Int. Fin. Markets, Inst. and Money 27 (2013) 59–75

Contents lists available at ScienceDirect

Journal of International Financial Markets, Institutions & Money

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

The information content of open-market repurchase announcements in Taiwan

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ARTICLE INFO

Article history:
Received 22 October 2012
Accepted 20 July 2013
Available online 6 August 2013

JEL classification:
G10
G14
G32

Keywords:
Open-market repurchases
CARs
Announcement information
Premium
Event study

ABSTRACT

Utilizing information disclosures of open-market repurchases in Taiwan, this paper investigates two topics. The first is the association between corresponding announcing information and market responses. The results show that intention ratio is positively correlated with two-day announcement effect and the market responses of the entire execution period. However, the positive relationship is insignificant one month after the termination of the programs. The findings also reveal that price location is significantly negative when related to market responses of the overall execution period, and that such a relationship can last longer. Second, while proxy for undervaluation is properly considered, our findings suggest that the interaction between price location and market responses resulted from a higher premium rather than undervaluation, indicating that price location sends a signal of premium.

1. Introduction

Stock repurchase programs have become a popular and important financial method for firms in many countries to distribute corporate cash to shareholders. In a repurchase program, a firm buys back a portion of its outstanding shares in the market over a period lasting from months to years. Empirical studies provide considerable evidence of significantly positive price responses to announcements

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http://dx.doi.org/10.1016/j.intfin.2013.07.010

of stock repurchase programs (e.g., Comment and Jarrell, 1991; Ikenberry et al., 1995, 2000; Oded, 2005). One common explanation is that firms use stock repurchase announcements to convey a signal of undervaluation (e.g., Dann, 1981; Vermaelen, 1981; Comment and Jarrell, 1991; Ikenberry et al., 1995; Stephens and Weisbach, 1998; Ikenberry et al., 2000). This is also confirmed by declarations of top managers upon announcing repurchase programs that their current stock prices are too low, making their companies attractive investments (e.g., Dann, 1983; Baker et al., 2003).

In addition to uncovering possible motivations for a stock repurchase announcement, some studies compare the signaling power of different forms of common stock repurchases. Comment and Jarrell (1991) indicate that Dutch-auction self-tender offers give a weaker stock undervaluation signal than do fixed-price self-tender offers, possibly because Dutch auctions offer less of a premium over the market price when compared to fixed-price tender offers. In other words, the magnitude of the offered premium over the market price is positively associated with market response. However, disparate market reactions between the two could be due to regulatory differences in the form of stock repurchase programs. For example, a fixed-price offer specifies a single repurchase price, while a Dutch auction specifies a range of prices. The different specifications of repurchase prices may convey different information to market participants and thus induce different market responses.

Unlike in the United States, where three methods are available for stock repurchases,[1] in Taiwan, open-market repurchase (OMR) is the only way for firms to repurchase their shares.[2] In particular, listed companies in the Taiwan Stock Exchange Cooperation (TSEC) are required to specify the purpose,[3] price range, and number of shares to buy back before executing an OMR program. In addition, the program should be completed within two months and the firm must make a statement on the number of shares actually repurchased, average share cost of the repurchase, and/or reasons for not acquiring one hundred percent of the targeted shares. Among these features, the disclosure of a price range (i.e., the specification of ceiling and floor prices) is particularly unique in that it allows us to measure the location of the firm's stock price on the announcement day in relation to the ceiling and floor prices.

Thereby, before executing an OMR program, the aforementioned three announcing variables may convey varying information to investors, which in turn leads to varied market responses. First, the number of shares to be purchased may convey information regarding the goal of a firm's buyback behavior. We would anticipate that a higher intention ratio will lead to higher market reactions. Second, the distinct buyback motivations may transmit different information to investors. Compared with the need to give buyback shares to employees as part of their total compensation, the undervaluation reason may cause higher market responses. Specifically, as a company repurchases outstanding shares for employees only, investors may anticipate that such a firm will passively buy back shares—and consider this to be a weak signal. In contrast, when a firm repurchases shares because of undervaluation, investors may view this kind of motivation as a welcome signal since the company may repurchase shares with great effort.

Third, the relative location of the firm's current stock price in the repurchase price range may convey to investors information regarding the magnitude of the premium[4] and/or the degree of undervaluation. More precisely, a firm with its current stock price close to (or above) the ceiling price has little room for the repurchase premium over its stock price; hence, it should receive a smaller market response. That is, investors view this kind of announcement as a profitless signal. On the other hand, it may also convey that the company is not inclined to buy back shares since the current stock price is high. Investors can infer from the signal that the undervaluation of the firm's stock might not be severe and would therefore not react very favorably to the announcement.

Conversely, when the current stock price of an announcing firm is close to (or below) the floor price, investors would interpret it as a signal for a large or significant premium and respond positively to the

[1] They are privately negotiated transactions, tender offers, and open-market repurchases.

[2] It was not until August 2000 that firms in Taiwan were allowed to buy back outstanding shares.

[3] The three most cited reasons for their repurchases include the need to give existing shares to employees as part of their total compensation, the belief that shares are undervalued, and the need to cover the issue of employee stock options.

[4] To the extent that the relationship between price ranges and market prices of OMR firms in Taiwan is analogous to an offer's premium over the market in a tender offer in the U.S. market.