provide adequate resources to fund ongoing operations relative to its current expectations, organizational structure, and operating agreements. If the assumptions underlying our current expectations regarding future revenues and operating expenses change, or if unexpected opportunities arise or strategic priorities change, we may need to raise additional cash by future modifications to our existing debt instruments or seek to obtain replacement financing. The Company's ability to obtain, if needed, amendments to its existing financing or replacement financing may be impacted by the timing of the Company's ability, if at all, to extend its relationship or operating arrangements with CBS Radio beyond March 31, 2009.

END of Westwood One's 10-K Management Discussion.

Westwood One to Avoid: http://www.fool.com/investing/high-growth/2006/04/06/westwood-one-to-avoid.aspx

Vitaliy Katsenelson, CFA April 6, 2006

The value guy in me always awakens when I see a stock scratching at multiyear lows, and **Westwood One** (NYSE: WON) piqued my interest a couple of weeks ago. It declined from more than $30 two years ago to around $11 today, trading at about 11 times 2006 earnings. That's cheap -- but is it cheap enough?

At first, the company seemed very appealing: It pays a nice 3.7% dividend, and its small capital expenditures help it generate a lot of free cash flow. In addition, **Sirius** (Nasdaq: SIRI) and **XM Satellite Radio** (Nasdaq: XMSR) are its friends, not foes. Westwood One doesn't own radio stations; it creates content like traffic updates and Jim Cramer's radio show, selling those shows to both terrestrial and satellite radio stations.

However, a deeper look at the company makes me think that it may be cheap for two good reasons:

1. Westwood One has showed little revenue growth over the last five years. Actually, "little" doesn't do it justice -- there's been *zero* revenue growth since 2002. In real terms (after inflation), revenues actually declined.
2. Instead of reinvesting money and growing the business, Westwood One bought back stock as if it was going out of style. Unfortunately, the stock itself has been going out of style over the last five years, declining from more than 35 times earnings in 2002 to today's P/E of 11. Sadly, the company was buying the stock all the way from the top to bottom, paying an incredibly high P/E multiple in the process.

A vexing valuation
I can understand when a company buys back undervalued stock and it subsequently gets cheaper; timing those things is very difficult. However, buying back stock that's trading at a very high valuation -- and I'd argue that 25-35 times earnings is high, especially for a company that isn't growing revenues -- and leveraging its balance sheet to support those purchases shows management's disregard for shareholders. All earnings-per-share growth since 2002 came from share buybacks -- none of it was organic.

I cannot fault management for this no-growth company's ridiculous prior valuation; investors had everything to do with that. But I *can* fault management for buying back stock at very high valuations, instead of reinvesting earnings to grow its core business, or paying a nice fat dividend. (The company only started to pay a dividend in 2005.)

How much do you pay for this kind of business? Today's valuation assumes absolutely no growth of cash flows -- none! However, in the last quarter, revenue declined 3%. Management has blamed many external factors for stealing advertising dollars and audiences' interest. That's the favorite song management sings when it doesn't want to take responsibility for its actions (or lack thereof).

In addition, Westwood One executives noted that the absence of political advertising in the last quarter created tough comparisons with the presidential election year of 2004 - the Super Bowl of radio advertising. Judging by historical revenue performance, revenue does decline in odd (non-election) years between 2%-8%, at least partly supporting management's claim. Management also mentioned that it is investing in new shows that have not yet reached the economy of scale necessary to boost revenues.

Will the growth come back? The good news for Westwood One -- and bad news for the rest of us -- is that political advertising will make a comeback with the 2006 midterm elections. But it will only bring revenues up to par, rather than driving long-term growth.

Advertising adversity
Westwood One's cousins in the newspaper business are facing similar troubles. Despite a readership that was slowly vanishing into the abyss of the Internet, firms like **Gannett** (NYSE: GCI) and **Knight Ridder** (NYSE: KRI) were previously able to raise advertising prices. Revenue growth from those higher ad rates helped to mask the gradual deterioration in the underlying business, as advertisers gradually paid more for fewer readers. Westwood One was not so lucky; radio is a more competitive market, especially in national advertising, where Westwood One has a large presence. That limited the company's pricing flexibility.

The old joke in the advertising industry is that half of the money spent on advertising is wasted -- but nobody knows which half. Unfortunately for media companies, corporate America is enjoying all-time high profit margins, and they want to hold onto them as long as possible. Companies are desperately trying to figure out which half of their advertising spending is wasted. **Procter & Gamble**'s (NYSE: PG) plans to cut its TV advertising budget speak volumes; P&G is one of the United States' savviest marketing companies, and other corporations will likely follow its lead and rationalize their ad spending.

The advertising pie's growth is slowing down, even as it's being sliced into smaller pieces by a relatively new breed of competition: **Google** (Nasdaq: GOOG), **Yahoo!** (Nasdaq: YHOO), and a small army of Internet portals and search engines, most of which didn't even exist a decade ago. Google's revenues went from $439 million in 2002 to $6.1 billion in 2005; if not for Google or Yahoo!, most of this money would have flown to Westwood One, Gannett, and the rest of the media pack.

The story only gets worse. Though we have two ears but can only listen to one thing at a time, in the future, we will be listening to more prerecorded podcasts from the Internet, ad-free satellite radio, and tunes stored on media players like **Apple**'s iPod. None of these will help the growth of the radio-advertising pie.

Foolish bottom line
Westwood One's revenues may receive a short-term boost from political advertising, the speculation of a takeover may spark interest in the stock, or a hedge fund may try to right this ship by taking it private. Nonetheless, long-term revenue growth is suspect at this point. The company believes that new radio shows should fuel its growth, but history and recent events aren't on its side.

I believe long-term revenue growth is very unlikely. Management should admit to shareholders and itself that growth has left the building, and focus instead on creating shareholder value by increasing the dividend, cutting costs, and managing the company as a cash cow. The new CEO appointed in December 2005 may shake things up, but I'll believe it when I see it. Westwood One may appear to be cheap, but it's cheap for the right reasons.

Editor: The misallocation of capital—including a buy-back of a company's own shares-- in a declining business is lethal as shown below in the chart of Westwood One, Inc. Pundits might call the chart below an example of a "value trap" which is a company that seems "cheap" on historical metrics but those metrics turn out to be a lure for the unwary investor who doesn't grasp the decline in the business or the amount of wealth destruction from prior management actions.

Case Study #4 Teledyne Corporation and Dr. Henry Singleton

Due to the length of the case please go here: www.csinvesting.wordpress.com and search for Teledyne to access this case.

Suggested additional readings:

Clear Thinking about Share Repurchase: Capital Allocation, Dividends, and Share Repurchase. Why Buybacks are so Important Now by Michael Mauboussin, January 10, 2006. Go to: **http://www.lmcm.com/pdf/ClearThinkingAboutShareRepurchase.pdf**

Mind Matters: Investment Myth Busting: Repurchase Rip-offs, March 16, 2009 by James Montier. *This article describes how managements have tended in the past decade 1999 – 2009* ***to increase share buybacks at cyclical earnings peaks and decreasing buyback at earnings troughs.*** *This research would tend to confirm Mr. Buffett's comment that often share buybacks recently (1999) have not been wealth enhancing for shareholders.—Editor.*

Warren Buffett on stock buy backs

January 26, 2009 by greenbackd

Warren Buffett took the opportunity Friday to lend his considerable intellectual weight to the debate about buy backs, saying, "I think if your stock is undervalued, significantly undervalued, management should look at that as an alternative to every other activity."

We've been banging the drum for buy backs quite a bit recently. We wrote on Friday that they represent the lowest risk investment for any company with undervalued stock and we've written on a number of other occasions about their positive effect on *per share* value in companies with undervalued stock.

In a *Nightly Business Report* interview with Susie Gharib, Buffett discussed his view on stock buy backs:

Susie Gharib: What about Berkshire Hathaway stock? Were you surprised that it took such a hit last year, given that Berkshire shareholders are such buy and hold investors?

Warren Buffett: Well most of them are. But in the end our price is figured relative to everything else so the whole stock market goes down 50 percent we ought to go down a lot because you can buy other things cheaper. I've had three times in my lifetime since I took over Berkshire when Berkshire stock's gone down 50 percent. In 1974 it went from $90 to $40. Did I feel badly? No, I loved it! I bought more stock. So I don't judge how Berkshire is doing by its market price, I judge it by how our businesses are doing.

SG: Is there a price at which you would buy back shares of Berkshire? $85,000? $80,000?

WB: I wouldn't name a number. If I ever name a number I'll name it publicly. I mean if we ever get to the point where we're contemplating doing it, I would make a public announcement.

SG: But would you ever be interested in buying back shares?

WB: I think if your stock is undervalued, significantly undervalued, management should look at that as an alternative to every other activity. **That used to be the way people bought back stocks, but in recent years, companies have bought back stocks at high prices. They've done it because they like supporting the stock…**

SG: What are your feelings with Berkshire. The stock is down a lot. It was up to $147,000 last year. Would you ever be opposed to buying back stock?

WB: I'm not opposed to buying back stock.

You can see the interview with Buffett here (via *New York Times' Dealbook* article *Buffett Hints at Buyback of Berkshire Shares*

END