FIN 514
Repurchase Tender Offers

1. Cash flow out of the firm to shareholders
   - alternative to dividend payments
   - before recent changes in the tax laws, capital gains were taxed at lower rates (so this was better than dividends for making payments to shareholders)
   - unless all shareholders tender all of their shares, the payments to shareholders are not in proportion to stockholdings
2. Usually there is a premium offered to induce shareholders to sell
   - to realize capital gains and pay taxes

RPO's:
How Should Stock Prices Behave?

"Cash-box model of the firm"

- firm's asset is a box of cash ($10 million)
- pre-offer price per share = $10 (1 million shares)
- buy-back 20% of shares @ 20% premium (200,000 shares @ $12)
- post-expiration of the offer stock price is [($10-$2.4)/.8] = $9.50

RPO's:
Cash Box Model (cont.)

- equivalent to paying a special $.50 dividend and retiring 200,000 shares

During the offer period the price should stay at $10

- each 100 shares of stock bought for $10 would be worth 80 shares at $9.50 plus 20 shares at $12 ($1,000)

- all shares should be tendered so that each shareholder will receive his pro-rationed share of the "dividend"

RPO's: Cash Box Model (cont.)

NOTE: this is a purely financial transaction (paying cash out of the company)

- the ex-dividend price of the stock equals the original stock price minus the implied dividend
- there is no information effect

RPO's:
Information Effect

If management thinks the stock is undervalued, it is willing to pay a premium for the stock

- **opposite of a seasoned equity offering**
  - **often, management or insiders choose not to participate in the offer**

Summary of Evidence on Repurchase Tender Offers

Dann's JFE paper:

- 20% premium for 15% of the stock
- 14.6% of shares outstanding acquired (18% tendered!)
- duration of offer 22 trading days (one month)
- 2-day announcement return to stock = 15%
- small (2-3%) drop in CAR after 20 trading days = ex-dividend effect

Dann's JFE paper on RPO's

Small downward drift in CAR in the 40 days before the offer is announced

- price remains about 12% above pre-offer price after the offer expires
- not a wealth transfer from bondholders
- convertible bond and stock prices rise, straight bond prices stay the same

Vermaelen's JFE paper on RPO's

Similar behavior for RPO's

- except no downward drift before the offer

243 open market repurchases follow -5% downward drift in prices before announcement, and a 2-3% announcement effect

- these don't offer a premium, so there is no ex-dividend effect and a smaller information effect
- earnings behavior is much better in 5 years after repurchase than in 5 years before

Masulis' J Fin paper on RPO's

-5% stock price reaction when oversubscribed and firm doesn't decide to buy all shares (pro-rata purchase)

- relatively bad news

Comment & Jarrell J Fin paper on Dutch Auction RPO's

97 fixed price and 72 Dutch Auction RPO's; 1,197 open market repurchase authorizations from 1984-89

<u>Dutch auction:</u>

- **firm specifies number of shares it wants to purchase and range of prices**
- **shareholders tender shares with minimum acceptable price**
- **firm sets repurchase price by finding lowest price that will yield number of shares sought**

Signaling by Insiders in RPO's

3-day announcement return is larger for fixed price offers

- 8.3% vs. 7.5%

offer premiums are larger (in %) for smaller firms

- Lakonishok & Vermaelen (JFin, 1990): 24.3% for smallest quintile vs. 8.3% for largest quintile

announcement effect is larger if officers & directors forego a large "dividend"

Stock Price Reaction to Self-Tender Announcements (Table 5)

Open market & tender offers combined, 3-day return:

constant =	.68%	(t=2.15)
Dutch auction =	1.77%	(t=1.67)
fixed price =	2.18%	(t=1.49)
O&D "at risk" =	5.03%	(t=3.64)
max % sought =	.20	(t=6.48)
prior 40 day excess return =	-.09	(t=-5.04)
current market return =	1.15	(t=27.2)
R-squared =	.448	(N=1,284)

Repurchase Tender Offers: Summary

(1) "Cash box" model of the firm doesn't explain the facts

- stock price jumps when premium RPO is announced
- "ex-dividend" effect occurs after offer expires, but price remains about 12% above pre-offer price

(2) Information/signaling effect of RPO's is greater when insiders say they are foregoing the dividend

- lower, on avg, in Dutch auction offers

Repurchase Tender Offers: Questions

(1) Why would a firm buy back 20% of its stock? (at a 20% premium?)

(2) Is a premium RPO an alternative to a cash dividend for disgorging cash?

- Do shareholders receive the dividend in proportion to ownership?
- Does it matter?

(3) What are the corporate control implications of a large RPO?

- Is it a partial LBO?

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