SHARE REPURCHASE AND FIRM PERFORMANCE IN MALAYSIA

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I certify that I have supervised and read this study and in my opinion it conforms to acceptable standards of scholarly presentation and is fully adequate in scope and quality as a research paper for the degree of Corporate Master in Business Administration.

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STATEMENT OF ORIGINALITY

The work described in this Research Paper, entitled

"SHARE REPURCHASE AND FIRM PERFORMANCE IN MALAYSIA"

is to the best of the author’s knowledge that of the author except where due reference is made.

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ABSTRACT

SHARE REPURCHASE AND FIRM PERFORMANCE IN MALAYSIA

By

WINNIE WONG WANG ENG

This paper discusses the share repurchase and its relation with the firm performance by Malaysian firms from January 2005 to December 2009. The evidence indicates that ROA have a significant relationship with the total consideration paid for repurchase, dividend yield, debt, days spent to repurchase and cash flow. This evidence could be interpreted as profitable firms repurchase more shares to signal the undervaluation of their current stock price relative to their fundamentals.
ABSTRAK

BELIAN BALIK SAHAM DAN PRESTASI FIRMA
DI MALAYSIA

Oleh

WINNIE WONG WANG ENG

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CHAPTER ONE
INTRODUCTION

1.0 Introduction

Share repurchase refers to the practice of a company that repurchases its own stock from existing shareholders. The share repurchase (also known as the repurchase of stocks or shares reacquisition) refers to the acquisition of shares by the company itself. According to Company Law in the United States, specifically there are five main methods of share repurchase, these include:

- private negotiations;
- repurchase "put" rights;
- open markets; and
- fixed price offer; and
- Dutch auction.

Fixed-price tender (FPT) offer refers to when firms tender their shares with a specified price (usually higher than market prices) within the specified period (usually about three weeks from the offer date) to interested investors. On the other hand, Dutch auction (DA) offer allows purchase to be made the offer with a range of price. DA tender offer need to select its price, and sometimes the tender received for their stock is lower than the market price (Lamba and Ramsay).
Open market repurchase (OMR) of shares refer to the act of a company buying back its own share in the open market. Only this type of share repurchase is currently allowed in Malaysia. The number of shares intent to be repurchased is decided by the Board of Directors, which authorized a firm to buy shares, sometimes for a specified future period of time. Open market repurchase involves the company repurchasing the shares on daily basis from the open market by stock brokers. The seller usually does not know the company the shares are sold to.

1.1 Background

Share repurchase was permitted in Malaysia starting 1st September 1997. Before that, share repurchase was not permitted. From then on, the market witnessed increase in the number of firms making repurchase of share. According to Isa, Ghani and Lee (2011), the decision to permit share repurchase policy changed during the early period of year 1998, after Asia financial crisis that caused some firms having to repurchase in order to support their underpriced share. It was an effort to help stabilize the weakening market at that point in time.

However, the share repurchase strategy was not totally effective, because the market value continued to drop due to the lack of the market confidence. Under normal situation, the share will be repurchased when management believed the price is too low as opposed to the fundamentals of the firm or when the price dropped too much. This was how the strategy had become an effective tool for price stabilization (Isa, Ghani and Lee, 2011).
Comments and Jarrell (1991) pointed out that DA was widely used by security analysts and other informed the company is relatively with the investors. Business management had a relatively low percentage of stock because the shares were managing risk widely with low relatively as companies are "not suitable" to provide a strong credible signal to send premium repurchase. Comment and Jarrell explained such firms DA are similar to OMRs.

Many companies have similar characteristics of stock repurchases in the 1990s, such as the use of stock options. The use of stock options enabled these firms to make cash payouts based on the discounted values of optimistic expectations of future net cash flows and stimulated the use of share repurchases.

In contrast, the corporate dividend payments and the increase of income accounted for the high concentration in spending, which were then responsible for the total dividend rise. Therefore, although share repurchases cannot replace dividend, but it may be performed using different functions (Weston and Siu, 2002).

Share repurchase provided excellent benefits such as cash to existing shareholders of the company. Repurchasing reduced outstanding shares and it was not deducted from earnings of the purchase of stock (Weisbenner, 2000). Cash increased as the number of outstanding shares for exchange decreased. Share repurchase uses retained profits to effectively reduce the shares from the public to regain its own shares. After repurchase, the company will hold them for re-issue at a later time. Sometimes the
company retain repurchased treasury shares in order to re-sell them, or assign them to fulfill an option or otherwise to avoid the issuance of new shares.

Management decision needs to be made on the purchase of shares and retirement, especially if they believe investors are underestimating the company's stock. The share repurchase will usually raise the stock price by reducing the outstanding shares, thereby increasing the percentage of the company's equity investors. Although it is designed to benefit investors, shareholders may prefer to use excess cash flow and return in the form of cash dividends to investors.

The "signaling" seeks to transfer the information of the undervalued share prices. The consultation emphasized the market value of the firms and other employees that if a company's shares are significantly below their intrinsic value, the rate of return from the share repurchase may exceed some or all of the company's actual return on investment (Rapaport, 1998). However, the most critical question is whether the market value is underestimated that there were no options but to adhere to the market inefficiencies in the form of undervalued price (Isawaga, 2002).

Most public companies distribute profit in the form of cash dividends to shareholders. However, there is an increasing proportion of this cash being directed for the allocation of shares through the repurchase share from the public shareholders. The increased use of repurchase has two common explanations. First, stock repurchase is usually more efficient for tax purposes compared to distributing dividend to the shareholders. Second, the value of repurchase of shares is less than dividends, and to
reduce the value of managers’ stock options. However, the facts show that most of
the cash is still being distributed through dividends, and that share repurchase is not
perceived superior to all aspects of dividend.

According to Brav (2003), the main reason to repurchase was due to the undervalued
share price. There is positive NPV if the stock was undervalued which may generate
benefits to shareholders. When the fund manager noticed the share price was
undervalued, the fund manager may be predicting the future operating performances
which are better than capital market. Therefore, the side effect of share repurchases
is that it conveyed favourable information about market performance (Lie, 2001).

1.2 Reasons for Undertaking Share Repurchase

Several researches such as Comment and Jarrell (1991); Ikenberry, Lakonishok and
Vermaelen (1995); Chan, Ikenberry, and Lee (2004); and Grullon and Michaely
(2004) looked into various aspects of the reasons a company undertake share
repurchase. The findings are different as there were differences in rules and
regulations, size and the maturity of market (either in a developed or developing
market), which responded differently to the announcement of share repurchase.
Under normal circumstances, the company may repurchase its own shares for one or more of the following reasons, such as:

- to be used as employees' pension and compensation plans,
- to be invested in some of the surplus cash alternatives for distribution of dividends which may have a positive effect of the company to establish a market.

In addition, the company can

- adjust the owner's equity and capital structure;
- reduce the public float of shares to take strategic steps towards tax incentives,
- increase the market price by reducing the company's issued shares to create additional demand of company (Sabri, 2003).

Theoretically, a firm has many reasons to repurchase their share. Three reasons are mentioned in this section. The first reason is share repurchase an alternative as substitution to the cash dividends. However, share repurchase does not function like cash dividends. A firm will prefer to distribute cash to shareholders rather than repurchase share when the capital gains tax rate is lower than dividend tax rate.

The share repurchase will enhance the profitability of shareholders; this is due to capital income taxes incurred are lower than individual income taxes. Hence, some fund managers preferred share repurchase to distribution of cash dividend. This supported the evidence of Isa, Ghani and Lee (2011) who stated that share value increased when repurchases were preferred to cash dividends.
Apart from that, Skinner (2008) and Von and Megginson (2008) clarified that there was observable trend among the US and the European markets, and it was believed that the firms utilized share repurchase as a substitution of cash dividends. Therefore, the second reason was to adjust the company's capital structure frequently by reducing the property right component, and increases the form of debt component. The third reason was to evaluate the "signalling" hypothesis.

According to Vermaelen (1981) and Comment and Jarrel (1991), there was positive market reaction to share repurchase where the appearance of "management" view – information asymmetry between management and the investors – was seen as signal of that the market price was underestimated.

In the 1990s, the world had witnessed a substantial increase in the number of companies which announced stock repurchase program. Although this company repurchases shares for a variety of reasons, managers often cited the motivating factor as due to underestimated price. Share repurchase programs may be underestimated within company's future performance is expected at the same times check of insider trading. Chan, Ikenberry, and Lee (2004) examined insider trading in the open market repurchase program of underestimated concurrently.

The Financial Engineer (2008) cites Persons (1997) showed that the undervalued companies to signal with their share repurchases and pay a high premium to overestimate the company to imitate them. The companies tend to use dividends as a signal, but only the most undervalued companies try to repurchase. The company
decides to repurchase share after verifying the signal of undervalued share and pay parts of the high fixed costs of high premiums.

1.3 Scenario in Malaysia

Most studies have suggested the positive impact of share repurchase at market prices, it may not be applicable for Malaysian scenario. Based on dividend substitution concept, the firms may choose to either repurchase share or distribute cash dividend. Even if there was a positive influence on share repurchase based on the current market price, it may not be obvious when applied. The substitution hypothesis of the dividend is the highly doubtful that firms prefer the use of share repurchase to distribution of cash dividend.

Although the dividend income may have taxes incurred, but capital income is not fully putting the imputation on the system assurance. Shareholder who practiced in Malaysia gains from tax deduction on gross dividend. This reduction on tax created advantage for share repurchase. Moreover, the Malaysian firm knew that they pay lower dividend in comparison to developed country. Isa (2008) listed the firms in year 1990s and 2000s which probably used 60 percent cash to pay the dividend and those who paid only dividend with average yield arrangement from 2 to 3 percent.

Most investors preferred and controlled the local markets which focused on short-term price based on individual perspectives (Isa and Lim, 1995). Cultural wise, Malaysian are unlikely to hold debts in their capital structure towards share
repurchase by using capital structure adjustment which increases leverage. Kester and Isa (1994) noted that manager require new asset to the debt when the new external finance existed. In addition, if the share repurchase was cancelled, leverage will increase. The shareholders have the right to choose and recognize the retention of share as the treasury stocks either authorize to use or sell to the market in Malaysia by Lim and Bacha (2002).

Some open market share repurchase practiced it on a gradual process, purchasing in small batches through a broker from the first day of share release. The maximum of two brokerages were allowed in Bursa Malaysia (Rachagan, Pasco, and Joshi, 2005). The firms paid normal commission rate and the sellers who do not know which companies the shares were sold to.

1.4 Problem Statement

Recently, share repurchase has concerned many parties’ especially financial analysts, investors, shareholders and the capital market regulatory authorities. During the period of uncertainties due to financial crisis, the government has launched share repurchase to stabilize the market share prices and improve the gloomy exchange performance.

If (either directly or indirectly cost, to any management of the company) announced that the open market scheme cost is very low that top management may confused and mislead the investors of the repurchase undervalue was false signal once
announced as the price had increased. Perhaps these suspicious repurchase program announced by the company is a simple extension of more general ethical issues.

Barth and Kasznik (1999) revealed that companies preferred the intangible assets to exercise of share repurchases. The authors claimed to be assets indicators of the company's share undervalued. Undervalued companies can gain from the company's market value is less than the book value so if the company is buying back its shares in the open market, it paid less for the share of the company that manager believes the share is valuable.

Most of the research had discovered the repurchase of shares one of the strategies of earnings management. Brav, Graham, Harvey, and Michaely (2005) discovered more than three quarters of surveyed financial executives identify the increased earning share seem to be important determinant factor of increased earnings per share seem to be of its decisions on buying back shares.

In addition, Gong, Louis and Sun (2008) proved that improvements of the firm operating performance after share repurchases are driven by pre-repurchase of earnings management. In the same way, Fenn and Liang (2001) reviewed a strong and positive relationship between the options in managing shares with a tendency to prefer open market repurchase.
1.5 Research Objectives

1.5.1 General Objective

- To identify the relationship between share repurchase and firm performance

1.5.2 Specific Objective

- To identify the relationship between share repurchase and firms performance in Malaysia.
- To identify other factors that link share repurchase and performance of the firms such as debt of the shares.

1.6 Hypothesis

This study examines the relationship between the share repurchase and firm performance. In particular, the motivation factor for a profitable firm to repurchase its own shares. One theory that may explain this tendency is that the management wants to signal to investors that their shares are undervalued, and that their shares should worth more than the current market price.

\[ H_0: \text{Share repurchase does not affect firm performance} \]

\[ H_1: \text{Share repurchase affects firm performance} \]
1.7 Limitation of Study

There is little study that examines the effect of share repurchase to firm performance in Malaysia. Most of the resources available are taken from studies conducted in US, Canada, UK, Europe countries, Australia, Hong Kong, and Taiwan. Hence, it was a challenge to acquire reference journal or article to support the findings.

1.8 The Organization of the Study

The study is organized into five chapters. The first chapter describes the introduction. The literature review of the developed and developing countries and Malaysia's share repurchase scenarios are described in the second chapter. The third chapter focuses on the research methods used in the study. This chapter also describes the study sample selection and data collection. The fourth chapter describes the analysis and findings from the data. The final chapter concludes the analysis of data. Finally, recommendations are provided for future research.
CHAPTER TWO
LITERATURE REVIEW

2.0 Introduction

This chapter discusses the theory of share repurchase decision by firms in Malaysia. Various journals, articles, thesis and discussion for the activities on the share repurchase were reviewed in order to conclude whether the decision of share repurchase affected firm performance.

There are many studies about the influence of share repurchase on firm performance in other countries outside Malaysia. Most of the studies were done in US, Canada, UK, Europe countries, Australia, Hong Kong, and Taiwan. Only a few of the studies were conducted in Malaysia. However, it is equally important to know of the factors affecting the share repurchase and the firm performance in Malaysia.

The study on the effects of share repurchase and firm performance by the previous papers are compared with the different methods, so that this study can proceed systematically. There were a few relevant research reports, journals, books, reading materials and so on from different expertise used in this study.

The following are divided into few sections. The first section discussed the evidences on share repurchase activities among developed and developing countries. This is followed by empirical research of econometric studies in the 1990s and the