Biotech buybacks—good or bad?

Tom Jacobs

When a biotech company succeeds, it can find more cash in the bank than needed for research and development. It may decide to buy back, or repurchase, its own shares. A buyback is neither good nor bad by definition, but may be smart, dumb or bordering on fraudulent.

To make you a savvier, more confident and profitable biotech investor, this month's column explains buybacks, why biotechs undertake them and how to know if they are good or bad. In this and forthcoming columns, I show you how to test your own companies, singling out the biggest biotech buyers of their own stock in history: Amgen (Thousand Oaks, CA, USA; Nasdaq:AMGN) and Genentech (S. San Francisco, CA, USA; NYSE:DNA). These two biotech giants have long repurchased shares; in 2004 and 2005 alone they shelled out an astonishing $8 billion and $3.8 billion, respectively—more than the gross domestic product of many countries. This is big, but biotech investors need to know whether it's smart.

Baby, buy back

In a buyback, the company takes cash from the company checking account and buys its own shares. In theory, this reduces the amount of shares outstanding, so that each shareholder owns a larger percentage of the business. If you think of the company as a pizza, your slice remains the same absolute size, but it's bigger relative to the now-smaller pie. This is theoretically neutral because the money used to buy back the shares was money you as a shareholder owned in part anyway, but now you don't have to guess how management will spend it.

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The decision can have two very important consequences. First, because there are fewer shares, the company's free cash flow and accounting profits per share increase. If the company makes $10 million on 10 million shares, that's $1 a share. With a 10% buyback, leaving 9 million shares, $1 rises to $1.11 a share. Broadly speaking, rising 'per-share' measures of a company's performance—in this case $1 to $1.11—lead to rising stock prices and more gains for you. On the flip side, if the business performs poorly, the declines will be larger per share as well. Buybacks magnify the effect of company performance, good or bad, on the stock price.

Second, the company is making an investment in its own shares that may prove good or bad. It repurchases $10 million in stock or 1 million shares at $10 each, and retires the shares. Later, shares rise to $20, so the company can reissue the stock but needs only 500,000 shares at $20 to raise the same amount of capital. The company gains 100% on the stock, which is fantastic. But if the stock declines, the company made a bad decision, because it must issue more dilutive stock to raise the same amount of money.

So many choices

Against these consequences, management's buyback decision has two parts. In finance speak, a CEO's job is to be a great capital allocator, to move money here or there for the best return. All the time, the CEO must decide whether to invest in drug candidate research and development, acquisitions, alliances, office buildings, fat salaries, executive jets, dividends or company shares. To do that, top management must estimate the potential return from every alternative investment including the company's own stock.

How to know the value of company stock? Every day, companies and investment banks evaluate the right price at which not only to buy and sell companies, but to buy or sell pieces of them, form joint ventures or invest in product alliances. They estimate the net present value of the future cash flows (which we'll call intrinsic value or IV) that will come in the lifetime of the company or from the product being bought. The stock market is simply a moment-to-moment snapshot of all investors' estimates of a company's IV, and because it is emotional, it may offer lower or higher prices at any given time. If you are a buyer, you want to pay less than IV; as a seller, you want charge more. That's what negotiations resolve.

Golden Buyback Rule

The bottom line forms our 'Golden Buyback Rule': a company may only buy back shares if the difference between the current valuation and IV is the same or greater than the potential gains from alternative investments. If the current stock price is $10 and the IV is $11, that's a theoretical potential gain of 10%. The company may only repurchase shares if it can find no other investment with the potential to earn 10% or more.

You want one thing and one thing only: that management believes that opportunistic investments in its own stock will provide a better potential gain than any other use for cash in the company checking account—cash which is, after all, your money.

It's interesting to note, that both of our biotech giants fail this threshold test: in its 2005 Annual Report Form 10-K, Genentech notes it intends "to use the repurchased stock to offset dilution caused by the issuance of shares in connection with our employee stock plans"; whereas in its 2005 annual report, Amgen believes "that [repurchasing shares] is an effective way of returning cash to our stockholders." Both assertions are dead wrong and all too common among companies, biotech or otherwise.