Shareholder Distributions vs. Reinvestment: The Gap Grows

Although dividends and buybacks have ballooned, the data shows that S&P 1500 CFOs are still mindful of the need to reinvest. By David Denis, Gaurav Jetley, and Laura Comstock

Cash distributions to shareholders via dividends and share buyback programs have kindled passionate debates about the focus of shareholder value. Some market analysts and observers express chagrin at what they believe is a widespread increase in shareholder payouts, led by companies such as Apple, which bought back $70 billion of stock in 2019. Why all the fuss? Critics view these distributions as occurring at the expense of companies' long-term value.

Buybacks and dividends are not necessarily detrimental. But do increasing amounts of shareholder payouts mean more companies are choosing short-term shareholder gains over reinvesting in their businesses for the long term? If so, what are the consequences for those trying to gauge companies' valuations and the drivers of their financial strategies? And are historical levels of payouts and reinvestment still useful indicators of the optimal level?

To shed some light on those questions, Analysis Group compiled historical data (1999-2019) on payouts (in the form of dividends and share repurchases), on reinvestment (in the form of capital expenditures and research and development), and on operating income for the S&P 1500. We excluded financial firms and regulated utilities. We then looked at the absolute levels (in real terms) of payouts and reinvestment for each company and in the aggregate at five-year increments (1999, 2004, 2009, 2014, and 2019). We also calculated each company's ratio of payouts and reinvestment to operating income.

Our analysis stops short of the unprecedented and anomalous impacts of the widespread business disruptions caused by the COVID-19 pandemic. However, although we end with a few thoughts placing our analysis in the context of the pandemic, we nonetheless gained insight into some of the structural changes that we believe will carry through to the new "business as normal," when that day comes.

Buyback Growth

Companies engage in buyback programs in particular for a variety of reasons and under many circumstances. In addition, it is assumed that different companies have different needs for capex and R&D. So, year-to-year changes in these measures are likely to be idiosyncratic and spiky, making it difficult to discern meaningful trends.

But we do see some data that confirms the widely held belief that companies see shareholder distributions as an increasingly attractive option for deploying excess cash. Overall, we found that total payouts for our sample of S&P 1500 companies tripled (in real terms) between 1999 and 2019, increasing from about $280 billion to $850 billion. (See the chart, "High-Payout Companies Ratcheted Up Rewards, page 19.)

Over the same period, operating income increased at just a little more than half that rate (162%), growing from $1.26 trillion to $2.04 trillion. In other words, in 2019 (just before the pandemic hit) S&P 1500 companies on average, distributed more of each dollar of operating income to their shareholders than they did 20 years before.

That was especially true for the "high-payout companies," or HPOCs. HPOCs generally are larger and have higher cash balances and more income.

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They ranked in the top quartile of our S&P 1500 sample based on the share of operating income they distributed to shareholders. (In 2019, 254 companies comprised the HPOC group and 754 companies the non-HPOCs.)

In 1999, for HPOCs, the median value for the ratio of payouts to operating income was 47%; in 2019, the median shot up to 69%. In other words, the typical HPOC in 1999 paid out a little less than 50 cents of every dollar of operating income. Twenty years later, the typical HPOC paid shareholders 69 cents of every dollar of operating income.

In 2019, for example, Bristol-Myers Squibb spent $7.3 billion buying back its stock and distributed an additional $2.7 billion in shareholder dividends. In total, the company paid out $1.17 for every $1 of its 2019 operating income.

But we also found that, despite non-HPOCs' much lower payout ratios, even they increased shareholder distributions in recent years. Through 2009, the total level of distributions by non-HPOCs remained flat, while the median value for the ratio of distributions to operating income declined modestly. By 2014, however, both total distributions and the median ratio to operating income jumped substantially, remaining at about the same levels through 2019.

For both HPOCs and non-HPOCs, the buyback portion of distributions increased much more dramatically than the dividend portion.

Reinvestment Remains Strong

While dividends and buybacks rose, S&P 1500 companies continued to make substantial reinvestments in R&D and capex. Companies in both groups spent considerably more dollars on those two categories recently. For example, in 1999 the non-HPOCs, in aggregate, reinvested $575 billion, but that amount increased to $665 billion by 2019. For the HPOCs, the aggregate reinvestment increased from $180 billion to $355 billion over the 20-year period. On an aggregate basis, S&P 1500 companies invested over $1 trillion in capex and R&D in 2019.

Take Bristol-Myers Squibb again. The company spent $7 billion on R&D and capex in 2019, nearly 27% more than the $5.5 billion it spent on those items just five years earlier and 79% more than it did 20 years earlier. (Bristol-Myers Squibb remained in the HPOC group in each of the studied years.) For further context, that $7 billion reinvested in Bristol-Myers Squibb was equivalent to 82% of the company's 2019 operating income—not as high as the 117% rate it paid out to investors, but substantial nonetheless.

Overall, the median shareholder payout ratio for non-HPOCs has been slowly converging toward the reinvestment ratio. That suggests that shareholder distributions are becoming a more important element of capital allocation strategies, even for businesses taking a more conservative financial path.

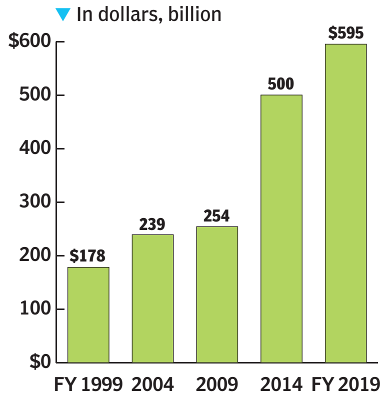
In contrast, for HPOCs, median payout ratios are larger than median reinvestment rates, and the gap is growing. (See the chart, "Shareholder Payouts Surpass Reinvestment," page 20.) In 1999, a typical HPOC spent 40% of its operating income on capex and R&D, while the median ratio of distributions to operating income was not much higher. In 2014 and 2019, the reinvestment rates' median values fell by a couple of percentage points for the HPOCs. However, the median values for the distribution ratio climbed to about 70% of operating income.

Value Creation Abandonment?

Despite reinvestment ratios remaining flat as shareholder payout ratios grew, market valuations on average have increased over the last 20 years. The Shiller PE ratio (S&P 500) has steadily risen since its financial-crisis low point. So, on average, it does not appear that

High-Payout Companies Ratcheted Up Rewards …

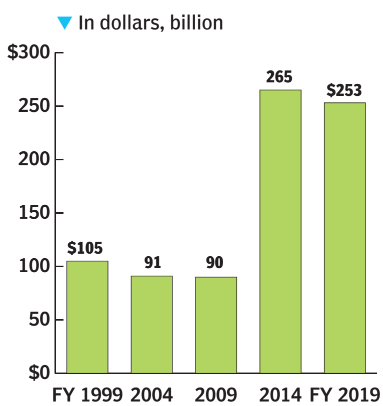
Over 20 years, high-payout companies (HPOCs*) more than tripled the amount of capital spent on shareholder distributions (buybacks plus dividends).



*HPOCs are companies in the top quartile of the S&P 1500 sample based on share of operating income distributed to shareholders.

… While Others Took Years to Boost Distributions

Shareholder distributions from non-HPOCs* remained relatively flat until 2014, when they took off.



*Non-HPOCs are those companies in the S&P 1500 sample not ranked in the top quartile for shareholder payouts.

Source: Analysis Group

companies are sacrificing long-term value in favor of short-term payouts to shareholders.

How does that reconcile with the observation that HPOCs, on average, distribute more and more of each dollar of operating income to shareholders?

Part of the story is that public companies increasingly reinvest in ways other than capex and R&D.

For example, companies incur substantial costs to build their "organizational capital," that is, things like talent base, product innovation, brand loyalty, customer relationships, and distribution systems. Expenditures on these items tend to be recorded as SG&A expenses. But for all practical purposes they are investments in the sense that, like capex and R&D, they represent costs incurred today to produce profits in the future. Many academic studies have shown that such expenditures on intangible capital have grown substantially recently.

Moreover, shifts in the composition of the industries represented in our sample reinforce the importance of these trends in intangible investment. In 1999, nearly two-thirds of the HPOCs were traditionally capital-intensive manufacturing firms. By 2019, manufacturing firms comprised less than half of the HPOCs, while services firms comprised almost 25% of the group (up from 16% in 1999). Industry composition for the non-HPOC group remained largely unchanged from 1999 to 2019, perhaps reflecting the relative sizes of the two groups (where subtler changes in the much smaller HPOC group had larger relative impacts).

Given this shift, it is perhaps not surprising that we find a growing interest in distributions, as well as a shift in reinvestment: more companies favoring R&D over capex. That occurred for HPOCs in particular. Over the years studied, business services companies like eBay replaced capital-intensive companies like Kraft and Heinz (before their 2015 merger) and General Mills in the high-payout group. Service companies simply do not require the same rate of reinvestment in physical capital as manufacturing companies, but they do tend to invest heavily in intangible capital.

In addition, in the early 2000s other technology companies, such as payments company First Data, began creeping up the HPOC list, and the arrival on the scene of technology firms like Apple and Amazon—not to mention the continuing shift of traditional "brick and mortar" retailers to "bricks and clicks"—may have also contributed to a greater emphasis on R&D over capex.

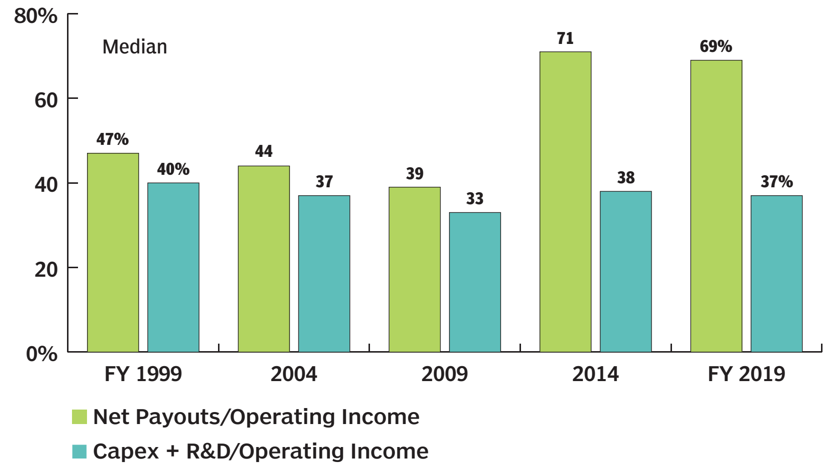
Left Vulnerable?

Historical measures of reinvestment may not be useful measures today, due to the shift in the composition of companies toward service- and technology-based industries. The high rates of spending on intangibles in these industries, coupled with high equity prices, suggest that increased rates of corporate payouts have not prevented companies from pursuing valuable investment opportunities.

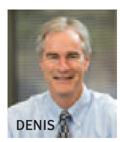
It is still possible, however, that the increased payouts have left some companies vulnerable to economic shocks. When those shocks happen, they may limit the cash available to firms for necessary reinvestment. Time will tell whether the ability of companies to weather the global pandemic is a function of their past payout activity. In any event, the pandemic and its associated economic consequences will undoubtedly provide important lessons for how companies can strategically optimize the allocation of profits. CFO

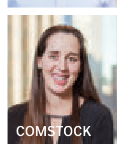
Shareholder Payouts Surpass Reinvestment

By 2019, for high-payout companies in the S&P 1500, buybacks and dividends represented a much larger share of operating income than capex and R&D.



Source: Analysis Group





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