Operating performance following open market share repurchase announcements

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Available online 1 June 2005

Abstract

I document that operating performance improves following 4,729 announcements of open market share repurchase programs from 1981 to 2000. Moreover, the capital market responds favorably to earnings announcements after the program announcements. Further analysis reveals that both the operating performance improvement and the positive earnings announcement returns are limited to those firms that actually repurchase shares during the same fiscal quarter. Last, I report that a subsample of firms that initiate the repurchases in quarters following the program announcements experience improvements after the initiation quarter, suggesting that actual repurchases, and not announcements per se, portend future performance improvements.

JEL classification: G35

Keywords: Share repurchase; Operating performance

1. Introduction

The last two decades have witnessed a dramatic increase in the use of open market repurchases, and by 1998 the total value of share repurchases (led by open market...
repurchases) exceeded that of dividends (Grullon and Michaely, 2002). According to
the survey evidence in Brav et al. (2003), managers regard undervaluation of the
stock to be the most important reason for repurchasing shares. If the stock is truly
undervalued, share repurchase programs represent positive NPV projects that benefit
shareholders. Any undervaluation likely stems from managers expecting future
operating performance to be better than the capital market expects. Thus, a side
effect of share repurchases is that they convey favorable information to the market
about future performance.

Consistent with the notion that open market share repurchases convey favorable
information to the capital market, Vermaelen (1981) and Comment and Jarrell
(1991) report that the stock market reaction to announcements of open market share
repurchase programs is positive. Bartov (1991) provides some evidence that the
positive wealth impact is attributable to an improvement in earnings. In particular,
he reports that analysts revise upward their earnings forecasts around open market
share repurchase announcements relative to control firms and that earnings improve
during the announcement year. However, using a much larger sample, Grullon and
Michaely (2004) find no evidence that analysts revise their earnings forecasts upward
around open market share repurchase program announcements, and only weak
evidence that earnings improve during the announcement year. In addition, neither
Bartov nor Grullon and Michaely find any evidence of earnings improvements
during post-announcement years. Overall, there is little evidence in extant literature
that announcements of repurchase programs portend improvements in operating
performance. If there is an improvement, it appears to primarily take place during
the announcement year. It is difficult, however, to interpret any changes during the
announcement year, because they might occur during the fiscal quarters before the
announcement or the fiscal quarters afterward. This distinction is important, because
it might tell whether decisions to launch open market repurchase programs depend
on insiders’ expectations of future performance changes and whether performance
changes can explain the positive average stock price reaction upon program
announcements.

I reexamine changes in operating performance around open market repurchase
program announcements using quarterly data. Quarterly data permit me to better
disentangle changes in performance immediately before and after the announce-
ments. In addition to reporting performance changes for firms that announce
repurchase programs and performance changes net of corresponding changes for
industry peers, I report performance changes net of changes for firms with similar
pre-event performance. Fama and French (2000) show that past performance
patterns affect future performance changes. For example, a firm with superior
performance will likely experience a subsequent reversion to the industry norm as
other firms imitate its strategy and products. As a result, Barber and Lyon (1996)
and Lie (2001) report that when analyzing whether future performance changes
unexpectedly for firms with superior performance, the failure to compare the
performance changes to those for firms with similar past performance generates
biased test-statistics. Because firms that announce repurchases generally exhibit
superior performance, I primarily rely on the changes for the sample firms net of the
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