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CEO's CDO's and Baby Got BuyBack

Well here we are in the middle of the biggest financial meltdown in a generation. Congress is having a field day playing the blame game. Their attacks are focused on mortgage brokers, bond rating agencies, hedge funds to name a few. Curiously absent from the list of perpetrators is Congress itself. Where was the oversight from Christopher Dodd's Senate Banking Committee and Barney Frank's House Finance committee? Well, we will save that rant for a future post. Let's talk about CEO's their compensation, and how they manage the companies that we invest in.

Executive compensation is a topic we all like to complain about, especially when share prices are moving lower. Pay for performance has been the operative mantra for executive compensation since the '87 market crash. The performance benchmark is almost always the stock price. Therefore, most CEO's and senior executives manage their business to the quarterly earnings reports and the stock prices that are driven by those reports. We're all fat and happy as long as our stocks and 401K's are moving up and we hardly notice the gradual toxic buildup occurring on the firm's balance sheet. Under the guise of growth, we don't even notice that multiples (P/E ratios) creep higher and higher as the prospects of the "E" ever catching up to the "P" grow dimmer and dimmer. (See previous post "Rethinking Equities).

When multiple expansions fail to deliver higher share prices and earnings begin to plateau, what is a responsible CEO to do with excess free cash flow? Pay off debt? Declare a decent dividend? No, they buy back stock (Baby got BuyBack) under the theory that reducing the number of shares outstanding will result in higher stock prices because they assume that the market will assign the same total value to the equity but divided by fewer shares. Often, just the announcement of an intent to buy back stock will juice share prices. How does that help the business? Beats me! But it sure feathers a few nests in the executive suite. The fallacy here is that corporations are lousy market timers. If fact the peak of stock buybacks during the last year coincided exactly with the market top before the recent bear market slide. So tell me. How was that strategy efficient use of capital?

Lets face it. There is nothing sexy about using excess free cash flow to pay off debt. After all, the financial geniuses tell us that if your return on capital exceeds the cost of capital, then debt is a good thing. But what if there is a downturn in the business cycle and returns go in the tank? The cost of capital (debt) has not changed as bondholders will continue to expect their interest payments.

Cold hard reality is now setting in. Our government has too much debt, we owe too much on our credit cards, too much on our mortgages and corporate debt is too high. As companies experience difficulty in securing debt financing in this slump, they are now returning to the suckers in the equity markets for a lifeline. Whoops! So much for buybacks.