Study: Some stock repurchase plans just empty promises

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University of Illinois finance professor David Ikenberry says phantom stock repurchase programs are rare, and most are rooted in sound economic motives that generally pay off for both companies and investors. Credit: Photo by L. Brian Stauffer, U. of I. News Bureau.

A new study backs longtime speculation on Wall Street that companies sometimes ballyhoo stock repurchase programs they never plan to pursue, hoping to stir a buzz that will mislead investors and pump up sagging share prices.

But phantom repurchase programs are rare, and most are rooted in sound economic motives that generally pay off for both companies and investors, said David Ikenberry, a University of Illinois finance professor and researcher for the study.

"The good news is that the vast majority of repurchase programs are solid and well intentioned," he said. "But there appear to be a handful where companies are indeed trying to mislead the market. They're down on their luck and hoping a repurchase announcement will spark a price reaction that might not be warranted."

Among other reasons, firms routinely launch buybacks when they perceive that shares are undervalued, said Ikenberry, whose study will appear in the *Journal of Corporate Finance*. Buybacks can provide a competitive return by reducing publicly held stock, boosting per-share earnings even if profits remain the same.

In those cases, announcements of repurchase plans are often greeted as a bullish signal, sparking bargain hunting by investors that drives up share prices, said Ikenberry, who has studied stock repurchase programs for 15 years.

But he says Wall Street analysts have long worried the positive market reaction could also spawn abuse, encouraging troubled firms to tout repurchase programs they have no intention of following through on.

"The concern has always been that there is no requirement that these buybacks ever be completed," Ikenberry said. "So you have this potential for cheap talk and empty promises by firms who are down on their luck and just looking for a quick fix."

He says those suspicions are supported by a study of more than 7,600 repurchase programs announced between 1980 and 2000, which found that firms showing signs of financial distress are less likely to follow through on buybacks.

Firms that used aggressive accounting accruals to pad earnings but still saw stock prices decline repurchased fewer shares than healthy companies, according to the study, co-written by business professors Konan Chan, of the University of Hong Kong, Immoo Lee, of the National University of Singapore, and Yanzhi Wang, of Yuan Ze University.

"This paints a picture of companies that are struggling and their stock prices are falling even though they're doing everything they can to pump up earnings," Ikenberry said. "Announcing a share repurchase may be just one more public relations tool in their effort to turn the tide."

He says the study is the first empirical review of repurchase programs that have the potential to be misleading, and was sparked by long-standing concerns among analysts, scholars and observers such as Jim Cramer of CNBC's "Mad Money."

"By definition, there can be no smoking gun with the tools we have," Ikenberry said. "Yet we do have compelling circumstantial evidence, and find a limited number of cases where it's plausible that some misleading behavior on the part of management did occur."

Investors can guard against buying into phantom repurchase programs through due diligence, he said. Warning signs include strong earnings despite weak cash flow, indicating aggressive accounting practices, coupled with a long-term pattern of languishing stock value.

But Ikenberry says the study shows that deceptive repurchase programs are the exception not the rule, and cause no long-term harm to the market. While stock prices often surge with the repurchase announcement, they soon dip if earnings fail to support the increase.

He compares the market's rise and fall to long lines that follow hype for a new restaurant.

"If the food turns out to be good, business will stick and there will be lines for a long time," Ikenberry said. "But if it's not good food, the hype and buzz will fade and business will, too."

Source: University of Illinois at Urbana-Champaign (news : web)

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