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An empirical comparison between operations of stabilization funds and stock repurchases in Korea

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Abstract

We examine stock repurchases in Korea. Korea allows unique mechanisms, stock stabilization funds. Our results indicate that these funds are treated by the market as a weak form of repurchase. Firms in Korea that announce open market repurchases repurchase 90% of the announced shares within 3 months. This compares to a smaller percentage in 3 or more years in the United States. The market response in Korea to a repurchase announcement is similar to the United States. Tests of the determinants of the market response to announcements indicate a positive relation between ownership concentration and the market response.
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1. Introduction

Open market stock repurchases by corporations have been studied extensively. However, until recently one limitation of the existing literature has been its almost exclusive focus on the United States market. Several recent studies report results from other countries that differ

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to varying degrees from results in the United States (e.g. Li and McNally, 1999; Ikenberry et al., 2000; Ginglinger and L'Her, 2002; Lamba and Ramsay, 2002; Oswald and Young, 2004; Otchere and Ross, 2002; Rao and Vermaelen, 2002; Zhang, 2002; Hatakeda and Isagawa, 2004). While these studies serve to partially fill this gap in our understanding of the phenomena of open market stock repurchases, the question remains as to how well results derived using data from the United States apply to other countries. This is particularly true for countries whose financial markets are not as fully developed as the United States and in countries with legal systems based on something other than the Anglo-Saxon common law.

In this paper, we study stock repurchases in the Korean market. We believe that the Korean market is a particularly good market in which to study stock repurchases for several reasons. First, while some of the repurchase methods that are common in the United States (fixed price tender offers and Dutch auction tender offers) are not allowed in Korea, the Korean market allows an indirect stock repurchase method, a stock stabilization fund, which is not utilized in the United States. Thus, the Korean market provides an opportunity to examine an alternative means of repurchasing stock, which to our knowledge has not been previously studied.

A second reason for studying the Korean market is the openly stated desire on the part of the government and corporations to "stabilize" stock prices. This motive is featured in the name "stock stabilization fund," and Korean firms overwhelmingly cite this motive as the primary reason for conducting open market repurchases. Stock stabilization is also the reason provided by the Korean government for several of the changes that authorized stock repurchases. We hypothesize that this motive combined with greater possibility of price manipulation due to the relatively small size and trading volume of the Korean market should, *ceteris paribus*, make the market response to a repurchase announcement larger in the Korea than in the United States.

A third reason for studying the Korean market is that one of the regulatory requirements in Korea allows us to directly measure the number of shares actually repurchased during the program. Until very recently, in the United States, the actual number of shares repurchased could only be approximated. In Korea, 90% of the announced shares are actually repurchased *within 3 months*. Stephens and Weisbach (1998) estimate that in the United States, between 74% and 82% of announced shares are repurchased *within the first 3 years*. Thus, Korean repurchases are much more rapid than in the United States. We hypothesize that the rapidity of the repurchases in Korea should, *ceteris paribus*, make the market response to a repurchase announcement larger in Korea than in the United States.

A final reason for studying the Korean market is that the Korean legal system is substantially different from that in the United States and other countries whose legal system is based on the Anglo-Saxon common law. Recent studies indicate that the origin of a country's legal system has an important influence on corporate governance, financial markets and financial institutions (e.g. La Porta et al., 1997, 1998, 1999, 2000). For example, the stock of firms in countries such as Korea is not nearly as widely held as the stock of public firms in the United States.[1] Further, there are frequently substantial

[1] We are aware of only three other studies that examine open market stock repurchases in countries with legal systems not based on the Anglo-Saxon model—Ginglinger and L'Her (2002) for France, and Zhang (2002) and Hatakeda and Isagawa (2004) for Japan.

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