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Bridging the Disclosure Gap

An Engagement Guide Based on Findings from the Share Buybacks Disclosure Initiative

UAW RETIREE
Medical Benefits Trust

EXECUTIVE SUMMARY

Much has been written about the recent surge in corporate share buybacks and the overwhelming lack of disclosure. In the fiscal year ending January 2016, companies spent more on share buybacks than they earned in free cash flow after dividends.[1] Without passing judgement on the merits of share buybacks, investors are rightly concerned as share buybacks represent a large discretionary use of cash.

Despite these large cash outlays, U.S. securities laws do not require companies to disclose critical information investors need to analyze and evaluate share buyback programs. Currently, companies are only required to disclose the number of shares authorized for repurchase, the shares actually repurchased, the average price per share, and information about when the plan expires. The U.S. Securities and Exchange Commission reported that while companies generally comply with these limited disclosures, they usually don't report much more.

To better understand the disconnect between corporate share buyback programs and the lack of disclosure, herein referred to as the Disclosure Gap, a coalition of 11 institutional investors representing $500 billion in assets led by the UAW Retiree Medical Benefits Trust launched the Share Buybacks Disclosure Initiative. The objective of the Initiative and the focus of this white paper is to gather information from a diverse sample of twelve corporate boards to understand:

- The capital allocation analysis and decision-making process that boards undertake in determining how, when, and why they initiate a share buyback program; and

- The information that boards are able and willing to share regarding the foregoing that would add value to investors' diligence process.

In summary, the group's findings presented in this report are:

1. Boards are actively engaged in the capital allocation process including analyzing key metrics, often incorporating information from outside experts.

2. When asked, Boards are clearly able and willing to share important information about the overall capital allocation decision-making process and specifically share buybacks that will certainly enhance investors' understanding.

To facilitate engagement, this report provides a framework to address the Disclosure Gap consisting of a set of questions investors can use in dialogues with companies regarding capital allocation decisions, including share buybacks.

Our hope is that this paper encourages increased attention to share buybacks among investors and other market participants as well as an increased willingness on the part of companies to voluntarily improve disclosures related to share buybacks, specifically, and the entire capital allocation process, more generally.

INTRODUCTION

Capital allocation decisions are among the most important decisions a company can make. Investors depend on boards of directors to actively oversee a decision-making process for capital allocation that will support a long-term business strategy in an objective and transparent manner. One capital allocation option whose use has increased significantly in recent years is the share buyback, through which a company purchases its own stock.[2] Share buybacks present opportunities and risks[3] for investors, both of which are amplified when the amount of capital dedicated to buybacks increases. Because equity investors are constantly engaged in diligence to evaluate future profitability, cash flows, and balance sheet risks, a free flow of information, including about share buybacks, is critical. The combination of accelerating share buybacks, which represent a large discretionary use of cash at the exclusion of other uses, and inadequate shareholder disclosures create the Disclosure Gap.

The genesis of the Disclosure Gap is weak disclosure requirements. Applicable U.S. securities law disclosure guidelines are limited to the most rudimentary information about the share buyback program. Neither statutes nor regulations require companies to explain their reasons for repurchases, the review and approval process, and the impact share repurchases have on the business and investors; so, many companies do not. Investors and the marketplace need this critical information and full transparency to properly analyze and evaluate share buyback programs.

This white paper found that: (1) boards are actively engaged in the capital allocation process; and (2) when asked, Boards are clearly able and willing to share important information about the overall capital allocation decision-making process. We suggest that companies should seek to improve investor confidence by proactively going beyond the current regulatory requirements and sharing more information with shareholders about their capital allocation strategies, especially as they relate to share buybacks.

We have organized this white paper around a set of questions that investors and other market participants such as analysts can use during dialogues with companies. Each section outlines a question covering a critical dimension of share buyback practice and provides an explanation as to why this dimension should be of importance to investors, including examples from company responses to the Initiative.

Please note that this paper does not serve as a referendum on share buybacks, which can be appropriate as part of a long-term business strategy. Nor does it put forth a proposal for specific regulations that should be considered by the U.S. Securities and Exchange Commission. Rather, the framework encompassed by this paper is a tool for investors to identify risks and opportunities at portfolio companies. Finally, note that we have not attempted to rate or recommend best practices for actual capital allocation strategies; we are focused primarily on bridging the Disclosure Gap.

INVESTOR INTEREST IN SHARE REPURCHASE PROGRAMS: OPPORTUNITIES & RISKS

Similar to any capital allocation strategy, share buybacks present both opportunities and risks that should be visible to and understood by company boards, management, and investors. For long-term shareholders, share buybacks are most defensible if done carefully and within the context of a long-term growth strategy.[4] However, as interest among institutional investors in capital allocation strategies has grown, so too have concerns about the long-term sustainability of specific capital allocation strategies such as share buybacks.

Share buybacks alter the capital structure of a company in ways that can be advantageous to investors. There is some evidence that companies see a slight bump in the stock price when a repurchase program is announced (although the effect may be temporary),[5] and the sheer reduction in the number of shares outstanding can result in higher earnings per share, return on assets, return on equity, and a lower price-to-earnings ratio. Companies that fund share buybacks through debt also are advantaged by the current low interest rate environment, allowing companies that are under-leveraged to increase debt and potentially reduce weighted average cost of capital with benefits that flow to shareholders. Further, share buybacks can provide a company with more flexibility than a dividend, allowing a company to return cash to shareholders opportunistically while avoiding the market's expectation for a regular payout. A company also may need to repurchase shares to offset dilution from issuing employee stock options.

Conversely, a growing pool of data highlights the risks share buybacks may pose to companies and their investors. Allocating capital to share buybacks may result in fewer resources for reinvestment in growth such as developing new products or services, hiring or retraining workers, or building new facilities.[6] Some evidence shows that companies may repurchase shares at or near the top of the economic cycle when they are most expensive, resulting in financial economic loss,[7] opportunity loss,[8] and thus the destruction of value for long-term investors. Recent studies also have shown that firms repurchasing shares may have poorer performance across a number of dimensions, including lower median total shareholder return,[9] lower share price returns,[10] lower market value as measured by Tobin's Q and book-to-market ratios,[11] lower P/E multiples,[12] lower return on investment,[13] and lower internal rate of return[14] than firms that do not engage in share repurchases. Moreover, senior executives may favor share buybacks, even when other capital allocation strategies may yield better long-term results, because of their potential positive impact on performance metrics linked to executive compensation thereby boosting executive pay.[15]

EXISTING BOARD REVIEW AND DISCLOSURE

Despite all of the recent share buyback activity, disclosure to shareholders about share buyback programs has been relatively sparse due to limited disclosure requirements. First, before a company can begin repurchasing shares on the open market it must announce that the board has approved a share buyback program. But as securities law expert Jesse Fried has noted, the announcement itself "need not provide specific details about the program. [At the time of the program's announcement, a] firm is not required to indicate the number or dollar amount of shares to be repurchased. Nor must the firm indicate the expiration date of its buyback program. Even if a firm voluntarily indicates a repurchase target, it will typically state that actual repurchases will depend on market conditions. As a result, firms do not commit—and are not obligated—to buy back any stock."[16]

Once a firm chooses to repurchase shares, a company must disclose on a quarterly basis the number of shares authorized for repurchase, the shares actually repurchased, the average price per share, and information about when the plan expires; this disclosure is made in either a company's 10-Q or 10-K reports.[17] But because individual or even daily transaction details are not provided and the disclosure is often made months after a repurchase is executed, it is difficult for investors to meaningfully evaluate the timing or pricing of share buybacks or to respond in real time.[18]

Finally, neither statutes nor regulations require companies to discuss their reasons for repurchases, the process for review and approval, and the impact share repurchases have on the business and investors. It's therefore unsurprising that an August 2016 report by the IRRC Institute and Tapestry Networks

("IRRCi/Tapestry Networks Report") detailing the views of 44 directors who serve on 95 public company boards regarding share buybacks found that few companies actually provide public disclosure of the decision-making process around share repurchases or discuss the reasons for establishing and executing a buyback program in the first place.[19] Further, the SEC noted in its 2016 disclosure effectiveness review that while companies generally comply with these limited reporting requirements, they do not report on the impact of share repurchases.[20]

There have been some questions raised about whether board oversight of capital allocation and share buyback decision-making is adequate, with conflicting evidence. A 2015 KPMG survey revealed that executives are dissatisfied with the quality of board member and management discussion regarding alignment of the company's capital allocation and strategy.[21] Although audit committees act as a natural locus of responsibility for capital allocation, no legal, regulatory, guidance, or best practices exist to address capital allocation strategies.[22] Meanwhile, the IRRCi/Tapestry Networks Report noted that directors consider themselves "central players" who "actively engage with the different views of senior managers and their colleagues to evaluate whether to return capital and how they should do it."[23]

THE SHARE BUYBACKS DISCLOSURE INITIATIVE

In June 2016, an investor coalition launched the Share Buybacks Disclosure Initiative to address the lack of disclosure around share buybacks. The Initiative engaged large public company boards to determine how to close the Disclosure Gap for investors interested in evaluating the long-term impact of buybacks on share value. The Initiative sent letters to the boards of 12 large public companies across multiple industries asking them to describe their roles and responsibilities in overseeing capital allocation strategy, discuss how they manage potential conflicts of interest related to share repurchases, and increase transparency to shareholders around capital allocation decisions—particularly decisions related to share buybacks.

Through this Initiative and as a result of its findings, the coalition developed a set of questions for investors to ask companies about share buyback activities in the next section of this paper.

THE DISCLOSURE GAP ENGAGEMENT GUIDE

To help close the Disclosure Gap and guide discussions between investors and portfolio companies about capital allocation strategies—particularly share buyback decisions—we have developed a comprehensive list of questions derived from the Initiative, experts, and other relevant source material. We suggest company-investor dialogues on share buybacks cover the following three key areas:

1. **GOALS AND APPROACH: Describe the intent of the share buyback program and the basis on which share buybacks are executed.**

2. **PROCESS: Discuss who is responsible for governance of the share buyback program and how the company chooses among capital allocation options, including any analysis used to compare available options.**

3. **MANAGING CONFLICTS: Discuss how conflicting priorities and potential conflicts of interest among stakeholders, including insider trading, are managed.**

The following guide includes questions that cover each of the three areas. A selection of responses from respondent companies are featured in the boxes accompanying the questions. As noted above, this framework is a tool for investors to minimize risks and identify opportunities at portfolio companies and does not purport to identify best practices in the evaluation and execution of share repurchase programs.

GOALS AND APPROACH

What are the goals of the buyback program?

We found that companies pursued share buyback programs to accomplish varying goals and objectives. These goals should be clearly stated so that investors can understand the purpose of the buyback program, how it fits into capital allocation more broadly, and how to assess performance.

While other companies may have different goals in executing a buyback program, the responses received generally fell into the following four categories:

- Return cash to shareholders after other capital allocation opportunities have been exhausted. This appears to be the most popular reason for executing buybacks among the respondents.
- Increase shareholder value by opportunistically repurchasing shares when they trade at a discount to the boards' assessment of intrinsic value.
- Offset dilution from the issuance of shares as a part of executive compensation programs.
- Achieve payout targets that vary with income or free cash flow (as a complement to dividends, which are relatively stable).

Does the company have a hierarchy for various capital allocation options? If so, what are the company's capital allocation priorities?

Many respondents stated that they have a hierarchy for capital allocation options. For example, several stated that they prioritize organic investments and only consider funding acquisitions once they have exhausted desirable organic investment opportunities. Some literature has called this a "pecking order" approach. By contrast, other respondents suggested that they evaluate capital allocation options on a "returns" basis, with preference for the highest returning option, regardless of historical practice or preference.

> "[O]ur approach to capital allocation in general prioritized order is (1) Organic growth: Investment in retail stores, expansion of other businesses; (2) Maintain cash dividend; (3) Acquisitions to enhance capabilities and product offerings; (4) Increase in cash dividend to maintain or increase the payout ratio; (5) Repurchases of stock to offset dilution from stock plans; (6) Distribution to shareholders in the form of additional buybacks."
>
> "Under the company's balanced approach, dividends are a priority while share repurchases represent a discretionary use of cash only after meeting the needs of the business."
>
> "Finally, once these capital allocation strategies are achieved, cash on hand in excess of these needs [organic growth, accretive acquisitions, strengthening the balance sheet, dividend growth] is evaluated in light of potential additional investment, market conditions, and possible share repurchases."

Regardless of approach, companies should be clear about their approach to capital allocation planning because it so strongly influences capital allocation outcomes. Companies should disclose whether they use a hierarchy for capital allocation decision-making and, if so, what the hierarchy is. They should also offer an explanation as to why this approach best fits the company. If companies approach capital allocation decision-making using a returns-based or other framework, they should provide similar explanation.

Are there conditions that need to be met in order for buybacks to be approved and ultimately executed?

Even if share buybacks are part of a company's overall capital allocation plan, companies may still have tests or conditions that must be met in order for a share buyback to be executed. For example, some companies said they would only repurchase shares if they did not have other reinvestment opportunities that met a specific hurdle rate of return. Others stated that they would not undertake a buyback if they did not believe their shares were trading significantly below intrinsic value. Still others set parameters related to maintenance of liquidity and credit rating. Even where conditions are not codified as policy but are instead used as rules of thumb, disclosing the basic criteria can help investors more clearly understand the intent and parameters of a company's share buyback program.

"Management is given parameters within which they are tasked to execute these decisions. Particular focus is paid to increasing the 'intrinsic value' of the Company as well as optimizing our cost of capital and mitigating risk."

"[The company] actively looks at intrinsic valuation based on discounted cash flows and peer multiples as part of any share repurchase decision."

"[W]e perform a comparative analysis on our peer groups' enterprise value to EBITDA multiples to gauge whether we are being fairly valued in the market – and repurchase stock when it is trading below this enterprise value per share (and there are no better investment opportunities available)."

One company stated that is uses intrinsic valuation to set parameters for forward-looking repurchase decisions. The board grants authorization at specific price points guided by that valuation, less a discount.

PROCESS

How are the goals for the share buyback determined and what factors are considered when making this decision?

According to the responses, the first step in implementing a share buyback program is deciding on its goals and, as discussed above, share buyback goals and objectives can vary widely. It is therefore important that companies explain how those goals are set, how frequently they are revisited, and what collateral factors are considered in making these decisions. For example, does a board of directors review the goals of a share buyback program on an annual basis or less frequently? Does the board consider perspectives about which goals are best addressed through share buybacks vs. other means? Investors will want to know that companies are not on autopilot when it comes to making the strategic decisions that frame the rest of their share buyback choices.

Who is responsible for reviewing and approving buyback programs and how frequently are buybacks discussed?

All of the company respondents stated that the responsibility for reviewing and approving buyback programs lies within the boardroom. Some boards retain this responsibility with the full board while others delegate the decision-making process to one or more board committees.

"Capital deployment is just too important to leave to committees. Our full board discusses those issues as a full board so board committees don't have any specific oversight. The audit committee does oversee risks related to financial or accounting. And the compensation committee pays attention to alignment. But these are full board decisions. Every member of the board needs to be fully engaged. We think that's the right way to go."

"Our capital allocation and sourcing decisions are made by the full Board, not a committee, so as to leverage the full range of our Trustees' diverse expertise, experience and points of view."

"The individual Board committees are involved in these uses of capital in various ways. The Audit Committee takes primary responsibility for assessing the major financial risks associated with various investments. The Corporate Governance/Nomination Committee assesses strategic and operational risks, and applicable Company controls used to mitigate these risks, associated with various investments. The Compensation Committee evaluates compensation, benefit and training investments. The Board as a whole has oversight of the Company's capital structure and all of the uses of the Company's capital and uses input from its various committees, and other sources, to make strategic decisions."

"The Board regularly reviews and approves [the Company's] strategic and multiyear business plans, including capital allocation strategies. The Board also discusses the general parameters of our stock buyback program, with the Audit Committee receiving quarterly reports on actual share repurchase activity."

Does the board engage outside consultants to assist the Board in its oversight of capital allocation decision-making and, if so, what is their role?

Many companies rely on a wide range of consultants and experts in executing capital allocation decisions. The role of outside consultants may be to provide input and recommendations on various capital allocation topics, which are then carefully discussed and evaluated by the Board. Two companies, out of ten who responded to this question, explicitly stated that they do not rely on outside consultants.

"[T]he Board has, at various times, used outside consultants as advisors to provide information and answer questions regarding capital allocation decisions. These advisors range in background and expertise and have included investment bankers, compensation experts and outside legal counsel. In each case, the outside consultants have been utilized to provide input and recommendations on various capital allocation topics, which are then carefully discussed and evaluated by the Board."

"[The company] regularly engages with all the major investment banks on capital strategy and allocation. Periodically, we conduct reviews with them on our approach, target capital structure, WACC minimization, benchmarking, and capital allocation philosophy/tactics. This informs periodic board reviews and plays a more major role in the review that is done with the board annually on capital allocation."

Are the pros and cons of share buybacks compared to alternative uses of capital prior to approval of a share buyback program? If so, what metrics does the company use to make the comparison?

If share buybacks are pursued on the basis that they are a better use of capital than other options, it is important for companies to disclose on what basis they make this assessment. Well-defined metrics allow boards and management to make comparisons among the various capital deployment strategies on an apples-to-apples basis. Furthermore, companies using hurdle rates should consider disclosing the threshold return that various capital deployment options must meet in order to be considered or favored.

Responses to the coalition's letter clearly show that companies rely on a wide range of metrics in comparing capital allocation strategies or evaluating existing strategies, which include:

- Internal rate of return (hard target)
- Weighted average cost of capital
- Free cash flow (actual and anticipated)
- Dividend discount models
- Enterprise value-to-EBITDA multiples vs. peer group
- Peer total payout ratios
- Return on invested capital
- Revenue growth
- Operating margins
- Net income

What information does the Board collect on the historical performance and balance sheet impact of prior share buybacks, and how is this information used to inform future decision-making?

One company states that the board reviews historical data when evaluating repurchases, as well as regularly reviewing the assumptions that underlie models used to assess the company's valuation.

Given that share buyback program returns can vary significantly, boards may consider periodically reviewing the historical returns of their programs and examine the underlying decision-making process in order to evaluate the success of the program.

Included in the answer to the question should be a discussion of how historical returns to the buyback program are calculated and benchmarked.

Does the company conduct any other analysis to inform its decision about whether or not to repurchase shares?

"Particular focus is paid to increasing the 'intrinsic value' of the Company as well as optimizing our cost of capital and mitigating risk. . . If the Company's common shares were to once again trade significantly below 'intrinsic value,' the Company may again engage in active repurchases."

The above questions only cover a few basic areas and companies may conduct other analyses to inform their decision-making about share repurchases; companies should disclose if there are other meaningful steps they undertake. For example, if a company considers intrinsic value as a part of the decision-making process, that should be disclosed.

MANAGING CONFLICTS

Does the company seek feedback from investors on its capital allocation program, and if yes, to what extent does investor feedback impact future capital allocation decision-making?

"The Board and management are fully committed to engaging with shareholders and incorporating feedback into strategic thinking around the business and governance strategy, including capital allocation. Over the last few years, we have looked to achieve this with members of the Board engaging directly with shareholders."

Public companies are held by a wide range of shareholders, who will each have investment objectives and timelines that may differ which creates conflicting priorities. Long-term investors may favor organic growth through reinvestment in the business. However, short-term investors may demand share repurchases for a slight bump in stock price, which may be adverse to long-term growth goals.

Some companies structure incentive awards using metrics that can be affected by buybacks, e.g., earnings per share. If your company uses any such metrics, are performance goals set in a way that mitigates the impact of buybacks (anticipated and unanticipated) from the achievement of those metrics?

"Related to the portion of the 2014 performance-based restricted stock grant subject to a performance target tied to achieving a certain earnings per share target (on a constant share count basis and excluding restructuring, impairment and debt retirement expenses) with such target measured following the completion of fiscal 2014." *(From 2015 proxy statement.)*

"[W]e adjusted the Company's 2015 EPS result for incentive plan purposes to exclude the impact of 'unbudgeted share repurchases.'"

If executive compensation metrics are sensitive to the weighted average number of shares outstanding, implementing a share buyback program would reduce the number of shares outstanding which could boost an executive's earnings. Not all of the respondents used metrics sensitive to the number of shares outstanding to set executive pay but some of those that did stated that the impact of share buybacks is factored into targets set at the beginning of the performance cycle. Other companies adjusted earnings per share to exclude the impact of buybacks that were not announced at the beginning of the fiscal year ("unbudgeted buybacks"). One company calculated EPS targets on a constant-share basis to ensure that the share count remained the same throughout the performance cycle and thus was not impacted by share buybacks.

What policies, processes, and controls does the Board have in place to manage conflicts of interest and/or insider trading related to share repurchases (for example, 10b5-1 plans) and what information about these measures is disclosed to investors?

Boards may opt-in to the SEC's voluntary "safe harbor" provisions, which protect companies from enforcement action when executing share buybacks, effectively shielding the company from liability arising out of improper trading.[24] Boards may also adopt "10b5-1 plans" when executing share repurchases[25] to protect insiders who are regularly exposed to material non-public information from prosecution when buying and selling stock. Only half of the ten companies who responded to this question used 10b5-1 plans, while others relied on internal insider trading policies.

"[The company] enters into 10b5-1 share repurchase plans only during open trading windows during which time the Board and senior management are not in possession of material, non-public information."

"[W]e have a robust securities trading policy that strictly prohibits trading in [company] securities by insiders based on material nonpublic information. Every employee of the Company, including members of senior management, is required to certify on an annual basis as to his or her compliance with such policy and the Company's Code of Conduct. We do not have a 10b5-1 trading plan in place."

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We hope that this guide has been informative and helpful in facilitating further dialogue between shareholders and the companies in which they invest on capital allocation and especially share buybacks. We also would like to thank the twelve companies that participated in this Initiative for their insight and candor.

APPENDIX

Company Respondents to Share Buybacks Disclosure Initiative

Best Buy

Dr. Pepper Snapple Group

GameStop

Hewlett-Packard

Legg Mason

Macy’s

O’Reilly Automotive

Public Storage

Starbucks

Tesoro

UPS

Walmart

Investor Participants in Share Buybacks Disclosure Initiative

AFL-CIO Office of Investment

Amalgamated Bank

Calvert Investments

CtW Investment Group

Domini Social Investments

Hermes Equity Ownership Services

The Marco Consulting Group

The Nathan Cummings Foundation

National Industry Pension Fund

Trillium Asset Management

UAW Retiree Medical Benefits Trust

[1] S&P 500 companies spent 101.7 percent of free cash flow after dividends on share repurchases during the twelve months ending in January 2016. Andrew Birstingl, *Buyback Quarterly,* FactSet (Mar. 17, 2016), https://www.factset.com/websitefiles/PDFs/buyback/buyback_3.17.16. Further, a Reuters analysis shows that, among the 1,900 companies that have bought back their shares since 2010, buybacks and dividends amounted to 113 percent of their capital spending, compared with 60 percent in 2000 and 38 percent in 1990. Karen Brettell, David Gaffen & David Rohde, *The Cannibalized Company*, Reuters (Nov. 16, 2015), http://www.reuters.com/investigates/special-report/usa-buybacks-cannibalized/. *See* Lu Wang, *Dividend Bull Case Deflates as Payouts Rise Least Since 2010*, Bloomberg (Oct. 19, 2015), http://www.bloomberg.com/news/articles/2015-10-19/dividend-bull-case-deflates-with-payouts-rising-least-since-2010.

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[4] *See, e.g.*, Chris Andersen & Ray Lynch, *Boards Should Be More Prudent with Buybacks*, Agenda (Apr. 18, 2016), http://agendaweek.com/c/1334353/152043?referrer_module=SearchSubFromAG&highlight=repurchase.

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[8] *Id.*

[9] Gregory V. Milano, *Are Buybacks the Best We Can Do?* Fortuna Advisors (Feb. 16, 2010), http://www.fortuna-advisors.com/buybacks.html.

[10] Chao Zhuang, SHARE REPURCHASES: HOW IMPORTANT IS MARKET TIMING? 39-41 (Sept. 30, 2013), http://www.usc.edu/schools/business/FBE/seminars/papers/F_10-4-13_ZHUANG-JMpaper.pdf.

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