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## Buyback behavior of initial public offering firms

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## ABSTRACT

We examine the motives behind the share repurchase decisions of initial public offering (IPO) firms by studying the stock and operating performance after the IPO date. We find that IPO firms that announce repurchases within 3 years of IPO dates exhibit poorer long-run abnormal operating performance than other IPO firms. These IPO firms also experience poorer stock return performance and downward analyst forecast revisions. Moreover, these firms show intensive insider selling transactions after the IPO date. These results for IPO announcing repurchase firms are consistent with the misleading hypothesis, which suggests that these IPO firms mislead investors by announcing repurchases as false signals.

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## 1. Introduction

Anecdotal evidence shows that soon after their listing, some initial public offering (IPO) firms announce share buyback programs. For example, Lexmark International Group Inc., a printer manufacturer, announced open market share repurchase programs in 1998, 2 years after its IPO date. Lexmark cumulatively bought back 10 million shares (or 14%) of 71.1 million shares outstanding. The total value of the shares repurchased is equivalent to over \$600 million dollars.<sup>1</sup> In a sample of 3614 IPO firms between 1990 and 2004, we find that 14.2% of the firms announced repurchase programs within 3 years of their listing. In this paper, we aim to answer the question of why firms go through the IPO process and then pay back part of the cash to investors through share buybacks soon after the capital raising.

To shed light on the buyback behavior of IPO firms, we propose three hypotheses. The first is the *free cash flow hypothesis*. It is argued that if IPO firms do not improve their profitability in the post-issue period, they likely face a shrinking investment opportunity set and will accordingly have lower capital expenditures and R&D expenses. Hence, cash distribution via repurchases might reduce a firm's over-investment problem and may be followed

by a positive market reaction in the long run (Grullon and Michaely, 2004; Oswald and Young, 2008; Harris and Glegg, 2009; Oded, 2011).

The second explanation is the *signaling hypothesis*. Firms may repurchase stock to signal undervaluation (Vermaelen, 1981; Ikenberry et al., 1995; Chan et al., 2004; Liang, 2012). IPO firms typically tend to have a serious information asymmetry problem. Hence, a profitable IPO firm could convey positive information by repurchase announcements under asymmetric information, particularly as the firm is not overvalued. It is possible that an IPO's buyback plays a signaling role.

The third explanation is the *misleading hypothesis*. Teoh et al. (1998) and Chan et al. (2008) argue that IPO firms might manipulate earnings to support the firm's IPO and that IPO firms with a more aggressive accruals policy are likely to underperform more in the long run than other IPO firms. In addition to earnings manipulation, the repurchase could be another way to support an IPO stock price (Hribar et al., 2006; Chan et al., 2010). That is, the IPO firm's earnings fall after it goes public, and managers announce buyback programs to support the stock price against the profitability decline.

We use long-run stock and operating performance, analyst forecast revisions, and insider trading of IPO firms to investigate IPO firms' buyback behavior and test the hypotheses. Under the free cash flow scenario, the IPO firm buying back shares faces a shrinking investment opportunity set, and the firm reduces free cash flow by the repurchases. Hence it is expected that operating performance deteriorates and analyst forecasts become more negative,

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and the reduction in free cash flow causes a positive long-run stock return. Under the signaling hypothesis, a profitable firm may signal its undervaluation via repurchases, and the insiders of the firm may repurchase for their personal wealth enhancements. Thus, we expect improved operating performance, upward analyst forecast revisions, and more insider purchases for the IPO firm buying back shares. Under the misleading hypothesis, if the IPO firm uses the repurchase to send false signals, we should see deteriorating operating performance, downward analyst forecast revisions, and accordingly, the long-run stock return should be negative. Moreover, the insiders of the firm may engage in more insider sales because the repurchases of the IPO firm are not related to improved profitability.

We collect data on 3614 US IPO firms between 1990 and 2004. The general results indicate a deterioration in IPO operating performance and analyst forecasts, which is consistent with the studies of Ritter (1991), Jain and Kini (1994), and Teoh et al. (1998). IPO firms that announce repurchases within 3 years of their IPO date, hereafter called *IPO announcing repurchase firms*, tend to exhibit poorer operating performance. On a performance-adjusted return-on-assets (ROA) basis, the ROA of IPO announcing repurchase firms is  $-7.49\%$  while other IPO firms experience an ROA equal to  $-2.28\%$  in the sixth year after the IPO date.<sup>2</sup> Evidence from analysts' forecast revisions supports the operating performance results. Analysts are more likely to downgrade their forecasts of earnings per share (EPS) on the IPO announcing repurchase firms than forecasts on other IPO firms. We also see negative long-run stock returns for IPO announcing repurchase firms. The Fama–French three-factor model estimates an average monthly abnormal return for IPO announcing repurchase firms of  $-1.01\%$  over the 5-year post-issue period. More importantly, insiders of IPO announcing repurchase firms tend to sell more shares than insiders of other IPO firms. Even though when we focus on repurchases with actual buyback or repurchases with actual buyback ratios of more than 1%, insiders of IPO announcing repurchase firms still sell more shares than other IPO firms. Therefore, we conclude that IPO firms may announce repurchase programs to mislead the market, and accordingly revise the market valuation. This evidence is consistent with the misleading hypothesis, but it does not support the free cash flow and the signaling hypotheses.

In point of fact, few studies have explored IPO firms' payout behavior. Jain et al. (2009) examine the payout behavior of IPO firms. They document that IPO firms are more likely to employ repurchases but not dividends as the payout initiation mechanism. They also conclude that repurchase decisions relate to signaling of undervaluation while dividend decisions are driven by life cycle and catering theory considerations. Our paper is different from Jain et al. (2009) because we examine the post-IPO performance, analysts forecast revisions, and insider trading behavior for IPO firms with and without repurchases to understand the repurchase behavior of IPO firms, whereas Jain et al. (2009) focus on the choice between repurchases and dividends for IPO firms. Moreover, Jain et al. (2009) suggest that repurchases by IPO firms are associated with the signaling hypothesis, but our findings indicate that they are more consistent with the misleading hypothesis.

In addition, several studies investigate the dividend payouts of IPO firms. Bulan et al. (2007) examine the timing of dividend initiations after IPO dates and argue against the signaling theory, finding that dividend initiators are more profitable, with ample cash but few growth opportunities. They explain the timing of dividend initiation using life-cycle scenarios that differ from

conventional explanations. Inversely, Kale et al. (forthcoming) provide evidence in support of predictions from the dividend-signaling models. We instead focus on repurchase, not dividend initiations. We believe that we are the first to undertake a comprehensive examination of the buyback behavior of IPO firms.<sup>3</sup>

The remainder of the paper is organized as follows. Section 2 describes our data and methodology. Section 3 examines the IPO's buyback behavior and long-run performance. Section 4 discusses the relation between the types of repurchases and our hypotheses. We summarize our findings in the final section.

## 2. Data and methodology

### 2.1. Sample formation

For this study, the IPO sample firms are from the Securities Data Corporation's (SDC) Global New Issues database during 1990–2004 and are listed on the American Stock Exchange (AMEX), New York Stock Exchange (NYSE), and Nasdaq. We exclude IPO firms whose return information is absent from CRSP files or whose accounting information is not available on annual Compustat files. We also exclude American Depository Receipts (ADRs), Real Estate Investment Trusts (REITs), closed-end funds, unit offerings, financial firms (SIC code 60), and IPO firms with an offering price of less than \$3. This process results in a final sample of 3614 IPO firms. For these firms, we collect the repurchase information (including open-market repurchases, tender offers, and privately negotiated repurchases) from the SDC Mergers and Acquisition database between 1990 and 2005. Because the SDC provides more comprehensive repurchase data starting from 1990, we confine the IPO sample to years between 1990 and 2004 to match the repurchase announcements. Analyst forecast revision information is from IBES. The firm's funding date comes from Jay Ritter's website.<sup>4</sup> Data about the IPO firm's pre-IPO total assets is from Jay Ritter and the SDC database. Insider trading information is from the Thomson Financial Insiders Filing Database.

### 2.2. Definition of an IPO's buyback behavior

We define any repurchase announcement made within 3 years of the IPO year as the IPO announcing repurchase firm. There are two reasons for specifying a 3-year observation window. First, other IPO researchers usually observe long-run stock return on the basis of either 3 years or 5 years (e.g., Ritter, 1991; Brav et al., 2000; Ritter and Welch, 2002; Schultz, 2003). If it is shown that the IPO's buyback behavior is related to the underperformance of the IPO firm, the third year would be a critical year. The 5-year performance of the IPO firm is then examined. Second, the sample consists of IPO firms since 1990. Taking a long-horizon perspective may increase the sample size of IPO announcing repurchase firms, but, it would reduce the sample size for other IPO firms, especially in the 2000s. Thus, we divide the IPO sample according to whether the IPO firm announces repurchase within 3 years of the IPO date. Similarly, the repurchase sample is categorized by whether the repurchase announcement takes place within 3 years of the IPO date.

<sup>3</sup> We also examine dividend declarations of the IPO firms. In our sample of 3614 IPOs, 112 IPO firms announced significant dividend increases (i.e., with dividend yield increases by more than 10%). Our unreported results suggest that these 112 IPO firms tend to declare dividends for signaling purposes.

<sup>4</sup> <http://bear.cba.ufl.edu/ritter/>. Some supplemental data comes from the data in Field and Karpoff (2002) and Loughran and Ritter (2004). We appreciate the help of Jay Ritter on the funding date, accounting information prior to the IPO date, and buyout-backed IPOs.

<sup>2</sup> The 5.21% difference in ROA is economically significant. Given a  $-5.21\%$  difference of ROA for a firm with total assets of \$140 million, where \$140 million is the average assets for our IPO sample, such earnings would represent a loss of \$7.29 million every year.

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