



## The cost of financial flexibility: Evidence from share repurchases☆

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### ABSTRACT

Over the last two decades, share repurchases have emerged as the dominant payout channel, offering a more flexible means of returning excess cash to investors. However, little is known about the costs associated with payout-related financial flexibility. Using a unique identification strategy, we document a significant cost. We find that actual repurchase investments underperform hypothetical investments that mechanically smooth repurchase dollars through time by approximately two percentage points per year on average. This cost of financial flexibility is correlated with earnings management, managerial entrenchment, and less institutional monitoring.

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*It would have been wiser to wait. We are sorry.* James Dimon, CEO of J.P. Morgan Chase, apologizing for \$8 billion in buybacks done earlier in the year. (October 13, 2011)

### 1. Introduction

Poor market timing by J.P. Morgan Chase notwithstanding, the supposed advantages of repurchases as a means of distributing cash to shareholders are well known among academics and managers. Surveyed financial executives prefer repurchases to dividends because of their flexibility. Executives claim to “use this flexibility in an attempt to time the market by accelerating repurchases when they believe their stock price is low” as well as vary payout based on the availability of good projects (Brav et al. (2005)). While it is almost surely true that managers value this flexibility, it is less clear that they reliably add value using it.

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Payout policy – which encompasses the form, amount, and timing of distributions to shareholders – is a core corporate finance issue. Unlike dividends, which are sticky, repurchases provide managers flexibility with respect to the amount and timing of payouts. Ideally, managers use this flexibility to benefit shareholders. However, the existing literature raises questions on whether payout flexibility has costs as well. Jensen (1986) highlights the potential agency conflict, noting “conflicts of interest between shareholders and managers over payout policies are especially severe when the organization generates substantial free cash flow.” Barclay and Smith (1988) explore “a previously unrecognized cost associated with regular open-market repurchases” and assert that the presence of informed insiders affects bid-ask spreads and the cost of capital. More recently, Brown et al. (2007) study the 2003 dividend tax cut to understand the choice of payout and note that “consistent with a standard agency theory perspective that, rather than operating the firm solely in the best interests of shareholders ... managers are inclined to also incorporate their own financial incentives in corporate decisions.” Given these issues, our goal is to quantify the costs associated with giving managers flexibility with respect to payout.

We study actual share repurchases using a sample of 5498 firms that repurchased stock during at least one quarter between 1984 and 2010. To evaluate the cost of repurchase-related financial flexibility, we compare the average annualized rate of return on a firm's repurchased stock over varying windows to the rate of return the firm would have earned had it made regular, identically sized (i.e., dividend-like) repurchases. In other words, we estimate the difference in returns on the firm's actual repurchase strategy and an alternative repurchase strategy that assumes equal distributions across time, i.e., no flexibility. Using the actual dollar amount spent by a firm and assuming that buying occurs at the end of each quarter over the life of the firm in our sample, we find the average return on repurchase spending would rise significantly if firms had smoothed their buybacks more evenly. The average annualized rate of return earned by firms on repurchased stock is 7.66%, but this average return rises significantly to 9.64% if these same firms instead had smoothed repurchase spending evenly across time. The approximately two percentage point difference represents the cost of varying repurchases across quarters as opposed to holding repurchase dollars constant each quarter. Our naive, mechanical repurchase strategy outperforms actual repurchases if we smooth repurchases over shorter time windows (1, 2, 3, and 4 years instead of the entire sample period), but the longer the time window, the more our smoothed strategy outperforms the actual repurchase strategy. We replicate this analysis using actual buyback prices, which are available in quarterly filings starting in 2004. Though our sample is reduced, we document similar patterns.

We address a variety of potential concerns. We ensure the availability of cash on hand to execute our proposed smoothed repurchase strategy by smoothing repurchase spending forward in time such that actual repurchase dollars were spent during or before the smoothed repurchase quarter. We explore how the motive for repurchasing relates to the costs and benefits of repurchase flexibility. However, we find that even the subsample of firms that explicitly state undervaluation as a motive for repurchasing could have made a significantly better investment by spreading out their repurchases more evenly over longer smoothing periods. Further, we allow for optimal within-quarter repurchase timing by assuming that all repurchases occur at the minimum daily closing price each quarter and continue to identify a significant cost to repurchase flexibility. In fact, assuming firms can optimally time repurchases within the quarter increases our cost estimate to over 5.5 percentage points per year.

We rule out the argument that our smoothing strategy is not executable from a legal perspective by examining repurchase timing after the adoption of Securities and Exchange Commission (SEC) Rule 10b5-1 in 2000, when firms in our sample could have legally set up a regular trading schedule that closely resembles our proposed smoothed repurchase strategy. We address the concern that suspending repurchases may be rational *ex ante* by examining only completed repurchase plans. Further, we show that firms with low completion rates – firms that may be more deliberate or strategic in their repurchase program – also could benefit from our smoothed repurchase strategy. Finally, our results withstand a battery of additional robustness tests, which include: (1) excluding Dutch auctions, tender offers, and accelerated share repurchases, which provide less flexibility than open market share repurchases; (2) stopping our sample period prior to the recent financial crisis; (3) conditioning on only the most liquid firms, whose prices are least sensitive to repurchase buying pressure; (4) calculating repurchases net of stock issues; and (5) using size and book-to-market benchmark-adjusted returns. In all cases, we identify a positive and significant cost to repurchase-related financial flexibility.

We conclude by examining the cross-sectional determinants of the cost of repurchase flexibility, measured as the difference between the actual repurchase return and that of the smoothed (no flexibility) repurchase strategy. This approach sheds light on the frictions preventing firms from reducing this cost. We find that the cost of repurchase flexibility is greater when there is a desire to manage EPS, when institutional ownership is low, when institutional investors are selling into the repurchase, and when managers are more entrenched. These results are consistent with firms with high agency costs incurring greater costs associated with repurchase flexibility.

Our findings contribute to the literature along multiple dimensions. We contribute to the dividend substitution literature by highlighting a significant cost to payout flexibility. We add to the literature on whether managers reliably exploit inside information through repurchasing at attractive values. One strand of this literature identifies positive and significant long-run abnormal returns following open market share repurchase announcements (e.g., Ikenberry et al. (1995); Peyer and Vermaelen (2009)), often interpreted as evidence of repurchase timing skill. A second stream of literature focuses on the execution of share repurchase programs and provides evidence that firms can time repurchases well over relatively short periods of time (e.g., Brockman and Chung (2001); Cook et al. (2004), and Dittmar and Field (2015)). Conversely, Dittmar and Dittmar (2008) examine repurchases at the macroeconomic level and conclude that repurchases increase following GDP growth and are thus highly pro-cyclical. We conclude that if firms exploit inside information through repurchase transactions, the information must be short-term (less than 1 year) rather than long-term in nature. We contribute to the literature on monitoring and corporate governance by showing that the cost of financial flexibility is significantly correlated with incentives to manage earnings,

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