THE REPURCHASE OF SHARES - ANOTHER FORM OF REWARDING INVESTORS - A THEORETICAL APPROACH

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Abstract: *Among the shareholder remuneration policies, in recent years, share repurchases are gaining more and more ground. Like any other phenomenon or financial practice, repurchases lacked no theories to explain their motivation, effects and controversies. This paper proposes a theoretical approach to the subject by summarizing relevant research in order to highlight the motivations behind this decision and its implications.*
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1. INTRODUCTION

Literature deals with share repurchases as a form of dividend policy, since it is actually a way the company offers its investors liquidity. From our perspective, the process is a form of directing the available cash to shareholders but, unlike traditional dividend policy, following repurchases, shareholders lose the ownership of shares and if they desire future dividends they are obliged to buy new equity titles.

Share repurchases, however, both in theory and in practice, are a controversial topic with many implications for investors. Although they offer the opportunity to receive liquid funds in exchange for shares, buybacks require an allocation of significant funds which directly affects the overall liquidity of the firm. The paper proposes a theoretical approach to buyback practice in terms of revealing the motivations and implications behind this decision, based on relevant research.

2. WHY AND WHEN REPURCHASE SHARES?

Buyback phenomenon is relatively new in academia. Among the most important studies on this topic we could mention Bagwell and Shoven (1989), Stephens and Weisbach (1998), Grullon and Michaely (2004), Dittmar and Dittmar (2004). The interest for repurchases grew along with the increasing number of such initiatives, in recent years, as the international practice shows. Like any other decision of a listed company, share repurchases increased in volume, due to their perceived advantages for the issuer or the investor, more or less honorable.

For the issuing company, the repurchase of its shares is primarily a safeguard against possible hostile takeovers, an attempt to increase market value, to reduce agent costs and an alternative to directly remunerate investors without increasing dividends. International media insisted on the use of repurchases as a form of granting the business decision makers, by influencing the price shares to go up and facilitate their ability to execute the contract options offered for their quality of employees. Thus, there are many large firms that have adopted an oscillating behavior: the issue of new shares - repurchase - further issue of shares.

Another bad behavior of large companies, noted also by the international press, is to take advantage of the low borrowing cost, issuing bonds for 30 years in order to repurchase a part of outstanding shares. Specifically, corporations want through the repurchase of shares to no longer create commitments to investors, as they would be required to by adopting, for example, a clear dividend policy.

Among the most relevant advantages for investors, offered through share repurchases, we could mention the possibility to obtain financial resources for those interested, the increase of EPS (Earnings Per Share) due to decrease of the number of outstanding shares, the increase of exchange rate and the manifestation of a psychological effect related to the firm belief that the shares are undervalued.

Other relevant findings regarding the repurchase of shares, specifically related to the motivations of such an initiative are presented in the following table.

Table 1. Research results about the repurchase of shares by listed companies

Study	**Result**
Firth and Yeung (2005)	The perception of undervalued shares and the availability of cash surplus are the major factors in the decision to repurchase.
Von Eije and Megginson (2008)	Firms with liquid shares often repurchase and those with a high free float (public distribution range), less often.
Chan, Ikenberry, Lee and Wang (2010)	Some companies use the repurchase of shares as a way to manipulate investors.
Brockman, Howe and Mortal (2008)	Managers prefer share repurchases and then providing dividends due to tax and flexibility reasons.

Note: Results are personal interpretations.

In what it concerns the timing of share repurchase, literature confirmed the existence of certain waves or cycles of this phenomenon, for different reasons. One of them refers to the time when market shares are undervalued and managers consider as appropriate to repurchase, or a necessity to correct the market price (Brav et ali., 2005). Another motivation for the use of repurchases is the existence of a cash surplus. Used as an effective mechanism for the distribution of cash surplus (Skinner, 2008), share repurchases are a significant source of information for the market.

Of course, financial and academic environment offered other motivations for repurchases, such as trying to avoid hostile takeovers or to implement those programs of share distribution among employees. These last reasons cannot be considered primary factors in the attempt to explain the evolution and cyclical character of repurchases phenomenon.

An interesting approach belongs to Skinner (2008) which divides firms in two categories: firms that only repurchase shares and firms which, in addition, also practice a dividend policy. Managers of the latter companies avoid eliminating dividends due to a potential negative signal given to the market, but they use repurchases when there is sufficient cash surplus. Market liquidity is the one that generates a substitution effect between repurchases and dividends, for large firms with tradition in practicing a dividend policy.

3. LATEST IDEAS ABOUT REPURCHASES

In the previous section, asking when it is necessary to initiate a share repurchase, we saw that the most results converge towards two directions: when shares are undervalued and when the company has financial resources in excess. However, other recent studies addressed repurchases in connection with the issue of shares, which are actually two opposite decisions, and also have invalidated the shares undervaluation hypothesis as being the optimal time to repurchase. If for issuing shares, managers choose the moment shares are overvalued, by virtue of logic, repurchases should be initiated when shares are undervalued, as the relationship between the two events should be negative.

According to researchers Dittmar and Dittmar (2008), covering the period from 1971 to 2004, the relationship is positive, so this fact calls into question whether market timing is an important element in the company's decision to issue or repurchase shares. Moreover, they argue that the waves recorded during the buyback process cannot be explained by the undervaluation of shares.

Under these conditions, the trigger is sought from another perspective. After focusing the attention upon the company and knowing that in order to repurchase there must be enough cash, while by issuing shares it shows the need for such financial resources, the life cycle of the firm seems to be a key element. Moreover, the national economic situation, measured by the GDP level influences the manifestation of these processes over time. According to the positive correlation found between GDP growth and share repurchases, the last ones are common when the economy is at the beginning of an expansion period and therefore it has sufficient cash resources.

In what it concerns the relation between GDP growth and shares issue, it is a negative one, despite the positive relation between issue – repurchase of shares and between GDP growth – repurchases. A more detailed analysis reveals that although issues or buyback programs tend to increase in periods of economic expansion, the first type of process occurs in the early stages of the business growth, when the need for capital is high and the second process occurs later, in the same context of economic growth, but at the end of it, when the company is in a different business cycle and has sufficient financial resources. Thus, the business cycle is a key element in explaining the evolution of these two phenomena.

The idea that shares issue and repurchases increase or decrease depending on the economic environment becomes elementary. Another problem that arises in this context is to understand the factors that determine some firms, in an economic growth period, for example, to issue shares and to repurchase others. Dittmar and Dittmar (2008) provide some important conclusions about this topic:

• The incorrect market evaluation of shares does not directly generate repurchases and share issues;

• Repurchases and share issues depend to a greater extent of the cost of capital;

• The identified waves are actually the results of different responses given by the companies to the same stimulus. Thus, the GDP growth explains in a high degree the increased number of issues and repurchases. In a context of economic growth, the cost of capital decreases compared to the cost of debt, which leads many companies to issue shares. On the other hand, due to the uncertainty of future events, the company is tempted to repurchase some of the issued shares.

In our opinion, the issue and repurchase of shares are two complementary processes, at least in terms of the capital need. Thus, in terms of deficit or surplus, the firm chooses the issuance or repurchase as two opposing financial flows. In terms of market appreciation, in the light of recent studies, a final conclusion regarding the relation between the two phenomena is premature. At first glance, when shares are over valuated, the company chooses to issue new ones and when shares are underestimated – to repurchase. However, variables such as economic growth, business cycle and the decision to signal the market are factors which make it difficult to draw a strong line between the issue of shares and their repurchase moment.

If shares issues and repurchases are positively correlated with past capital gains, not the same idea can be mentioned about future earnings. Baker and Wurgler (2000) argue that managers intend to take advantage of shares overvaluation moments through this negative relationship between issues and future earnings. According to the data obtained, the firm decision depends to a greater extent of those changes in the business cycle than of the market changes.

The most popular theory about the buyback phenomenon is *the signaling one* (Ikenberry et al., 1995; Lie 2005; Peyer and Vermaelen 2009) – according to which managers announce that the shares are undervalued in terms of good perspectives for the company, and *the free cash flow theory* (Grullon and Michaely 2004; Nohel and Tarhan, 1998) – which recommends the distribution of cash-flow to shareholders instead of using it in inefficient projects.

A reference work belongs to Liang et ali. (2012). The authors studied the motivational factors behind the decision to repurchase shares, using as a fundamental resort the development stage of the company. The analysis focuses over 4285 decisions to repurchase adopted by U.S. firms during 1990 and 2006. Researchers choose as variables the firm age, its size, sales and dividends and used as main indicators - value to price ratio and free cash flow ratio. The main conclusion of the study is that firms in the growth phase take the decision to repurchase their shares with the motivation of signaling, while mature companies choose buybacks to use the cash surplus, as the theory of free cash flow states.

Without excluding the signaling theory, Peyer and Vermaelen (2009) proposed an analysis of three major hypotheses explaining the higher yields recorded after a public program buyback: *risk modification hypothesis* – according to which the share evaluation is made because of the positive signaling related to the decreased risk (it is announced that the company has reduced growth prospects, approaching a mature stage and thus the risk is reduced) and not because of the future revenues (Grullon and Michaely, 2004); *the liquidity hypothesis* – which sustains that share repurchases reduce liquidity which is compensated by the share price growth (Pastor and Stambaugh, 2003); *the overreaction hypothesis*, according to which the stock appreciation is due to the market correction of another overreaction previously manifested, before the share repurchase, as a result of negative news. The analysis focuses upon 3481 public buybacks announcements of U.S. firms, from 1991 to 2001.

Among the three hypotheses, only the last one is validated by practice, so the authors conclude that when the company decides to repurchase the undervalued shares it does that not because it expects a revenue growth but in order to manifest disagreement with market expectations related to decreased revenues in the coming years. The study shows that after the announcement of repurchase, the price of shares appreciates over 48 months, to a greater extent at the securities which price decreased over 6 months before the buyback announcement. In this last case, not the increasing revenue forecasting but market overreaction with no trust in the stock is the main cause why managers take the decision to buy back shares, trying to signal that the market is wrong.

As we mentioned before, the number of repurchases grew in the recent years, becoming the first among the forms of shareholders payment. However, reality has exposed another strange behavior of companies: the public announcement of the decision to repurchase shares without actually getting to do it or making it in a small percentage. However, the market reaction is positive which allows investors obtaining significant capital gains.

If Peyer and Vermaelen (2009) conducted the previous mentioned study without considering asymmetric information to play an important role, Oded (2005) considered this phenomenon a key factor in the decision of companies to repurchase shares.

Signaling the market is costly, according to the practice, in a higher degree by distributing cash to shareholders, as a way to remunerate their confidence in the company. Also practice showed that less successful firms often adopt the behavior of good companies in order to transmit false information to the market. Specifically, bad companies easily announce buybacks, considering that this announcement is not an obligation, just to benefit from stock prices growth. However, this behavior does not go on forever and it certainly involves costs, including the loss of credibility.

4. CONCLUSIONS

Having into consideration the presented facts, we conclude that the decision to repurchase shares is related, most times, to the following situations: shares are undervalued, the company has free cash (Grullon and Michaely, 2004) and wants to signal the market (Peyer and Vermaelen, 2009). Moreover, the repurchase of shares was found to depend to a large extent of the firm life cycle and also of the economic environment in which it operates. Dittmar and Dittmar (2008) concluded from the undertaken survey that a company is more inclined to run a repurchase of its own shares when it is in a mature stage (has enough financial resources) and the economic environment is also in an expansion period (gross domestic product is growing).

The undervaluation of shares is not the reason why a company decides to buy back shares, according to Liang et ali. (2012), but the development phase of the firm is. They conclude that growing firms repurchase shares to signal investors while mature companies repurchase to use the available cash. The approach of Peyer and Vermaelen (2009) is also interesting. They connect the repurchase of shares to the moment in which shares are undervalued, but from a slightly different perspective: the company decides to buyback the undervalued shares not because it expects a revenue growth (so we don't assume here an opportunistic decision of managers) but to manifest disagreement with market expectations related to decreased revenues in the coming years.

Through the present study we brought up to light some of the most relevant articles about share repurchases, with the assumed possibility to have omitted other important research. The diversity in findings is an argument in favor of the idea that the repurchase of shares is a complex decision of listed companies, with multiple implications. The theoretical approach certainly opened the appetite for future studies upon the firm decision to repurchase its shares, as this decision is positioned by the financial practice among the top forms of rewarding shareholders, in the recent years.

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