

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?**