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INTERNATIONAL ISLAMIC UNIVERSITY MALAYSIA
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Price Effect of Share Buyback Exercises on the KLSE

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MBA PROJECT PAPER

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APPROVAL

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**PRICE EFFECT OF SHARE BUYBACK EXERCISES
ON THE KLSE**

The undersigned certifies that the above candidate has fulfilled the conditions of the project paper prepared in partial fulfillment of the requirements for the Master of Business Administration (MBA).

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ABSTRACT

This paper studies the effect on price of stocks as a result of share buyback exercises conducted by the management. A total of 131 public listed companies were identified to have obtained shareholders' approval to carry out the share buyback. However, to date, only 38 main board companies and 5 second board companies actually repurchased their own shares. This study separated the 131 companies into 4 sub-samples, representing Main Board and Second Board companies that actually bought back their own shares and those that did not follow through with the actual repurchase i.e only obtained shareholders' approval.

This study evaluated the mean abnormal returns and the cumulative abnormal returns for the four different sub-samples, and tested the statistical significance of these results at 5% and 10% level. There is statistical evidence that the share buyback announcement can be considered a significant event from the price viewpoint. The Malaysian stock market appears to respond positively to the share buyback announcement, particularly to those announced by Main Board companies that later implemented their share buyback plan.

There are some differences between the Main Board and Second Board companies in terms of the market's reaction and in stock price performance between the companies that actually repurchased their own shares and those that only obtained the shareholders' approval. The post-announcement abnormal gains appears to be longer lasting for Main Board companies while for Second Board companies, the market response is more selective. The market is more skeptical about the credibility of some of these Second Board announcements and as such there is a delayed positive but temporary price reaction.

Since there is a time lag between the decision making process of the company (privy only to the insiders) and the share buyback announcement (available to the market), there is an opportunity for information leakage and insider trading. This study concludes that there is a significant extent of insider trading prior to the share buyback announcement. About 45% of the total 131 companies involved in the share buyback exercise appeared to be influenced by information leakage.

PRICE EFFECT OF SHARE BUYBACK EXERCISES ON THE KLSE

MBA PROJECT PAPER

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CHAPTER 1 - INTRODUCTION

1.1 Study Background

This project paper is intended to determine the effects on price of stocks as a result of the share buyback exercises conducted by a company's management. Due to the lag time between the decision-making process of the company and the actual exercise of share buyback, there is a possibility of an information leakage which provides an opportunity of insider trading to take advantage of privileged information. Hence this study is hopeful of studying both the price effects and the extent of insider trading during share buyback exercises in KLSE.

1.2 Why the Interest in Share Buyback?

Share buyback is a fairly recent phenomenon in Malaysia and hence considered worth studying because the share buyback exercise was only allowed in Malaysia at the height of the 1997 economic crisis. Although share buybacks are fairly common in developed nations such as United States (known as stock repurchase), public listed companies in KLSE were previously prohibited from buying back their own shares.

On 29 August 1997 during the midst of the recent economic crisis, the Registrar of Companies announced the addition of a new section "Section 67A" to the Companies Act 1965 which allows public listed companies to purchase their own shares. The new Section 67A was duly gazetted and came into effect on 1st September 1997.

Since then, about 163 main board companies and about 47 second board companies have either amended their Memorandum of Association and the Articles of Association (better known as M&A) or sought shareholder approval for their share buyback exercises.

However not all of these public listed companies (PLC) actually implemented their share buybacks. Only 38 main board companies and 5 second board companies actually repurchased their own shares ⁽¹⁾.

The breakdown of these PLCs i.e for those who only amended their M&A, those who had sought shareholders' approval for the share buyback and those who had actually repurchased their own shares, are presented in Table 1.1. A complete list of these companies is attached in Appendix A.

Table 1.1 : Breakdown of public-listed companies involved in share buyback

Breakdown by Type	Main Board Companies	Second Board Companies	Total PLCs in KLSE
Amended their M&A	163	47	210
Obtained shareholders' approval at EGM/AGM	112	19	131
Actually repurchased shares	38	5	43

Sources:

Data from KLSE - period covering September 1, 1997 to June 30, 2001

It can be seen from Table 1.1 that the number of PLCs that had already obtained shareholders' approval to date only totaled 131 companies i.e. consisting about 16.2% of the total number of listed companies in KLSE (the KLSE website indicated that 512 companies are listed on the Main Board and another 297 are listed on the Second Board, giving a total of 809 PLCs as at 2 July 2001).

Although the Companies Act 1965 was amended in 1997 to allow companies to repurchase their own shares, it was only after 1998 that the share buyback exercises became popular to the management of the PLCs. Table 1.2 shows the breakdown by year of PLCs that had implemented their share buyback.

(1) - cut-off date of this study is June 30, 2001

Table 1.2: Breakdown by year of public-listed companies that actually implemented their share buyback (repurchased own shares)

Breakdown by Year	Main Board Companies	Second Board Companies	Total PLCs in KLSE
1997	1	0	1
1998	11	3	14
1999	11	0	11
2000	9	1	10
2001 ^{#1}	6	1	7
Total to date ^{#2}	38	5	43

Sources:

Data from KLSE

#1 indicates the period from January 1 up to June 30, 2001

#2 indicates the period covering September 1, 1997 to June 30, 2001

1.3 The Motivation for This Study

The main motivation and justification in carrying out this study that share buybacks are a fairly recent experience in Malaysia and not many academic research had been carried out on this area with regards to the domestic experience. The only academic work known thus far is by Mohamad b. Jais and Y.F. Chin (2001) who evaluated the effects of share buyback on a small sample of 34 PLCs that made open-market share repurchase announcements between November 1997 and June 1998.

To illustrate a point, in more developed capital markets such as in United States and Europe, there had been a longer history of share buyback and hence a plethora of academic studies had been carried out to assess the various aspects such as the market underaction or overaction to the open-market share repurchases, the price effects of repurchase announcements, the various hypotheses surrounding the repurchases including the signaling hypothesis, their impact on taxation and other relevant issues relating the similarities between share repurchases and dividend payouts.

1.4 Research Questions

As a study of the impact of share buybacks on the underlying stock price, this study emphasizes price reaction to the events surrounding the buyback, i.e. the announcement of buyback, shareholder approval and the execution of the buyback.

Thus the research questions are as follows:-

1. Is the share buyback announcement a significant event or is it a non-event, from a price viewpoint ? If the buyback announcement is a significant event, is there a price effect on the share prices of those PLCs ?
2. Are there significant differences in stock price performance between the companies that actually repurchased their own shares and those that only obtained the shareholders' approval ?
3. Are there differences between the Main Board and Second Board companies in terms of the market's reaction ?
4. Is there an information leakage with regards to the announcement and what is the extent of the insider trading as a result of the share buyback exercise ?

CHAPTER 2 – LITERATURE REVIEW

2.1 The Motivation for Share Buyback

There are many reasons for the decision to pursue the share buyback option. Studies in the United States and other developed economies have shown that share buybacks are prompted by various and often interrelated motives. The two most commonly quoted reasons in Malaysia are given below.

1. The share buyback will help stabilize the demand and supply, as well as the prices of shares for the public-listed company (PLC) on KLSE and ultimately create a healthy environment for capital market in Malaysia, particularly in the current bearish market.

This is the most common reason given by the Malaysian PLCs in their circulars to the shareholders seeking approval and authority to buy back their own shares.

2. The management of the PLC feels that the current market price is lower than the fundamental or intrinsic worth of their company, particularly those that are trading below their net tangible asset (NTA). They hope that the share buyback will be influential enough to support or boost depressed share prices during the prevailing weakness in the local stock market, when the current levels do not reflect the true value of their shares.

Vermaelen (1981) mentioned that firms repurchase stock to signal undervaluation. This was supported by the subsequent work of Stephens and Weisbach (1998). They also showed that the repurchase activity is negatively correlated with prior share returns, indicating that firms repurchase their shares when their share prices are perceived as undervalued.

The undervaluation hypothesis is based on the premise that information asymmetry between insiders and shareholders may cause a firm to be misvalued. If insiders believe that the stock is undervalued, the firm may repurchase stock as a signal to the market or to invest in its own stock and acquire mispriced shares. According to this hypothesis, the market interprets the action as an indication that the stock is undervalued.

Other common reasons include the following.

3. Allows the distribution of surplus cash to shareholders in lieu of cash dividends, and provide a means of utilizing surplus cash

When a firm's capital exceeds its investment opportunities, the firm can either retain the excess cash or distribute it to shareholders (Easterbrook, 1984; and Jensen,1986). Jensen (1986) stated that firms repurchase their shares to distribute excess cash flow. Repurchasing shares, like paying dividends, is one method to distribute excess capital to shareholders. A repurchase may be preferred to dividends for two reasons. First, in open market repurchases (the most prevalent type), the firm does not have a commitment to repurchase. Additionally, unlike a dividend, there is no expectation that the distribution will recur on a regular basis. Thus, a repurchase is a more flexible means of distributing capital. Jensen's findings were supported by the work of Stephens and Weisbach (1998), that found a positive relationship between repurchases and the levels of positive cash flows.

In the American perspective, share buyback may also be preferred over dividends as a means of distribution due to the personal-tax-rate advantage of capital gains. This tax advantage of stock repurchases exists because capital gains are often taxed at a lower rate than dividend income; only the portion of the repurchase that is a capital gain is taxed, and investors can defer the capital gains tax until they realize the gain and sell their stock.

Thus, an increase in the capital gains tax rate would decrease the relative advantage of repurchases.

4. Improve the capital structure of the company

Bagwell and Shoven (1988) and Opler and Titman (1996) examine and show the impact that repurchasing stock has on leverage. The results of these papers indicate that firms may repurchase stock to increase their leverage ratio. When the firm distributes the excess fund to shareholders, it reduces its equity and increases its leverage ratio. Thus, assuming that an optimal leverage ratio exists, firms may use a stock repurchase to achieve this target ratio. A firm is therefore more likely to repurchase stock if its leverage ratio is below its desired debt / equity ratio. Thus, a firm's capital structure will affect its decision to repurchase.

5. Discourage the conversion of derivatives, such as warrants

6. Share buyback as a defense mechanism against hostile corporate takeover.

This was researched by Bagwell (1991) and explained how firms use repurchases to fend off unwanted takeover attempts. Stock repurchases increase the acquisition price because shareholders selling in a stock repurchase are those with the lowest reservation values. Thus, a repurchase can be used as a takeover defense because a repurchase can increase the lowest price for which the stock is available. According to this hypothesis, firms that are at a higher risk of becoming takeover targets are more likely to repurchase stock.

7. Counter the dilution effects of employee and management stock options, as illustrated by Jolls (1996) and Fenn and Liang (1997).

In the United States, the use of management stock options increased in the late 1980s and early 1990s. During this period, the use of management stock options increased, and thus more firms may have preferred repurchases to dividends. A firm that compensates its executives with a large number of stock options may find it beneficial to repurchase stock.

2.2 The Benefits and Drawbacks of Share Buyback

A company that bought back its own shares can either choose to cancel the said shares or keep them as treasury shares. Because of this, the share buyback is expected to bring the following potential benefits to both the company and the shareholders.

Potential Benefits of Share Buyback To the Company

1. Allow companies to better manage their capital structure by focusing on an optimal mix of gearing and equity to maximize share price and shareholder wealth. It will allow the company the flexibility in attaining its desired capital structure
2. Provide a defense mechanism for undervalued listed companies from becoming takeover targets in hostile bids by “corporate sharks”
3. Prevent or limit excessive manipulative attack by speculators by outside parties, particularly when the shares are undervalued, and thus retaining genuine investors
4. Provide an alternative use of surplus funds by keeping the shares bought back as treasury shares. Long term return from share appreciation should be better than deposit rates

5. Gives companies an opportunity to realize significant or exceptional gains in the future from the resale of the treasury shares in the open market during the next stock market rally (if it were to eventually dispose of the shares at higher-than-average cost of purchase)
6. Provide better returns than interest earned on idle funds. Investment in new business opportunity (uncertainty) or bank deposit (lower deposit rates) in the current economic climate are unattractive, and will not generate the required rate of return.

For example, YTL Power is sitting on some RM3.5 billion cash. Rather than a yield of some 4.0 per cent in fixed deposit rates, the company buys back its shares at a PE multiple of 20 times and earns a yield of 5.0 per cent. Theoretically, this is far better when it finally shows up in the profit and loss.

7. Enhance earnings (increase EPS and NTA per share) by canceling the shares bought back. Shares that are bought back are kept as treasury shares which are excluded from the calculation of most financial ratios. Hence, buybacks can typically enhance EPS, which in turn brings down price earnings (PE) ratios.
8. Share buybacks, as allowed under the new addition of Section 67A in the Companies Act 1965 (amendment 1997), effectively serve to facilitate PLCs to undertake the process of capital reduction by canceling the share bought back.

Prior to the introduction of Section 67A, all companies incorporated under the Companies Act are not allowed to repurchase their own shares and therefore those having intention to reduced their issued and paid-up capital have to go through the long and costly process of capital reduction that involves various professional advisors and the High Court of Malaysia.

9. The company can reward their employees under the Employees Share Option Schemes (ESOS) by giving them the shares bought back that were retained as treasury shares.

Potential Benefits of Share Buyback To Shareholders

10. Shareholders benefit directly if prices were to go up substantially as a result of the share buyback
11. Shares bought back that are retained as treasury shares can be utilized as future dividend payout to shareholders
12. Minority shareholders gain from better corporate performance (eg. buybacks generally enhance earnings per share) and also benefit from the price stabilization and restoration of investor confidence.

Nevertheless, there are also several drawbacks from the share buyback exercise. Under KLSE Listing Regulations (Chapter 12 – Share Buybacks), it is required that companies seeking to buy back their own shares to declare both the effects of potential advantages and disadvantages of the proposed purchase on both the listed company and its shareholders respectively.

Among the notable drawbacks of share buyback are as follows.

Drawbacks of Share Buybacks

1. Repurchase of shares can weaken the company's capital base and make it more reliant on borrowings. This, in turn, can increase financial risks for potential and existing shareholders.
2. It can imply that the company does not make profitable investments on its surplus funds. This may not augur well for the pursuit of corporate growth.
3. Buybacks can be open to abuse, by unscrupulous majority shareholders who may be trying to unload their shares in the market.

4. “Buybacks do not guarantee share price performance.”⁽²⁾ This view is held by many local analysts, including online investor adviser Surf88.com.

They commented that the spate of buybacks is unlikely to stir much excitement in the market as there are over-riding factors that could negate any share price support for such schemes. Their contention is that buybacks will help support, but cannot reverse, share price direction in the event of sweeping industry changes or any other factors which may significantly affect fundamentals and/or investors' perception. The issue of poor corporate governance and the treatment of minority interests will dampen any potential excitement which could otherwise be easily stirred by repurchases.

For example, take the case of Malaysian Pacific Industries (MPI). It had done relatively well initially as it started off its buyback programme at RM5.81 per share in March 1999, before the technology rally pushed the share price to a high of RM57. The company resumed buying in late July 2000 when interest in technology stocks started to wane. Surf88.com pointed out that the share price had fallen by over 50 per cent over the period as external factors such as earnings risk and the technology down cycle had more than overwhelmed the share buyback effects.

2.3 The Hypotheses explaining the Share Buyback and their Price Effects

The major research question in this study is to determine whether the share buyback announcement is a significant “event” that will create a price effect on the shares of those Malaysian companies announcing their intention to repurchase their own shares. From the literature review, there were many studies conducted in the United States that looked at the market reaction to repurchase announcements.

(2) – source from The Edge magazine, dated February 5, 2001

Several explanations or hypotheses and predicted effects of share repurchases were put forward in the finance literature. Among the three most plausible and frequently mentioned hypotheses regarding the share repurchases are :-

1. Personal Tax Saving Hypothesis
2. Signalling or Information Hypothesis
3. Expropriation or Wealth Transfer Hypothesis

These hypotheses were said to have a mostly positive effect on the value of the equity or shares. They were supported by studies that generally showed market participants' positive reaction to the share repurchase announcement.

Personal Tax Saving Hypothesis

The first hypothesis argues that personal tax savings arise from the differential tax treatment (in United States) of dividend versus capital gain. From the shareholders' perspective, the full amount of any dividend distribution received is taxable at ordinary income tax rates. In contrast, cash distributions by means of share repurchases is taxable only to the extent that the repurchase price exceeds the shareholder's price and then only at capital gains tax rates. This results in a tax advantage for stock repurchases because capital gains are often taxed at a lower rate than dividend income. Hence when share repurchases are substituted for dividend distributions, share value is increased. The empirical implication of this hypothesis is that the share price increases (a positive price effect) after the announcement of a forthcoming share purchase.

But Black and Scholes (1974) disagreed and argued that firms cannot affect their value by changing the distribution policy. Their contention is that firms will adjust their payout policies until the spectrum of policies offered by the firms matches the spectrum of policies demanded by investors. Once this equilibrium is achieved, the firm is not able to increase the price of its shares simply by changing the payout policy. Hence based on the personal tax considerations, a share repurchase announcement should not affect the price of the share.'

Signalling or Information Hypothesis

The Signalling or Information hypothesis, has emerged as the most quoted and prevalent explanation for share repurchase, both in the developed countries such as United States (see Vermaelen,1981 ; Dann,1981 ; Asquith and Mullins,1986 ; Ofer and Thakor,1987 ; Constantinides and Grundy,1989 ; Comment and Jarrell,1991 ; Dann, Masulis, and Mayers,1991 ; Hertzal and Jain,1991 ; Lee, Mikkelson, and Partch,1992) and also in Malaysia (Mohamad Jais, 2001).

The announcement of the share repurchase constitutes a revelation by the management of new information about the firm or company. The most widely cited motive by firms announcing open-market share repurchase in US is to signal undervaluation of the firms' shares. In their survey of repurchasing firms, Guthart (1967) reported that alleged undervaluation was a frequently mentioned reason for repurchase. Twenty years later, the same motive was still valid as found by Tsetsekos, Kaufman and Gitman (1988) and Netter and Mitchell (1989) for the majority of firms announcing share repurchase programs.

In a way, the signaling hypothesis of the share repurchase is similar to dividend signaling. Lintner (1956) suggested that corporate dividend policy is designed to reveal earnings prospects to investors. He first proposed that dividend changes convey useful information about future earnings and argued that managers will only commit themselves to higher dividends when they believed that the firm's earnings have permanently increased (Brook, Charlton, and Hendershott, 1998). As a result, share returns are positively correlated with dividend changes (Asquith and Mullins, 1983).

However, there could be two sides to the coin for the case of share repurchase. Disclosure of this information could give opposite signals. If it is a value-increasing or positive signal that cite management's belief that its firm's shares are undervalued and hence their rationale for the share repurchase (Stewart, 1976; Nantell and Finnerty, 1974; Coates and Fredman,1976), then the market will most likely react positively to the repurchase announcement.

If the interpretation of the share repurchase is negative i.e. the management is signaling that the firm does not have desirable investment opportunities available in sufficient quantity to utilize all its internally generated funds, then it is a value-decreasing signal and will most likely decrease the value of the firm.

Therefore given the signaling influence, can open market repurchases increase the share price? Would there be a positive or negative price effect?

The positive price effect from the open market repurchases has been well documented. For example, Vermaelen (1981) examined 243 open-market repurchase announcements by NYSE-listed firms during 1970 to 1978 and found abnormal price increases of 3.37% after the announcement of a share repurchase while Comment and Jarrell (1991) documented a similar result with an average positive excess return of about 2% to 3% for open market repurchase announcement in the period 1984 to 1988. An analysis of a sample of 121 open market repurchase announcements by Dann (1980) showed a mean rate of return of slightly more than 3% for a 2-day span over the announcement date. Ikenberry, Lakonishok and Vermaelen (1995) found that the average market response to the announcement of an open market repurchase is 3.5% and that the market reacted more favorably to announcement made by low market capitalization firms and by firms announcement large repurchase program. A more recent local study by Mohamad Jais (2001) showed a difference between those firms that followed through with the share buyback exercise (a gain of about 4%) and those who did not follow through (a gain of 1.2% but not statistically significant).

Vermaelen (1981), Comment and Jarrell (1991) and Ikenberry and Vermaelen (1996) reported that the repurchase proportion also signals positive information about the firm value. They found a significant positive correlation between the announced target repurchase proportion and the market's price response in that announcement period. Ikenberry and Vermaelen (1996) also found a significant positive relationship between the firm's total risk and the announcement return i.e. the repurchase increases the riskiness of the firm. This is because the firm pays cash for the share repurchase and reduces its holdings of its least risky asset, or if the payment is via borrowing, then its leverage is increased.

In addition, Comment and Jarrel (1991) reported a pattern, consistent with the signaling hypothesis, in which the share price falls before the announcement and then drift upward after the repurchase announcement.

There were also numerous studies documenting share price underreaction and overreaction due to open market repurchase announcements. Evidence of market overreactions have been shown in the studies by Chopra, Lakonishok and Ritter (1992), De Bondt and Thaler (1985) and Lehmann (1990), while interpretations of market underreactions were evident in the studies by Bernard and Thomas (1990), Foster, Olsen and Shevlin (1984), Freeman and Tse (1989) and Mendenhall (1991).

Liu and Ziebart (1997) found that the market overreacts to repurchase announcements that are deemed as “good news” but neither price reversal or price drift is observed after announcements deemed to be “bad news”. On the other hand, Ikenberry, Lakonishok and Vermaelen (1995) disagreed with the immediate price adjustment based on an efficient market response and hypothesized that the market treats the repurchase announcements with skepticism, leading prices to adjust slowly over time (i.e. Underreaction Hypothesis). This is consistent with an earlier Netter and Mitchell (1989) study on the US open market repurchase experience after the 1987 crash that reported no evidence of an overwhelming rush to actually repurchase their shares.

In addition, Ikenberry, Lakonishok and Vermaelen (1995) also examined the long term returns following the announcement. Over the long run, they found that the largest abnormal returns following buyback announcements are observed for high book-to-market firms (i.e. “value” stocks that are significantly undervalued) and no abnormal performance is observed for low book-to-market firms (i.e. “glamour” stocks). For “value” stocks, companies are more likely to be repurchasing shares due to undervaluation, their average abnormal return over the next four years is 45.3% while no positive drift in abnormal returns is observed for “glamour” stocks. The combined results gave an average abnormal 4-year buy-and-hold return measured after the initial announcement was 12.1%.