Research in International Business and Finance 25 (2011) 156–168

Contents lists available at ScienceDirect

Research in International Business and Finance

journal homepage: www.elsevier.com/locate/ribaf

Economic conditions and the motives for multiple open-market share buybacks

Damien Farrugia [a], Michael Graham [b,*], Alfred Yawson [c]

[a] GM Holden, P.O. Box. 1714, Melbourne, VIC 3001, Australia
[b] School of Economics, Finance, and Marketing, Royal Melbourne Institute of Technology (RMIT) University, Melbourne, VIC 3001, Australia
[c] The Business School, University of Adelaide, Adelaide, SA 5005, Australia

ARTICLE INFO

Article history:
Received 16 February 2010
Received in revised form 1 January 2011
Accepted 4 January 2011
Available online 13 January 2011

Keywords:
Multiple buyback
Motivation
Repurchase
Shares

ABSTRACT

We examine the impact of business conditions on the frequency of share repurchases. The results generally indicate that share repurchase programs are positive and statistically significant in HIGH economic states relative to the other economic states. Segmenting the data into frequency of repurchases, we find evidence suggesting different economic states exert influence on frequent and infrequent but not occasional repurchase programs. Further, we show that firms that institute frequent share repurchasing programs experience stronger returns across different business cycles compared to infrequent and occasional share repurchasers.

1. Introduction

Open-market share buybacks have become an established mechanism to distribute cash flows to residual claimants. This program can also be seen as a change in ownership, capital structure and payout policies of the firm. Many potential reasons have been posited to explain why firms purchase their own stock. These include the information-signalling (Dann, 1981; Vermaelen, 1981; Grullon and Ikenberry, 2000; Jagannathan and Stephens, 2003), free cash flow hypothesis (Jensen, 1986; Lang and Litzenberger, 1989; Grullon and Michaely, 2002), dividend substitution hypothesis (Jagannathan et al., 2000; Grullon and Michaely, 2002; Brav et al., 2005), option funding hypothesis (Dittmar, 2000; Kahle,

* Corresponding author.
E-mail addresses: damien.farrugia@gm.com (D. Farrugia), michael.graham@rmit.edu.au (M. Graham), alfred.yawson@adelaide.edu.au (A. Yawson).

0275-5319/$ – see front matter
doi:10.1016/j.ribaf.2011.01.003

2002), capital structure hypothesis (Mitchell and Robinson, 1999; Hovakimian et al., 2001; Grullon and Michaely, 2004), and the takeover deterrence hypothesis (Stulz, 1988; Bagwell, 1991).

An examination of the literature, however, suggests that signalling is the motive most commonly attributed to share buybacks as a firm's announcement of its willingness to invest in itself is seen by many market participants and researchers as a signal that the stock is undervalued. It is, however, improbable that a firm could credibly signal that its stock is undervalued on a regular basis. Thus, the motivations for repurchasing shares on a frequent basis may differ from reasons to repurchase shares occasionally. This is supported by Jagannathan and Stephens (2003) who segment the frequency of repurchase programs into three categories and find that infrequent, occasional and frequent share buybacks (we defined these below in Section 2) seem to be motivated by different rationales.

Share buybacks are mainly seen as an isolated occurrence. The empirical evidence, however, suggests that firms that buyback their shares on the open-market are doing so more frequently (Ikenberry et al., 1995; Jagannathan et al., 2000). Grullon and Michaely (2002) document a substantial growth of share buyback programs and note that the value of share repurchases has exceeded the value of dividend payments in the US. Similar to the equity markets in the US, share repurchase programs are also common in Canada and the UK. Ikenberry et al. (2000) outline the growth of share buybacks in Canada while Oswald and Young (2004) posit that although very significant, share repurchase programs in the UK are small compared to the US. Parallel to the US evidence, both the UK and Canadian studies suggest that share repurchase announcements are in part a response by management to perceived undervaluation of the firm.

Distinct from the North American markets and other developed markets like the UK, many markets in the Asia-Pacific region have only effectively allowed share buybacks in the 1990s. These include Japan, Hong Kong, New Zealand, and Singapore (Firth and Yeung, 2005; Zhang, 2002).[1] Zhang (2002) provides evidence indicating that the Japanese market generally interprets share repurchase announcements as positive signals. The evidence further suggests that Japanese corporate managers occasion stock repurchase announcements to take advantage of possible undervaluation by the market. Evidence from Hong Kong suggests that firms initiating share buyback have surplus cash and are undervalued. Also the number of shares repurchased is determined by cash flow availability and prior repurchased programs. Koerniad et al. (2007) investigate share purchases in New Zealand and find evidence supporting the agency and free cashflow hypothesis.

Despite the importance of open-market share repurchase in distributing cash flows to residual claimants, the literature on rationale for initiating such programs, particularly motives for multiple repurchase programs, remain thin compared with dividend distribution. We, therefore, provide further evidence on the motivation behind open-market share repurchase programs. Specifically, we extend Jagannathan and Stephens (2003) study by investigating the impact of economic conditions on various categories of stock buyback programs (infrequent, occasional, and frequent) using Australian data.

The use of Australian data is motivated at several levels. First, differing taxation systems provide alternate conditions imposed on share buybacks and dividends. For example, Australia and the US operate under dividend imputation system and classical taxation system, respectively. Although share repurchases are taxed on a capital gains basis in both countries, shareholders in the US would prefer excess cash flows to be distributed via a share repurchase program than in the form of a dividend to benefit from the lower taxes on the capital gains (see Black, 1976; Barclay and Smith, 1988). Brown and Howard (1992) contend that the imputation tax system in Australia, where tax rate on dividend income is lower than that on capital gains, creates a bias towards increasing dividend distributions. This suggests that further examination of the motivation behind multiple stock repurchases using data other than the US is warranted.

Secondly, many factors about firm behaviour vary by country (Gilson and Roe, 1993). For instance, there are significant variations in the legal and regulatory environments between the US and Australia. In the US, firms repurchasing their shares transfer them to their respective treasury holdings, which at

[1] Hong Kong first allowed companies to repurchase their own shares in 1991. Share repurchases were effectively not possible before 1994 in New Zealand and Japan. Furthermore, Singapore only permitted share repurchases in 1998. Many European countries, e.g., France and Germany, also did not allow share repurchases until the late 1990s.