Big Blue: Stock Buyback Machine On Steroids

By David
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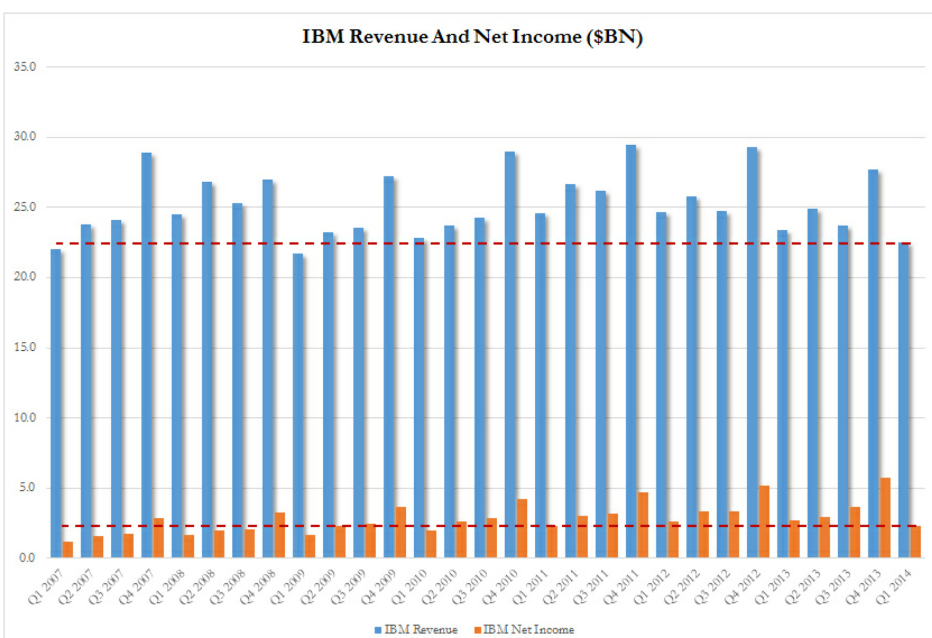
The Fed's financial repression policies destroy price discovery and honest capital markets. In the process these deformations turn financial markets into casinos and corporate executives into prevaricating gamblers. To be specific, most CEOs of the Fortune 500 are no longer running commercial businesses; they are in the stock-rigging game, harvesting a mother lode of stock option winnings as the go along.

Those munificently rising stock prices and options cash-outs owe much to the Fed's campaign to suppress interest rates and fuel stock market based "wealth effects", but the CEOs are doing their part, too. They have become full-time financial engineers who use the Fed's flood of liquidity, cheap debt and soaring stock prices to perform a giant strip-mining operation on their own companies. That is, through endless stock buybacks and M&A maneuvers they create the appearance of "growth" while actually liquidating the balance sheet equity and future asset base on which legitimate earnings growth depends.

The poster boy for this deformation is IBM which for all intents and purposes has become a stock buyback machine on steroids. It had a bad hair day yesterday, reporting still another year/year decline in sales, but that goes right to the heart of the matter. During the last seven years IBM has been a stock traders dream, climbing an almost picture perfect chart from $94 per share in March 2007 to a recent peak of $212.

But as shown below, those gains had nothing to do with what has been a historic ingredient of stock appreciation—-namely, expansion of its asset base and revenues. In fact, sales revenues in Q1 2014 clocked in at virtually the same number as Q1 2007:



So how has IBM and its ilk achieved revenue-less earnings growth? After all, reported EPS has gone from about $7 per share to $15 during the period. The short answer is that its executives and board have utilized every accounting and financial engineering short-cut in the book to disguise an equity liquidation campaign as a splendid strategy for "growth".

During the 7-years ending in 2013 IBM booked about $100 billion in net income, and ***spent virtually every single penny on share buy backs.*** So the once and former king of the global high-tech industry had nothing better to do with its cash than shrink it equity base. Accordingly, its share count dropped by 20% over the period, thereby accounting for about 45% of its EPS growth.

Moreover, it also distributed another $20 billion in dividends over the 7-year period. In all, it delivered cash into the maws of the fast money and hedge fund complex that amounted to 120% of its net income for 2007-2013. Needless to say, the robo traders can never get enough of this kind of "shareholder friendly" action at any given moment in time–no matter that it amounts to corporate liquidation eventually.

Coughing up rivers of cash was only one arrow in the quiver of IBM's shareholder value enhancement strategy, however. Its lawyers and accountants weighed in smartly, too. During fiscal 2007 Big Blue's tax rate was already low at 28%, but by dint of the best tax maneuvers money can buy, IBM's tax provision dropped to just 15.5% last year. So if you hold constant IBM's tax rate and share count at the 2007 level, EPS would have been about $9.50/share in 2013, not the $15 reported.

Yet even that modest 5% growth rate since 2007 isn't all that. IBM also spent nearly $25 billion on "acquisitions" during the period—financing these deals with the kind of ultra-cheap blue chip corporate debt issues that has been on fire sale since the Fed lowered the boom on the treasury benchmark rate under QE. Consequently, ***IBM's acquisitions are inherently and prodigiously "accretive" to per share earnings not because they make any economic sense, but because its after-tax cost of debt capital is nearly zero.***

It might wondered, however, why a globe spanning company with $100 billion in revenues, top-drawer facilities, limitless professional talent and a huge legacy of intellectual capital needs to shuffle around Wall Street making two-bit M&A deals on a continuous basis—that is, why it doesn't "build" rather than "buy".

But then just check out the "cookie jar" of accounting reserves it establishes on each deal completion along with its near zero-cost of debt capital. ***It becomes quickly evident that EPS "accretion" on an accounting basis may have virtually no relationship whatsoever to genuine corporate value creation–***the ostensible point of the mindless M&As that preoccupy the C-suites of corporate America.

Indeed, IBM's financials make it self evident that its stock rigging strategy is not about value creation thru "investment". Thus, during the past seven years IBM has consumed about $35 billion in DD&A charges, but invested less than $30 billion in Capex. Even if IBM has gone the "services and software" route, it might by questioned how a technology giant can prosper over time by consuming 15% of its capital assets each and every year.

And that's especially true since its R&D expense line is going south even faster. In 2007 it spent about $6.2 billion generating new products, processes and intellectual capital; last year in inflation-adjusted dollars it spent $5.5 billion or nearly 15% less.

In short, IBM is a poster boy for the deformation of American capitalism that has resulted from monetary manipulation and central planning. Today it carries nearly $40 billion of super-cheap debt—up by nearly 21% from 2007. It has used that gift from the Eccles Building to make ends meet—that is, carry on normal operations while it steady liquidates its capital and feeds prodigious amounts of cash into the Wall Street casino.

Yes, IBM is a buy back machine on steroids that has been a huge stock market winner by virtue of ***massaging, medicating and manipulating*** its EPS. But eliminate the accounting razzmatazz, M&A tricks and under-investment — and IBM's true earnings might be fairly estimated at $8/adjusted share.

That means that even after today's hit Big Blue is valued at nearly 24X. And that's for a company that has not grown in 7 years; which has had a weak-dollar tailwind inflating its earnings; and has now become personae non-grata in much of the BRIC world due to its service to the Spy State in Washington.

Under those circumstances, the next "M" may stand for monkey-hammered.

Below is an excerpt from "The Great Deformation: The Corruption Of Capitalism In America" where this baleful tale of corporate self-liquidation was first exposed (pp 563-565):

> *BIG BLUE: STOCK BUYBACK CONTRAPTION ON STEROIDS*
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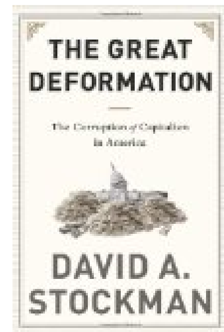
> *IBM's huge share buyback program, by contrast, shows that financial engineering does not always produce such immediate untoward results. Yet it is nonetheless a dramatic illustration of how the Fed's bubble finance régime enables companies to literally "buy" themselves a higher stock price, at least temporarily, by plowing massive amounts of cash into share repurchases, thereby creating the false impression of robust earnings growth.*



> *Big Blue's reported earnings thus surged 16 percent annually from $7 per share in 2007 to $13 in 2011, but those results were not apples to apples by any stretch of the imagination. The company's stock buyback program re- duced its net share count by 22 percent, and profits on its massive overseas operations had been artificially boosted by a double-digit decline in the dollar. IBM's reported results also reflected a 12 percent reduction in its tax rate and $16 billion of acquisitions, all highly accretive mainly because they were financed with ultra-cheap long-term debt.*
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> *In the absence of these one-timers and financial engineering maneu- vers, however, the picture was not so buoyant. Based on organic revenues, constant exchange rates, and no reduction in tax rates and share counts, earnings per share grew by about 5 percent annually, not 16 percent, over the past five years. It is far from evident, therefore, that IBM's true mid- single-digit growth rate justified the doubling of its share price during the period.*
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> *Upon closer examination, in fact, IBM was not the born-again growth machine trumpeted by the mob of Wall Street momo traders. It was actu- ally a stock buyback contraption on steroids. During the five years ending in fiscal 2011, the company spent a staggering $67 billion repurchasing its own shares, a figure that was equal to 100 percent of its net income.*
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> *This massive and continuous stock-buying program brought approxi- mately 550 million, or 36 percent, of the company's 1.5 billion of outstand- ing shares into its treasury, but needless to say, they did not all stay there. Nearly two-fifths of these shares reentered the float, mainly to refresh the management stock option kitty.*
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> *It goes without saying that in this instance the interests of stock traders and top management were aligned—perversely. The steady, deep shrink- age of the IBM float kept a bid under the stock and thereby delivered a "perfect" price chart, rising almost continuously from $100 to $200 per share over the past five years. It was a carry trader's dream.*
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> *Likewise, top executives got big-time pay packages they may or may not have deserved, but in any event they were dispensed in envelopes marked "tax once over lightly." Former CEO Sam Palmisano, for example, cashed out $110 million worth of stock options a few weeks after his retirement party.*
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> *This rinse-and-repeat shuffle of stock buybacks and options grants is undoubtedly a significant source of left-wing jeremiads about executive pay having gone to three hundred times the average worker's*

> *compensa- tion when, once upon a time, allegedly, the ratio was more like 30 to 1. But the issue is not simply whether this kind of financial engineering has con- tributed to the sharp tilt of income flows to the top 1 percent in recent years. There can be little doubt, on the math alone, that it has.*
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> *The more crucial question, in this instance, is whether the massive CEW evident in IBM's numbers is setting up another of the great iconic American companies for a fall sometime down the road, similar to Hewlett-Packard. The data on this score are not encouraging. Total shareholder distributions, including dividends, amounted to $82 billion, or 122 percent, of net income over this five-year period. Likewise, during the last five years IBM spent less on capital investment than its depreciation and amortization charges, and also shrank its constant dollar spending for research and development by nearly 2 percent annually. Neither of these trends is compatible with stay- ing on top in the fiercely competitive global technology industry.*
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> *Most especially, however, IBM's earnings—like nearly all the big cap global companies—could not be flattered permanently by the Fed's bubble finance. Already, the plunge of the euro has taken a toll on the company's reported results, causing the artificial translation gains it booked on its huge European businesses during the weak dollar cycle through 2011 to now unwind. Indeed, with nearly two-thirds of its sales outside the United States, the company's sales are now actually falling in dollar terms, and will likely continue to do so for the indefinite future.*