Buybacks are another reason to start embracing UK equities again

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After a Brexit-induced hiatus, marginal buyers are coming back to the UK. Overseas demand for UK gilts has never been higher. Offshore private equity firms are competing for a deep pool of attractively valued businesses. And, with some of the highest free cash flow yields in the world, many UK blue chips have started to pull the buyback lever as part of broader plans to return capital to shareholders.

Combined, these are firm signs that confidence in the UK is returning. Businesses are in good shape, the post-Brexit, post-Covid outlook is brightening, and the stock market continues to trade at a discount to global peers – for now.

A renaissance for neglected old economy stocks?

Today's situation is markedly different to the pre-pandemic peak in buybacks when Trump tax reforms (and, in some cases, cheap leverage) drove a buyback bonanza in the US that spilled over to the UK. What stands out today is the highly unusual situation whereby larger incumbents – the so called "old economy" stocks – have accumulated vast amounts of capital during the pandemic which many have been holding due to restrictions on capital payments (e.g. in the financial sector) and/or to ride out the downturn.

Although buybacks in the UK are currently running at about 35% below the five-year average, the taps are reopening. Roughly £7.0bn of buybacks were announced during the most recent reporting season, across a range of sectors. With restrictions on the return of capital from financials starting to lift, it is quite possible that this figure could climb towards the peak level of £43bn seen in 2018. Resources stocks, which is another UK buyback mainstay, have started to announce programmes.

Buyback plans north of £1bn have been unveiled by the likes of Diageo, Unilever, Anglo American, Royal Dutch Shell and BP, with solid plans also being announced by BAE Systems, and financial stocks, Aviva, Barclays, Standard Chartered and, most recently, NatWest. We have seen buybacks across a wide range of businesses, including capital light companies like Domino's Pizza which has flourished during the lockdowns and sees its share price potentially undervaluing its growth prospects.

NatWest is an interesting case study of an incumbent business whose buyback programme could be a catalyst for sustained long-term shareholder returns*. It recently announced plans to return a minimum of £1bn to shareholders, including via a £750m buyback programme, which it will grow in time.

In this unique example, shareholders are not just benefiting from the removal of Covid-era restrictions, but also from the reduction in the government's holding established during the Global Financial Crisis. The company also bought back 5% of the UK Treasury's stake in March and we would not be surprised to see further bilateral trades over the coming years.

For the bank's management team buying back shares at a price-to-book of roughly 0.7x is value accretive, and the group is well-capitalised to honour plans to return further capital to shareholders. The bank has about £7.0bn in excess capital (equivalent to roughly 30% of its market cap), which reflects both its transition to a more vanilla banking group and also very low loan default rates that persisted during the pandemic.

Given the prospect of a resurgent domestic economy and a pick-up in inflation which is putting upward pressure on interest rates, combined with possible write backs from material loan provisions during Covid, NatWest's low valuation appears anomalous, even with the government's shareholding. The bank's buyback and dividend plans could start to change that.

Increased competition for assets

While private equity buyouts might be grabbing the headlines, buybacks are a nuanced example of the increased competition for assets that is playing out in the UK. Indeed, they are often viewed as a strategy for management teams to defend against predatory takeovers by not only reducing the roster of marginal sellers on the register, but also enhancing valuation metrics.

Moreover, unlike previous years when we have seen peak buybacks, this activity is occurring at a time when earnings for FTSE100 businesses have been rising faster than share prices, earnings per share revisions have been beating those of markets in the US and Europe, and revisions of net income margins are the highest for 20 years. Further encouragement comes from the fact Britain is expected to grow faster than G7 counterparts this year due in no small part by its successful vaccination programme which is the envy of much of the rest of the world.

Competition for assets, attractive valuations and improving company fundamentals, set against a strong economy, offer a rare opportunity for investors in UK equities. In our view, the market's valuation gap to global peers, which has been in place since the Brexit vote, may finally be starting to close.

*NatWest is included as an example only and the discussion is not a recommendation to buy or sell shares in the company.

For a comprehensive list of common financial words and terms, see our glossary at: http://www.edinburgh-investment-trust.co.uk/glossary

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