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When a buyback isn't a buyback: open market repurchases and employee options ☆

Kathleen M. Kahle*

Katz Graduate School of Business, University of Pittsburgh, Pittsburgh, PA 15260, USA

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Abstract

This paper examines how stock options affect the decision to repurchase shares. Firms announce repurchases when executives have large numbers of options outstanding and when employees have large numbers of options currently exercisable. Once the decision to repurchase is made, the amount repurchased is positively related to total options exercisable by all employees but independent of managerial options. These results are consistent with managers repurchasing both to maximize their own wealth and to fund employee stock option exercises. The market appears to recognize this motive, however, and reacts less positively to repurchases announced by firms with high levels of nonmanagerial options. © 2002 Elsevier Science B.V. All rights reserved.

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1. Introduction

Early studies of open market stock repurchases document positive abnormal returns of 3–4% at the announcement (Vermaelen, 1981; Dann, 1981). The two most commonly accepted interpretations of this reaction are the signaling theory and the free cash flow theory. The signaling theory posits that the repurchase constitutes a

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*Corresponding author. Tel.: +412-648-1519; fax: +412-648-1693.

E-mail address: kkahle@katz.pitt.edu (K.M. Kahle).

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revelation by management of favorable new information about the value of the firm's future prospects. Several empirical studies find evidence consistent with this theory. Comment and Jarrell (1991) find that the announcement-day return is positively associated with the percent of outstanding shares repurchased and negatively associated with the firm's recent stock returns. Ikenberry et al. (1995) examine the long-run performance of companies following open market repurchases, and find that firms that are more likely to be repurchasing shares because of undervaluation exhibit positive abnormal returns of 45.3% in the four years after the announcement. Further support for the signaling theory comes from the companies themselves, who often cite 'undervaluation' as the motive for their open market repurchases (*The Wall Street Journal*, April 1, 1998, p. T2, and Sept. 9, 1998, p. NE2).

A second explanation for the positive market reaction to repurchase announcements is the free cash flow hypothesis. According to this theory, open market repurchases mitigate agency conflicts by returning free cash flow to shareholders. Other methods of distributing cash, such as debt-for-equity swaps, leveraged recapitalizations, and dividends also alleviate agency problems. Repurchases, however, are more flexible and efficient than major leverage-increasing transactions such as debt-for-equity swaps and leveraged recapitalizations. Compared to dividends, repurchases are tax advantageous to shareholders and do not imply the future commitment to returning cash to shareholders that is commonly associated with dividend increases. Special dividends would also not imply a future commitment, but DeAngelo et al. (2000) document that special dividends have been rare in recent years; in 1995, only 1.4% of NYSE firms paid special dividends. However, there is no evidence that specials have been displaced by common stock repurchases.

While these traditional motives for repurchases still exist, neither the signaling nor the free cash flow hypotheses explains the surge in buybacks during the 1990s. During this period, the number of firms repurchasing stock, as well as the dollars spent on repurchases, increased drastically. Fig. 1 shows the total dollar value and number of open market repurchases reported by Securities Data Corporation (SDC) from 1980 through 1997. In 1996, a record 1,475 companies announced plans to buy back \$177 billion in stock. In contrast, 600 companies announced repurchases totaling less than \$40 billion in 1992 and 1993 combined.

One explanation for the increasing popularity of buybacks in the 1990s is that recent innovations in compensation policy, in particular the growing use of stock options by companies, have caused changes in payout policy. ShareData, a California-based research firm, reports that the number of companies granting stock options to all employees has increased substantially in recent years. They find that 45% of companies with 5,000 or more employees have option plans, while in smaller companies, 74% offer option plans to all employees. The value of stock options and grants grew from \$8.9 billion to \$45.6 billion between 1992 and 1997 (Strege, 1999). Further, according to Executive Compensation Reports, "mega" option grants of 250,000 shares or more are now doled out by one of four companies (*The Wall Street Journal*, Mar. 27, 1997, p. C1). Fig. 2 graphs the average number of