SHARE REPURCHASES ANNOUNCEMENT EFFECT ON EARNINGS: EVIDENCE FROM SOUTH AFRICA

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ABSTRACT

This study investigates the effect share repurchases announcements have on earnings of companies listed on the Johannesburg Stock Exchange over a period of 8 years from 2001 to 2008. The study investigates 27 companies listed in the middle capitalization and large capitalization stocks of the Johannesburg Stock Exchange. The study measured earnings by 1) earnings per share percentage change, 2) dividend per share percentage change and 3) cash flow per share percentage change. These variables were investigated over a period of 6 years, 3 years pre- and 3 years post-announcement of share repurchase. The data was analyzed and tested using the T-test and the Wilcoxon parametric paired test.

JEL: G14

KEYWORDS: Stock buy-back, share repurchases, repurchase announcement, earnings

INTRODUCTION

Since 1 July 1999, South African companies have been allowed by law to repurchase their own shares. This was enacted by the amendment of the Companies Act, Act 61 of 1973 (RSA, 1973) to make provision for companies to acquire their own shares. The Act imposes various restrictive regulations on repurchase activities, mainly to guard against liquidity and solvency being compromised. According to Bester et al (2010), the repurchase of shares has been limited. The uncertainty about tax laws and the inconsistency between the Companies Act and the Johannesburg Stock Exchange (JSE) listing requirements were the main reasons for the slow pace. Once these were clarified, the number of companies making repurchase announcements grew from a mere 45 in 2001 to about 121 JSE listed companies in June 2007, making 312 repurchase announcements (Bester, 2008). Unlike the American markets, that have extensive databases to use for repurchase research, South Africa is faced by a lack of comprehensive share repurchase databases. Share buyback is a decision taken by management to repurchase the company shares in the market place, reducing its number of issued shares.

Many public listed companies in different markets have started using share repurchases as an additional form of cash distribution to shareholders. Companies are faced with strategic decision of allocating surplus capital, either through investing in line with business objectives or to return cash to debt holders and shareholders. An investigation of the open market share repurchases by Ikenberry, Lakonishok, and Vermealen (1995) found that stocks of companies making repurchases experience an immediate 3.5% average abnormal return, as well as a 12% average abnormal return during the longer term period of four years following the announcement date.In South Africa, Daly (2002) and Bhana (2007) have gone to great length in proving the immediate and long-term impact of share repurchase on company share prices. If future earnings of the company were to become negatively affected by the repurchase of its shares, then the firm's ability to make other distributions could become negatively impacted. This could lead to the reduction or elimination of other distributions to owners, such as dividends on various classes of shares issued by companies.The primary objective of our study was to test whether companies that announced buybacks of their own common stocks had an observable difference in earnings returns following such an announcement. Share buybacks have implications for affordability. If companies announce their intention to complete the repurchase with internal funds, this implies that earnings will not be negatively affected by the repurchase irrespective of the number of shares targeted for the repurchase.

The remainder of this paper is organized as follows: A section on literature review giving the background to the study, then a methodology section, followed by results and a concluding section.

LITERATURE REVIEW

There is no limit to the number of shares that can be bought back under specific authority in terms of the JSE Listing requirements; however, companies are required to repurchase a maximum of 20% of their issued shares in a financial year (JSE, 2008). In South Africa share repurchase intentions are announced through the JSE SENS. Once companies have acquired accumulative 3% of their initial number of issued shares and any other 3% thereafter, the announcement must be made to the SENS (RSA, 1999). Company's management communicates their intentions with investors and general public through the announcement of repurchase plans. Although disclosure of share repurchase is required by the JSE, these are conducted quietly and at the sole discretion of the company, without further announcements, as long as the repurchase is within the required limits. It is for the reason of flexibility that most literature studied on share repurchases covers announcement rather than actual repurchase transactions; therefore this study treated announcements as a proxy for an actual repurchase. Kelly (2008) used companies listed in the S&P 500 and investigated the impact of their share repurchase on earnings and common stocks return. She used six years data, three years pre-announcement and three post-announcement. Four variables were used to measure earnings. This study revealed a significant relationship between pre-announcement means of these variables and the post-announcement means.

Managers of companies would often signal to investors that their shares are undervalued. Investors would believe the announcement and buy the share as they believe management has inside information or they could ignore the announcement due to a belief that management is too optimistic. Numerous studies on share repurchase have shown that repurchases happen more often among value shares than growth shares. Grullon (2000) shows two forms of signaling explanation on share repurchase: Repurchases convey management's optimism about the company's future earnings and cash flow. In this form, the company uses repurchases to correct its inability to communicate convincingly its prospects to the market.

Management expresses its disagreement with how the market is pricing their company's shares. In this form, the market fails to reflect publicly available information in the price of the share, resulting in market inefficiency.Because of information asymmetry, management's belief that the share trades at a discount to its intrinsic value results in a decision to repurchase, benefiting long-term shareholders when the price recovers. There is extensive literature demonstrating that the company's decision to repurchase is influenced by a perceived undervaluation. Dittmar (2008) found that about 86% of CFOs agreed an undervalued stock was the most dominant reason for share repurchases. The Barth and Kasznik (1999) study suggested that the intangible assets were significantly positively related to share repurchases. The findings on asymmetric information are also supported by Sanders and Carpenter (2003).

Literature reveals that many empirical studies report that open market repurchases are associated with significant negative performance prior to the announcement and followed consistently by positive stock market reactions associated with the signal of a company's intent to repurchase its own shares (Ikenberry et al (1995); Bhana, 2007; Lin et al (2011). An investigation of the open market share repurchases by Ikenberry et al (1995) found that stocks of companies making repurchases experience an immediate 3.5% average abnormal return, as well as a 12% average abnormal return during the longer period of 4 years following the announcement date. Lin et al (2011) found that different industries in the Taiwan market responded differently to announcements; some were more sensitive than others.

Bhana (2007) noted an abnormal return of 4.38%, which is an initial market reaction to repurchases on the JSE. Using a buy and hold strategy, the three year abnormal performance following the announcement was 14.35%. Bhana further looked at companies in the JSE that showed a high book to value (undervalued), and in a three year period these companies showed a 32.78% abnormal return. Bens et al (2003) are of the view that share repurchases are used strategically to increase reported EPS. There is however, very little evidence that repurchases are used to boost reported EPS.

SAMPLE SELECTION, DATA SOUCE AND METHODOLOGY

The study's sample consisted of companies that made share repurchase announcements in the years 2001 through 2008. A sample of 27 companies was selected from the Top 40 and mid cap stocks. The following criteria were used to select the 27 stocks:Each company was a designated middle capitalization or large capitalization ranked firm at the time of the study (not time of announcement). These companies must have at least made one repurchase announcement between 2001 and 2008.Small capitalization companies are excluded purely because of poor data availability; they could be repurchasing their shares as a major shareholding transaction. Companies that do not have a 3 year data pre-announcement year and 3 year data post-announcement year were excluded.The average proportion of shares to be repurchased by firms in the study was approximately 4.57% and the literature revealed an average repurchase target of 7% (Stephens & Weisbach, 1998).This study did not examine the determinants of alternative distributions, as it only focused on the effect on earnings from a repurchase announcement, with the announcement a proxy for the actual repurchase of shares. The data on announcements for this study was obtained from the JSE SENS, the company's website (or the companies' websites) and Standard Bank online trading.

Research Question: Do companies that announce a repurchase of their own shares demonstrate a post-announcement change on earnings? Earnings returns were measured by the following financial instruments:Percentage change in cash flow per share from the prior year (CFPSP), Percentage change in earnings per share from the prior year (EPSP), Percentage change in dividend per share from the prior year (DPSP)

Hypotheses To Be Tested: The research hypotheses: There is a significant difference between pre- and post-announcement values for earnings when earnings are measured by CFPSP, EPSP, and DPSP.

Statistical Procedures And Limitations: This study utilized the Wilcoxon signed-rank test as a supplement to the t-test. The Wilcoxon test can be useful when the distribution may not be normal, but the sample is believed to be symmetrical with the same mean and median. The statistical tests were conducted using Microsoft Excel

ANALYSIS AND PRESENTATION OF RESULTS

The study focused on investigating the effect an announcement has on earnings of a company in a three year period after the announcement. The financial characteristics of each firm were examined for a period of six fiscal year ends, with 3 years occurring in the pre-announcement period and 3 years occurring in the post- announcement period.

Table 1: Summary Statistics of the Data Sample over an 8 Year Period from 2001 to 2008

Financial Metrics for Target Repurchase and Earnings		**Minimum of Metric**	**Maximum of Metric**	**Mean of Metrics**	**Standard Deviation of Metrics**
Target shares %		0.02	16.76	4.57	5.00
EPSP	*Pre*	-2960.00	2442.11	42.74	326.24
	Post	-96.81	3130.00	62.82	201.43
DPSP	*Pre*	-100.00	718.18	47.85	57.78
	Post	-100.00	640.74	13.41	48.67
CFPSP	*Pre*	-1100.00	397.13	23.24	103.72
	Post	-1428.57	1181.82	10.12	155.96

Table 1 gives a summary of the main statistic values for target shares, EPSP, DPSP and CFPSP; the latter three variables are used to measure earnings. Both the pre-announcement values and the post-announcement values of the earnings variables are summarized into minimum, maximum, mean and standard deviation values. This table shows "targeted shares" as the first metrics, which gives the proportion of shares target. This variable had a range of 0.02% to 16.76% for the sample size of 27 announcements. The sample had an average repurchase target of 4.57% and a median of 2.83%.

It was expected that the means of the three financial variables would show a significant difference between the pre- and post-announcement values. As shown in Table 1, there seemed to be a bigger difference between the pre-announcement mean values and post-announcement mean values for all three metrics. The post-announcement mean for the EPSP was larger than the pre-announcement mean value, while for both DPSP and CFPSP the post-announcement mean was smaller than the pre-announcement, which suggests a smaller degree of change in earnings after a repurchase announcement was made than before an announcement.

Table 2: Mean Comparison of the Pre-announcement and Post-announcement on the Variables Using the t-Test

Metrics for Earnings	Mean Difference	Std. Deviation	Std. Error	t-Test	df	Sign Test (2-tailed)
EPSP	20.08	481.75	92.71	0.22	26.00	0.83
DPSP	-34.44	79.01	15.20	-2.27**	26.00	0.03**
CFPSP	-13.12	153.77	29.59	-0.44	26.00	0.66

*Table 2 shows the estimated results from a difference in means of pre- announcement and post announcement. The study looked at the standard deviation, standard error of all three metrics for earnings (EPSP, DPSP and CFPSP) and calculates the t-test and identifies its level of significance. The t-test refers to the t-value of the standardized-residual cross-section. Sign test refers to the nonparametric test. ***, ** and * indicate significance at the 1, 5 and 10 percent levels, respectively.*

The differences in the means were not significant for two of the three metrics; this implies that there was no statistically significant difference between pre and post announcement financial figures for EPSP and CFPSP. Only the DPSP showed a significant difference at 95% confidence level. Two of the values in the last column of Table 2 are larger than 0.10, indicating that the differences in means for pre- and post-announcement values were not significant for these variables at a minimum acceptable confidence level of 90%. The findings of this study using a t-test were contrary to the expectations of the study. The study expected the earnings to change significantly once a company announces a share buyback plan or strategy. It is very possible that the sample of 27 firms was very small and not normally distributed, hence no insignificant difference for some of the variables between pre- and post-announcement means. The significant change in divided could be an indication that these companies are starting to use both dividend and repurchase as a payout strategy to shareholders instead of only using dividend.The Wilcoxon test was conducted to address this shortfall and its findings are presented in Table 3 below.

Table 3: Mean Comparison of the Pre-announcement and Post-announcement on the Variables using the Wilcoxon test

Financial Metric for Earnings	Z-score	Sign Test (2-tailed)
EPSP	-1.16	0.25
DPSP	-2.34	0.02**
CFPSP	-1.80	0.07*

*This table shows the z-score from calculating the mean differences between the pre-announcement and post-announcement values using the Wilcoxon format. The z-score is then calculated from the standard deviation of the difference and the difference sample mean. The corresponding significance level to the z-score is identified from the normal distribution table. Sign test refers to the nonparametric test. These tests examine the significant levels of mean differences. ***, ** and * indicate significance at the 1, 5 and 10 percent levels, respectively.*

The Wilcoxon test can be useful if the sample size is considered small and/or if the distribution of values is far from normal. The results in Table 3 show the observed significance values for two of the three variables, DPSP and CFPSP, which are less than 0.05 and 0.1 respectively. A significant difference between the means of pre- and post-announcement on DPSP (p=.02) and CFPSP (p=.07) was found. Therefore the announcement to repurchase shares had a significant effect on earnings change after the announcement date. The results from the Wilcoxon test are not consistent with the null hypothesis for two of the three variables. This test supports the hypothesis that announcing a share buy-back has an effect on the company's earnings in the three years after the announcement. The findings in Table 3 indicate that earnings can change in either a favorable or unfavorable direction after a repurchase announcement, but the study did not predict the direction. Looking at Table 1, it is obvious that the repurchase announcement led to a reduction in the mean of DPSP and CFPSP post the announcement.

CONCLUSION

The primary objective of our study was to test whether companies that announced buybacks of their own common stocks had an observable difference in earnings returns following such an announcement. This study attempts to investigate the effect share repurchases announcements have on earnings of companies listed on the Johannesburg Stock Exchange (JSE) in South Africa. Over a period of 8 years from 2001 to 2008, the study explores the statistical significance of the impact the shares targeted for buyback have on earnings. These earnings are examined through the use of three financial metrics. 1) Percentage change in cash flow per share from the prior year (CFPSP), 2) Percentage change in earnings per share from the prior year (HEPSP), and 3) Percentage change in dividend per share from the prior year (DPSP). Share buyback announcement was used a proxy for actual repurchase and the financial characteristics of each company were examined for a period of six fiscal year ends, with 3 years occurring in the pre-announcement period, and 3 years occurring in the post- announcement period. The null hypothesis of this study was that, there is no significant difference between the pre- and post-announcement values for earnings when earnings are measured by CFPSP, EPSP, and DPSP.

The first set of results showed a contrary output to predictions of this study. The t-tests revealed that only DPDP showed a significant difference between pre- and post-announcement earnings as measured by the matrices described above. Some reasons for results contrary to predictions may be that certain characteristics of the sample influenced these findings. The study did not distinguish a firm that makes repeated announcements from a firm making its first repurchase announcement nor did the study consider the market risk factors of a firm and any effect this may have on a repurchase target.

A non-parametric Wilcoxon test was then used. Considering that the number of companies investigated was only 27 which is a small sample, the Wilcoxon test is usually more effective with small samples and also useful if the distribution of values is not normal. The results indicated that there exist significant differences between the means of pre- and post- announcement of these two financial metrics DPSP ($p=0.02$) and CFPSP ($p=0.7$), which suggest that the announcement to repurchase shares had a significant effect on earnings change after the announcement date.

Consistent with expectations were findings that post-announcement earnings differed significantly from pre-announcement earnings for two of the three metrics with the Wilcoxon test. This finding led to the rejection of the null hypothesis. Some limitations of the study included the exclusion of companies that started making repurchase announcement in 2008. These companies were excluded as they lack three years post announcement financial information. Their three year financial information will only be realized at the end of 2011 which is the year of this research. Metropolitan which has been one of the companies that actively used share repurchase as a distributing strategy to shareholders was also excluded. This is because it was difficult to get information due to its recent merger with momentum to form MMI. This study provides some evidence that South African business leaders are becoming more receptive to the use of share repurchases as and additional form to dividend of distributing earnings. The positive impact repurchase announcement has had over share prices with the impact they have on earnings post the announcement is an evidence of a paradigm shift. Further research may reveal the extent to which companies in South Africa substitute share repurchases for dividend. Further work in this area can also include looking at the significant impact the proportion of shares repurchased has on earnings.

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