NORTH-HOLLAND

The Quarterly Review of Economics and Finance
43 (2003) 483–504

The QUARTERLY REVIEW Of ECONOMICS And FINANCE

Why companies use open-market repurchases: A managerial perspective

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Received 25 January 2001; received in revised form 13 December 2001; accepted 27 March 2002

Abstract

We survey 642 top financial executives to learn their views about their firm's share repurchases from January 1998 to September 1999. Based on 194 responses from managers of firms engaging in open-market repurchases, the results show that the most highly cited reasons for repurchasing shares of common stock are consistent with the signaling hypothesis, specifically the undervaluation version of this hypothesis. When compared to the results of previous surveys, our findings suggest that the importance management attaches to certain reasons for repurchasing shares of common stock may have changed over the past few decades. Reasons such as repurchasing shares to provide shares for incentive plans and to remove large blocks of stocks appear less important while reasons such as repurchasing shares to adjust the firm's capital structure and to avoid dividend taxation appear more important.

JEL classification: G350

Keywords: Share repurchase; Cash disbursement

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1062-9769/02/$ – see front matter © 2002 Published by Board of Trustees of the University of Illinois.
PII: S1062-9769(02)00151-5

1. Introduction

Although companies have been permitted to repurchase their stock for many years, U.S. corporations did not begin widely using share repurchases until the mid-1980s. Today, the repurchase of common shares is a common practice. For example, in the 5-year period between 1995 and 1999, U.S. corporations announced intentions to repurchase about US$ 750 billion worth of their stock and in 1998 distributed more cash to shareholders via repurchases than cash dividends (Grullon & Ikenberry, 2000).

The increasing level of repurchase activity contrasts sharply with the decreasing proportion of firms paying dividends.[1] According to Bierman (2001), the reasons that U.S. corporations have increasingly repurchased significant amounts of their own common shares have been subject to numerous, and often conflicting interpretations. Although no fully satisfactory explanation exists for changes in repurchase activity over the past several decades, especially the dramatic increase in the use of open-market share repurchases during the 1990s, several factors may have contributed to this development.

One factor is the improved regulatory environment for repurchases resulting from the adoption of rule 10b-18 by the Securities and Exchange Commission in late 1982. Another factor involves the economy. Several market crashes, such as in October 1987 and October 1989, temporarily caused stock prices to fall. Evidence suggests an inverse relationship between program announcements and broader moves in the market; that is, the number of announcements tends to rise when stock prices fall (Netter & Mitchell, 1989).

A third explanation for the increased popularity of buybacks, especially during the 1990s, is the growing use of stock options to compensate not just management but all employees in a firm. Several studies, including Bartov, Krinsky, and Lee (1998), Jolls (1998), Weisbenner (1999), and Fenn and Liang (2000), examine stock options and the payout policies of firms. For example, in a study of open-market repurchases from 1993 to 1996, Kahle (2002) finds support for the notion that changes in compensation policy have caused changes in payout policy. Her results show that firms announce repurchases when executives have large numbers of options outstanding and when employees have large numbers of options currently exercisable. After the firm decides to engage in a repurchase, the amount repurchased is positively related to total options exercisable by all employees but independent of managerial options. These results are consistent with managers repurchasing both to maximize their own wealth and to fund employee stock option exercises.

The finance literature has examined many aspects of repurchase activity including why firms repurchase common stock, how stock prices react to repurchases and repurchase announcements, and how different repurchase methods (open-market share repurchases, fixed-price tender offers, and Dutch-auction repurchases) affect the repurchase experience. Early research clearly shows that repurchase announcements are associated with stock price increases (Dann, 1981; Masulis, 1980). The market reaction to share repurchase announcements is often quite strong with the size of the reaction depending on such factors as the form of the repurchase method and the reason for the repurchase (Vermaelen, 1981).

Our study focuses on the issue of why corporations use open-market stock repurchases. Specifically, we survey corporate managers whose companies recently repurchased shares to determine their reasons for the repurchase. Grullon and Ikenberry (2000) discuss five major