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Share repurchases, catering, and dividend substitution

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ABSTRACT

We first extend Baker and Wurgler's (2004a) catering theory of dividends to share repurchases. Consistent with the notion that firms cater to investor demand for share repurchases, we report evidence that the market's time-varying repurchase premium *positively* affects firms' choice to repurchase shares. Next, we use the catering behavior as a novel framework for testing the dividend substitution hypothesis. Consistent with the notion that managers consider dividends and share repurchases to be substitute payout mechanisms, we find that the dividend premium *negatively* affects the repurchase choice, whereas the repurchase premium *negatively* affects the choice to pay dividends.

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1. Introduction

The extant literature offers numerous explanations for why firms disburse funds to their shareholders in the form of dividends and/or share repurchases. Most notably, Bhattacharya (1979), John and Williams (1985), and Miller and Rock (1985) propose that firms disburse funds to signal favorable information to the capital market. Nissim and Ziv (2001) and Lie (2005a) report evidence in favor of the signaling theory, whereas Benartzi et al. (1997), Grullon, Michaely, and Swaminathan (2002), Grullon et al. (2005), and Gong et al. (2008) question this evidence. Related to the signaling theory, Brav et al. (2005) report that CFOs and Treasurers deem undervaluation of the stock to be the most important consideration for the decision to repurchase shares (but not to pay dividends). Alternatively, Easterbrook (1984) argues that payouts mitigate agency problems between managers and shareholders by reducing funds available to managers, but the empirical evidence on this in Denis et al. (1994), Lang and Litzenberger (1989), Yoon and Starks (1995)), and Lie (2000) is also mixed.

In their seminal paper, Baker and Wurgler (2004a) propose a new theory for why firms pay dividends. They argue that investors' demand for dividend-paying stocks is time-varying, thereby causing the relative prices of dividend-paying and non-dividend-paying stocks to fluctuate. Consequently, managers cater to investor demand for dividends by paying dividends when investors place a premium on dividend-paying stocks. Consistent with their theory, they report empirical evidence that aggregate dividend initiations are positively related to their measure of dividend premium. Furthermore, Baker and Wurgler (2004b) report that the dividend premium is related to the propensity to pay dividends documented in Fama and French (2001).

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While Baker and Wurgler's (2004a) original catering theory pertains to dividends, it has since been extended to other corporate decisions. Baker et al. (2009) propose a catering theory of nominal share prices in which managers set the stock price in response to demand for shares in different price ranges. This can explain the choice of IPO offer prices and the timing of stock splits. Polk and Sapienza (2009) suggest that the market might misprice firms according to their investment level, causing managers to try to inflate share prices via their investment decisions. Finally, Aghion and Stein (2008) argue that managers choose between maximizing sales growth and improving profit margins depending on what is in vogue in the stock market.

There is, however, no study on managers catering to time-varying demand for share repurchases. This is surprising, because share repurchases are similar to dividends and have become increasingly popular during the last couple of decades. In this study, we empirically examine catering incentives for corporate share repurchases. In this sense, we extend the literature on the multiple ways in which firms cater to investors' time-varying demands.

In addition, we use the catering behavior to provide new evidence on the hypothesis that managers view dividends and share repurchases as substitutes. The prior literature provides mixed evidence on this. On the one hand, DeAngelo et al. (2000) report that even though the frequency of special dividends has decreased over time, they were not displaced by share repurchases. Furthermore, Jagannathan et al. (2000) find evidence that firms use dividends to disburse permanent cash flows and repurchases to disburse temporary cash flows. They conclude that "Repurchases do not appear to be replacing dividends; rather they seem to serve the complementary role of paying out short-term cash flows" and that "Dividends and repurchases are used at different places in the business cycle by different types of firms" (page 382). On the other hand, Grullon and Michaely (2002) find that firms that disburse less funds in the form of dividends than predicted tend to repurchase relatively more shares, consistent with a substitution effect. Our research approach is novel, because we examine not only the effects of premiums on the corresponding corporate decisions (i.e., the effect of the dividend premium on the dividend decision and the effect of the repurchase premium on the repurchase decision), but also the effects of premiums on the alternate decisions (i.e., the effect of the dividend premium on the repurchase decision and the effect of the repurchase premium on the dividend decision). This allows us to study whether managers consider both payout mechanisms before making a choice.

As the first step of our empirical analysis, we develop a time-varying repurchase premium measure based on the values of firms that have repurchased shares during each of the last three years versus the values of other firms. There are two reasons why we focus on firms that have repurchased during each of the last three years rather than just the last year. First, we are concerned that some firms seek to repurchase shares only when they are undervalued, which, could induce some bias in our repurchase premiums. We believe that firms that have demonstrated a longer-term and regular commitment toward share repurchases are less likely to be motivated primarily by perceived undervaluation, and that focusing on these firms mitigates bias stemming from misvaluation. In contrast, measuring dividend premiums that simply compare last year's dividend payers to nonpayers does not suffer from similar bias, because the capital market generally assumes dividend payers are committed to paying them regularly (i.e., dividends are sticky). Second, to the extent that repurchases occur irregularly, they might be viewed by investors as a peripheral firm characteristic. We mitigate this concern by focusing on firms that have repurchased during each of the last three years, because investors likely view the repurchasing behavior for these firms to be a salient characteristic.

We find that the relations between the repurchase and dividend premiums and the payout decisions are consistently in support of catering theory. The repurchase premium positively affects the probability that firms will initiate or continue their share repurchase activity. Meanwhile, the dividend premium positively affects the probability that firms initiate or otherwise increase dividends. Importantly, these results are robust to the inclusion of the firm risk measures suggested by Hoberg and Prabhala (2009) in our multivariate analysis, and the dividend and repurchase premiums therefore do not appear to merely proxy for risk. Rather, it appears that managers cater to investors' separate demands for share repurchases and dividends.

Next, we examine the substitution effect. We find that the dividend premium negatively affects the probability that firms initiate or continue their share repurchase activity, whereas the repurchase premium negatively affects the probability that firms initiate or otherwise increase dividends. In fact, the effect of the dividend premium on the repurchase decision seems as strong as its effect on the dividend decision, and the effect of the repurchase premium on the dividend decision seems as strong as its effect on the repurchase decision. These results suggest that managers are considering both payout mechanisms before making a final payout choice. In this sense, dividends and share repurchases are treated as substitutes, at least until investor demand tilts the choice toward one or the other. Our results complement those in Grullon and Michaely (2002), who also conclude that share repurchases and dividends are substitutes. While Grullon and Michaely find that firms that pay less dividends than predicted instead repurchase more shares, they do not provide evidence on whether managers actually consider both payout mechanisms before making a choice, as we do.

In a contemporaneous study, Kulchania (2012) also studies how catering might lead to a substitution between repurchases and dividends. Kulchania creates a "difference premium" measure, calculated as a repurchase premium minus a dividend premium. He finds that when the difference premium is high, firms are more likely to repurchase and less likely to pay dividends. He further finds weak evidence that the difference premium explains deviations from "expected" dividend payouts based on the Lintner (1956) model, and that the abnormal stock returns surrounding dividend increase (cut) announcements are negatively (positively) correlated with the difference premium. In contrast, we break out the repurchase and dividend premiums. Doing so allows us to focus on how the repurchase premium incrementally affects the dividend decision while controlling for the dividend premium, and how the dividend premium incrementally affects the repurchase decision while controlling for the repurchase premium. Furthermore, we provide important insights by examining important sub-categories of firms that initiate dividends/repurchases versus firms that continue dividends/repurchases.

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