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Is the market underreacting or overreacting to open market share repurchases? A UK perspective

Ian Crawford[a,*], Zhiqi Wang[b,1]

[a] School of Management, University of Bath, Bath, Claverton Down, BA2 7JX, UK
[b] Department of Management & Organisational Psychology, Faculty of Business School, Birkbeck, University of London, London, UK

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ABSTRACT

Using UK open market repurchases, we reject the market underreaction hypothesis and the market overreaction hypothesis proposed by Ikenberry et al. (1995) and Peyer and Vermaelen (2009), respectively. The evidence suggests that the UK market reacts slowly to actual repurchases made by value firms. UK repurchases on average do not suffer from share undervaluation prior to the announcement. Value firms perform just as well as glamour firms during the authorisation period but outperform glamour firms significantly 2 years following the announcement. It turns out that value firms repurchase over 6% more shares than glamour firms during the authorisation period.

1. Introduction

Share performance of US open market share repurchases has been extensively studied and two main explanations are offered to explain the seemingly die-hard existence of abnormal returns following the announcement. Ikenberry et al. (1995) propose the market underreaction hypothesis which suggests that the market treats repurchase announcements with scepticism, leading prices to adjust slowly over time (4 years). Some years late, Peyer and Vermaelen (2009) find evidence consistent with the overreaction hypothesis which suggests that open market share repurchases are a response to a market overreaction to bad news prior to the repurchase. Long run abnormal returns are in

* Corresponding author. Tel.: +44 012 2538 4399; fax: +44 012 2538 6473.
E-mail addresses: mnsipc@bath.ac.uk (I. Crawford), zhiqi.wang@mbs.bbk.ac.uk (Z. Wang).
[1] Tel.: +44 020 7631 6467.

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particular persistent among value firms (high book-to-market ratios) and are strongly related to pre-announcement share undervaluation. Will this phenomenon exist in the UK where characteristics of and regulations governing open market repurchases differ significantly from the US?

Despite the similarities in law and language between US and UK markets, UK open market share repurchases have significantly different characteristics and are governed by different law and reporting regulations. According to the listing rules of the London Stock Exchange, listed firms must publish actual repurchases on the regulatory news services (RNS) which are viewable to the market and investors the next business day. In addition, the UK company law (Companies Act 1985) required firms to report actual repurchases (the amount and quantity of share repurchases) in Annual Reports. Based on the repurchase information provided by Annual Reports and the RNS, the market and investors can easily gauge the commitment level of managers towards announced repurchase programmes. Unlike US repurchases, UK repurchases have an authorisational duration between two consecutive Annual General Meetings (usually 12 months). Thus, long run share performance is subject to less influence from other corporate events or economic situations which have taken place following the announcement. As a result, UK open market share repurchases present an excellent opportunity to understand the market reaction to the announcement outside of the US markets.

The aims of this paper are not to challenge the market efficiency theory or to investigate the motivations of repurchases, but to answer the following questions. First, are open market repurchases announced by UK firms on average preceded by share undervaluation at the announcement? Second, is the initial market reaction of UK open market repurchases a response by the market to correct its overreaction to bad news prior to the announcement? Third, are open market share repurchases attracting a positive and significant return following the announcement? In particular, how does book-to-market affect long run abnormal returns? Finally, would the impact of book-to-market on long run abnormal returns suggest market underreaction to repurchase news or overreaction to bad news?

Relying on a sample of 468 repurchases announced between January 1999 and December 2004, we examine share performance surrounding and following the announcement with consideration of characteristics of firms and repurchases. We first consider short-term returns surrounding the announcement. The average market return of sample firms prior to the announcement is statically positive and reveals limited evidence of share undervaluation. The average market return surrounding the announcement is positive and statistically significant, consistent with the literature. Further, when the sample is segmented by size quartiles and book-to-market quintiles, small firms and glamour firms (low book-to-market ratios) appear to earn higher 5-day initial market returns than big firms and value firms. However, announcement abnormal returns of small firms can hardly compensate the share undervaluation these firms suffer before the announcement. Firms in other size quartiles and book-to-market quintiles show no sign of pre-announcement share undervaluation. Finally, the regression analysis shows that the initial market return is unrelated to characteristics of firms and repurchases such as size, book-to-market and the percentage of repurchase. We find no evidence to suggest that the initial market reaction is a response to share undervaluation prior to the announcement.

We then investigate the long run share performance. Long run abnormal returns can be influenced heavily by different measurement methods (Barber and Lyon, 1997; Lyon et al., 1999; Kothari and Jerold, 1997; Mitchell and Stafford, 2000). Here, two different methods are used to determine whether our sample firms on the whole exhibit abnormal share performance 1 and 2 years following the announcement. It is evident that our sample firms outperform matched size and book-to-market portfolios in the long run using any of these two measurement methods. One year buy-and-hold abnormal returns of value firms are only slightly higher than these of glamour firms. Further analysis reveals that the relationship between book-to-market and 1-year buy-and-hold abnormal returns disappears after controlling size, percentage of shares sought, actual repurchases and other factors. On the other hand, book-to-market is a dominant factor in determining 2-year buy-and-hold abnormal returns. The average 2-year buy-and-hold abnormal return of value firms is 15.86% ($p = 0.004$) while it is 6.74% for glamour firms ($p = 0.154$). Firm size does not have significant influence on long run abnormal returns in spite of the fact that small firms suffer from significant share undervaluation prior to the announcement. The results suggest that long run abnormal returns can hardly be explained by the market overreaction hypothesis or the market underreaction hypothesis. We also notice that actual repurchases during the authorisation period are not influenced by share price movement. However, the