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Governance and post-repurchase performance

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ABSTRACT

Payout policies based on share repurchase programs provide greater flexibility than do those based on cash dividends. We develop and test an empirical model in which strongly governed companies outperform weakly governed companies after announcing share repurchase programs. Our findings include positive associations between strong governance and both post-announcement adjusted operating performance and abnormal stock returns. The results are robust to sample selection bias, different sample criteria, governance measurement, and various control variables. In addition, governance strength is associated with larger post-announcement changes in CEO incentive compensation and merger and acquisition activity, both of which we argue are consistent with strongly governed companies using the financial flexibility derived from choosing share repurchases over cash dividends to drive better performance. Consistent with current literature on attenuation of former anomalies, the associations we find between governance and post-announcement performance tend to disappear in the latter half of our sample period.

1. Introduction

We propose and test an agency-based hypothesis to explain the relation between company corporate governance and changes in company valuation and operating performance after *open market share repurchase program* announcements (henceforth share repurchase programs). For companies that possess it, free cash flow presents a potential agency conflict (Jensen, 1986). Companies can mitigate this conflict between managers and shareholders by simply paying out excess cash to shareholders through cash dividends or share repurchases (Easterbrook, 1984; Jensen, 1986). Cash dividends represent a costly, credible agency cost-reducing pre-commitment to pay out cash to shareholders for the foreseeable future (John and Knyazeva, 2006; Brav et al., 2005). These pre-commitment costs may include sub-optimal future investment policy, cash dividend taxation, and future external financing costs. Share repurchases do not face these costs, but do not provide the agency cost-reducing pre-commitment to pay out future cash. Despite their lack of pre-commitment benefits, share repurchases by US corporations represent a significant and increasing portion of total distributions.[1]

Following John et al. (2015), we develop a model where corporate governance and cash payout policies are substitutes for one another in reducing agency conflicts. In the context of their particular governance environment, companies choose their payout

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[1] Babenko et al. (2012) report that although the greatest number of repurchase announcements occurred in 1998 and 1999, the combined total dollar amount was higher in 2006 and 2007. Wang and Bost (2014) report on www.bloomberg.com that the proportion of cash flow used for share repurchases has doubled in the last decade.

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policy. Firms with relatively weaker governance mitigate their inherently higher agency conflicts by choosing to pre-commit themselves to future cash dividends, while strongly governed companies, with inherently lower agency conflicts, choose to maintain financial flexibility by paying out excess cash through share repurchases. In choosing its payout policy, each firm makes a tradeoff between governance and payout type. John et al. (2015) report results consistent with this model, concluding that weakly governed companies tend to use regular cash dividends, and strongly governed companies tend to use nonbinding share repurchases (or special dividends) for payouts (see also Grullon and Michaely, 2014). Using a 21-year sample of repurchasing companies, we examine whether adherence or lack of adherence with these tendencies is reflected in differential long-term post-announcement stock and operating performance.

We find that announcements of share repurchase plans by strongly governed companies that adhere to the tendency reported by John et al. (2015) are associated with better long-term performance relative to weakly governed companies, which do not adhere to the tendency. Our results hold after controlling for different measures of performance, multiple control variables, and the self-selection problem identified by Heckman (1979). Our results are new to the literature, and suggest that the strength of a company's corporate governance system plays an important role as an ex ante indicator of announcing companies' future performance. However, this positive association between governance and performance only holds for the first half of our sample period. We find no statistically significant association between governance and performance in the period after the year 2000, which is consistent with the findings in the growing literature on the attenuation of former market-related anomalies (Chordia et al., 2014). We conclude that a firm's corporate governance system is both an important factor in the payout choice decision, as was concluded by John et al. (2015), and an ex ante indicator of future performance, but that its association with performance has recently diminished (Fu and Huang, 2015).

In Section 2, we develop our agency-based hypotheses by reviewing the literature on share repurchase programs and corporate governance, and briefly preview our results. We explain our data and methodology in Section 3. We present and discuss our results in Section 4. Our summary and conclusions appear in Section 5.

2. Literature review and hypothesis development

2.1. Substitution between payout policy and corporate governance

Our goal is to analyze the role corporate governance plays in the post-announcement performance of share repurchasing companies. Managers of strongly governed companies are relatively more closely monitored, which tends to mitigate agency conflicts at these firms. Weakly governed companies, conversely, face higher levels of agency conflicts due to their lower levels of managerial monitoring. Gillan et al. (2011) show that individual corporate governance mechanisms may act as substitutes for one another. For instance, companies with powerful boards tend to also have a greater number of protective antitakeover charter provisions and vice versa, which is consistent with the existence of an optimal mix or adequate number of governance mechanisms, beyond which there may be diminishing returns to additional agency conflict-reducing mechanisms.

Governance is not the only way to reduce agency conflicts. Easterbrook (1984) describes the agency cost-reducing role played by cash payouts to shareholders via cash dividends and share repurchases, arguing that formal managerial monitoring is costly. Regular cash dividends force managers to generate the cash to make the payout and to access outside capital markets more frequently, both of which tend to substitute for tighter formal monitoring of management.

John and Knyazeva (2006) and John et al. (2015) argue that since a company's corporate governance system defines its level of formal managerial monitoring, governance measures can be used to test the substitution between formal monitoring and cash payouts. While not contractually required, as are interest payments on debt, regular quarterly cash dividends represent an implied pre-commitment to pay out cash to shareholders. Surveys of corporate executives indicate that managers are loath to reduce or omit a cash dividend payment (Lintner, 1956; Baker et al., 1985; Brav et al., 2005). This reluctance is backed by empirical findings of significant negative returns to dividend cuts and omissions (Lang and Litzenberger, 1989; Healy and Palepu, 1988). Consistent with the agency cost-reducing role of dividends proposed by Easterbrook (1984), John et al. (2015) report event study results showing that the market reacts more negatively when weakly relative to strongly governed companies announce a surprise dividend cut. This stronger adverse market reaction when cutting their dividends combined with their greater tendency to pay dividends supports John et al.'s (2015) hypothesis that weakly governed companies supplement their formal monitoring systems by pre-committing to regular cash dividends. Conversely, the tendency for strongly governed companies to pay out cash by repurchasing shares, coupled with a relatively less negative market reaction to dividend cuts is consistent with these companies having sufficient levels of monitoring without the need to pre-commit to cash dividends. For these companies, which already benefit from low agency conflicts, such pre-commitments are not only unnecessary, they may decrease value as the costs of the pre-commitment outweigh marginal reductions in already low agency costs. Without the need to pre-commit to cash dividends, distributing excess cash via more flexible share repurchase policies allows strongly governed companies to take advantage of value-enhancing closer ties between earnings, payouts, and investment policies.

2.2. Hypotheses

We hypothesize that substitution between strong governance systems and pre-commitment to pay cash dividends, both of which reduce agency conflicts, implies a difference in repurchasing companies' post-announcement performance. Strongly governed companies enhance value by not pre-committing to permanent increases in cash dividends, thus avoiding their