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Market underreaction to open market share repurchases

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Abstract

We examine long-run firm performance following open market share repurchase announcements, 1980–1990. We find that the average abnormal four-year buy-and-hold return measured after the initial announcement is 12.1%. For 'value' stocks, companies more likely to be repurchasing shares because of undervaluation, the average abnormal return is 45.3%. For repurchases announced by 'glamour' stocks, where undervaluation is less likely to be an important motive, no positive drift in abnormal returns is observed. Thus, at least with respect to value stocks, the market errs in its initial response and appears to ignore much of the information conveyed through repurchase announcements.

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1. Introduction

Corporations distribute substantial sums of wealth to shareholde: chasing their own stock. From 1980 to 1990, the aggregate valı repurchased on the New York Stock Exchange (NYSE), the Ame: Exchange (ASE), and the National Association of Securities Dealers Quotations (NASDAQ) was about one-third of the value distribu dividends. Toward the end of the 1980s, the dollars involved in ı increased substantially, becoming nearly half the amount paid as casl Framed differently, the dollar value of stock repurchases announc 1985 and 1993 was nearly three times larger than that raised thr(public offerings (IPOs).[1] In 1994, stock buybacks continued at a r(more than $65 billion were announced. Firms can reacquire sh through tender offers or through open market transactions. Histori agers have chosen the latter approach by wide margins. For example, dollar value of all share repurchases announced between 1985 and to be completed through open market transactions. In this paper, \ the long-run performance of firms that chose this approach for re shares.

The literature provides a lengthy list of motivations for why cc might repurchase their own shares: capital structure adjustment, ta fense, signaling, excess cash distribution, substitution for cash divi wealth expropriation from bondholders. While all of these reasons ar signaling has emerged as one of the most prevalent explanations (' 1981; Dann, 1981; Asquith and Mullins, 1986; Ofer and Thakor, 198' tinides and Grundy, 1989). The Traditional Signaling Hypothesis, motivated by asymmetric information between the marketplace aı managers. If, in management's assessment, the firm is undervalued, choose to buy back stock. Making such an announcement is thus serving a valuable signal to a less informed marketplace. If marke efficiently, prices should adjust immediately in an unbiased manne: equilibrium price should fully reflect the 'true' value of the new inforn no wealth transfer should occur between long-term shareholders selling shares to the firm.

When managers are asked why they repurchase shares on the op the most commonly cited reason is 'undervaluation' and that tl represent a 'good investment', two reasons seemingly consistent wit (Baker, Gallagher, and Morgan, 1981; Dann, 1983; Wansley, Lane, a

[1] From 1985 to 1993, the total value of all announced share repurchases recorded by S(Company was $334 billion (excluding REITs and closed-end funds). The comparable d initial public offerings over the same period was $114 billion.