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# Share repurchases can be a good deal

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From being a rather obscure, mainly US activity, share repurchases have become an important global transaction. Since 2000, the number of share repurchase announcements made by non-US companies is at least as large as it is in the US. The total global US dollar volume of buyback activity reached its peak in 2005, at approximately $400bn, although the number of repurchase announcements was much larger in the late 1990s.

The increase in repurchase activity outside the US is the result of factors such as deregulation, tax changes, increased concern about shareholder value and the adoption of stock option plans. Share repurchases used to be illegal in many countries or were discouraged using tax laws. Moreover, managers typically prefer to use excess cash to grow and expand, rather than return it to shareholders. Finally, a repurchase can be used to minimise the dilution created by executive stock option compensation.

**Share repurchase methods**

A company can repurchase shares in four different ways: a fixed-price tender offer; a Dutch auction tender offer; a repurchase in the open market; and a privately negotiated repurchase from a large investor.

■ **Fixed-price tender offer** This is when a company offers to repurchase a specific number of shares at a given price (the tender price) before a given date (the expiration date). For example, on July 5, **Prepaid Legal Services** announced a fixed-price tender offer for 1m shares at $35 per share. The offer expired on August 2, so investors had about one month to decide whether to tender their shares. However, because the stock price rose to $35 after the announcement, only 166,960 shares were tendered. It seems that the market believed that the company was trying to buy back stock cheap. As a result, most investors did not tender. This may have been a consequence of the fact that the tender price was only 5 per cent above the market price prior to the repurchase, which is far below the typical premium of 22 per cent reported by various researchers.

This highlights some of the problems with fixed-price tender offers: if the tender price is below or equal to the market value after the repurchase announcement, the offer will be unsuccessful. If, however, the tender price is significantly higher than market value, the offer will be heavily oversubscribed, and the company may feel it has paid too much.

■ **Dutch auction tender offer** In this case, the company specifies a range of prices within which each tendering shareholder chooses their minimum acceptable selling price. Dutch auctions can be more appealing to a corporation than a fixed-price tender offer. There are several reasons for this: it is a cheaper way to buy back a specific number of shares than a fixed-price offer; you are essentially repurchasing from the most pessimistic investors, who would be the first to sell the company to a hostile bidder; and the repurchase price is not fixed in advance, but moves with the general level of the stock market, which means the company is better hedged against stock market crashes.

On July 20, **Microsoft** announced a Dutch auction tender offer to buy back about 808m shares for a price per share no greater than $24.75 and no less than $22.50. Each shareholder then informed the company of the number of shares he was willing to sell and the minimum acceptable selling price. The company then pays to all stockholders the lowest price that will secure the number of shares sought. However, on the expiration of Microsoft's offer, on August 17, only 155m of the 808m shares sought were tendered and the company had to pay the top price of the price range ($24.75). So, even a Dutch auction failed to pay off as planned.

■ **Repurchase of shares on the open market** If the company is not in a hurry to repurchase a lot of stock, wants to preserve flexibility and does not want to pay a premium above the market price, it can repurchase shares in the open market. This is the most common repurchase method, representing about 90 per cent of all repurchases. With this method, the company instructs a broker to occasionally buy back some shares on the open market. Although open-market repurchases seem to be the cheapest way to repurchase stock, they are often subject to volume and price restrictions.

■ **Repurchase of shares from large investors in private transactions** These repurchases could take place at a premium above the market price, at the market price or at a discount. One type of special premium transaction is called greenmail, where the company buys back stock from a potential raider. Such transactions were popular in the US in the 1980s, when hostile bids were common, but have all but disappeared in recent years.

According to research conducted with my Insead colleague Urs Peyer, approximately 45 per cent of private repurchases take place at a discount from the market price. These repurchases are driven by a desire to provide liquidity for large investors who want to exit rapidly and are in a poor negotiating position.

**The short-term effect of share repurchases on share price**

On average, stock prices increase as a result of repurchase announcements. The strongest positive reaction is found in fixed-price tender offers, followed by Dutch auctions, open-market repurchases and privately negotiated repurchases. So, while it is true that buying back through a fixed price tender offer is more expensive than buying back stock in a Dutch auction offer and an open-market repurchase, the fact is that the more expensive the repurchase method, the larger the increase in shareholder value, at least in the short run.

Studies on European open-market repurchases by Meziane Lasfer of Cass Business School found much smaller announcement returns (1 to 1.5 per cent). This could be explained by the fact that, unlike in the US where the board of directors approves buyback authorisations, in Europe shareholder approval is necessary. As a result, many buyback authorisations are routine requests made at the normal shareholder meetings, not tactical market-timing decisions, as in the US.

Research conducted by Hua Zhang, of the Chongqing Institute of Technology, on open-market share repurchases in Japan, is consistent with this hypothesis. In Japan, as in the US, only the board of directors has to approve buybacks, and these buyback announcements generate large announcement returns of 6 per cent, on average.

**The benefits of share repurchases**

There are three main benefits to share repurchases.

■ **Corporate tax savings** If a company borrows money to buy back stock, it lowers its corporate tax bill, as interest is a tax deductible expense. To the extent that interest earned on excess cash is subject to corporate income taxes, a similar argument can be made for repurchases financed with excess cash.

■ **Agency costs reductions** Share prices increase because the market expects excess cash to be wasted in value-destroying projects. Of course, this assumes that managers are unwilling or incapable of "parking " excess cash in investments that don't destroy value.

■ **Information signalling** The repurchase is a signal that management believes that the stock is undervalued. Indeed, a repurchase is an investment in the company. To the extent that managers are also owners, buying back stock is, in some ways, a form of indirect insider buying, which should be a good sign.

Although these benefits are not mutually exclusive, there are at least two facts that are consistent with the signalling hypothesis, but not with the other hypotheses. First, regardless of the repurchase method, abnormal returns are highly correlated with the repurchase premium. This makes sense in a signalling framework, as the higher the repurchase premium, the more costly it is for managers to buy back stock if the company is not undervalued. So, the signal is more credible

with a high repurchase premium. Note that for the other hypotheses the premium does not matter; only the total amount of cash distributed is relevant.

Second, even if the repurchase is unsuccessful, stock prices increase. This can be seen in the case of Prepaid Legal Services: although the company was largely unsuccessful in repurchasing stock, stock prices rose as a result of the repurchase announcement.

**The long-term effect of open-market share repurchases**

In a study by Alon Brav, John Graham, Campbell Harvey and Roni Michaely, US CFOs stated that the most important reason for repurchasing shares is the belief that they are undervalued.

Specifically, if the market response after an open-market repurchase announcement is correct, the stock will no longer be undervalued after the announcement. But in that case, as an open-market repurchase plan is not a firm commitment, companies simply would not complete the repurchase.

However, research conducted by Clifford Stephens and Michael Weisbach from the University of Illinois shows that more than 70 per cent of repurchase programmes are completed. So, managers must believe that, on average, the market under-reacts to repurchase announcements.

In a research project I conducted with David Ikenberry and Josef Lakonishok of the University of Illinois at Urbana-Champaign that looked at repurchases between 1980 and 1990, we found that, on average, managers are right: buying shares after open-market repurchase announcements and holding them for three to four years generates significant abnormal returns. For value stocks (stocks with low market-to-book value, which one expects to be more undervalued than other stocks), the abnormal performance is the most significant, and close to 45 per cent after four years.

In another paper, co-authored with Prof Peyer, I examined a more recent period (1990-2001) and used a broader measure of the probability of undervaluation, the so-called undervaluation index. This index is based on four factors, which we believe are associated with the likelihood of undervaluation: book-to-market; firm size; stated reason for the repurchase; and stock price behaviour during the previous six months.

We did the following tests of the strategy. Starting in January 1992, we invested in the 50 stocks that had announced an open-market repurchase programme during the previous year and had the largest undervaluation index measure among the companies that announced a repurchase programme in 1991. This strategy beat the S&P 500, with 48 per cent after three years and 65 per cent after four years. This strategy was repeated in all following years until 2002. In each of these years, the portfolios of buyback stocks beat the S&P 500 three and four years after portfolio formation.

Why does the market remain so inefficient? One possible answer is that stocks with the best long-term performance are small companies beaten up during the six months prior to the buyback. These businesses are downgraded by analysts. So, buying shares after a repurchase announcement means going against the opinions of those who are supposed to be the most knowledgeable about the business. Apparently, investors are reluctant to do this.

**Conclusion**

A repurchase is a payout decision and a capital structure decision, but, above all, it is an investment decision. On average, managers seem to be able to make good investment decisions, especially in small companies that have been beaten down by analysts. This means that buyback announcements should be relevant for portfolio managers as well as for financial executives.

**Further Reading**

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To find out more about buyback investing, visit **www.repurchasefund.com**, or the webpages of **Urs Peyer** and **Theo Vermalen**

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