Share Repurchases and the Need for External Finance

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Stock prices tend to go up after buy back announcements. The main explanation for the market's generally positive reaction to buybacks is "information asymmetry." Managers often have better information about the firm's prospects and value than outside investors. Investors look at buyback announcements as credible "signals" that the shares are undervalued.

Buybacks may also add value by returning cash that cannot be profitably invested inside the firm. Particularly in mature companies with limited investment opportunities, managements may waste excess cash on low-return projects. In such cases, buybacks reassure investors by confirming management's commitment to pay out excess capital.

Undervalued companies that expect to raise more equity in the near future can eliminate the undervaluation of their shares by offering to buy back shares *before* issuing new ones. A financing strategy of seasoned equity offerings preceded by repurchases can limit the information costs associated with raising outside capital.

Announcements of repurchases that were followed within three years by SEOs received more favourable market reactions than announcements of other repurchases. Announcements of SEOs preceded by share repurchases (hereafter "repurchase SEOs") met with a stock price reaction that was 1.7% higher (that is, less negative) than the returns to a matched sample of SEOs not preceded by a repurchase (non-repurchase SEOs).

Companies often fail to carry out announced open market repurchase programs. For those repurchase SEOs where shares were actually repurchased, the difference between their SEO abnormal returns and those of matched companies was 2.2%.

Shortening the time interval between repurchase and SEO announcements also appears to improve the market reaction to equity offerings. Mean SEO abnormal returns for the short-interval companies were 1.2% higher than those with more time between the announcements.

For the companies that actually repurchased shares and where the SEO announcements came relatively soon after the repurchase announcements, there was an average SEO abnormal return of 0.54%, which is insignificantly different from zero. The negative effect of equity issuance appears to have almost disappeared completely. In contrast, the companies with relatively close announcements that did not repurchase shares experienced a mean SEO announcement abnormal return of –2.7%.

Repurchases reduce asymmetric information. Undervalued firms with good investment opportunities that may need external finance can announce buy backs to convey their undervalued state. The market reaction to the repurchase is more positive for companies likely to raise equity. Repurchase-SEOs have a 1.69% greater SEO mean abnormal return than that of the matching non-repurchase-SEOs. This difference increases to 2.20% for the subgroup of repurchase-SEOs where actual repurchases occurred prior to the SEOs. Repurchase-SEO combinations that occur closer together result in less negative SEO announcement reactions. Where the repurchases and SEOs are relatively close in time and the firm actually repurchases shares, the negative price reactions come close to disappearing and are not significantly different from zero. By buying back shares prior to the announcement of an equity offering, the management can address the firm's undervaluation problem while also limiting the negative market reaction associated with new equity issues.