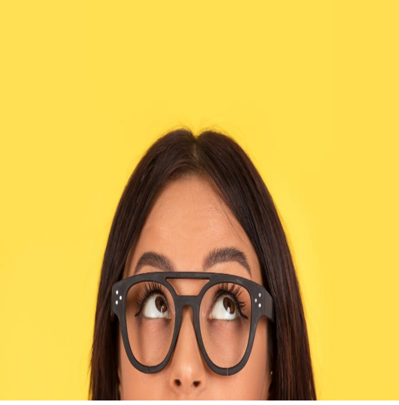

Are Stock Buybacks a Positive Sign?

Description

It’s not uncommon these days to see stocks announcing that they will start buying back shares. Especially in the current environment, where many stocks are cheap but private sector valuations haven’t fallen as substantially, it’s not unusual to see companies struggle to find growth and turn to stock buybacks to increase shareholder value.

Of course, not every stock will be buying back shares. For example, often, growth stocks will be doing the opposite and issuing more shares to fund growth.

But with plenty of more established businesses now announcing stock buybacks, you may be wondering what this means and if this is a positive sign.

Are stock buybacks a positive sign?

When a company announces stock buybacks, whether or not that’s positive depends on several factors. In general, a stock that’s in a position to buy back shares is favourable, because it likely has a hefty cash position.

In addition, when stocks announce a buyback, it can be a sign that it’s undervalued. This is because management knows best how the company is performing and what its value should likely be.

Plus, stock buybacks are designed to increase shareholder value by decreasing the shares outstanding (the opposite effect of dilution). So, when companies buy back their shares at undervalued prices, it will increase shareholder value even more significantly.

However, while buying back stock increases shareholder value, sometimes it isn’t necessarily the best use of capital. Other times, it could indicate that a company’s organic growth potential is slowing.

So, it’s crucial that when a stock announces a buyback, you look for management’s commentary on the matter to figure out whether or not it’s positive.

Of course, you don't want a company with a tonne of cash on its balance sheet just sitting around, especially in this high-inflation environment. But you also don't want companies to put themselves in a precarious position just to do something with the cash they have.

What are the downfalls of companies buying back shares?

For most companies buying back shares should likely be the last use of capital after investing in growth or paying down debt. And in the past, there have been instances where businesses have gotten themselves into trouble due to stock buybacks.

Take **First Capital REIT** (TSX:FCR.UN). In 2019, the company spent nearly $750 million to buy back shares. And for reference, its adjusted funds from operations were just over $250 million that year. It also took on another $350 million in debt to help finance the repurchase of those shares, adding to its already large debt load.

That likely wouldn't have been a problem for First Capital. However, three months into 2020, the global pandemic hit, and in addition to marking down the value of assets, First Capital's income was also negatively affected.

This led the stock to become over-leveraged. And while nobody could have seen the pandemic coming, the stock buybacks in 2019 certainly played a role in First Capital's issues. As a result, the stock had to cut the dividend and is now committed to paying down its debt and deleveraging its balance sheet.

Despite those issues, today, at the current price First Capital trades at, and after paying down more than $300 million in debt over the last few quarters, it's in a much better position and for long-term value investors, likely worth a buy.

However, the lessons we can learn from First Capital are clear. And it's just one of several adverse developments that stocks have experienced soon after spending a tonne of cash to buy back shares.

So, although stock buybacks are generally a positive sign, it's crucial that investors understand how easily the company can afford to do so and whether or not it's the best use of capital at the time.

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