### FIN 423/523

**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 \[\frac{($10-\$2.4)}{.8}\] = $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)

<table>
<thead>
<tr>
<th>Open market &amp; tender offers combined, 3-day return:</th>
</tr>
</thead>
<tbody>
<tr>
<td>constant =</td>
</tr>
<tr>
<td>Dutch auction =</td>
</tr>
<tr>
<td>fixed price =</td>
</tr>
<tr>
<td>O&amp;D &quot;at risk&quot; =</td>
</tr>
<tr>
<td>max % sought =</td>
</tr>
<tr>
<td>prior 40 day excess return =</td>
</tr>
<tr>
<td>current market return =</td>
</tr>
<tr>
<td>R-squared =</td>
</tr>
</tbody>
</table>
## 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 foregoeing 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?
Return to FIN 423/523 Home Page

http://schwert.ssb.rochester.edu/f423/f423main.htm