Journal of Corporate Finance 20 (2013) 22–40

Contents lists available at SciVerse ScienceDirect

Journal of Corporate Finance

journal homepage: www.elsevier.com/locate/jcorpfin

How do share repurchases affect ownership concentration?

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ARTICLE INFO

Article history:
Received 17 November 2010
Received in revised form 15 November 2012
Accepted 17 November 2012
Available online 27 November 2012

JEL classification:
G30
G32
G35

Keywords:
Share repurchases
Ownership concentration
Blockholders
Corporate governance

ABSTRACT

We study how share repurchases affect the ownership stake of outside blockholders in 950 publicly-traded US corporations from 1996 through 2001, using a control function approach to address the possible endogeneity of repurchases. We find that share repurchases tend to make outside ownership less concentrated: repurchasing 1% of outstanding common equity decreases the fraction owned by large shareholders by around one and a half percentage points. This may decrease outside shareholders' influence over firm decision-making. Our results are confirmed when we restrict the sample to institutional owners, but not to individual owners.

1. Introduction

The purpose of this paper is to investigate whether open-market share repurchases change the concentration of outside (non-management and non-director) equity ownership. To the extent that large outside shareholders play a role in the governance of the firm, this could, in turn, affect its decision-making and efficiency. The idea that the equity holdings of large shareholders may change with a share repurchase finds theoretical support in the corporate finance literature. In general, when the firm enters the demand side of the market for its own stock, market conditions, for example liquidity (Brockman and Chung, 2001; Ginglinger and Hamon, 2007) and risk (Grullon and Michaely, 2004), are likely to change. Large and small shareholders may react differently to these changes, resulting in size-dependent trading behavior and changes in ownership concentration (Admati et al., 1994; Bhide, 1993; Demsetz and Lehn, 1985; Maug, 1998).

The specific question we ask is whether the extent of share repurchase changes the concentration of outside ownership, measured by the fraction of shares held by blockholders who are not insiders. Exploiting the carefully measured ownership data constructed by Dlugosz et al. (2006), we study some 950 publicly-traded US corporations during the period from 1996 to 2001 and find evidence that share repurchases tend to decrease the concentration of outside ownership: a buyback of 1% of outstanding common equity is associated with a decrease in the fraction of shares in the hands of large outside owners of around one and a half percentage points. Hence, it seems that in a share repurchase, large outside shareholders participate disproportionately. Our evidence indicates that this change in ownership concentration is due to large institutional investors selling their shares.

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http://dx.doi.org/10.1016/j.jcorpfin.2012.11.002

Our work is related to several strands of the corporate finance literature. First, our research question owes its importance to the central role ascribed to large shareholders in the governance structure of the corporation. This is because in the face of agency problems, as first pointed out by Grossman and Hart (1980), monitoring of management is a public good among the shareholders.[1] As a result, active corporate ownership is subject to a free-rider problem. Because they enjoy a larger fraction of the benefits, large owners have a stronger incentive to monitor management, and in equilibrium only the largest shareholder monitors while the rest free-ride on her effort. Therefore, managerial monitoring increases with ownership concentration: the larger is the stake of the largest shareholder, the larger is her benefit from monitoring, and the more of it she will choose to supply. The effect of more intense monitoring can be either beneficial or detrimental for efficiency. On the positive side, more monitoring could prevent self-interested behavior by corporate management. On the negative side, Burkart et al. (1997) argue that in the presence of contractual incompleteness more monitoring could discourage managerial initiative and investment in the firm's operation. Either way, the firm may fail to achieve the ownership concentration that maximizes its value because the free-rider problem prevents efficiency-enhancing trades between large and small shareholders.[2]

Active monitoring and involvement in its decision-making is not the only way that large shareholders could influence what happens in the firm. Admati and Pfleiderer (2009) develop a theoretical model in which a credible threat of disinvestment by large shareholders with ensuing decreases in share price can alleviate managerial incentive problems: rather than risking the consequences of a lower share price when she alienates her large owners, the manager refrains from inefficient opportunistic behavior. An important implication of this argument is that the mere presence of large shareholders can improve firm governance even if they have no direct visible influence on corporate decisions.

The empirical evaluation of whether or not large shareholders in general, and institutions in particular, play a role in disciplining management is far from settled.[3] Several studies — McConnell and Servaes (1990), Mehran (1995), Agrawal and Knoeber (1996), and Renneboog (2000), to name a few — fail to confirm that large outside shareholders affect firm decision-making and/or performance. But there is also plenty of evidence to support that at least some types of large shareholders do contribute to the governance of the firm. One type of evidence looks for direct shareholder influence on corporate decisions such as investment, executive compensation, and takeover activity. Examples of research that finds such direct influence towards less opportunistic behavior includes Mikkelson and Partch (1989) and Shivdasani (1993) for takeovers, Denis and Serrano (1996), Franks and Mayer (2001), Kaplan and Minton (1994), and Kang and Shivdasani (1995) for management/director turnover, Yafeh and Yosha (2003) for discretionary spending, and Bertrand and Mullainathan (2001) for managerial compensation. Similar evidence specifically for institutional shareholders is provided by Hartzell and Starks (2003) for managerial compensation and Chung et al. (2002) for earnings management.

Another approach is to study the effect of the presence of large outside shareholders on different measures of firm performance. Becker et al. (2011) and Dlugosz et al. (2006) find that firm performance improves with large outside shareholders present, while Brickley et al. (1988), Chen et al. (2007), Cornett et al. (2007), Cronqvist and Fahlenbrach (2009), Gompers and Metrick (2001), and Nesbitt (1994) find the same thing for at least some large outside institutional shareholders. Finally, the idea that the threat of exit by large shareholders can discipline managers gets empirical support from Bharath et al. (2011) for shareholders in general and from Edmans et al. (2011) and Parrino et al. (2003) for institutions in particular. Overall, the empirical evidence certainly leaves open the possibility that some large outside institutional shareholders play a significant role in the firm's governance and that their departure when the firm makes a share repurchase could have real consequences for firm decision-making and efficiency.

Second, we contribute to the surprisingly scant research on what determines the concentration of outside corporate ownership. Demsetz and Lehn (1985) provide a reduced-form theoretical model of ownership concentration that they test on a 1980–81 cross-section of about 500 US corporations. They find that, in accordance with their theoretical model, firms have more concentrated ownership if they are smaller and if they are subject to more firm-specific uncertainty. Building on this work, Bergström and Rydqvist (1990) bring a similar model to Swedish data. Their sample consists of publicly-traded Swedish firms observed at five points in time between 1968 and 1986. Considerable care is taken in the measurement of ownership concentration, in particular in the identification of coalitions that allow groups of shareholders to exercise joint control. Once again, the empirical results indicate that ownership concentration increases with firm-specific risk and decreases with size. Cash flow and the presence of dual-class shares appear not to influence the concentration of ownership.[4]

Third, following their increased importance over the last quarter century, the literature on share repurchases is by now immense.[5] One type of repurchase, the open-market share repurchase, is far and away the most common.[6] In this type of

[1] See also Shleifer and Vishny (1986).

[2] If the largest shareholder sold shares to the small shareholders, she would decrease her monitoring. Suppose that this decrease enhances the efficiency — and therefore also the value — of the firm. The trade of shares to decrease ownership concentration is now a Pareto improvement among the shareholders. Nevertheless, it may not occur. The reason is that each small shareholder is negligibly small and therefore does not recognize that if she fails to buy the trade is less likely to happen. Each small shareholder therefore refuses to offer enough to compensate the large shareholder for the efficiency gain, hoping other small shareholders will do so instead. As a result, the parties fail to agree on a price and the trade cannot be executed.

[3] For overviews of the literature, see Holderness (2003), Gillan and Starks (2003), and Cornett et al. (2007).

[4] It is worth highlighting that while Bergström and Rydqvist (1990) and Demsetz and Lehn (1985) study all large shareholders, we study only large outside shareholders, i.e., those that are not formally involved in the management of the firm.

[5] Allen and Michaely (2003) and Dittmar (2000) provide overviews of this research.

[6] In 1998, the other two types of general share repurchases — fixed-price tender offers and Dutch auctions — together accounted for less than 5% of the spending on stock buybacks (Allen and Michaely, 2003, p. 405).