



# Bond repurchase objectives and the repurchase method choice<sup>☆</sup>



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## ABSTRACT

This study investigates how firm's bond repurchase objective affects its choice of repurchase method. Unlike tender offers, open-market repurchases are not pre-announced and buyer's identity is unknown to the seller. We provide evidence that firms are likely to repurchase on the open-market when bonds are mispriced and when firms seek to manage their financial reports, either to meet earnings targets or avert debt covenant violations. When firms seek to amend indenture terms, they prefer tender offers. We also find that firm's information quality affects the likelihood of mispricing exploitation behavior and that insiders buy firm's stocks around open-market repurchases.

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## 1. Introduction

Recent years have seen a surge in firms repurchasing their bonds, reaching a high of \$89 billion worth of transactions in 2010.<sup>1</sup> This increase has motivated academics to investigate the causes and effects of the phenomenon (e.g., Kruse et al., 2014; Julio, 2013; Lemayian, 2013; Mao and Tserlukevich, 2014; Reindl, 2013). The literature, however, assumes away the implications of the differences between the two repurchase methods—a repurchase on the secondary open market and a tender offer—the most notable being that an open-market repurchase is not pre-announced and bondholders are unaware that the issuing firm is the counterparty to the transaction. We analyze the choice of repurchase method and provide evidence that the method used is likely a function of the repurchase objective. Specifically, we document that firms repurchase on the open market to exploit mispricing of their bonds and help manage financial reporting to meet earnings targets and avoid debt covenant violations. Firms use tender offers, in conjunction with consent solicitations, to pressure bondholders into agreeing to indenture amendments. We also find that open-market repurchases benefit firms' shareholders and insiders.

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<sup>1</sup> Julio (2013).

Whereas tender offers are pre-announced with a set price, typically at a premium over the market price, open-market repurchases are not, and the price, different for every seller, is set in private negotiations, typically over the phone, between the buyer's and seller's dealers. These transaction characteristics make the bond market more fragmented and significantly less liquid than the stock market (Coffee and Klein, 1991; Easton et al., 2009; Bao et al., 2011), where an average bond is traded only in eight days of the year compared with 243 days for a stock (Easton et al., 2009). Heightened uncertainty in capital markets, which impedes lenders distinguishing good borrowers from bad (Mishkin, 1997; Mishkin and White, 2002), can accentuate informational problems in the secondary bond market. That, in turn, intensifies bondholders' challenges in pricing the bonds and increases the likelihood of mispricing.

Economic literature suggests that managers exploit market mispricing when buying their own securities (Ikenberry et al., 1995). Consistent with that evidence, Mao and Tserlukevich (2014) suggest that creditors should not sell risky debt back to the borrower at less than face value, even if the price at which they are willing to trade with each other is lower. Hence, if bond issuers (borrowers) wish to exploit mispricing, they would benefit from conducting the repurchase in a way that conceals their identities—that is, to buy on the open market. Using the implied volatility of the S&P 500 stock index, commonly known as the VIX index, to measure uncertainty in capital markets, we show that the likelihood of firms choosing the open market to repurchase bonds increases with uncertainty. We also find that the relation between the VIX and the likelihood of open-market repurchase weakens with three measures of firm information quality: whether sell-side analysts cover the firm's debt, the timeliness with which the firm records bad news on financial reports, and whether the firm regularly provides earnings guidance. These results suggest that, while issuers do exploit uncertainty to repurchase mispriced bonds on the open market, information quality can mitigate such behavior. This is consistent with the findings of studies, such as those by Merton (1987), Drake et al. (2009), and Johnston et al. (2009), that suggest high information quality reduces the magnitude of security mispricing. We conduct multiple sensitivity analyses that rule out illiquidity as an alternative interpretation of the results.

Unlike stock repurchases, bond repurchases result in gains and losses recorded on the income statement. Whenever the repurchase price of the bond is lower than the bond's carrying value on the balance sheet, a firm records a gain from debt extinguishment. A recent study by Lemayian (2013) suggests that firms repurchase bonds at a profit when, absent the repurchase profits, earnings are likely to miss targets. As open-market repurchases allow firms to exploit mispricings and limit their repurchase size to the amount required to beat the target, if they want to manage earnings, they are likely to choose the open market. Consistent with that idea, open-market repurchases increase firm's income by an average of 1 percent of total assets, whereas tender offers have no effect. Further analyses suggest that firms are more likely to repurchase on the open market when, absent the repurchase profits, they are likely to miss prior-year earnings numbers and analysts' earnings forecasts and when they have a history of managing earnings.

Beating earnings targets is not the only motive to manage reported financial figures through bond repurchases. Firms may also repurchase bonds to manage financial ratios in debt covenants. Beneish and Press (1993) estimate the cost of renegotiating to restructure debt after technical default at 0.37% of a firm's market equity value. DeFond and Jambalvo (1994) and Beatty and Weber (2003) suggest that firms use accounting choices to avoid covenant violations. We find that, when firms are pressured to repurchase debt due to tight leverage or interest-coverage ratio covenants on their private debt, they tend to repurchase on the open market.

Additional analyses provide further evidence of mispricing in open-market repurchases and suggest that shareholders and insiders likely benefit from them. First, we document measurable positive abnormal returns for bonds repurchased on the open market in the year following the repurchase, and, second, we document a measurable increase in insiders' buying when trading stocks around open-market repurchases.

Finally, bond indentures may include provisions that limit firms' ability to enter into transactions such as selling a major asset or making large investments. When tendering bonds, firms approach all known bondholders. Hence they can better obtain the required majority to amend indenture terms than if they approach each bondholder separately. In addition, bundling a tender offer with a consent solicitation, in which acceptance of the offer is conditional on consenting to the indenture change, pressures bondholders to accept the offer, knowing that holding out may leave them with less favorable terms (Chattarjee et al., 1995). Both these factors suggest that a tender offer is the likely repurchase method choice when a firm needs to secure votes to amend indenture provisions. We find that firms seeking to amend bond indentures are more likely to choose tender offers over open-market repurchases.

This study makes several contributions to the literature. First, it highlights the fundamental differences between the two repurchase methods and the implications they have for achieving the repurchase objectives. Both the theoretical and empirical literatures have largely assumed away these differences. Second, by documenting that, when seeking to manage reported earnings and avoid financial covenant violations, firms repurchase on the open market, we extend the literature on management of reported numbers through real activities (e.g., Roychowdhury, 2006) and, specifically, the recent evidence by Lemayian (2013) that firms repurchase bonds to manage earnings. Finally, by documenting that exploiting mispricing motivates bond repurchases, we provide unambiguous evidence of mispricing as a stand-alone motivation for firms to trade in their own securities. Unlike bond repurchases, stock repurchases are all pre-announced. The announcements have been suggested to signal managers' private information (Vermaelen, 1981; Dann, 1981; Vermaelen, 1984; Ofer and Thakor, 1987; Persons, 1994) about stock value. Thus, the actual repurchase of stocks can be interpreted as acting on a signal to uphold a firm's credibility rather than an effort to exploit mispricing.

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