THE IMPACT OF SHARE PRICE ON OPEN MARKET SHARE REPURCHASES IN MALAYSIA

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Statement of Originality

The work described in this Final Year Project, entitled "The Impact of Share Price on Open Market Share Repurchases 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

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By

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The purpose of this study is to examine the price behavior of the firms following open market share repurchases in Malaysia. Specifically, this study attempt to test on the impact of share prices of public listed firms listed in Bursa Malaysia on the day of the repurchases and the long run performance after share repurchases took place. This study uses the daily data of the firms' share price collected from the Thomson Reuters Datastream database and the date of actual share repurchases from Bursa Malaysia. The results show that the price impact on the share repurchases day exhibit a positive abnormal return of 0.56% throughout the four years period of study. The long run performance shows the buy-and-hold abnormal return of 46.62% throughout the study. The results indicate that the signaling hypothesis and undervaluation hypothesis exist as investors react positively on firms repurchasing their shares and perceived the firms to be undervalued. The findings of this study are consistent with the findings found in prior studies.
ABSTRAK

KESAN HARGA SAHAM ATAS PEMBELIAN SEMULA SAHAM PASARAN TERBUKA DI MALAYSIA

Oleh

Goh Shin Peih

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CHAPTER ONE

INTRODUCTION

1.0 Introduction

Share repurchases has become increasingly significant yet common in most of the countries nowadays. Grullon and Michaely (2002) found an upward trend of share repurchases in the United States where the spending for share repurchases increased from 4.8% in year 1980 to 41.8% in year 2000 and the most famous method for firms to repurchase their shares is through open market share repurchases. Recent issues such as deregulation, changes in taxation, recognition of shareholder value maximization as main corporate objective and increasingly significant use of executive stock option have contributed to the growth of worldwide share repurchases activities (Vermaelen, 2005). Moreover, more firms recently prefer share repurchases than dividends as a pay-out method to shareholders as they view it to be more flexible. There is no obligation for firms to repurchase their shares and repurchases can result in an increase of the firm's earning per share. According to Brav, Graham, Harvey and Michaely (2005), managers use this advantage when they found the existence of good investment opportunities for the firm by adjusting the pay-out, adapting with time-varying factors which will influence the earning per share of the firm, eliminate the stock option dilution or repay capital to shareholders when the share price are believed to be undervalued.
Basically, the major form of share repurchases is open market share repurchases, followed by Dutch auction and fixed price tender offers (Vermaelen, 2005). In open market share repurchases, the firm’s directors approve to repurchase a number of shares, price range for repurchases and time constraints for repurchases in the secondary market. In Malaysia, the only method for the firms to repurchase their share is through an open market share repurchases which the firms will instruct the authorized broker to buy shares on the stock market. Before the year 1980, share repurchases was not legalized or discouraged by tax law for all the countries except in the United States (Vermaelen, 2005). However, concerning the issues such as creditors’ protection in the firms, manipulation of price, uneven treatment between shareholders and insider trading of the firms have caused the share repurchases to be allowed in some countries (Rasbrant, 2011). On the 1st September 1997, share repurchases was legalized in Malaysia as a pay­ out method for publicly traded firms through the amendment of Malaysian Companies Act 1965 under Section 67A. The reasons that share repurchases was introduced and permitted in Malaysia are to gain back the confidence of investors and to overcome the clouds surrounding the capital market in Malaysia due to a huge outflow of money during the Asian Financial crisis in year 1997. Subsequently, repurchasing the undervalued shares has caused the increase in share prices and regenerates the capital market as well as the recovery Malaysia’s economy (Santhirasegaran, Zamri, & Sitraselvi, 2009).

The regulatory frameworks between different countries are different. Unlike other countries, Malaysian firms must disclose their repurchase transactions on a daily
basis. Firstly, the firms must get the approval from the shareholders and amend the Memorandum of Association (MOA) for the intention to repurchase the shares in the annual or extraordinary general meeting. Share repurchases is also not permissible if the firms' total number of share repurchases more than 10% of their issued and paid-up capital (Bursa Malaysia, n.d.). The next section will be discussing in more detail about the legal and regulatory framework in Malaysia.

1.1 Legal and Regulatory Framework in Malaysia

Share repurchases had only been permitted in Malaysia since 1st September 1997. The share repurchases practices should be in accordance to Section 67A of the amended Malaysian Companies Act 1965. Under this section, the firm should make sure that the firm is solvent at the time of the share repurchases and not turn into bankruptcy as to pay for the debt for the shares that had been purchased. Furthermore, the only method that the Malaysian's firm is permitted to repurchase the shares is through open market share repurchases where the shares of the firm are quoted and followed the relevant rules of the Stock Exchange. The directors of the firms can also cancel the shares, retain the shares in treasury shares or retain part of the shares as treasury shares and cancel the remainder after the shares have been purchased. The firm shall also lodge a notice in prescribed form with the Registrar of Company and the Stock Exchange within fourteen days after share repurchases (Bursa Malaysia, n.d.).
Furthermore, the firms should also follow the rules stated in Chapter 12: Share Buy-Backs under the Kuala Lumpur Stock Exchange (KLSE) Listing Requirement for main market in Bursa Malaysia. The firm can only repurchase its shares when directors of the firm were given authorization from the shareholders during the annual general meeting by ordinary resolution subject to the Act. The announcement of the intention for a firm to repurchase the share and the result from general meeting about share repurchases must be informed to the Stock Exchange on the same day. In addition, the firm should also make sure that the total of the shares intended for repurchases is less than the firm’s issued and paid-up capital when repurchases or hold it as treasury shares which is less than 10% of the issued and paid up capital. Additional requirement also require the firm to repurchase the shares at the price less than 15% of the weighted average market price of five market days before the repurchases happened. Any notification of purchase, resale or cancellation of share repurchases must be immediately announce to the Stock Exchange not later than 6.30pm on the same day where the purchase, resale or cancellation is made (Bursa Malaysia, n.d.).

Moreover, the firms should also comply with the requirement for Technical Release on Share Buybacks—Accounting and Disclosure which was introduced by Malaysian Accounting Standard Board (MASB) on April, 1999 for the purpose to manage with the issues of share repurchases for that time. The Technical Release represents the MASB’s view on the proper treatments on accounting and disclosures of share repurchases which are within the law and following the Generally Accepted Accounting Principles (GAAP). Under Section 67A subsection 3A of the Malaysian
Companies Act 1965 allow the public listed firms to cancel the shares so bought, or to retain the shares so bought in treasury shares or to cancel the shares so bought and retain it in treasury shares upon the actual share repurchase. Subsection 3B also allows the directors of the firms to allocate the treasury shares in the form of share dividend to the shareholders or to resell it on the market of the Stock Exchange. There are two alternative accounting treatments as prescribed in MASB Technical Release which are the treasury stock method and the share retirement method. The firms can choose any one of the methods or combining both methods in share repurchases (Malaysian Accounting Standards Board, n.d.).

1.2 Problem Statement

Although open market share repurchases has gain popularity, information on actual share repurchases in the United States is unavailable as the regulation does not require firms to disclose information on share repurchases. Under the Rule 10b-18 Purchases of Certain Equity Securities by the Issuer and Others in the Securities Exchange Act of 1934 in the United States, it provides a voluntary “safe harbour” from liability for manipulation which means that the firms are not required to disclose information on share repurchases. As a consequence, unavailability of data causes the difficulty in measuring the actual repurchases as cannot be measured directly. Most of the previous studies used the announcement on share repurchases to measure the share repurchases activities which does not reflect the real situation of share repurchases.
activities. According to Stephens and Weisbach (1998), they suggested four ways to measure the share repurchases: looking at CRSP shares outstanding, Compustat share outstanding, purchase of common and preferred stock from Compustat cash flow data, and Compustat changes in treasury stock. However, the methods used are just an estimation of share repurchases activities whereby they only used the data on the announcement of share repurchases and not the actual share repurchases activities.

Besides that, share repurchases announcement send a signal of a firm to the investors and the direction of this signal has been the subject matter of debate. Some investors perceived that the share price of the firm will rise following the share repurchases as it shows the shares are undervalued. It also demonstrates the investors a good sign on future where firms signal that they might have excess money and better future ahead. Alternatively, in the event where the excess money in the firm is only temporary, share repurchases is more suitable than dividends as increase in dividend yield may not be sustainable over the long period (Coleman, n.d.). Recently, BHP Billiton had announced on 16 February to spend US$10 billion to repurchase its shares (Robertson, 2011). Surprisingly, the share price of BHP Billiton had fallen to over 3% following the share repurchases which is inconsistent with the signalling hypothesis where share repurchases will increase the firm’s profitability (Wang & Johnson, 2008). This shows the uncertain impact of the firm whether or not to repurchases the shares.

Share repurchases may become a signal of lack of future growth of the firm as the investors perceive the firm has no other business opportunities for growth. This is consistent with the free cash-flow hypothesis which suggest that the firm will more
favour to repurchase the shares when it has little growth opportunities (Jensen, 1986). Besides that, uncertainty on whether the firm will actually repurchases the share as the firm has no obligation to keep the promise to repurchase the share after the announcement. The firm has the right to not repurchase the share or repurchases few shares after the announcement. Furthermore, share repurchases puts the firm at risk as the firm must be certain about the future of the business before making the announcement. Otherwise, this will land the firm in trouble during the economy downturn (Coleman, n.d.).

As a consequence, the announcement of share repurchases do not actually follows the signalling hypothesis as proposed by Bhattacharya (1979), Miller and Rock (1985) and Vermaelen (1984) where the firm’s future profitability cannot be determined through the private information about the future cash flows and after the share repurchases.

1.3 Objective

1.3.1 General Objective

The general objective of the study is to examine the share price behaviour of Malaysian’s firms following the open market share repurchases to the public.
1.3.2 Specific Objective

This study attempt to achieve the following specific objectives:

a. To test the impact of share price of the firms on the day of repurchases.

b. To test for the long-run relationship among share price and share repurchases.

1.4 Hypotheses

To achieve the objectives of the study, the following hypotheses have been formulated to test whether the abnormal return on share repurchases activities and the long-run average buy-and hold abnormal return exists.

Hypothesis 1

\[ H_0 \quad : \text{Average abnormal return is equal to zero.} \]

\[ H_a \quad : \text{Average abnormal return is not equal to zero.} \]

Previous studies have documented a positive market reaction on the repurchases announcement. Unlike previous studies which focus on the effect of share repurchases announcement, this study attempts to investigate the abnormal return on the repurchases days. When share repurchases activities took place, these might triggered the investors
to react differently towards these event. By calculating the abnormal return on the share repurchases days, the magnitude of this event can be determined as it measured the differences between the share prices of the firms and the Composite Index.

**Hypothesis 2**

\[ H_0 \quad : \quad \text{Average buy-and-hold abnormal return is equal to zero.} \]

\[ H_a \quad : \quad \text{Average buy-and-hold abnormal return is not equal to zero.} \]

Unlike previous studies used cumulative abnormal return to test on the long-run performance after firms repurchases their shares, this study used a more powerful approach which is the average-buy-and-hold abnormal return. Cumulative abnormal return is a bias estimator as it measures the average periodical abnormal return. On the other hand, average buy-and-hold abnormal return put weight on each of the return which helps to determine the magnitude of the performance after share repurchases activities.
1.5 Significance of Study

As the share repurchases become more important in Malaysia, more and more researchers have attempted to examine the impact on open market share repurchases. However, most paper look into the announcement effects of share repurchases, while this paper attempts to track the price changes following the actual share repurchases activities. As the share repurchases provide signal to investors, this signal perceived by the investors will have strong influence on share price of the firm. The importance to study the share price impact would enhance the firms by carefully examine on the share price behaviour before making the share repurchases announcement.

Besides that, this study should be of interest to the new and present investors in Malaysia’s stock market as they can, through this study monitor on the movement of share price after the share repurchases take place. Moreover, this study will also give contribution to the literature on further research for other researchers.

1.6 Scope of Study

The scope of this study is limited on determining the implication from open market share repurchases in Malaysia towards the share price of the firms. This study aim to study the share price behaviour during the share repurchases day and post-repurchases day of the firms.
The sample size of this study comprises of all the Malaysian's firms listed on Bursa Malaysia which involve in open market share repurchases during the period of 1st January 2005 through 31st December 2008 using the daily data.

1.7 Organization of Study

This study is organized into six chapters. Chapter 2 presents the literature review on previous research about the share price impact on open market share repurchases. Chapter 3 focuses on the data and methodology that would be used in this study. Chapter 4 presents the empirical result of the test using the data and methodology from Chapter 3. Lastly, Chapter 5 discusses about the result and conclusion from this study.
CHAPTER TWO

LITERATURE REVIEW

2.0 Introduction

Although there is a rich literature and research papers conducted previously about open market share repurchases, most of it is related to United States and only a limited number of it is related to other countries. This is because the share repurchases is only allowed in Malaysia and other Asian countries after the Asian economic crisis in year 1997. Share repurchases was not famous in Malaysia at the beginning stage but slowly increased from year 1999 to year 2005 which is from 16 firms in year 1999 and increased to 206 firms in year 2005 announced on share repurchases on that year (Rohaida, 2010).

Some studies support the idea that the firms repurchases their shares provide signal to the investors while some others support that the purpose for share repurchases as to pay out excess cash of the firms, to maintain firms’ optimal leverage, as a replacement for dividend, for firms’ tax advantage, and to protect the interest of the firms’ managers. There are several theories study on the purpose of share repurchases which included signalling hypothesis (such as, Ikenberry et al., 1995; Baker et al., 2003; Dixion et al., 2008), free cash flow hypothesis (such as, Jensen, 1986; Dittmar, 2000; Grullon & Michaely, 2002), optimal capital structure hypothesis (such as, Masulis, 1980; Dittmar, 2000), tax saving hypothesis (such as, Grullon & Michaely, 2002; Dittmar,
2000; Rau & Vermaelen, 2002) and undervaluation hypothesis (such as Chan, Ikenberry, & Lee, 2001; Tieu, 2011) which will further discuss on the next sections. Some other hypotheses which are also contributed to the purpose of share repurchase included dividend substitution hypothesis, liquidity change hypothesis, and management incentives hypothesis (Rohaida, 2010).

2.1 Signalling Hypothesis

Various previous studies had examined that the open market share repurchases announcements to be perceived by investors as a positive signal towards the firm which caused the rising trend in share repurchases (Ikenberry et al., 1995). One of the theories that are important in detecting the reasons of firms repurchases their shares is the signalling hypothesis. Signalling hypothesis is one of the most widespread hypotheses which assume that asymmetric information between the managers and the investors. This means that the firm’s managers retain valuable information about the future cash flows which is not available to the investors.

One of the facets of signalling hypothesis is that the firms are on undervaluation. Under this hypothesis, the firm should repurchase the shares when they perceive the price to be undervalued and to act to the interest of investors. By doing this action, it shows that the managers are confident with the firms as good investment and use share repurchases to correct the mispricing of the firms. It is consistent with the survey result from Baker et al. (2003) found that the undervaluation of a firm’s stock price is the main
reasons to repurchase the shares. Furthermore, the questionnaire survey conducted by Dixion et al. (2008) also discovered that the motives for the firms to repurchase share are all related to information-signalling hypothesis, leverage hypothesis and investment hypothesis.

2.2 Free Cash Flow Hypothesis

Free cash flow hypothesis states that the conflicts of interest between the shareholders and managers exist when the firms have excess free cash flow (Jensen, 1986). According to Jensen (1986), agency problems happened in the firms that have substantial free cash as the firms' managers tend to invest more in the negative net present value projects, consume more discretionary incentives for private benefit such as reward and bonuses instead of pay out to the benefit of shareholders, or retain the firms' cash unnecessarily. Hence, distribute these excess funds to shareholders as dividend will reduce the agency problem as well as agency costs as this will minimize the firms' default risk.

As comparison with dividend, distribution of these excess cash through share repurchase is more preferable by the firms' managers as they view it to be more flexible in magnitude and timing of the distribution. As distribution of dividend to shareholders occurs on a regular basis, share repurchases is more flexible as it will not occur regularly. Timing of the distribution is also vital as firms' managers can wait for the suitable time where the share price of the firms is undervalued (Dittmar, 2000). Unlike penalty