When Share Buybacks is a Dumb Idea

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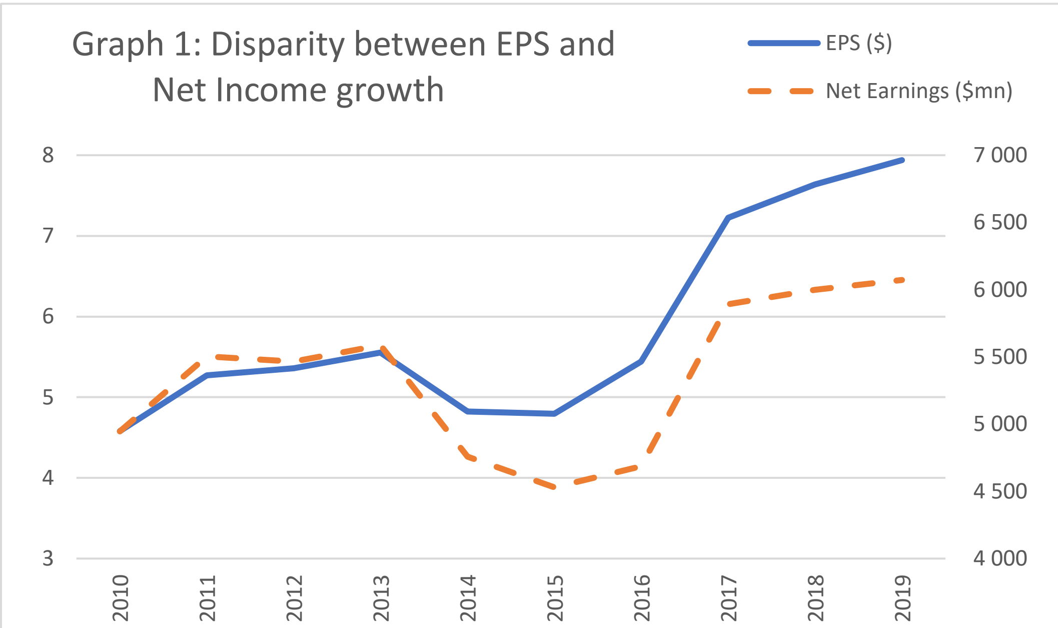
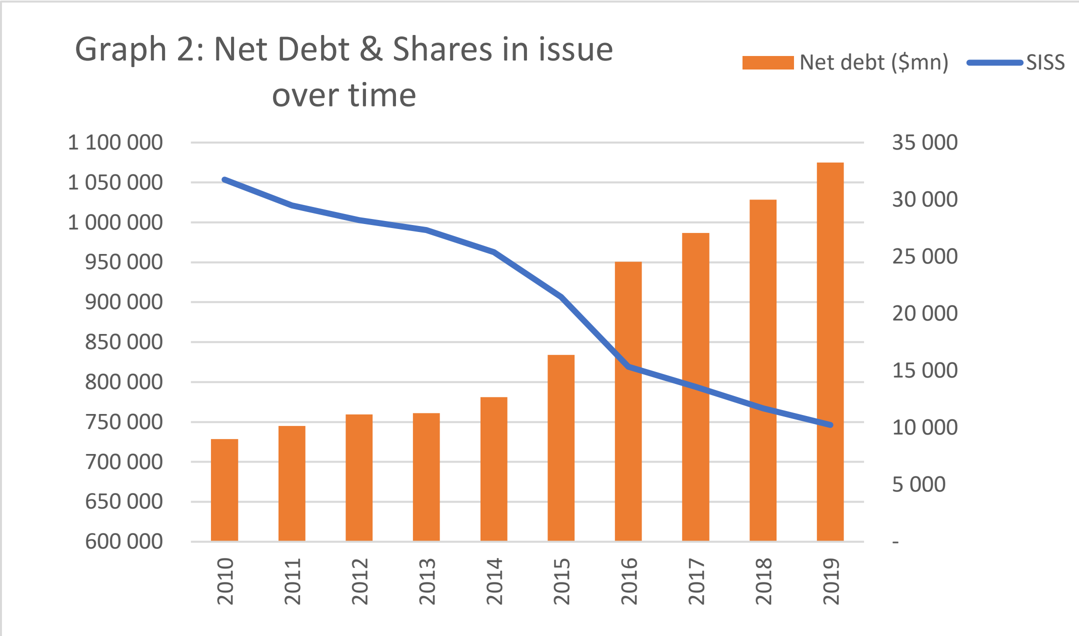
The past 10 years has seen prolific share buybacks as a largely undisputed management tool of 'distributing wealth back to shareholders'. According to Bloomberg, companies in the S&P 500 spent $1.6 trillion on buybacks between 2018 and 2019 alone. **McDonald's** is an example of a company not only using its free cash flow but also significantly gearing up its balance sheet to repurchase shares, quite clearly with zero consideration given to valuation levels.

McDonald's grew earnings *per share* (EPS) at 6.3% p.a. since 2010, above global GDP growth – at first glance not too bad for a large, mature company. Graph 1 shows the lag in growth between the absolute level of earnings to EPS growth. Earnings grew by only 2.3% p.a.



EPS can only outpace the absolute level of earnings by reducing the number of shares. McDonald's bought back shares at a rate of 3.7% p.a. over this timeframe. These buybacks add up to an incredible $33.7bn.

Graph 2 shows how McDonald's funded the combined buyback of a third of their market capitalization, without cutting dividends or cutting back on capital expenditure. Net debt to EBITDA increased from a reasonably conservative 1.05 times in 2010 to a much more aggressive 3.13 times in 2019.



With recent developments in the world impacting the fast food industry severely, I suspect McDonald's shareholders might on reflection regret management's decision to gear up the balance sheet in order to buyback its overvalued shares.

The saddest part of it all? The cash foregone to purchase shares at *any price* could now have been used to support it in hard times and opportunistically buy troubled competitors or its own shares.

Our work continues…

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