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Legal Institutions, Ownership Concentration, and Stock Repurchases Around the World: Signal Mimicking?☆

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Abstract

One of the central puzzles of signaling theory is how to assess signal quality, in particular the potential for signal mimicking. Our study provides evidence of signal mimicking in the context of stock repurchases. Employing an ex-ante proxy for the likelihood of mimicking stock repurchases and data on open market stock repurchases from 30 countries, we find that long-term operating and market performance following stock repurchases improve less for suspected mimicking firms. This finding contradicts the conventional characterization that managers use stock repurchases to signal undervaluation and enhanced future performance. We find that mimicking firms have smaller capital investments, need greater external financing, buy back fewer shares, and issue more new shares (and/or resell more treasury shares) in the year of the repurchase. Our analysis further shows that mimicking is more likely in countries with weak investor protections and in firms with higher ownership concentration. Further, mimicking associated with concentrated ownership is mitigated in

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countries with stronger investor protections and by the adoption of International Financial Reporting Standards (IFRS). Altogether, our findings provide evidence of signal mimicking in stock repurchases in international data that is influenced by market, ownership, legal, and financial reporting characteristics of countries.

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1. Introduction

Open market stock repurchases have become increasingly frequent corporate transactions, especially in the U.S., and this activity has received considerable attention from both academics and practitioners. Grullon and Michaely (2002) report that since 1999, U.S. firms have spent more money annually on stock repurchases than on dividends. Since the late 1990s, an increasing number of countries outside the U.S. have adopted similar laws allowing firms to buy back their shares. As a result, repurchase programs have become more common worldwide.

Eije and Megginson (2008) find that while the proportion of European firms paying dividends has declined significantly, the proportion of firms repurchasing their own shares has grown steadily. A similar trend can be observed in East Asia. Following a revision of the Commercial Law, Japanese firms have been able to execute stock repurchases without the approval of a shareholders' meeting since 1997. Despite the growing popularity of stock repurchases as a payout method, little international research has been conducted on the subject. Given the high degree of institutional variation across countries, any conclusions applicable to stock repurchases in the U.S. might not be generalizable elsewhere.

Stock repurchases are a flexible and discretionarily temporary payout method. Firms can immediately offset any discretionary capital payout to the degree they choose by selling offsetting treasury shares or issuing new shares, whereas firms treat dividends as longer-term commitments (Jagannathan, Stephens, & Weisbach, 2000). Previous studies identify several motives for stock repurchases, such as to signal undervaluation, distribute free cash flows, achieve an optimal leverage ratio, fund stock options, defend against takeovers, or exploit tax advantages (e.g., Bagwell & Shoven, 1988; Comment & Jarrell, 1991; Gup & Nam, 2001; Ikenberry, Lakonishok, & Vermaelen, 1995; Lie, 2005; Lie & Lie, 1999).

Although firms repurchase stocks for various motives, the literature maintains that the signaling of undervaluation is a dominant rationale (Chan, Ikenberry, & Lee, 2004; Dittmar, 2000).[5] Brav, Graham, Harvey, and Michaely (2005) show that managers commonly time the market when they believe their stock price is low. The signaling hypothesis suggests that when information asymmetry exists, corporate insiders use repurchases to signal undervaluation or better future performance. It is argued that for this

[5] Dittmar (2000) investigates the relation between stock repurchases and distribution, investment, capital structure, corporate control, and compensation policies. She finds that firms repurchase stock to take advantage of potential undervaluation and to distribute excess capital. However, firms also repurchase stock during certain periods to alter their leverage ratio, fend off takeovers, and counter the dilution effects of stock options.