International Review of Economics and Finance 19 (2010) 427–435

Contents lists available at ScienceDirect

International Review of Economics and Finance

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

Does prior record matter in the wealth effect of open-market share repurchase announcements?

Shao-Chi Chang [a], Sheng-Syan Chen [b], Li-Yu Chen [a,*]

[a] Institute of International Business, National Cheng Kung University, Tainan, Taiwan
[b] Department of Finance, College of Management, National Taiwan University, Taipei, Taiwan

ARTICLE INFO

Article history:
Received 18 March 2009
Received in revised form 26 June 2009
Accepted 25 August 2009
Available online 4 November 2009

JEL classification:
G14
G35

Keywords:
Share repurchase
Record on actual buyback
Stock performance

ABSTRACT

This study investigates whether prior experience of share repurchases matters in the market reactions to the subsequent repurchase announcements. Specifically, we study the prior record on actual buybacks and post-announcement stock performance. We find that upon the announcement of share repurchases, stock markets not only respond more positively to those made by firms that have better record on actual buyback following their previous repurchase plan announcements, but also experience a stronger reaction for announcing firms with better stock performance after prior repurchase announcements. These results hold even after controlling for other variables that are found important in influencing the market reactions to repurchase announcements.

1. Introduction

Open-market share repurchases have become common for firms to conduct on a repeated and regular basis. For example, in 1996, more than 54% of firms had previously bought back their shares, and around 27% of the firms made multiple open-market repurchase programs in the prior five years (Jagannathan & Stephens, 2003). Previous studies indicate that firms announcing share repurchases in the open-market convey that they are undervalued (Comment & Jarrell, 1991; Ikenberry, Lakonishok, & Vermaelen, 2000; Ofer & Thakor, 1987; Stephens & Weisbach, 1998). Consequently, after share repurchase announcements, announcing firms experience an average buy-and-hold yearly return of 26.2% following the announcement date (Chan, Ikenberry, & Lee, 2004).

However, several studies related to open-market share repurchase announcements indicate that announcing firms attempt to boost share price without intending to actually complete the buyback. In fact, it has been reported that corporations on average have followed through on only 20% of their announced buyback programs[1]. In addition, Stephens and Weisbach (1998) find that a substantial number of firms acquire no shares at all in the three years following the announcement of a repurchase program, and practitioners have long speculated on these reasons for this.[2] Bens, Nagar, Skinner, and Wong (2003) and Hribar, Jenkins, and Johnson (2006) argue that share repurchases may be motivated by an attempt to increase earnings-per-share by reducing total shares outstanding.

* Corresponding author. Present address: Institute of International Business, College of Management, National Cheng Kung University, No. 1, University Road, Tainan, Taiwan. Tel.: +886 6 2757575 36343.
E-mail address: lychen@mail.fgu.edu.tw (L.-Y. Chen).

[1] See *Fortune*, Sept. 4, 1995 Vol.132, Issue 5; p133.

[2] For example, the *Wall Street Journal* (Mar. 7, 1995) reports that "*When it comes to stock-buyback, public traded companies show a lot of bark than bite. It's oh-so-easy for a company to announce a buyback program. And it's gratifying, no doubt, for a company to watch its share price jump as a result of the announcement. But the open secret on Wall Street is that few companies actually buy anywhere near the amount of stock that they indicate they might.*"

1059-0560/$ – see front matter © 2009 Published by Elsevier Inc.
doi:10.1016/j.iref.2009.10.015

However, do investors learn from a firm's past behavior and accordingly adjust their valuation of it over time? When firms make repurchase announcements, the market expects that they will follow the repurchase program and experience a better stock performance following the announcement date. An interesting question is thus whether announcing firms whose actual repurchasing behavior and post-announcement stock performance fall short of the market's expectations will experience a decrease in the announcement effect when they subsequently state their intention to undertake 'another' repurchase. We expect that there is an impact of previous share repurchase experience on the announcement effect of subsequent repurchase announcements. Specifically, the market should have more favorable responses to share repurchase announcements made by firms with good records of actual repurchases. Similarly, we anticipate that there will be greater announcement effects of share repurchases by firms that have previously delivered better post-announcement stock performance in prior share buybacks.

Investors may take advantage of the record on actual repurchases and stock performance after share repurchase announcements to sort managers into those that signal truthfully and those that signal falsely. If investors are as rational as suggested by traditional finance, they should be able to learn the record for a share repurchase announcement from prior experience. Managers who develop a reputation for credible post-announcement actually repurchasing behavior and post-announcement stock performance are likely to be believe the next time they make such announcements, while managers who develop a reputation for false signals may receive significantly discounted responses.

To date, several prior studies have already shown that there is a positive or insignificant relationship between current actual buybacks and current announcement effect (Chan et al, 2004; Stephens & Weisbach, 1998; Zhang, 2005). In addition, Lie (2005) indicates that firms that actually buy back shares during the announcement quarter experience a significant improvement in short-term abnormal operating performance. Furthermore, Gong, Louis, and Sun (2008) find that downward earnings management in the pre-announcement period of open-market repurchase announcements results in abnormal operating performance. However, to the best of our knowledge, our hypotheses have never been tested before in the literature.

A sample of recurring share repurchase announcements is collected for the period 1986–2005 to test our hypothesis. Consistent with prior studies, share repurchase announcements are associated with significantly positive abnormal returns. When we investigate the effect of actual repurchase, the results show that firms with better records of actual repurchases have significantly stronger market reactions to subsequent announcements of such repurchases. The results also indicate that the market rewards firms that delivered better stock performance in the prior share repurchases. This conclusion holds even after controlling for other important variables in explaining the market reactions to share repurchase announcements.

Given the evidence, when announcing firms' actual repurchasing behavior and performance after buyback announcements do not meet market expectations, investors may view the disappointing results as evidence that the managers intentionally sent incorrect signals. Hence, investors may use this information to interpret the current share repurchase announcement, and offer a more cautious reaction. To the extent that managers' goals do not change, the record of prior actual repurchasing behavior and post-announcement stock performance should serve as useful indicators of the likely consequences of the current share repurchase announcements.

The overall evidence provides strong support for the hypothesis that prior experience matters in the value assessment of the subsequent announcements of share repurchases. Our evidence also suggests that it is difficult for managers to consistently use repurchase announcements merely to boost share prices, as investors observe and learn from a firm's past behavior and accordingly adjust their valuation of it over time. The rest of the paper is organized as follows. Section 2 discusses the data and methodology, while Section 3 presents the empirical results. Finally, the conclusion is given in Section 4.

2. Data and methodology

2.1. Sample selection

Our initial sample of share repurchases is obtained from Security Data Corporation (SDC) for the period from 1986 to 2005. To be included in the final sample, repurchasing firms must satisfy the following criteria.

(1) Since this study examines a sequence of share repurchase announcements, we include only those firms that made at least two such announcements[3] during the sample period.
(2) The sample firm must have return data available on the Center for Research in Security Prices (CRSP) database.
(3) The sample firm must have financial information available from Compustat database.

Following these initial selection criteria, we collect a sample of 5717 open-market share repurchase announcements made by 1741 firms during the sample period.

2.2. Measuring abnormal stock return

We employ standard event-study methods to examine stock price responses to announcements of share repurchases. The event-study methodology is well accepted and has been widely used in a variety of disciplines, such as finance, accounting, business strategy, marketing and organizational behavior (Chen, 2008; Floros & Tsetsekos, 1996; Hanson & Song, 1998; Stephens & Weisbach, 1998). To measure the abnormal stock returns to the announcements, we follow Brown and Warner (1985) by using the market model to obtain estimates of expected returns. The abnormal return is calculated as the residual from the actual return

[3] The requirement of two repurchase announcements means two repurchase programs.