
SHARE REPURCHASES, REVISITED

Concerns Rise for Companies with High Levels of Share Repurchases

In the year since Audit Integrity first alerted the market about risks associated with share repurchase programs, the practice of stock buyback has continued to grow. At the same time, other researchers and leading media including Forbes, Business Week, and CFO have joined us in questioning the motivations and risks related to this type of corporate behavior.

Audit Integrity effectively identified this risk area through forensic analysis, uncovering dozens of metrics statistically associated with SEC enforcement actions. Explicitly, high levels of share buybacks and insider selling are two key factors which are often found to be indicative of fraud, shareholder litigation or other negative events. When combined, the potential risk effects of these two elements are frequently magnified.

Since buybacks are commonly initiated by management when a company's stock is believed to be undervalued, management sales of personal positions during this period can raise a number of questions, especially when selling activity is notably high. Essentially, if the company stock is undervalued in relation to current assets or future growth prospects, why would key executives boost the sale of their personal holdings during the buyback period? That is what we set out to analyze.

This report also expands on the research Audit Integrity provided to Forbes.com for their recent article, "[Buyback Binge](#)" by Elizabeth MacDonald, published May 21, 2007, which identified 30 companies experiencing heightened levels of both share repurchases and simultaneous insider selling in 2006. The list focused on those companies with total repurchases and insider sales above a threshold of 5% of reported equity and with at least \$100 million in market capitalization. As a result of our findings, Audit Integrity is forced to question whether management's interests are aligned with shareholder interests at the companies in question.

When buybacks and insider trading combine

In terms of maximizing shareholder value, stock buybacks can oftentimes prove to be an inefficient use of corporate capital. As noted in the Forbes.com article, "They give a temporary, one-time, artificial boost to earnings, they cause creaky cash-poor companies to load up on debt, leaving them vulnerable should the economy unexpectedly deteriorate and they pulverize credit ratings, causing borrowing costs to soar."¹

The most consistent benefit is that they tend to be good for management by producing the appearance of earnings growth where none may exist, while providing management with additional bonuses and compensation at those companies which reward executives for increased earnings per share (EPS).

Although stock repurchase activity is often touted by management as a countering force to the dilutive EPS effect of option and stock grants (which creates an inflow of new shares in the market) the actual number of shares repurchased is often much greater than such dilution would warrant. At the companies in our study, the average dollar amount repurchased was almost three times the value of options exercised over the previous year, and four times the value when both were measured over the previous three years.

The red flags

The analysis Audit Integrity conducted for this report focused on two of the various metrics that are incorporated in the Accounting and Governance Risk (AGR®) assessment. One metric test checked if a repurchase plan was commenced during the four quarters ending in the third quarter of 2006. The second metric whether a significant level of insider trading occurred during the same time period. The market cap and asset value, noted on the table below, provide context on the financial state of the company at the time.

¹ http://www.forbes.com/2007/05/19/sprint-tribune-stocks-biz-cz_em_0521buyback.html

The companies listed on this report had one thing in common. All had high levels of both share repurchases *and* insider selling, measured as a percent of total equity. While some of these repurchase plans may turn out to be a positive event for the companies involved, a number of the firms engaged in activity that appears to go beyond the bounds of prudent corporate behavior.

Some of the more dramatic examples are these:

- Choice Hotels, which reports a negative equity value of **-\$78.3 million**, found the resources to repurchase \$26.5 million in stock while insiders sold off shares worth \$33.4 million.
- Nutrisystem Inc. repurchased shares that equated to 40 percent of their equity value while insiders netted **118 percent** of equity value selling their stock.
- Travelzoo Inc. invested 88 percent of equity in share repurchases, while insiders recouped **236 percent** of equity value by selling their shares.

Of course, not every large-scale sale of stock by insiders should be viewed critically. For example, some large blocks are often justifiably liquidated by founders who have no remaining management role in the company. The data in the following table, however, suggests a potentially different catalyst is involved. The numbers particularly warrant analysis given the ubiquitous use of stock options in today's executive compensation packages, as the potential effects of such elements are often obscured and/or difficult to quantify.

Beyond raising questions about corporate integrity, these numbers rouse a couple of observations. In the best cases, the effect of the buyback process on long-term growth in equity value is at most uncertain. In the worst cases, our net result is a management enriching itself palpably at the expense of shareholders.

In either scenario, large-scale stock repurchases thus combined with heightened insider selling (as is seen in these companies), should establish a clear call of caveat emptor. *Shareholder* beware.



List of Companies With Flagged Share Repurchase Activity

Company Name	Ticker	AGR Score	Market Cap (mm)	Equity (mm)	Repurchases last 4 Quarters (mm)	Executive Stock Sales last 4 Quarters (mm)	Repurchases/Equity*	InsiderSales/Equity*
NutriSystem Inc.	NTRI	23	\$2,330.3	\$114.7	\$45.4	\$134.9	40%	118%
Forward Air Corporation	FWRD	34	\$1,024.9	\$177.1	\$43.8	\$13.2	25%	7%
First Cash Financial Services, Inc.	FCFS	40	\$662.2	\$169.1	\$24.8	\$34.0	15%	20%
United Therapeutics Corporation	UTHR	47	\$1,317.8	\$275.0	\$42.2	\$29.5	15%	11%
HouseValues, Inc.	SOLD	51	\$140.8	\$91.7	\$9.1	\$11.3	10%	12%
Meredith Corporation	MDP	51	\$2,555.4	\$702.7	\$162.8	\$57.1	23%	8%
Seagate Technology	STX	51	\$13,859.3	\$5,164.0	\$549.0	\$675.4	11%	13%
USANA Health Sciences, Inc.	USNA	51	\$837.7	\$51.9	\$67.3	\$12.4	130%	24%
Administaff, Inc.	ASF	52	\$1,082.9	\$214.1	\$23.8	\$36.3	11%	17%
Holly Corporation	HOC	52	\$2,849.5	\$462.7	\$188.2	\$79.2	41%	17%
Landstar System, Inc.	LSTR	56	\$2,519.8	\$240.4	\$114.6	\$30.9	48%	13%
LoJack Corporation	LOJN	59	\$318.5	\$102.8	\$27.7	\$8.3	27%	8%
Choice Hotels International, Inc.	CHH	60	\$2,861.1	-\$78.3	\$26.5	\$33.2	N.M.	N.M.
Sciele Pharma Inc.	SCRX	60	\$766.9	\$372.4	\$19.2	\$47.8	5%	13%
ValueClick, Inc.	VCLK	60	\$2,074.7	\$595.0	\$103.4	\$32.4	17%	5%
NVR, Inc.	NVR	63	\$3,270.3	\$1,086.5	\$635.4	\$48.9	58%	5%
Aspect Medical Systems, Inc.	ASPM	64	\$404.7	\$76.1	\$5.0	\$9.2	7%	12%
Nordson Corporation	NDSN	64	\$1,413.0	\$410.0	\$22.5	\$144.1	5%	35%
Papa John's Int'l, Inc.	PZZA	64	\$1,062.2	\$163.0	\$102.5	\$39.1	63%	24%
Manor Care, Inc.	HCR	65	\$3,562.7	\$616.1	\$283.4	\$39.9	46%	6%
Travelzoo Inc.	TZOO	66	\$487.6	\$32.5	\$28.6	\$76.6	88%	236%
Steiner Leisure Limited	STNR	67	\$752.5	\$166.6	\$48.0	\$25.3	29%	15%
Varian Medical Systems, Inc.	VAR	69	\$6,585.7	\$797.3	\$270.6	\$64.0	34%	8%
Websense Inc.	WBSN	70	\$1,159.2	\$168.8	\$97.9	\$23.2	58%	14%
Arbitron Inc.	ARB	71	\$1,241.7	\$72.7	\$70.0	\$7.6	96%	10%
Health Grades, Inc.	HGRD	71	\$130.6	\$12.0	\$2.3	\$1.3	19%	11%
SEI Investments Company	SEIC	72	\$5,754.2	\$575.1	\$116.7	\$69.7	20%	12%
Tempur-Pedic International Inc.	TPX	73	\$1,269.0	\$146.2	\$220.0	\$29.1	150%	20%
Select Comfort Corp.	SCSS	78	\$1,102.6	\$129.0	\$53.0	\$12.1	41%	9%
Varian, Inc.	VARI	78	\$1,405.5	\$552.0	\$63.1	\$34.7	11%	6%

* Both ratios had to be >= 5% for inclusion on this list