Lord Wolfson (Next Plc CEO) explains share buybacks with great clarity in this excerpt from the NEXT January 2013 Year-End report…

CASH GENERATION, NET DEBT AND SHARE BUYBACKS

BUYBACKS, EPS AND SHARE PRICE

Despite their increasing popularity, share buybacks are still widely misunderstood. There are still those who wrongly believe that they are some sort of share support scheme. This, of course, would be futile as any attempt to support a share price would evaporate as soon as the money ran out.

The only reason share buybacks can deliver long term value is because they *permanently reduce the number of shares in issue* and so increase the amount of profit attributable to each share (EPS). An important part of the logic of share buybacks is the implied link between growth in EPS and growth in share price. Whilst, in the short term there might appear to be no link, in the long run share prices tend to reflect the fundamental value of the earnings and dividend stream. If the share price did not rise with EPS, the buyback programme would eventually leave a single share owning all the profits and dividends!

The graph below illustrates the long term correlation of share price to EPS for NEXT plc over the period we have been buying back shares. The blue boxes indicate earnings per share and the black line shows the share price. The boxes at the top of the chart show the historic price/earnings (PE) ratio.

Earnings Per Share and Share Price History

EQUIVALENT RATE OF RETURN (ERR)

The tables below set out the maths used to calculate ERR. The top table shows the enhancement achieved from acquiring £250m of shares at £40, which is 4%. The second table shows that if we were to increase our profits by 4% we would have to invest in an asset yielding 10%. Given that share buybacks carry no additional operational risk, the returns at 10% remain very attractive.

Enhancement £250m Buyback (pre interest costs)

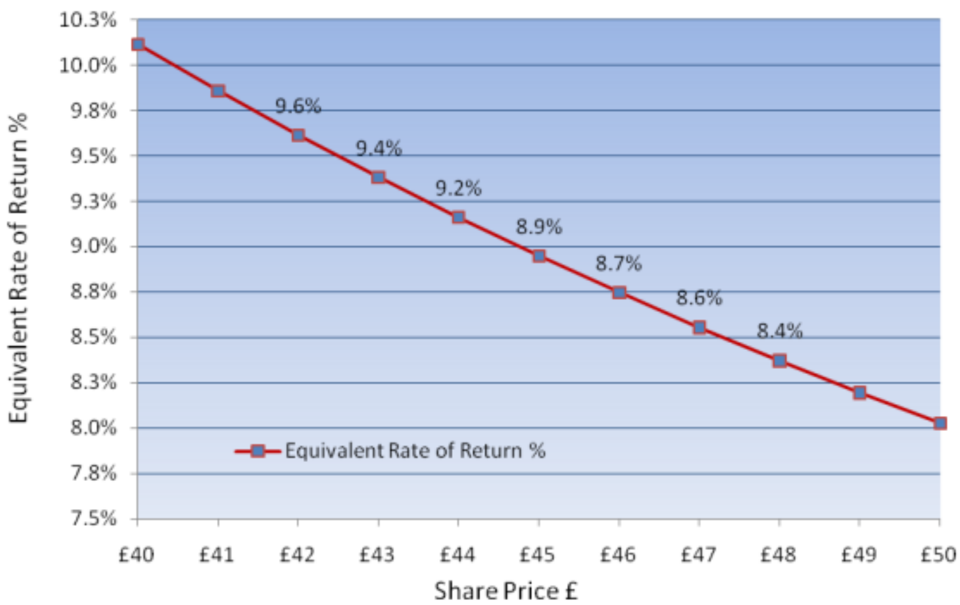
Share price	£40.00
Market capitalisation	£6400m
Cash used for buyback	£250m
% Acquired (250/6400)	3.9%
EPS Enhancement 1 / (1 - 3.9%)	4.1%

Calculating ERR

Company profits	£622m
Additional profit required for 4% growth in EPS	£25.3m
Additional profit as percentage of £250m invested in buyback (ERR)	10.1%

(These workings are a shown as an explanation of Equivalent Rate of Return. Of course, a simpler way of calculating ERR is to divide profit before tax into market capitalisation!)

The graph below shows how ERR falls as the share price rises. As the yield approaches the Market's expected return on equity (say 8%), the buyback becomes less attractive. If the returns dropped much below 9% we would become less enthusiastic, so to a certain extent the share price provides a natural moderator of a disciplined buyback programme.



THE LONG GAME – THE NEXT PLC RULES OF BUYBACKS

Over the long term, we have been following these rules when considering buybacks:

1. Share buybacks must be earnings enhancing and make a healthy Equivalent Rate of Return (see below).
2. Only use the cash the business does not need. NEXT has always prioritised investment in the business over share buybacks.
3. Use surplus cash flow, not ever-increasing amounts of debt. We have never allowed our share buyback programme to threaten our investment grade credit status and will not do so going forward.
4. Maintain the dividend at a reasonable level through growing dividends in line with EPS. NEXT will continue to increase dividends in line with EPS.
5. Be consistent. NEXT has been buying shares every year for more than 10 years, reducing the shares in issue by more than 50%.
6. For share buybacks to be an effective use of shareholder cash, the core business must have the prospect of long term growth.

EFFECT ON BUYBACKS OF A RISING SHARE PRICE

The graph above demonstrates that the relationship between our EPS and share price has recently returned to its near historical average. It is important to recognise that this relative rise in the PE ratio reduces the benefit of share buybacks. The more expensive the shares become, the smaller the share of the business can be bought with the same amount of surplus cash.

For example, two years ago when our share price was £21, our operational free cash flow of £200m enabled us to buy 5.2% of the Company. Today with the shares around £40 our expected surplus cash flow of £250m will only buy 3.9%.

The overall effect is simple: as the PE ratio rises the earnings enhancement of buybacks falls. So, given our current PE ratio, how should NEXT assess the desirability of share buybacks?

Essentially there are two measures we look at. The first is the *earnings enhancement* of a buyback when compared to the enhancement to earnings from keeping the cash in the bank and earning interest. The second is the comparison between the earnings enhancement of a buyback compared to the return that would have to be achieved from investing the cash in an alternative investment, the *equivalent rate of return (ERR).*

With long term borrowing rates for NEXT at around 4%, a share buyback of £250m at £40 would be 2.5% earnings enhancing. The problem with this method of assessing buybacks is that at low interest rates buybacks remain earnings enhancing beyond £60, so we consider the equivalent rate of return measure to be more helpful.