Robbing Peter to pay Paul

Tom Jacobs

When your biotech buys back its own shares, at best, it's a decision to invest cash to buy back shares today that may be worth more in the future, when the company can reissue the same shares for more money, netting more than it could earn investing the cash in drug development. At worst, it's robbing Peter to pay Paul, giving stock options to employees, while buying back stock with the other hand to mask that dilution of your interest. It may also be a wrong decision to prefer buybacks to dividends.

This matters because company cash is your money. And the two companies most-owned by biotech investors, Genentech (S. San Francisco, CA, USA; NYSE:DNA) and Amgen (Thousand Oaks, CA, USA; Nasdaq:AMGN), spent \$8 billion and \$3.8 billion in 2004 and 2005 of investor money, respectively, to buy back stock. That is not spare change, and it's wrongly spent.

Managing the share count

Let's say management determines that stock option grants are necessary to recruit the best executives and employees. No problem. Under new rules, you see their value clearly on the income statement.

But a company knows that the share count will increase when those options are exercised. Then, if your share number remains the same, your ownership share of the company decreases. Some management knows astute investors can see a rising share count, so it buys back stock to mask the effect of the stock option-based increase, without regard to whether the stock is the best place to invest for greater return. This is insulting to shareholders at best and bordering on malfeasance at worst.

The record

If you review the past five years of options grants and buybacks for Amgen and Genentech, you

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Table 1 Share buybacks over recent years at Amgen and Genentech

	Diluted shares (%)				
	2001	2002	2003	2004	2005
Amgen					
Net options granted	1.0	3.0 ^a	1.1	1.1	0.3
Shares repurchased	1.2	2.4	2.2	5.2	5.0
Net dilution	(0.2)	0.6	(1.1)	(4.1)	(4.7)
Genentech					
Net options granted	2.0	1.7	1.6	1.8	1.7
Shares repurchased	0.2	3.5	1.0	2.4	2.2
Net dilution	1.8	(1.8)	0.6	(0.6)	(0.5)

^aAmgen acquired Immunex's options. Source: SEC filings and my calculations.

will find that Amgen consistently buys back a far greater percentage of its shares than it issues in options—more than 10% of diluted shares in the past three years—whereas Genentech buys back only enough to maintain the status quo, to keep the numbers even (Table 1). This is no surprise, as we can see in Genentech's 2005 Annual Report Form 10-K:

"We intend to use the repurchased stock to offset dilution caused by the issuance of shares in connection with our employee stock plans. Although there are currently no specific plans for the shares that may be purchased under the program, our goals for the program are (i) to make prudent investments of our cash resources; (ii) to allow for an effective mechanism to provide stock for our employee stock plans; and (iii) to address provisions of our affiliation agreement with Roche relating to maintaining Roche's minimum ownership percentage. [emphasis mine]"

Genentech's avowed corporate policy is to dilute your ownership share through stock option grants and "offset dilution" by buying back shares using your cash. To be fair, yes, it nods in the direction of capital allocation in (i), but make no mistake—Genentech thinks a "prudent investment" means buybacks to manage the options dilution. Management is too smart not to know this is wrong.

When dividends are better

Less sinful but still wrong-headed is Amgen's

justification. Amgen's 2005 Annual Report Form 10-K states:

"Repurchases under our stock repurchase program reflect, in part, our confidence in the long-term value of Amgen common stock. Additionally, we believe that it is an effective way of returning cash to our stockholders."

As with Genentech, there is a nod in the right direction. "Confidence in the long-term value of Amgen common stock" reflects the belief that investing in company shares today is smart because they will be worth more tomorrow—more than could be gained by investing the cash in drug development.

But the second reason is plain wrong. It is not an effective way to return capital to shareholders. If you want to return money to shareholders because you can't find a better investment, then pay a dividend. Buybacks used to make sense when dividends were taxed twice (first as corporate income and second as investor income), but reforms mean that most dividends are taxed at a low 15% rate in the United States and as low as 0% elsewhere. Dividends, not buybacks, are the preferred means to return cash to shareholders.

As an investor, you want management to invest company cash correctly on your behalf. Last month and now, we see that the biotechs that should set the management standard for all fail the first two tests for buybacks. **B**