

FIN 423 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**

Dutch auction:

- 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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