Big pharma spends on share buybacks, but R&D? Not so much

By Gretchen Morgenson
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Under fire for skyrocketing drug prices, pharmaceutical companies often offer this response: The high costs of their products are justified because the proceeds generate money for crucial research on new cures and treatments.

It's a compelling argument, but only partly true. As a revealing new academic study shows, big pharmaceutical companies have spent more on share buybacks and dividends in a recent 10-year period than they did on research and development. The working paper, published on Thursday by the Institute for New Economic Thinking, is entitled "U.S. Pharma's Financialized Business Model."

The paper's five authors concluded that from 2006 through 2015, the 18 drug companies in the Standard & Poor's 500 index spent a combined $516 billion on buybacks and dividends. This exceeded by 11 percent the companies' research and development spending of $465 billion during these years.

The authors contend that many big pharmaceutical companies are living off patents that are decades-old and have little to show in the way of new blockbuster drugs. But their share buybacks and dividend payments inoculate them against shareholders who might be concerned about lackluster research and development.

A few companies have spent more money repurchasing shares than they allocated to research over the period, the study found. They included Gilead Sciences, which spent $27 billion on buybacks versus $17 billion on research, and Biogen Idec, which repurchased $14.6 billion in stock and spent $13.8 billion on research and development.

"The key cause of high drug prices, restricted access to medicines and stifled innovation, we submit, is a social disease called 'maximizing shareholder value,'" the study's authors concluded.

This concept, the authors said, is actually "an ideology of value extraction." And chief among the beneficiaries of the extraction are drug company executives, whose pay packages, based in part on stock prices, are among the lushest in corporate America.

"There's no shortage of spending on R&D in the U.S. economy, and no shortage of spending on life sciences, even though it has declined somewhat in real terms," one of the authors, William Lazonick, a professor of economics at the University of Massachusetts, Lowell, said in an interview. "But there really is very little drug development going on in companies showing the highest profits and capturing much of the gains."

(The other authors are: Matt Hopkins, Ken Jacobson, Mustafa Erdem Sakinç and Öner Tulum, all researchers at the Academic-Industry Research Network, a nonprofit organization.)

While stock buybacks appear to be particularly troublesome among drugmakers, big companies in other industries — in sectors like banking, retail, technology and consumer goods, among others — are also buying back boatloads of their shares. Through May, some $390 billion in buybacks have been announced this year, $13 billion more than at this time in 2016, according to figures compiled by Jeffrey Yale Rubin at Birinyi Associates, a stock market research firm.

June 28 was the biggest single buyback announcement day in history. That was when 26 banks disclosed buybacks worth $92.8 billion, largely a response to having just passed the stress tests administered by the Federal Reserve Board. That figure blew past the previous record of $56.4 billion announced on July 20, 2006.

Many companies contend that stock buybacks are a great way to return value to their shareholders. Investors often agree. By reducing the equity outstanding at a company, the repurchases increase its per-share earnings, often giving a boost to its stock.

Buybacks made at low cost can be a fine use of a company's capital. But when share repurchases replace a company's research-and-development spending, that indicates its management is unable or unwilling to spend on innovation that could generate future earnings to shareholders.

As the buyback binge continues, another new academic study shows, a heavy reliance on them actually hurts corporate performance over the long haul. These researchers found that the more capital a business invests in stock repurchases based on its current market capitalization, "the less likely that company is to experience long-term growth in overall market value."

"Secular Stagnation" is by Robert U. Ayres, emeritus professor of economics, political science and technology management at the global business school Insead, and Michael Olenick, a research fellow there. It compares the performance of companies that lean heavily on buybacks with those that do not.

Spending money on buybacks and dividends has increased among United States companies from negligible levels in the 1980s, the researchers said, to 38 percent of earnings in 2000. By 2011, buybacks had grown to 79 percent of earnings, rocketing to 110 percent in 2015.

The research looked at 1,839 large company buybacks from January 1990 through last month, examining 6,516 inflation-adjusted transactions. The academics then examined the amounts these companies had spent on repurchases compared with their current market capitalizations.

Mr. Ayres and Mr. Olenick found that 199 companies repurchased shares equal to at least half their current value. Some 64 companies spent over 100 percent of their current market capitalization on buybacks.

When the academics combined these companies' current market values with the amounts they had spent on buybacks, the sum showed what the companies should have been worth if they had invested the money in a money-market account instead.

Fifty companies have spent more inflation-adjusted capital buying back stock than their businesses are currently worth in market value, the study found. Companies on this list include HP Inc., J. C. Penney and Sears Holdings.

By contrast, the research identified 269 strong performers that have repurchased stock worth just 2 percent or less of their current market values. They include Facebook, Xcel Energy, Berkshire Hathaway and Amazon.

Company executives who buy back large numbers of shares instead of investing in their businesses are committing corporate suicide, Mr. Olenick said. "When managers can't create value in the business other than buying their own stock," he said in an interview, "it seems like it's time for a management change."

His co-author, Mr. Ayres, said he suspected the buyback craze was rooted in executives' laser focus on short-term results. "They have short-term expectations," he said in an interview. "They're in their jobs for a few years at most; they're not really interested in the long-term future of the company."

Share buybacks provide immediate gratification, the stock market equivalent of a sugar high. That makes them alluring in the short term. Until the crash that usually follows.