An analysis of stock repurchase in Taiwan

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1. Introduction

Three major theories in the finance literature explain why firms buy back their own shares (Grullon & Michaely, 2004; Ikenberry, Lakonishok, & Vermaelen, 1995; Kahle, 2002; Nohel & Tarhan, 1998). First, the undervaluation hypothesis suggests that firms repurchase their shares when the share prices are too low. Second, the signaling hypothesis asserts that the repurchase decision signals valuable information about better future prospects for earnings, profitability, or operating performance. Third, the free cash-flow hypothesis argues that firms tend to buy back their shares in order to reduce agency costs. A firm with high agency costs implies a high free cash flow and a low investment opportunity.

In light of these three motivations behind stock repurchases, many studies confirm the favorable market reaction to repurchases, with abnormal returns ranging from 3% to 5% on average around the time of the stock repurchase announcements (Chang, Chen, & Chen, 2010; Ikenberry et al., 1995; Lie, 2005; Rau & Vermaelen, 2002; Zhang, 2002). In addition, a long-term (e.g., three years or more) positive price performance after stock repurchase announcements was also seen, implying that the market may underreact to the stock repurchase information in the short term and thus challenges the efficient market hypothesis that the share price has adjusted information instantaneously in an unbiased way (Fama, 1998). Many studies, such as Ikenberry et al. (1995), Ikenberry, Lakonishok, and Vermaelen (2000), Chan, Ikenberry, and Lee (2004), Grullon and Michaely (2004), and Zhang (2005) document positive long-term price performance following the stock repurchases. They argue that the market underreacts to the repurchase announcement in the short term because the market treats the share repurchase announcements with skepticism and reacts slowly to the announcement. Thus, we observe the long-term positive price performance after the repurchase announcement.