



# Repurchases of convertible preferred stock and shareholder wealth<sup>☆</sup>



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## ABSTRACT

In this paper we provide the first comprehensive examination of the stock price reaction to announcements of convertible preferred stock repurchases over the 1981 to 2005 period. We document a positive and significant average common stock abnormal return of 3.27% around announcements of these repurchases. We test signaling and free cash flow explanations for the observed wealth effects by studying abnormal returns and changes in operating performance around repurchase announcements. We find that abnormal returns are positively related to size of repurchases and managerial ownership. We find no evidence of higher stock price reactions for low-*q* and high free cash flow firms. In addition, we find significant improvements in accounting profitability subsequent to repurchases, but not for low-*q* firms. Collectively, our results are most consistent with the signaling hypothesis.

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## 1. Introduction

An extensive literature in corporate finance has examined the wealth effects of repurchases of common stock and calls of convertible securities. Announcements of common stock repurchases are associated with positive stock price reactions (e.g., Asquith & Mullins, 1986; Dann, 1981; Peyer & Vermaelen, 2005; Vermaelen, 1981). The most common explanation proposed for the observed wealth effects is that repurchases signal better prospects and higher future cash flows (Bhattacharya, 1979; Miller & Rock, 1985; Vermaelen, 1984). On the other hand, calls of convertibles that force conversion into equity have been found to have negative wealth effects (see Hingorani, Makhija, & Shastri, 1994; Mais, Moore, & Rogers, 1989; Mikkelson, 1981). Stein (1992) argues that convertible securities can be used by firms as a way to raise common equity on a delayed basis and calls of these securities represent a completion of stock financing (see also Mayers, 1998). Hoffmeister, Hays, and Kelley (1987), Mann, Moore, and Ramanlal (1999), Kallberg, Liu, and Villupuram (2008), and Jung and Sullivan (2009) provide other potential motivations for convertible security issuance. Thus, similar to other stock issuance events, the most common interpretation of this negative wealth effect is that calls are signals of unfavorable information (e.g., Harris & Raviv, 1985; Ofer & Natarajan, 1987; Singh, Cowan, & Nayar, 1991).

Many studies have examined the wealth impact of calls of convertible preferred stock, a method to extinguish outstanding convertible preferred securities. Calls of in-the-money convertibles incentivize

convertible holders to convert into common equity since the call price is lower than the conversion value. Repurchases of convertibles can also be used to reduce outstanding convertible securities but this event has not yet been studied. Since the reduction of outstanding convertibles depends on the size of the repurchase, repurchasing firms can choose to retire a portion or all of an outstanding convertible issuance. Such repurchases require cash payouts and eliminate potential increases in common stock in the future, while conversion-forcing calls of convertibles require no payout and result in increases in common stock. The opposite nature of calls and repurchases of convertibles suggests that their motivations are likely to be different. Since calls have commonly been viewed by prior literature as signals of unfavorable information, repurchases may potentially be signals of better future prospects.

In this paper, we provide the first comprehensive examination of convertible preferred stock repurchases and evaluate two alternative motivations that have been studied in similar corporate events. First, the signaling hypothesis views convertible preferred stock repurchases as a signal of better prospects and higher future cash flows. Since repurchases of convertible preferred stock eliminate the option to convert into common stock when stock prices are higher in the future, managers with more favorable private information are likely to repurchase. Next, the free cash flow hypothesis predicts that convertible preferred stock repurchases will alleviate the free cash flow problem since repurchases require cash payouts. Hence, both the signaling and free cash flow hypotheses predict a positive stock price reaction to announcements of convertible preferred stock repurchases.

We analyze a sample of 92 convertible preferred stock repurchases, consisting of targeted repurchases, purchase tender offers, and open-market repurchases, over the 1981 to 2005 period and find a positive and significant stock price reaction to announcements of these repurchases. The average two-day abnormal return is 3.27%. This

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finding sharply contrasts with negative wealth effects reported for calls of convertible preferred stock, but is similar to the evidence documented for repurchases of common stock. The positive wealth effect is consistent with both signaling and free cash flow hypotheses.

We next conduct a series of tests to discern the primary explanation of the positive wealth effect. We conduct a cross-sectional analysis of announcement returns to test a signaling model similar to the one employed by Vermaelen (1981) and Peyer and Vermaelen (2005). We find abnormal returns are higher for larger repurchases and for firms with higher managerial ownership, consistent with the signaling hypothesis. In addition, if investors react favorably to convertible preferred stock repurchases because they consider them a signal of better future prospects, we would expect to find improvements in operating performance following repurchases. In line with this prediction, we find evidence of significant improvements in accounting profitability around repurchase announcements.

The free cash flow hypothesis, on the other hand, predicts a higher stock price reaction around repurchase announcements for firms with poor investment opportunities and high free cash flow. It also predicts greater improvements in accounting profitability around repurchases for firms with poor investment opportunities. None of these predictions are supported in our empirical analysis. Following Grullon and Michaely (2004), we also examine whether repurchasing firms reduce their levels of capital expenditures and R&D, and cash holdings, around repurchases. Inconsistent with the free cash flow hypothesis, we find no evidence of significant reductions in any of these measures. Collectively, our results are most consistent with the signaling hypothesis. Our findings indicate that the motivations behind conversion-forcing calls of convertibles and repurchases are opposite: calls signal overvaluation of common stock while repurchases signal undervaluation.

The rest of the paper is organized as follows. We develop our hypotheses in Section 2. Sample construction and descriptive statistics are reported in Section 3. Event study results and cross-sectional analyses of abnormal returns are presented in Section 4. An examination of operating performance is provided in Section 5. We conclude in Section 6.

## 2. Hypothesis development

We evaluate signaling and free cash flow hypotheses as potential explanations of the stock price reaction to convertible preferred stock repurchases. These hypotheses and their predictions are discussed below.

### 2.1. The signaling hypothesis

The most widely accepted explanation for the positive wealth effects associated with common stock repurchases has been information signaling (see, for example, Comment & Jarrell, 1991; Maxwell & Stephens, 2003; Louis & White, 2007). This hypothesis is based on asymmetric information between the market and managers. According to the cash flow signaling model of Miller and Rock (1985), repurchases can convey favorable information about firm cash flows to the market, even if managers are not intentionally signaling their private information. Also, Vermaelen (1981, 1984) and Peyer and Vermaelen (2005) demonstrate that managers deliberately use stock repurchases as a costly signal about future cash flows and to indicate that their stock is undervalued. Indeed, Brav, Graham, Harvey, and Michaely (2005) provide survey evidence that “undervaluation” is the most dominant response when managers are asked why they repurchase their company’s stock.

Signaling theory thus predicts a positive stock price reaction to announcements of convertible preferred stock repurchases since they eliminate the option to convert into common stock in the future. Managers with favorable private information are more likely to repurchase to prevent convertible preferred stockholders from sharing an increase in stock value in the future. Overvalued firms, on the other hand, have no urgency to repurchase since no immediate good news is expected. This argument is similar to the signaling explanation proposed by

Harris and Raviv (1985) for the negative stock price reaction to calls of in-the-money convertibles. Here, overvalued firms force security holders to convert and share in the impending bad news, while undervalued firms have no incentive to force conversion since delaying conversion is not costly to existing shareholders.

### 2.2. The free cash flow hypothesis

Jensen (1986) argues that firms with high free cash flow are likely to face substantial agency costs. Instead of paying out free cash flow to shareholders, managers may invest it in negative NPV projects for their own benefit. Repurchases of outstanding securities can reduce excess cash under the control of managers and thereby lower the likelihood of overinvestment and increase firm value. In support of the free cash flow hypothesis, Grullon and Michaely (2004) and Perfect, Peterson, and Peterson (1995) find that stock returns at common stock repurchase announcements are higher for firms that are more likely to overinvest (firms with low Tobin’s  $q$  and high cash flow). The free cash flow hypothesis thus predicts a positive stock price reaction to convertible preferred stock repurchases since they result in cash payouts and reduce free cash flow. The stock price reaction should be especially greater for low- $q$  firms.

## 3. Sample construction and descriptive statistics

### 3.1. Sample construction

A sample of 112 convertible preferred stock repurchases is initially collected from the Securities Data Corporation (SDC) Mergers and Acquisitions database for the period 1981 to 2005. After reading the synopsis for each entry, we eliminate 40 observations with a simultaneous repurchase of common stock. Four observations consisting of one call and three withdrawn repurchase tender offers are also eliminated, leaving 68 observations. We then search Factiva to verify the announcement date and collect the details of each repurchase.

As an additional source for identifying preferred stock repurchases, we also conduct a general search using the Factiva database over the same time period. We collect articles containing the words “repurchase”, “preferred”, and “stock” from the Factiva search. We also use the words “buy-back” and “shares” instead of “repurchase” and “stock”, respectively. The following criteria are used to further screen the data:

- (1) Repurchase announcements appear in Factiva and information on the value of repurchase is available.
- (2) Repurchasing firms are contained in the Center for Research in Security Prices (CRSP) file, and stock return data are available for at least 100 days before the repurchase announcement.
- (3) No other major news regarding the firm is reported in Factiva during the three days surrounding the announcement date. Although a simultaneous repurchase of common stock is the most frequent confounding event, others include announcements such as security issuance, exchange offers, negotiated block trade of common stock, earnings, mergers, and divestitures.

Applying these criteria results in 92 repurchases of convertible preferred stock – 51 observations from the SDC database and 41 observations from the Factiva general search.

The 92 repurchases are announced by 84 firms: six firms made two announcements and one firm made three announcements. Two of the firms’ announcements are separated by less than a year and have an overlap for the two-hundred-day estimation period we use for our event study. Five announcements have an overlap period within the five-year window we use for the operating performance analysis. Our results are similar when we exclude these announcements.

Table 1 reports the time distribution of the announcements and the industry distribution of sample firms based on Fama and French (1997). As reported in Panel A, convertible preferred stock repurchases occur

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