Stock Repurchases: Another Outlet for Managerial Opportunism?

By Shelly Alexander and Twila Logan

RESEARCH QUESTION

Are firms' share repurchase decisions associated with the firms' executive compensation? Specifically we get evidence on whether:

1. CEO compensation is associated with the value of firms' share repurchases? And whether

2. The CEO's variable pay component affects the probability of a firm making a share repurchase decision .

BACKGROUND

- Share repurchases (the buy back of shares from shareholders) may be done for many reasons e.g. to offset EPS dilution, to distribute excess cash flow (more tax efficiently than dividends), to fend off takeovers or to signal undervaluation.

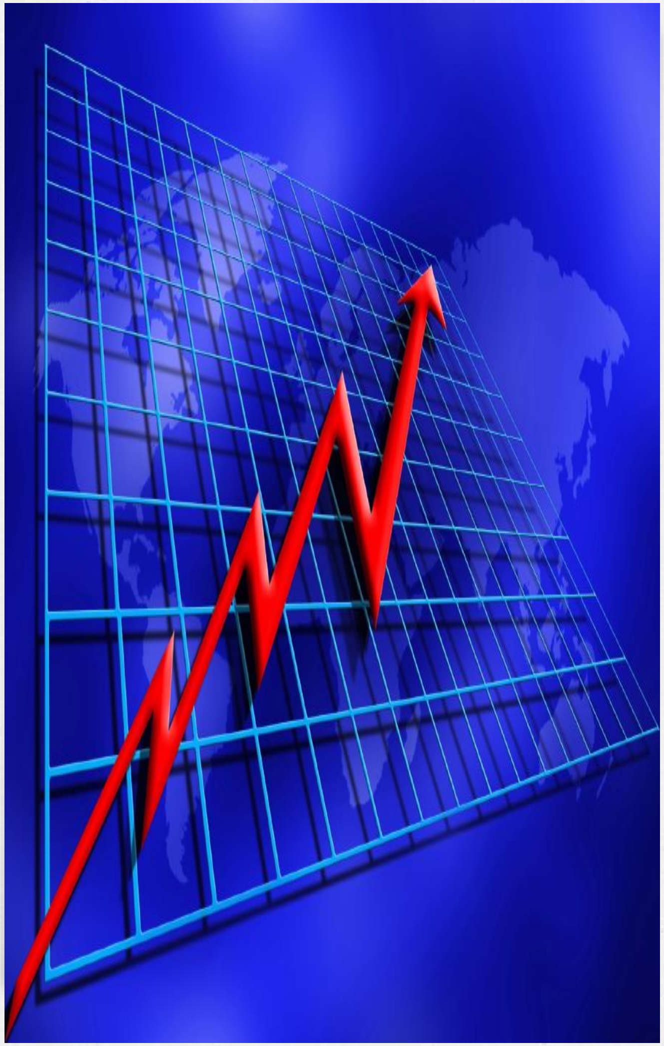
- Repurchases, by reducing the amount of stock outstanding, can increase the EPS. Further investors perceive buy backs as good news and there is usually an associated stock price increase.

BACKGROUND contd

- Managers with variable pay components usually have incentive targets tied to EPS and share price. Share repurchases therefore could be used as a means to achieve these targets.
- In the last decade- post SOX there has been a lot of pressure on managers and auditors to report the earnings figure truthfully. As earnings performance and targets are frequently reported on a per share basis, the manipulation of the denominator of the EPS ratio (shares, outstanding) could lead to management's objective of higher EPS and stock price.

Companies with largest volume of repurchases in the past year-*WSJ 9/14*

Apple	$32.9B
IBM	$19.5B
Exxon Mobil	$13.2B
Pfizer	$10.9B
Cisco	$9.9B
Oracle	$9.8B
Home Depot	$7.6B
Wells Fargo	$7.5B
Microsoft	$7.6B
Qualcomm	$6.7B
Disney	$6.5B



Motivation

- The *Economist* (9-13-2014) in an article entitled 'Corporate Cocaine' noted that blue chip stocks are engaged in a dangerous addiction to share buy-backs. American firms bought more than $500 billion of their own shares. IBM e.g. spent twice as much on share repurchases as it did on R&D.
- The *WSJ* states that stock buybacks are helping to buoy the Market. Corporations bought back $338.3 Billion of stock in the first half of the yr.

Motivation cont'd

- Stock repurchases have become far larger & more frequent over the last decade than anytime before.
- While many reasons have been advanced for companies buying back their stocks, repurchases can result in a neglect of long term investment projects and thus a decline in shareholder wealth and economic growth. Hence an understanding of stock repurchases their objectives and consequences is of concern to investors, the SEC and companies themselves.
- Good corporate governance is imperative for the growth of the capital market. Understanding the consequences of board and CEO compensation is important to improve capital market health.

Literature Review

- Badrinath and Varaiya (2001) state that when asked ‘why does your firm repurchase stock’ CEOs modal response was ‘to improve EPS numbers’.
- Brav et al (2005) reports that over 76% of CEOs and CFOs surveyed said that increasing EPS was an ‘important’ or ‘very important’ consideration in their repurchase decisions.
- Bens et al (2003) find that executive repurchase decisions are driven by incentives to manage diluted EPS.
- Hribar et al (2006) use stock repurchases to compensate for earnings shortfalls, and to meet or beat analysts’ targets.

Literature Review

- CEOs’ compensation packages generally have performance (variable) pay incentives aligned to meeting EPS and/or share price targets. Stock repurchases can be used to facilitate the meeting of these targets.
- The Bonus Hypothesis (Healy 1985) is particularly relevant.
- Bonus hypothesis states that managers are opportunistic and will maximize their short term interests.
- Hence we expect that the larger managers variable pay the greater their incentive to repurchase stock to increase short term earnings.

Hypotheses

We expect that the larger managers variable pay the greater their incentive to repurchase stock to increase short term earnings:

- **H1: The value of shares repurchased will be positively associated with CEO variable pay percentage.**

We expect that firms with CEOs with greater variable pay components are more likely to have a stock repurchase policy (be serial repurchasers) :

- **H2: Firms that are serial repurchasers are more likely to have CEO compensation packages with higher variable pay components.**

Sample

- We estimate stock repurchases as the number of stock repurchased during the quarter from the Compustat Quarterly database.
- We use the Compustat Annual data for information on the independent variables of interest and control variables.
- Next we match the firm’s financial data with corporate governance data on the GMI Ratings database to derive corporate governance measures.

Research Design

- To test Hypothesis 1 we use a Generalized Least Squares Model (GLM) to regress the value of repurchases on variables known to affect repurchases (leverage, dividend payout, debt), our variables of interest (CEO variable pay) and controls.

- To test Hypothesis 2 we employ a logit model with dependent variable = 1 if the company did a repurchase and 0 if the company did not repurchase in the 3 year period. To increase the power of the test we use a sample of non-repurchasers during the period and a sub-sample of our repurchasers who engage in buybacks in 11 or 12 quarters.

Model 1

$MVRepurchase_{i,t}$ $= \alpha + \delta$ year dummies $+ \lambda$ industry dummies $+ \beta_1$ div payout β_2 Insiders % $+ \beta_3$ CEO Var Pay $+ \beta_4$ Dir over 10 yr $+ \beta_5$ Board Size $+ \beta_6$CEO Base Pay $+ \beta_7$ Options Exer $+ \beta_8$FCF$+$ β_9 MB $+ \beta_{10}$ Firm Size$+ \beta_{11}$ Leverage $+ \beta_{12}$ Owners5% $+$ β_{13} Audit Fees % $+\beta_{14}$ #Board Mtgs $+ \mu$

Where: MV Repurchases = Log of the Market value of shares repurchased in the 2009.

Results of tests of H1

Parameter	Estimate
Dividend Payout	-0.0832
Owners' 5% Interest	-0.6613
Insiders' %	-0.0324
CEO Variable Pay	2.2804***
Directors >10 Year Tenure	-0.1710
Board Size	-0.0076***
Audit Fee %	-1.0045
No. of Board Meetings	-0.0112
Firm Size	-0.8834***
Leverage	-1.8107***
M/B	-0.0040
Free Cash Flow	-2.5647***
Ln Base Pay	-0.1160
Options Exercisable	-0.0011***

R-Sq 43%

Findings

- We find that share repurchases are positively associated with:
  - CEO's variable pay percentage (as hypothesized);
  - Our control variables for Firm size and Free Cash Flows – as expected.
- We find a negative association with:
  - Exercisable: Repurchased -
  - Board size – suggesting that repurchases are higher for firms with smaller boards;
  - Leverage – indicating that less leveraged firms repurchase higher values of treasury stock.
- We find that the value of repurchases is not associated with:
  - Dividend Payout (a factor normally cited for making repurchases:, nor with
  - CEO's base pay.

MODEL 2

$\text{Repurchase}_{i,t} = \alpha + \delta$ year dummies $+ \lambda$ industry dummies $+ \beta_1$ div payout $+ \beta_2$ Insiders % $+ \beta_3$ CEO Var Pay $+ \beta_4$ Dir over 10 yr $+ \beta_5$ Board Size $+ \beta_6$ CEO Shares Held $+ \beta_7$ Options Exer $+ \beta_8$ FCF $+ \beta_9$ MB $+ \beta_{10}$ Firm Size$+ \beta_{11}$ Leverage $+ \beta_{12}$ #Board Meetings $+\beta_{13}$ Audit Fees% $+\mu$

Where: Repurchases= 1 if Firm *i* was a serial repurchaser of shares during the three year period 2009-2011, and 0 if it only repurchased only once or twice during the period.

Results of tests of H2

Parameter		Estimate
Dividend Payout		0.0441
Insiders' Percentage		0.3423
CEO Variable Pay		1.1738***
Log of CEO's base pay		0.1272**
Directors >10 Year Tenure		0.3477*
Directors Total		0.0412*
Audit Fee %		-0.8387*
No of Board Meetings		-0.0058
Firm Size		0.2620***
Leverage		-0.9251***
M/B		-0.00216
Free Cash Flow		2.2839***

Findings

- We find that the probability of a firm adopting a share repurchase policy is higher when:
  - The CEO has a larger % of variable compensation;
  - The FCFs are higher; and when the
  - The firm is larger.

- The probability of a repurchase policy is reduced for firms with:
  - higher leverage.

Contribution

- This paper contributes to the literature by confirming another earnings management motivation for stock repurchases – CEOs incentive to maximize their short term earnings.
- This will alert compensation committees to the possible economic consequences of imposing a high level of risk on CEOs.
- Alert regulatory bodies as to the possibility of firms manipulating financial results through stock repurchases.

Conclusion

- The CEO's variable pay component is significantly associated with share repurchases.
- This suggests that current remuneration contracts may be imposing an inappropriate amount of risk on CEOs motivating them to shorten their decision horizon to maximize their short term interests rather than the long term interests of stock holders.

Future Research

- Assessing the consequences of stock repurchases by comparison of firms' performance before and after stock repurchases.
- A more powerful test of the bonus hypothesis could be conducted after CEO turnovers to see whether stock repurchases are used by the old CEO to increase his short term objectives; and not used by the new CEO who has a more long term horizon.

Thank you!