



Investment opportunities and share repurchases[☆]



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ABSTRACT

We examine the over-investment motivation for share repurchases using a sample of 139 Real Estate Investment Trusts (REITs) between 1996 and 2010. By combining a REIT's property portfolio data with project ROAs from the underlying real estate market, we are able to create a unique measure of the firm's investment opportunity set. Controlling for other possible buyback rationales, we find that poor investment opportunities are related to higher levels of share repurchases. Conditioning on investment opportunities, we find that the level of cash is positively related to repurchases only for low investment opportunity set firms. We also find a negative relationship between share repurchase announcement returns and investment opportunities.

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1. Introduction

Share repurchase has been an active area of financial research for the last four decades. It has also been increasingly significant in global financial markets. For example, in 1999, for the first time in history, the dollar volume of share repurchase exceeded the total amount of dividends paid by U.S. firms.¹ In addition, regulators in foreign markets have been relaxing restrictions on buybacks, leading to the rapid growth of repurchase outside the U.S.²

The majority of academic investigations into stock repurchase (these are briefly covered in the literature review in Section 2) examine the short- and long-term impact of the repurchase. These papers typically test theoretical buyback motives by employing an event study and/or a measurement of after-repurchase performance (either operating performance or abnormal stock returns). A number of more recent studies have used Logit and Tobit analyses to assess the determinants of the repurchase decision.

One of the most cited motives for repurchase is the lack of attractive investment opportunities relative to the firm's cash position; this is usually referred to as the over-investment hypothesis. While the academic studies have shed considerable light on the empirical validity of potential motives for repurchase, they have presented only indirect evidence addressing this important interaction between the firm's repurchase decision and the return on its investment opportunities.³ The most recent studies have generally supported the over-investment hypothesis, but the evidence is not unequivocal. This is due to the obvious

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¹ See Julio and Ikenberry (2004).

² See Kim et al. (2005) for a description of the changing foreign restrictions.

³ In a rather different context, Dellavigna and Pollet (2013) show that equity issuance is related to long-term, future demand shifts due to demographic changes.

difficulty in determining the firm's return on its possible projects. While these returns are available to firm insiders, they are not easily observable by researchers. Our study more directly attacks this essential aspect of the repurchase question by estimating the firm's expected project returns in order to determine the extent to which the firm's opportunity set influences the buyback decision.

We achieve this objective by focusing on Real Estate Investment Trusts (REITs). While this is a significant restriction and potentially limits the generality of our results, it has a very powerful advantage: it allows us to use available data on capitalization rates (project ROAs) from observed market transactions on different property types and locations to proxy for the REIT's project opportunity set.

REITs were established in 1960 to allow retail investors to invest in commercial and other forms of real estate. Because they are restricted to passive real estate investment and since they are required to pass on 90% of taxable income as dividends,⁴ REITs are essentially tax-free investment conduits.⁵ The reason for using REITs is that they are among the most transparent investment vehicles, and because of the severe restrictions on their allowable investments, we can use a diverse database of market transactions to determine cap rates. We then use the cap rates to estimate the REIT's feasible project returns at any point in time. It is reasonable to expect that cap rates are an excellent proxy for the REIT's anticipated IRRs. For example, an examination of our cap rates and expected IRRs obtained from surveys conducted by PWC Korpacz shows that these two measures have a correlation over 92%.⁶ So although we do not have actual IRRs, the measure we do have is very highly correlated with expected returns.⁷

Another advantage of using REITs in our study is that there are relatively few hostile REIT mergers.⁸ This virtually eliminates the use of repurchases as an anti-takeover device.⁹ Finally, restricting our analysis to one industry mitigates the confounding influence of varying levels of risk.

While a more precise definition is given in Section 3, informally one can think of the capitalization rate as the property's Return on Assets. We obtain cap rates on 109,430 transactions with a total transaction value of \$1.135 trillion over the period 1995 to 2010 from the CoStar and Real Capital Analytics databases. Our empirical analysis uses these transactions to create a time series of project returns for each of the 139 REITs in our sample. We then examine the relation between repurchase activity and project returns. The over-investment hypothesis asserts that REITs will be more likely to repurchase shares when expected project returns are relatively low, since this action would maximize shareholder value.

Overall our data are strongly consistent with this hypothesis. After controlling for the impact of over-valuation, firm size, leverage and executive option characteristics, a one standard deviation decrease in capitalization rates makes the REITs in our sample 14.5% more likely to repurchase shares and leads to an increase in the level of repurchases of approximately 47% of the average level of repurchases observed in the sample. Conditioning on investment opportunities, we find that the level of cash is positively related to repurchase activity only for low investment opportunity firms. Since REITs tend to repurchase in smaller amounts and because they have essentially no internal capital available for financing projects, one would expect that these results would be even stronger for typical corporations, which have far less dependence on external capital markets.

As a robustness check, we also examine announcement effects for firms announcing repurchase programs. Following the repurchase motivation methodology of Peyer and Vermaelen (2009), we find that firms with a stated repurchase motivation of facing poor investment opportunities have a 5.04% 3-day cumulative abnormal return around the repurchase announcement. Consistent with this, we also find that controlling for the size of the repurchase program, firms announcing repurchase programs in poor investment opportunity environments have 1.7% higher 3-day and 2.35% higher 5-day CARs than firms announcing in good investment opportunity environments.

The organization of the remainder of this paper is as follows: Section 2 provides an overview of the academic literature. Section 3 describes the data and empirical methodology. Section 4 presents the empirical results and Section 5 concludes.

2. Literature review

This section provides a brief review of the extensive academic literature on share repurchase, emphasizing those papers that are most relevant to the current study. A comprehensive treatment is presented in Allen and Michaely (2002).

2.1. Survey results

Wansley et al. (1989) present survey data on the motives for share repurchase.¹⁰ They list six possible motives: (i) Repurchase can act as a substitute for dividend payments: firms may view both dividends and repurchase as alternative mechanisms for distributing cash to shareholders; the firm could prefer one mechanism over another because of tax, signaling implications etc.¹¹ (ii) As a method to adjust leverage or control: repurchase will increase the firm's leverage and potentially give insiders more

⁴ This was 95% prior to 2001. See Boudry (2011) for an analysis of REIT dividend payout policy. This paper essentially shows that REIT managers set dividends so as to minimize the tax burden of their investors. See also Hardin and Hill (2008).

⁵ There is thus some difficulty in translating the typical motives for dividends versus repurchase as discussed in several studies of regular corporations; for example Grullon and Michaely (2002).

⁶ For Industrial properties the correlation is 86%, for Multifamily it is 97%, for Office it is 92% and for Retail it is 98%.

⁷ We do not use the Korpacz IRRs in this study due to the limited geographic dispersion available in these data.

⁸ There have been very few exceptions; see however Panovka (2007).

⁹ See Bagwell (1991).

¹⁰ See also Baker et al. (1981).

¹¹ Guay and Harford (2000) also analyze the role that permanent versus transitory cash flow shocks play in this decision.

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