Share repurchases

Letters: 1999, 2011, 2016 · Difficulty: Intro

Summary

A **share repurchase** helps the shareholders who stay only if the price paid is below the company's intrinsic value. Buffett explains Berkshire's rule: buy back shares only when they are clearly cheap, and only with cash not needed for the business.

1999 letter

Berkshire will someday have opportunities to deploy major amounts of cash in equity markets — we are confident of that. But, as the song goes, "Who knows where or when?" Meanwhile, if anyone starts explaining to you what is going on in the truly-manic portions of this "enchanted" market, you might remember still another line of song: "Fools give you reasons, wise men never try." Share Repurchases 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.

…

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 intrinsic value, repurchases usually make the most sense. In the mid-1970s, the wisdom of making these was virtually screaming at managements, but few responded.

…

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 support 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 only a portion of traded equities and then only when we employ a range of values, 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-shar e 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.

2011 letter

That's because they will be used in a variety of ways to increase future earnings and dividends of the investee. They may also be devoted to stock repurchases, which will increase our share of the company's future earnings. Had we owned our present positions throughout last year, our dividends from the "Big Four" would have been $862 million.

…

My task is clear, and I'm on the prowl. Share Repurchases Last September, we announced that Berkshire would repurchase its shares at a price of up to 110% of book value. We were in the market for only a few days – buying $67 million of stock – before the price advanced beyond our limit. Nonetheless, the general importance of share repurchases suggests I should focus for a bit on the subject.

Charlie and I favor repurchases when two conditions are met: first, a company has ample funds to take care of the operational and liquidity needs of its business; second, its stock is selling at a material discount to the company's intrinsic business value, conservatively calculated. We have witnessed many bouts of repurchasing that failed our second test. Sometimes, of course, infractions – even serious ones – are innocent; many CEOs never stop believing their stock is cheap. In other instances, a less benign conclusion seems warranted.

It doesn't suffice to say that repurchases are being made to offset the dilution from stock issuances or simply because a company has excess cash. Continuing shareholders are hurt unless shares are purchased below intrinsic value. The first law of capital allocation – whether the money is slated for acquisitions or share repurchases – is that what is smart at one price is dumb at another. (One CEO who always stresses the price/value factor in repurchase decisions is Jamie Dimon at J.P.

Morgan; I recommend that you read his annual letter.) Charlie and I have mixed emotions when Berkshire shares sell well below intrinsic value.

…

When we are buying, therefore, we want those exiting partners to be fully informed about the value of the assets they are selling. At our limit price of 110% of book value, repurchases clearly increase Berkshire's per-share intrinsic value. And the more and the cheaper we buy, the greater the gain for continuing shareholders. Therefore, if given the opportunity, we will likely repurchase stock aggressively at our price limit or lower.

You should know, however, that we have no interest in supporting the stock and that our bids will fade in particularly weak markets. Nor will we buy shares if our cash-equivalent holdings are below $20 billion. At Berkshire, financial strength that is unquestionable takes precedence over all else. ********** This discussion of repurchases offers me the chance to address the irrational reaction of many investors to changes in stock prices. When Berkshire buys stock in a company that is repurchasing shares, we hope for two events: First, we have the normal hope that earnings of the business will increase at a good clip for a long time to come; and second, we also hope that the stock underperforms in the market for a long time as well.

A corollary to this second point: "Talking our book" about a stock we own – were that to be effective – would actually be harmful to Berkshire, not helpful as commentators customarily assume. 6 Let's use IBM as an example.

…

Indeed, I can think of no major company that has had better financial management, a skill that has materially increased the gains enjoyed by IBM shareholders.

2016 letter

Nonetheless, Berkshire's collection of good businesses, along with the company's impregnable financial strength and owner-oriented culture, should deliver decent results. We won't be satisfied with less. 6 Share Repurchases In the investment world, discussions about share repurchases often become heated. But I'd suggest that participants in this debate take a deep breath: Assessing the desirability of repurchases isn't that complicated. From the standpoint of exiting shareholders, repurchases are always a plus.

Though the day-to-day impact of these purchases is usually minuscule, it's always better for a seller to have an additional buyer in the market. For continuing shareholders, however, repurchases only make sense if the shares are bought at a price below intrinsic value. When that rule is followed, the remaining shares experience an immediate gain in intrinsic value.

…

The same math applies with corporations and their shareholders. Ergo, the question of whether a repurchase action is value-enhancing or value-destroying for continuing shareholders is entirely purchase-price dependent. It is puzzling, therefore, that corporate repurchase announcements almost never refer to a price above which repurchases will be eschewed. That certainly wouldn't be the case if a management was buying an outside business.

…

Of course not. It is important to remember that there are two occasions in which repurchases should not take place, even if the company's shares are underpriced. One is when a business both needs all its available money to protect or expand its own operations and is also uncomfortable adding further debt.

…

This exception assumes, of course, that the business has a decent future awaiting it after the needed expenditures are made. The second exception, less common, materializes when a business acquisition (or some other investment opportunity) offers far greater value than do the undervalued shares of the potential repurchaser. Long ago, Berkshire itself often had to choose between these alternatives. At our present size, the issue is far less likely to arise.

My suggestion: Before even discussing repurchases, a CEO and his or her Board should stand, join hands and in unison declare, "What is smart at one price is stupid at another." ********** To recap Berkshire's own repurchase policy: I am authorized to buy large amounts of Berkshire shares at 120% or less of book value because our Board has concluded that purchases at that level clearly bring an instant and material benefit to continuing shareholders. By our estimate, a 120%-of-book price is a significant discount to Berkshire's intrinsic value, a spread that is appropriate because calculations of intrinsic value can't be precise.

…

If that level is reached, we will instead attempt to blend a desire to make meaningful purchases at a value-creating price with a related goal of not over-influencing the market. To date, repurchasing our shares has proved hard to do. That may well be because we have been clear in describing our repurchase policy and thereby have signaled our view that Berkshire's intrinsic value is significantly higher than 120% of book value. If so, that's fine.

…

Furthermore, our buying out "partners" at a discount is not a particularly gratifying way of making money. Still, market circumstances could create a situation in which repurchases would benefit both continuing and exiting shareholders. If so, we will be ready to act. 7 One final observation for this section: As the subject of repurchases has come to a boil, some people have come close to calling them un-American – characterizing them as corporate misdeeds that divert funds needed for productive endeavors. That simply isn't the case: Both American corporations and private investors are today awash in funds looking to be sensibly deployed.

Source: Warren E. Buffett, Letters to Berkshire Hathaway Shareholders: 1999, 2011, 2016 (berkshirehathaway.com/letters). Excerpts © Berkshire Hathaway Inc., all rights reserved; reproduced in part for non-commercial teaching. "…" marks skipped text. The summary is original course material by Jaeyoon Yu; not affiliated with or endorsed by Berkshire Hathaway Inc.