How the cult of shareholder value has reshaped corporate America

REUTERS/Brendan McDermid

AS STOCK BUYBACKS REACH HISTORIC LEVELS, SIGNS THAT CORPORATE AMERICA IS UNDERMINING ITSELF

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Part 1: Combined stock repurchases by U.S. public companies have reached record levels, a Reuters analysis finds, but as the recent history of such iconic businesses as Hewlett-Packard and IBM suggests, showering cash on shareholders may exact a long-term toll.

NEW YORK – When Carly Fiorina started at Hewlett-Packard Co in July 1999, one of her first acts as chief executive officer was to start buying back the company's shares. By the time she was ousted in 2005, HP had snapped up $14 billion of its stock, more than its $12 billion in profits during that time.

Her successor, Mark Hurd, spent even more on buybacks during his five years in charge – $43 billion, compared to profits of $36 billion. Following him, Leo Apotheker bought back $10 billion in shares before his 11-month tenure ended in 2011.

The three CEOs, over the span of a dozen years, followed a strategy that has become the norm for many big companies during the past two decades: large stock buybacks to make use of cash, coupled with acquisitions to lift revenue.

All those buybacks put lots of money in the hands of shareholders. How well they served HP in the long term isn't clear. HP hasn't had a blockbuster product in years. It has been slow to make a mark in more profitable software and services businesses. In its core businesses, revenue and margins have been contracting.

HP's troubles reflect rapid shifts in the global marketplace that pressure most large companies. But six years into the current expansion, a growing chorus of critics argues that the ability of HP and companies like it to respond to those shifts is being hindered by billions of dollars in buybacks. These financial maneuvers, they argue, cannibalize innovation, slow growth, worsen income inequality and harm U.S. competitiveness.

"HP was the poster child of an innovative enterprise that retained profits and reinvested in the productive capabilities of employees. Since 1999, however, it has been destroying itself by downsizing its labor force and distributing its profits to shareholders," said William Lazonick, a professor of economics and director of the Center for Industrial Competitiveness at the University of Massachusetts-Lowell.

HP declined to comment for this article.

CEO Meg Whitman has just overseen one of the largest corporate breakups ever attempted, creating one company for the PC and printer business, called HP Inc, and one for the corporate hardware and services business, called HP Enterprise. Ultimately, HP's turnaround efforts and restructuring will cost 80,000 jobs.

A Reuters analysis shows that many companies are barreling down the same road, spending on share repurchases at a far faster pace than they are investing in long-term growth through research and development and other forms of capital spending.

Almost 60 percent of the 3,297 publicly traded non-financial U.S. companies Reuters examined have bought back their shares since 2010. In fiscal 2014, spending on buybacks and dividends surpassed the companies' combined net income for the first time outside of a recessionary period, and continued to climb for the 613 companies that have already reported for fiscal 2015.

In the most recent reporting year, share purchases reached a record $520 billion. Throw in the most recent year's $365 billion in dividends, and the total amount returned to shareholders reaches $885 billion, more than the companies' combined net income of $847 billion.

The analysis shows that spending on buybacks and dividends has surged relative to investment in the business. Among the 1,900 companies that have repurchased their shares since 2010, buybacks and dividends amounted to 113 percent of their capital spending, compared with 60 percent in 2000 and 38 percent in 1990.

And among the approximately 1,000 firms that buy back shares and report R&D spending, the proportion of net income spent on innovation has averaged less than 50 percent since 2009, increasing to 56 percent only in the most recent year as net income fell. It had been over 60 percent during the 1990s.

COMPLEX LEGACY: During her tenure as Hewlett-Packard CEO, Carly Fiorina, now seeking the Republican presidential nomination, spent $14 billion on buybacks and nearly doubled the company's registered patents, but had no big, innovative successes. REUTERS/Brian C. Frank

"Even the Wall Street analyst crowd at some point will say, ''When are you going to grow?''"

David Melcher, chief executive, Aerospace Industries Association

Share repurchases are part of what economists describe as the increasing "financialization" of the U.S. corporate sector, whereby investment in financial instruments increasingly crowds out other types of investment.

The phenomenon is the result of several converging forces: pressure from activist shareholders; executive compensation programs that tie pay to per-share earnings and share prices that buybacks can boost; increased global competition; and fear of making long-term bets on products and services that may not pay off.

It now pervades the thinking in the executive suites of some of the most legendary U.S. innovators.

IBM Corp has spent $125 billion on buybacks since 2005, and $32 billion on dividends, more than its $111 billion in capital spending and R&D during the same period. Pharmaceuticals maker Pfizer Inc spent $139 billion on buybacks and dividends in the past decade, compared to $82 billion on R&D and $18 billion in capital spending. 3M Co, creator of the Post-it Note and Scotch Tape, spent $48 billion on buybacks and dividends, compared to $16 billion on R&D and $14 billion in capital spending.

At Thomson Reuters Corp, owner of Reuters News, capital spending last year totaled $968 million, more than half of which went toward R&D, according to the company's annual report. Buybacks and dividends for the year were more than double that figure, at a combined $2.05 billion. The company had 53,000 full-time employees last year, down from 60,500 in 2011. So far this year, capital spending is at $743 million, while buybacks and dividends total $2.02 billion.

"From a capital allocation perspective, we will always prioritize re-investments in our growth priorities over share buybacks," said David Crundwell, senior vice president, corporate affairs, at Thomson Reuters.

"A SCARY SCENARIO"

In theory, buybacks add another way, on top of dividends, of sharing profits with shareholders. Because buybacks increase demand and reduce supply for a company's shares, they tend to increase the share price, at least in the short-term, amplifying the positive effect. By decreasing the number of shares outstanding, they also increase earnings per share, even when total net income is flat.

Companies say buybacks are warranted when demand for their products and services isn't enough to justify spending on R&D, or when they deem their shares to be undervalued, and therefore a better investment than new projects.

Spreading the Wealth

The top 50 non-financial U.S. companies in terms of cumulative amounts spent on stock repurchases since 2000 are now often giving more money back to shareholders in buybacks and dividends than they make in profits – the first time that's happened outside of recessionary periods.

But if those buybacks come at the expense of innovation, short-term gains in shareholder wealth could harm long-term competitiveness. "The U.S. is behind on production of everything from flat-panel TVs to semiconductors and solar photovoltaic cells," said Gary Pisano, a professor at Harvard Business School and author of "Producing Prosperity: Why America Needs a Manufacturing Renaissance."

If U.S. companies continue to dole out their cash to investors, he said, economic investment "will go where it can be used well. If a company in Germany, India or Brazil has something to do with the money, it will flow there, as it should, and create growth and activity there, not in the United States. It's a scary scenario."

Even national security could be threatened as a shrinking defense budget has made it more difficult for contractors to justify research spending.

David Melcher, chief executive of the Aerospace Industries Association, said companies have turned to buybacks because of a dearth of new weapons programs and under pressure from Wall Street.

"Their investment community and the analysts that cover them are all saying, 'We want a better return and we want EPS to grow,' " Melcher said. "That's not a sustainable long-term strategy unless all these companies are going to go private...... Even the Wall Street analyst crowd at some point will say, 'When are you going to grow?' "

Among the largest U.S. defense contractors, Northrop Grumman Corp has spent more than $12 billion on share repurchases since 2010, even as revenue has declined in each of the past five years. Lockheed Martin's revenue has been flat since 2010; it has spent almost $12 billion on buybacks in that time.

In recent months, as the 2016 election campaigns have gathered momentum, concern about the long-term effects of the buyback craze has crept into public discourse and caught the attention of politicians.

Democrat Senators Elizabeth Warren and Tammy Baldwin have called on the Securities and Exchange Commission to investigate buybacks as a potential form of market manipulation.

Democratic presidential candidate Hillary Clinton has made shifting companies' short-term focus to the long term a key plank of her campaign. In July, she proposed increasing taxes on short-term investments and more rigorous disclosure of share repurchases and executive compensation. These moves, she said, will foster longer-term investment, innovation and higher pay for workers.

Fiorina, now a Republican presidential contender running on her record as a corporate executive, declined multiple requests for comment.

INVESTOR FAVORITE: Mark Hurd spent even more on buybacks than his predecessor while he also improved operating results, but managers said his cost-cutting disrupted product development. REUTERS/Stephen Lam

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Mark Hurd, forrmer CEO, Hewlett-Packard Co

Hurd, now a co-chief executive at Oracle Corp, told Reuters that repurchases were an appropriate use of capital. "HP had plenty of cash to buy back as much stock as it wanted to," he said in an interview. Operating cash flow during his tenure WAS $62 billion, a third more than he spent on buybacks. "It's a good use of capital," he said.

HP's revenue and share price rose while Hurd was in charge. He said decisions about the size of stock buybacks and investment in R&D, which totaled $17 billion during his tenure, were not related.

A spokesman for Apotheker, Hurd's successor, declined to comment.

Until 1982, companies were largely prohibited from buying their own shares. That year, as part of President Ronald Reagan's broad moves to deregulate financial markets, the SEC eased its rules to allow companies to buy their own shares on the open market.

At the time, free-market reformers argued that corporate America had become fat and wasteful after decades of postwar growth, with no checks on how managers spent cash – or didn't.

"The boards you had were managers themselves and their friends," said Charles Elson, finance professor and director of the

John L. Weinberg Center for Corporate Governance at the University of Delaware. “It was basically managerial power, unchecked.”

Over the years, however, a belief has taken hold that companies’ primary objective is to maximize shareholder value, even if that means paying out now through buybacks and dividends money that could be put toward long-term productive investments.

“Serving customers, creating innovative new products, employing workers, taking care of the environment… are NOT the objectives of firms,” Itzhak Ben-David, professor of finance at Ohio State University’s Fisher College of Business and a buyback proponent, wrote in an email response to questions from Reuters. “These are components in the process that have the goal of maximizing shareholders’ value.”

That goal has come to the fore in some high-profile cases of late as activist investors have demanded that executives share the wealth – or risk being unseated.

In March, General Motors Co acceded to a $5 billion share buyback to satisfy investor Harry Wilson. He had threatened a proxy fight if the auto maker didn’t distribute some of the $25 billion cash hoard it had built up after emerging from bankruptcy just a few years earlier.

DuPont early this year announced a $4 billion buyback program – on top of a $5 billion program announced a year earlier – to beat back activist investor Nelson Peltz’s Trian Fund Management, which was seeking four board seats to get its way. Even so, CEO Ellen Kullman stepped down in October after sales slowed and the stock slid.

In March, Qualcomm Inc, under pressure from hedge fund Jana Partners, agreed to boost its program to purchase $10 billion of its shares over the next 12 months; the company already had an existing $7.8 billion buyback program and a commitment to return three quarters of its free cash flow to shareholders. Still, the stock had been underperforming the S&P 500 for most of the past 10 years.

Jana wasn’t satisfied, and in July, Qualcomm announced it would shed nearly 5,000 workers, among other moves to cut costs. R&D spending, it said, would stay at around $4 billion a year.

Managers ignore shareholder demands at their own risk, especially when the share price is under pressure. “None of it is optional. If you ignore them, you go away,” said Russ Daniels, a technology and management executive who spent 15 years at Apple Inc and then 13 years at HP, where he was chief technology officer for enterprise services when he left in 2012. “It’s all just resource allocation. … The situation right now is there are a lot of investors who believe that they can make a better decision about how to apply that resource than the management of the business can.”

POLITICAL INTEREST: Democratic presidential candidate Hillary Clinton has recently decried companies’ focus on the short term and voiced support for measures to foster long-term growth and innovation. REUTERS/Jonathan Ernst

Maximizing shareholder value has “concentrated income at the top and has led to the disappearance of middle class jobs.”

William Lazonick, professor of economics, University of Massachusetts-Lowel

IBM Corp, once the grande dame of U.S. tech companies, spent $5.43 billion on R&D in the most recent year. It has been spending a lot more on buybacks.

For decades, the computer hardware, software and services company has linked executive pay in part to earnings per share, a metric that can be manipulated by share repurchases. Since 2007, IBM’s per-share earnings have surged 66 percent, though total net income has risen only 15 percent. (The company says in regulatory filings that it adjusts for the impact of buybacks on EPS when determining pay targets.

IBM has been among the most explicit in its pursuit of higher per-share earnings through financial engineering. In 2007, in communications with shareholders, it laid out the first of its “road maps” for boosting EPS, this time to $10 a share by 2010. It would do so, under the plan, through equal emphasis on improved margins, acquisitions, revenue growth, and share repurchases. It easily met its expectations.

In 2010, then-CEO Sam Palmisano doubled down, pledging to boost earnings by more than 75 percent to $20 a share by 2015. This time, more than a third of that increase was expected to come from buybacks. Palmisano left in 2011, having received more than $87 million in compensation in his last three years at the company.

For a while, the plan worked. Shares surged to an all-time high of $215 in March 2013. But the company’s operating results have lagged.

Revenue has declined for the past three years. Earnings have fallen for the past two. The stock is down a third from its 2013 peak, while the S&P 500 has risen 34 percent. To rein in costs, IBM has cut jobs. It now employs 55,000 fewer workers than it did in 2012.

“Morale is not too good when you see these cuts,” said Tom Midgley, a 30-year veteran of IBM’s Poughkeepsie, New York, plant. In recent years, he said, his wage increases have shrunk, as has the company’s contribution to 401(K) retirement savings.

IBM spokesman Ian Colley said that the company’s results have been hurt by currency shifts and business divestitures. He said that the company continues to grow, and that its buybacks have not affected research, development and innovation efforts. “IBM prioritizes investment in the business,” he said, citing recent acquisitions in cloud and other areas.

WEALTH BENEFIT

Share repurchases have helped the stock market climb to records from the depths of the financial crisis. As a result, shareholders and corporate executives whose pay is linked to share prices are feeling a lot wealthier.

That wealth, some economists argue, has come at the expense of workers by cutting into the capital spending that supports long-term growth – and jobs. Further, because most most U.S. stock is held by the wealthiest Americans, workers haven’t equally from rising share prices.

Thus, said Lazonick, the economics professor, maximizing shareholder value has “concentrated income at the top and has led to the disappearance of middle-class jobs. The U.S. economy is now twice as rich in real terms as it was 40 years ago, but most people feel poorer.”

Paul Bloom, who was an executive at IBM for 16 years, including chief technology officer for telecom research before leaving in 2013, is among the optimists who argue that venture capital and other alternative channels of R&D investment will take up some of the slack, supporting innovation and economic growth.

Now a consultant to venture capital firms, Bloom expects large companies to shift away from investing directly in R&D, focusing instead on acquiring startups and spinning off experimental projects that will be less constrained by bureaucracy and Wall Street demands. “You are going to see more and more corporate investing in the startups than you have in the past,” he said.

Many of the transformative breakthroughs of the past century – light bulbs, lasers, computers, aviation, and aerospace technologies – were based on innovations coming out of the labs of companies that could afford rich funding, like IBM, Apple, Xerox Corp and HP.

Some say a technological shift at companies like HP and IBM away from traditional manufacturing, which requires large investments in buildings and equipment, and toward data-based products is also changing the calculation of how much investment is needed in innovation.

“The way these companies spend dollars is different, the type of investment is hard to count. While you might think their spending is flat, I think it’s better utilized,” said Mark Dean, who worked in R&D for 34 years at IBM and was a member of the team that created the first personal computer in 1981. “Innovation is changing.”

THE HP WAY

For years, HP adhered to “the HP way,” a widely admired egalitarian corporate philosophy. Operating divisions were given broad autonomy to develop their businesses. Employees were encouraged to think creatively in a nurturing environment. R&D spending regularly topped 10 percent of revenue.

When Fiorina arrived in 1999, she upended that, implementing companywide layoffs, shifting jobs overseas and centralizing control.

Bill Mutell, a former HP senior vice president who joined from Compaq Computer Corp after HP paid $25 billion for it in 2001, spoke to Reuters at the suggestion of Fiorina's presidential campaign. He said that changes she implemented were needed because the company had become sluggish at innovation. HP would "aim, aim, and aim, and there was never any implementation and execution," he said.

Fiorina joined soon after the company had spun off what is now Agilent Technologies, the arm that housed much of the company's high-tech expertise.

In R&D, she focused on winning patents as a measure of the effectiveness of spending. The number of HP-registered patents rose from 17,000 in 2002 to 30,000 when she left in 2005, according to regulatory filings.

Even so, all of those new patents failed to yield any enduringly successful innovations. R&D efforts were scattered, and some projects overlapped.

Fiorina's compensation was linked in part to earnings per share when she joined in 1999. And from 2003, it was also linked to something called total shareholder return, a measure of performance, including stock-price appreciation plus dividends, that was then compared to returns for the S&P 500 Index.

Fiorina's buybacks failed to stop HP's share price slide after the dot-com bubble burst in 2000. Uneven earnings and concern about the Compaq acquisition whipsawed the share price during her tenure, helping lead to her ouster in 2005.

IN AND OUT: Leo Apotheker, Hurd's successor at HP, presided over a disastrous acquisition and $10 billion in stock buybacks during his brief 11-month tenure as CEO. REUTERS/Stephen Lam

Some managers struggling to meet Hurd's targets implemented spending freezes as the end of a quarter neared, halting procurement of supplies, according to former HP engineers.

Hurd streamlined the company's structure, which had ballooned after the Compaq acquisition. He slashed the number of research projects, from 6,800 to about 40, and cut costs across the company's PC and printer divisions, focusing instead on building higher-margin software and services businesses.

Market share in each division grew. But in the PC and printer divisions, researchers said, new limits on spending disrupted project timelines. Some managers struggling to meet Hurd's targets implemented spending freezes as the end of a quarter neared, halting procurement of supplies, according to former HP engineers.

"You can't turn it on and off like a faucet, turn it off one quarter to make the quarterly results look good, then turn it back on next quarter and have great products coming out the other end," said a former HP engineer.

Engineers at HP who had previously created prototypes at U.S. facilities were also now relying on Asian manufacturing sites tobuild them. Travel to these regions was on occasion delayed due to spending pressures. Workers at the company's labs werealso moved off the more experimental projects and realigned to work on existing product lines.

In the interview, Hurd said he wasn't aware of any spending freezes or project disruptions.

The changes he implemented led to sparkling results: From 2005 to 2010, net income rose 265 percent on a much smaller 45percent increase in revenue. HP's stock price more than doubled, from $20 to $50, during his tenure.

Thanks to hefty stock buybacks, earnings per share did even better, increasing 350 percent. HP increased share repurchases from $3.51 billion in 2005 to $7.78 billion in 2006, and again to more than $9 billion a year in four of the next five years. (Roughly 20 to 30 percent of annual repurchases offset dilution from employee stock-purchase plans.

Hurd said improving revenue and market share during his term was always his first concern.

"The share price is the result that occurs if the company is performing well," he said. "Short-term tricks to try to improve EPS,and eventually share prices, usually don't work...... Going out and saying I'm going to cut a dividend, make a one-time buyback,these are sort of like parlor tricks, they aren't sustainable." He said he declined shareholder requests that ranged fromincreasing dividends to adopting a specific EPS plan like IBM's "road map."

Because he nearly always met per-share earnings and other targets, his pay mostly rose, too. In 2008, for example, it jumpedto $42 million from $25 million the year before. (It fell in 2009 to $30 million when he failed to meet targets.

Investors were impressed by the turnaround. Operating margins, which had dropped below 5 percent under Fiorina, rose as high as 9 percent under Hurd, and the share price soared 200 percent.

Hurd resigned in August 2010 amid a scandal involving his relationship to an HP contractor.

His successor, Leo Apotheker, spent just shy of a year at the helm, marked by his decision to buy software firm Autonomy FOR$11 billion in October 2011. A year later – after Apotheker left – HP said an investigation had uncovered accounting fraud atAutonomy before the purchase. It took a charge against earnings of nearly $9 billion.

CEO Whitman has attempted to strike a balance with HP's plans to move into a growth mode from a turnaround effort. R&D spending rose slightly to $3.45 billion in 2014, the highest since 2008, even as revenue declined. At the same time, share repurchases rose to $2.7 billion, from $1.5 billion in 2013.

Post breakup, her immediate challenge is to build the higher-margin HP Enterprise. Both companies will continue with generous buyback programs. HP Enterprise said in September that it expects to give shareholders at least 50 percent of free cash flow next year through buybacks and dividends. HP Inc said it will give back 75 percent.

The Cannibalized Company

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