ABSTRACT

Malaysia’s share repurchase regulations were initiated in 1997 as a recovery strategy to stabilize the stock market due to the 1997 financial crisis. Since the passing of the Act, there has been a tremendous growth in the volume of share repurchase activities where past research showed that stabilizing stock prices was one of the dominant reasons why firms repurchase their shares. Now that a decade has passed and that Malaysia is over with the 1997 financial crisis, the increasing popularity of share repurchase activities among the Malaysian firms should be motivated by other reasons other than to stabilize stock prices. In fact, the literature on why firms repurchase their stock continues to evolve, presenting a mixed understanding of the economic role of repurchases. In this paper, an academic review of this literature is provided to ultimately shed light on economists’ collective understanding of why firms undertake share repurchases.

Keywords: Share repurchases, economic motivations
1. Introduction

Share repurchase is a corporate event which basically refers to a firm buying back its own shares from the market. It has now become a common and popular alternative to the conventional dividends as a form of corporate payout where firms distribute excess cash in returning capital to their shareholders. Its popularity began in the United States (US) market in the early 1980s, particularly fueled by open market repurchases (OMRs) and this surge in activity soon spread across to other developed countries like United Kingdom (UK) and Canada in the 1990s. In fact, globally, a host of other countries that formerly prohibited share repurchases also started to legalize share repurchase activities, for example Japan in 1995, Finland and Malaysia in 1997, Germany, Singapore and France in 1998, India, Norway and South Africa in 1999, Denmark, Sweden and Taiwan in 2000 etc.

Globally, many companies have grown to appreciate the value of share buybacks as a tool for capital management and to enhance shareholder returns. Some past research have shown that repurchases can provide economic benefits to both shareholders and firms alike and among them is that repurchases help improve liquidity through the reduction of costs incurred by shareholders in the buying and selling of shares (Cook, Krigman, and Leach, 2004; Franz, Rao, and Tripathy, 1995). Fried (2005) argued that with the increase in trading volume caused by repurchasing activities, it is much easier for the market makers to make a reverse position in the stock when the need arises, hence reducing stock holding costs which in turn lowers bid-ask spread, and ultimately increases shareholders’ net returns (Singh, Zaman, and Krishnamurti, 1994).

Other than improving stock liquidity, share repurchases could also provide firms with a more efficient method of distributing transient (non-recurring) excess cash flows, especially in relatively small amounts (Jagannathan, Stephens and Weisbach, 2000). Fried (2005) proposes that managers seeking to distribute transient cash flows would not wish to initiate regular dividends or increase the firm's current dividend as it may inadvertently signal a commitment by managers to continue paying dividends (or larger dividends) in the future. Share repurchasing could avoid sending such a commitment signal, especially OMRs as repurchase programs once announced still depends on managements’ discretion on whether or not to undertake share buybacks. The author posited that in times when firms only wish to make small payouts, a share repurchase would be more advantageous as compared to dividends. When a firm distributes cash through a repurchase, both the firm and the selling shareholders incur brokerage fees and as share trading is mediated through a market maker, both the parties would bear the cost of the bid-ask spread. Hence, if the amount distributed is sufficiently large, a dividend is likely to involve lower per-dollar transaction costs than a repurchase. However, for small amounts, a repurchase would be a more cost-effective method of distributing transient excess cash flows than a dividend.

Another advantage of repurchases over dividends is that they also enable firms to provide shares for increasingly popular employee stock option programs (Fenn and Liang, 2001 and Kahle, 2002). Fried (2005) proposes that a large portion of executive compensation comes in the form of stock options. Options are also widely used to compensate and motivate lower-ranking employees. Under these plans, employees are given options to buy the firm's stock at a certain strike price (usually equal to the grant-date market price). The options cannot be exercised until the end of their investing period. Upon exercise, the firm sells shares to the employee for the strike price, and the employee then typically sells those shares in the
market. Employee stock option programs thus require a steady supply of shares. Repurchases can provide those shares while dividends cannot.

All in all, the phenomenal growth in share repurchases as a form of corporate payout and its growing significance has attracted much attention and interest, as well as produced numerous studies on share repurchases in the developed countries such as US, UK and Canada. In Malaysia, since the passing of share repurchase regulations in September 1997 as a recovery strategy to revive and stabilize the stock market as a result of the 1997 financial crisis, there has also been a tremendous growth in the volume of firms’ share repurchasing activities, especially in the later decade. Unfortunately, documented evidence based on this transaction is acutely limited.

With respect to firms’ motivation to repurchase shares, the only study undertaken in the Malaysian context was by Zainudin and Regupathi, (2003) which examined 40 companies’ circulars to shareholders between October 1999 and May 2002 in which out of nine motivations for share repurchase in Malaysia, the five widely stated motivations are to stabilize price, pay stock dividend, investment opportunity, use surplus cash and increase shareholder returns. Now that a decade has passed and that Malaysia is over with the 1997 Asian financial crisis, the increasing popularity of share repurchase among the present Malaysian companies should be motivated by other reasons other than to stabilize share prices. In fact, even up to this stage, research on why firms buy back their stock continues to evolve, particularly when it entails considerably large deployment of firms’ capital where firms’ excess cash could have been better utilized in other profitable investments such as mergers and acquisitions, capital expenditures and working capital. Hence, it is the intention of this paper to provide an academic review of this literature so as to present economists’ collective understanding of why firms buy back their shares.

The remainder of the paper is organized as follows. Section 2 provides an overall view of the repurchase activity in Malaysia since its initiation in 1997. Section 3 presents the theories behind share repurchases and section 4 concludes the paper.

2. Open Market Share Repurchases (OMRs) in Malaysia

Before 1st September 1997, companies in Malaysia were generally not allowed to buy their own shares. Such prohibition as argued by Lim and Bacha, (2002) was probably premised on the potential conflicts of interests that could arise in that if stock prices reflect the collective judgment of markets on management, this would enable management to engage in price support which in turn could lead to value destruction.

Hence, it was not until September 1997 during the financial crisis which brought about the collapse of the stock market and asset prices that the Registrar of Companies (ROC) allowed the Malaysian companies to engage in share buybacks. The 1997 Asian financial crisis adversely affected the Malaysian ringgit which led to a 30% devaluation of the currency against the US dollar, and which subsequently led to the collapse of the stock market and asset prices in which the Kuala Lumpur Composite Index (KLCI) plunged 58% from its high for that year (Zainudin and Regupathi, 2003), falling from a level of 1277 in February 1997 to 512.41 in November 1997. It was viewed that the government interference in the Malaysian stock market through the legalization of repurchase activities was one of the recovery strategy to revive and stabilize the stock market which was put in force within three months when share prices in the Kuala Lumpur stock exchange fell sharply in June, 1997. In
fact, Grullon and Ikenberry (2000) found evidence that repurchasing program announcements are inversely related to market movements; implying that when stock prices fall, repurchase announcements rise, as reflected in the 1987 market crash as well as the 1998 market disturbance stemming from trouble in the global bond markets.

Since the passing of the Malaysia’s share repurchase regulations under Section 67A of the Companies (Amendment) Act 1997, there has been a tremendous growth in the volume of share buyback activities among the Malaysian firms. Still, share repurchasing is still considered a new phenomenon in that the buyback mechanism did not catch on until much later as it has not always been the norm for companies to repurchase their shares and that firms in the initial stage were probably vague as to the benefits of share repurchases. As firms over the years began to learn about the significance of share repurchases, especially from more mature markets such as the US where buybacks have been ongoing for about two decades since 1982, there has been a spree of buyback activities among the Malaysian firms ever since.

According to Sabri (2003), until 1999, out of 171 companies that had received approval for share repurchases, 16 companies had implemented the targeted repurchased shares (ROC, 1999). And according to Lim and Bacha, (2002), until 2001, 43 companies, consisting of 38 main board companies and 5 second board companies had actually repurchased their shares (Refer Table 1 and 2).

### Table 1 : Breakdown of KLSE Listed Companies involved in Open Market Repurchases

<table>
<thead>
<tr>
<th>Breakdown by Type</th>
<th>Main Board Companies</th>
<th>Second Board Companies</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Announced/Obtained shareholders' approval at EGM/AGM</td>
<td>112</td>
<td>19</td>
<td>131</td>
</tr>
<tr>
<td>Actually repurchased shares</td>
<td>38</td>
<td>5</td>
<td>43</td>
</tr>
</tbody>
</table>

### Table 2 : Breakdown by Year of Companies that Executed Open Market Repurchases

<table>
<thead>
<tr>
<th>Breakdown by Year</th>
<th>Main Board Companies</th>
<th>Second Board Companies</th>
<th>Total</th>
<th>Cumulative Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>1997</td>
<td>1</td>
<td>0</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>1998</td>
<td>11</td>
<td>3</td>
<td>14</td>
<td>15</td>
</tr>
<tr>
<td>1999</td>
<td>11</td>
<td>0</td>
<td>11</td>
<td>26</td>
</tr>
<tr>
<td>2000</td>
<td>9</td>
<td>1</td>
<td>10</td>
<td>36</td>
</tr>
<tr>
<td>2001#</td>
<td>6</td>
<td>1</td>
<td>7</td>
<td>43</td>
</tr>
<tr>
<td>Total</td>
<td>38</td>
<td>5</td>
<td>43</td>
<td></td>
</tr>
</tbody>
</table>

Sources: Data from KLSE

# indicates the period from January 1 up to June 30, 2001
In 2002, 36 repurchasing firms implemented share repurchase programs and this grew to 149 firms in 2006. Additionally, in 2002, share repurchase volume was 119.913 million shares and this grew to approximately 6.258 billion shares in 2006.

There are various methods of share repurchasing which are tender offer repurchase (where the firm specifies a price at which the firm will buy back its shares, the number of shares it intends to buy and the period of time for which the offer will be kept open), Dutch-auction tender offer (where the firm specifies a range of prices from which the shares would be repurchased), privately negotiated repurchase (where the firm buys back shares from a large shareholder(s) at a negotiated price) and the open market repurchase (OMR) where the firm buys back shares in the open market at the prevailing market price. Out of the above mentioned repurchasing methods, Malaysia practices the OMRs as stipulated by Bursa Malaysia’s Chapter 12 Share Buy-backs Listing Requirements, which allows only the OMR option where repurchases must only be effected on the market of the exchange. “on the market” refers to transactions that are to be made through the Automated Trading System of the Bursa Malaysia and excludes any forms of direct business transactions.

3. Motivations behind Firms’ OMRs

Firms have two alternatives for deploying capital, i.e. by reinvesting into the business via mergers and acquisitions, capital expenditures and working capital or by returning capital to shareholders through dividends and share repurchases. As suggested by Asquith and Mullins (1986), returning capital to shareholders with differing cash payout policies present one of the most puzzling and disturbing issues in corporate finance, particularly when share repurchase programs have now become increasingly more popular vis a vis the traditional dividend payout as a form of cash distribution to shareholders (Grullon and Michealy, 2002).

Based on past literatures, several hypotheses have been advanced in the literature to explain what motivate firms to initiate share repurchase programs and among them are the information signaling hypothesis where firms repurchase to signal optimistic information about their future operating and cash performance prospects (Dann, 1981; Vermaelen, 1981 and 1984; Ofer and Thakor, 1987 and Constantines and Grundy, 1989), the market undervaluation signaling hypothesis where firms repurchase to signal that their current stock price is below their true intrinsic value (Comment and Jarrell, 1991 and Ikenberry, Lakonishok and Vermaelen (1995), the agency costs of the free cash flow hypothesis where firms repurchase to mitigate potential problems of unmonitored spending of excess cash on unprofitable projects (Easterbook, 1984 and Jensen, 1986), the capital structure adjustment hypothesis where firms repurchase shares to adjust their financial leverage towards an optimal leverage ratio, thereby allowing firms to benefit from tax advantages of debt financing (Bagwell and Shoven, 1989 and Hovakimian, Opler and Titman, 2001), the takeover deterrence hypothesis (Brown and Ryngaert, 1991; Bagwell, 1991) where firms repurchase to fend off unwanted takeover attempts, the dividend substitution hypothesis where firms substitute dividends with repurchases as a form of corporate payout to benefit from tax savings through capital gains tax of repurchases which is usually lower than the ordinary dividends tax (Black, 1976; Barclay and Smith, 1988), where firms distribute temporary cash flows to the shareholders through repurchases and would increase dividends only when earnings is believed to have increased permanently (Jagannathan, Stephens and Weisbach, 2000) and finally, where firms repurchase shares to counter the dilution effects of employee and management stock option plans (Fenn and Liang, 2001).
All in all, the most commonly cited reasons by most researchers are the information signaling hypothesis, market undervaluation signaling hypothesis, the agency cost of free cash flows hypothesis and the capital structure adjustment hypothesis. The theories and hypothesis developments of each of these explanations will be discussed in the following subsections.

3.1 Information Signaling Hypothesis

The first to introduce the concept of information signaling on the study of wealth effects of share repurchases is Vermaelen (1981). Under the information signaling theory, it is assumed that information asymmetry exists between the managers of a firm and the shareholders or the outside investors. In economics, information asymmetry occurs when one party to a transaction has more or better information than the other party (Finance - Wikipedia encyclopedia). In this context, this implies that the managers have typically better information as to a firm’s true value as compared to the shareholders. In fact, as suggested by Miller and Modigliani (1961), when markets are incomplete i.e. in situations where shareholders are exposed only to public information and that the current stock prices are not able to reflect the private information that managers have, through changes in payout policies, for example by conducting share repurchase programs, managers are able to convey credible signals at some costs to the market of any new optimistic information that they have on the firm’s performance, particularly with regards to the firm's future earnings and cash flows prospects.

As explained by Miller and Rock (1985), when managers foresee better than expected future earnings and cash flows, the managers are more likely to distribute cash in advance to the shareholders, either in the form of dividends or share repurchase, as they are confident that future capital expenditure requirements can be funded from future increases in earnings. Additionally, Grullon and Michealy (2004) argues that there will be an increase in firms’ capital expenditures as well as research and development (R&D) expenses following share repurchase announcements as firms attempt to convey information about the good investments they are undertaking where cash flows from those investments would be realized in the distant future. Subsequently, the market then make adjustments accordingly in their assessment of the firm’s future earnings and cash flow expectations, which in turn result in a price increase for the repurchasing firm’s shares.

All in all, based on the studies of Vermaelen, (1981), Nohel and Tarhan, (1998), Grullon and Ikenberry, (2000) and Grullon and Michealy, (2004) on share repurchases, there are several empirical implications to the information signaling theory. One basic and immediate implication is that repurchasing firms would experience positive price changes after repurchase announcements. Next, the repurchasing firms would also experience improved operating performance, as proxied by return on assets (ROA) in terms of future earnings after repurchase announcements. In conjunction to this, it also implies that firms would increase its capital expenditure after repurchase announcements where the source of future cash flows and profitability come from. Finally, the repurchase announcements should also be immediately followed by positive revisions in the market’s expectations or analysts’ forecast about firms’ future profitability.
3.2 Market Undervaluation Signaling Hypothesis

According to the market undervaluation signaling hypothesis, which is also built upon the notion of information asymmetry that exists between the managers and shareholders, when managers believe that their current stocks prices are underpriced or not reflecting the true underlying value of the firm, they would attempt to correct this mispricing in the stock market by conducting share repurchase programs (Comment and Jarrell, 1991), pledging to buy back stock from the shareholders at the repurchase market price, even in cases when the stock is overvalued which in fact would make their position worse off (Fried, 2005). The market undervaluation signaling hypothesis is basically a case of management’s disagreement with how the market is pricing its current performance, in which just as firms are inclined to issue new equity when they perceive their stock price is too high, firms would prefer to conduct share repurchases when they think that the price is unfairly low. In fact, Ikenberry and Vermaelen, (1996) posited that OMRs effectively represent exchange options that provide the firm with the flexibility to exchange its market value for its “true” value at the management’s discretion. They argued that even if the management has no superior information or the market price of the stock is “fair” at the time of the repurchase announcement, the stock price should increase to recognize the option value that is created by the OMR program per se. However, it is argued again that the exchange option value ultimately depends on the ability of the management to detect valuation errors and seize the opportunities when share prices are relatively undervalued, otherwise the options will again be of little value.”

As with other hypothesis, the basic implication of the market undervaluation signaling hypothesis is that repurchasing firms would experience positive short term price changes after repurchase announcements, particularly with regards to firms that have high book-to-market values (BTMV) at the time of announcement, in which such firms are generally referred to as “value stocks” where post-announcement abnormal returns are expected to be higher as compared to firms with low BTMV, generally known as “growth stocks” (Ikenberry, Lakonishok and Vermaelen, 1995). As posited by Zhang (2005), the most undervalued firms are those that have high BTMVs and when such firms make share repurchase announcements, these are the firms that arouse the most response and reaction from the market. Likewise for the growth firms that have low BMTV, it is assumed that share repurchasing is motivated by other reasons instead of undervaluation. Other than the BTMV, the initial market reaction is also expected to be stronger for repurchase firms that are small as small firms are usually less scrutinized by analysts and hence are more likely to be mispriced (Zhang, 2005).

A more direct empirical implication is that repurchase firms are more likely to experience a period of price depreciation before the repurchase announcement, thereby exhibiting negative pre-announcement abnormal returns as an indication of share undervaluation (Dann, 1981; Vermaelen, 1981; Comment and Jarrell, 1991 and Ikenberry, Lakonishok and Vermaelen, 1995 and 2000). In other words, firms would typically initiate OMR announcements when they realize that their stock prices have been performing poorly as compared to the performance of the overall market (Stephens and Weisbach, 1998). Finally, the next implication would be that after experiencing poor pre-announcement stock price performance, the repurchasing firms would subsequently experience improvements in stock price performance over a period of time, thereby exhibiting positive post-announcement long term abnormal returns (Ikenberry, Lakonishok and Vermaelen, 1995 and 2000). As posited
by the authors, better long run performance is expected from repurchases that are driven more by undervaluation than by other motives.

3.3 Agency Costs of Free Cash Flow Hypothesis

Based on the early work by Berle and Means (1932) on the separation of ownership and managerial control, Jensen and Meckling (1976) posited that it is common for agency conflicts to arise between the managers (agents) and the shareholders (owners) as managers do not always undertake actions that maximize shareholder value. As shareholders do not have direct control over the daily running of the business, managers at times may undertake opportunistic behavior and eventually make decisions that protect their own interests over that of the shareholders’. Consequently, these agency conflicts result in agency costs in which such costs lead to a deterioration of firm value due to managers acting in their own interests. As put across by Jiraporn (2006) who relates the level of firms’ repurchase activity with the strength of shareholders’ rights, argued that based on the agency theory, firms with weak shareholder rights are likely to suffer higher agency costs as managers are more likely to put their own interests ahead of their shareholders’.

Subsequent to Jensen and Meckling (1976), Jensen (1986) went further to study agency costs with respect to free cash flows which is defined as those available cash flows that are in excess of those required to finance all of its investment opportunities that provides positive net present values (NPV). As in Lehn and Poulsen (1989), the free cash flow is defined as the operating income before depreciation minus interest expense, taxes and dividends, normalized by the total assets. Jensen posited that when managers face large amount of excess cash in the firm, higher agency costs could arise due to the higher possibility of managers squandering corporate resources on unprofitable investments, based on the premise that firms currently, on a temporary basis do not have positive NPV projects to invest, or that its reinvestment rate is declining. As managers are more inclined towards incentives that can achieve the target of size and growth such as empire building, takeover activities or perquisite consumption that can boost their reputation, power and remuneration, they would most likely invest the excess cash on new projects, even if those projects have negative net present values. Shareholders however would prefer that the free cash flows be allocated and distributed back to them in a form of special dividend or share repurchase instead of wasting the excess cash on unprofitable projects that can destroy firm value.

Therefore, according to Jensen’s agency costs of the free cash flow hypothesis, in situations of a firm facing with excess cash and poor portfolio of investment opportunities, when managers are inclined towards distributing the excess cash back to the shareholders in the form of share repurchase instead of retaining the excess cash in unprofitable projects, the market would react positively to the repurchase announcements to result in improvements in stock price performance. As argued by Jensen, the market is already aware of the firms’ reduction in profitable investments and the market basically interprets the repurchase announcements as positive news that conveys firms' commitment to reduce the amount of free cash flows at the management’s disposal as well as firms' commitment to mitigate potential agency cost of overinvestment, especially when it involves negative NPV projects that can lead to firm value deterioration which ultimately is not in the best interest of the shareholders.

Similarly, the free cash flow hypothesis also predicts that the market would react positively when firms, being in the state of over-invested, remedy the situation and improve firm value
by selling off negative or low NPV projects and distribute the proceeds to the shareholders in
the form share repurchase, signaling to the market that they are now committed to mitigate
agency problems and agency costs of free cash flows (Nohel and Tarhan, 1998). Nohel et al.
posited that agency costs, in this context, are not only related with actual excess cash on
hand, but are also with potential cash surpluses, that is those investments that can be
converted into cash, especially the negative NPV projects which can adversely affect firm
value if continuing funds are injected into those projects. As posited by Perfect, Peterson and
Peterson (1995), the more the firm is over-invested, the bigger the market response should be
from a repurchase announcement. In fact, in the seminal papers of Easterbook (1982) and
Jensen (1986), they argued that by taking excess cash from the firm through increasing the
level of payout, shareholders could indirectly control managers of the firm from unmonitored
spending of unprofitable projects. Then again, Isagawa (2000) showed that under some
reasonable conditions, managers choose OMRs to distribute excess cash if they feel there is
little benefit in taking on unprofitable new projects.

Along the line with Grullon, Michaely and Swaminathan (2002) which centers on the study
of dividends, Grullon et al. (2004) provide suggestion as to the reason why firms may
generate free cash flows and hence undertake share repurchases, is due to firms’ transition
from a higher growth phase to a lower growth phase, in which the former authors proposed as
the maturity hypothesis. These authors argued that during the growth phase of a firm’s life
cycle, firms usually have numerous positive NPV projects to undertake, high capital
expenditures, low free cash flows and high earnings growth. However, upon reaching a
certain stage, the firm faces deterioration in growth and enters into maturity stage. At this
phase, the firm’s investment opportunities decline and along with that, the firm’s
profitability, the requirement for capital expenditures and ultimately its earnings growth rate
will also decline, thereby resulting in the generation of high free cash flows in the firm.
Following Berk, Green and Naik (1999), when a firm has fewer options to grow, and their
assets play a bigger role in determining its value, the firm’s systematic risk will decline,
which in turn reduces the firm’s cost of capital. Hence, as proposed by Grullon et al. (2002)
and Grullon et al. (2004), cash payout announcements either through dividends or repurchase
programs particularly by mature firms can result in a positive market reaction where the
market interprets the announcements as positive news that conveys a decline in the riskiness
of the maturing firms’ assets, a notion that is consistent with the findings of Litner (1956) and
Brav, Graham, Harvey and Michaely (2005) that managers increase their cash payout when
they feel that the firm’s cash flows are less risky.

All in all, based on the above theoretical explanations of the free cash flow hypothesis, one of
the first few empirical implications is that repurchasing firms should experience a decline in
their profitability as proxied by ROA due to investment opportunities deficiencies. This is in
contrast to the information signaling hypothesis where repurchasing programs instead convey
positive news about future profitability. Likewise as a result of investment opportunities
deficiencies, repurchasing firms should also face a decline in their capital expenditures,
thereby reducing the need to keep cash reserves for further investments. In addition,
repurchasing firms, particularly with respect to mature firms, should also experience a decline
in the systematic risk and hence a reduction in the firms’ cost of capital. Next, in validifying
the free cash flow hypothesis, the market reaction of repurchase announcements should be
relatively stronger for firms that are more likely to over-invest, reflected from their high
levels of cash and few investment opportunities. Following Lang and Litzenberger (1989),
the Tobin’s Q is used as a proxy to measure a firm’s investment opportunities where a
Tobin’s Q value of less than 1 renders a firm to be classified as over-invested. Last but not
least, firms with higher repurchase activity should exhibit superior price performance with the view that repurchases help to reduce agency costs of free cash flows by getting rid of excess cash being invested in unprofitable projects (Jiraporn, 2006). Since OMRs are not legal obligations, hence the more a firm actually spends on repurchases; the better should be the firm performance.

3.4 The Capital Structure Adjustment Hypothesis

When companies repurchase their stock from the market, firms’ equity base will decrease which in turn would cause the leverage or debt to equity ratio to increase. Assuming that an optimal leverage ratio exists, firms may hence utilize share repurchasing as a financial tool to help firms adjust and manage its capital structure towards the attainment of its optimal leverage ratio (Bagwell and Shoven, 1989 and Hovakimian, Opler and Titman, 2001). According to the leverage adjustment hypothesis, a firm is more likely to undertake repurchasing programs if the firm’s leverage ratio is below the target leverage ratio (Dittmar, 2000). There are several factors that may cause a firm’s leverage to be below its optimal target and among them, as forwarded by Chan et al. (2004) is the use of executive stock options which when exercised, have the effect of increasing equity financing in the firm. The authors argued that it is therefore not surprising to see repurchase activity associated with either option grants, option exercises or an increase in stock price as options move into the money (Kahle, 2002 and Weisbenner, 2000). Likewise, equity dilutions such as dividend re-investment plans (DRIPS) and employee stock ownership plans (ESOPs) may also affect a firm’s capital structure in which left unchecked may result a firm’s leverage position to be away from its optimal position.

In repurchasing a firm’s stock from the market, the firm may finance its repurchases from its cash reserves and/or marketable securities where the extent of the increase in debt to equity ratio depends upon the method used to calculate the leverage ratio. If the share repurchases are financed with debt, as explained by (Guffey and Schneider, 2004), it is practically identical to debt-equity exchanges. The authors explained that when firms repurchase shares through debt to adjust their financial leverage, firms may benefit from the tax advantages of debt financing. (Mintz, 1995) argues that when firms increase their leverage, either by adding new debt or by depleting its cash, the tax savings conserves cash and lowers the cost of capital and the stock market will recognize that the tax savings will flow to the shareholders, hence resulting in an increase in market value by a factor consistent with the prevailing price-to-earnings (PE) ratio.

Mintz (1995) presents evidence that the 20 largest share repurchases in 1995 become tax benefits (shields) that are valued by the market at over $9,500,300,000. First, Mintz provides the magnitude of the buyback in terms of market value. The market value of the buyback is multiplied by the appropriate interest rate consistent with Standard and Poor’s credit rating at the time the buyback is announced to determine the tax shield created. Second, the tax shield is multiplied by the firm’s income tax rate to determine the amount that would otherwise go to taxes. The amount saved on taxes is then multiplied by the price-to-earnings ratio to determine the value of the benefit to the shareholders. The tax benefits are then divided by shares available producing an increase in market value per share. Mintz finds that the 20 largest buybacks produce increases in earnings per share that average $1.513. This increased share value benefits all shareholders, whether they participate in the share repurchase or not.
One of the first few empirical implications of the capital structure adjustment hypothesis is that the market reaction should be greater for repurchasing firms that experience low leverage ratios as compared to their industry peers (Chan, Ikenberry and Lee, 2004). Another implication as proposed by the above authors would be that the market reaction should be greater for repurchasing firms whose leverage had decreased the most prior to a repurchase announcement. To test the validity of the leverage adjustment hypothesis, total debt to equity and long-term debt to equity are used to measure capital structure and the level of indebtedness (Guffey and Schneider, 2004). These two ratios are used to examine the adjustment of long-term debt of repurchases relative to their equity levels. Chan, Ikenberry and Lee, (2004) used the ratio of the total debt to total assets at previous fiscal year-end to measure leverage which is adjusted for industry median.

4. Conclusions

It has now become common for publicly traded companies in Malaysia to repurchase shares from the open market. Even companies generally perceived as conservative have joined the fray, convinced that there are benefits from embarking on these buyback schemes. Despite the pick-up in buyback activity in Malaysia since its initiation in 1997, the debate has not ended as to what actually motivate firms to repurchase their shares from the market, especially when firms’ capital and cash resources could have been utilized in other profitable investments such mergers and acquisitions, capital expenditures and working capital that could have produced better returns to the companies. This paper presents theoretically the four commonly cited reasons by past researchers for firms’ repurchase programs, i.e. the information signaling hypothesis, market undervaluation signaling hypothesis, the agency cost of free cash flows hypothesis and the capital structure adjustment hypothesis. Scope for future research on other hypothesis as mentioned earlier could be further undertaken to provide a more comprehensive picture as to what motivate firms to repurchase shares, ultimately understanding how share repurchases can aid to enhance both company and shareholder values.

REFERENCES


