MARKET TIMING AND THE USE OF DEBT FOR STOCK REPURCHASES

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ABSTRACT

Recent increases in stock repurchases among U.S. corporations coupled with a historically low cost of debt since the Global Financial Crisis has created media speculation that firms in recent years are paying for their expanding share buyback programs with debt. This study examines this phenomenon and the likelihood of debt-financed repurchases during different interest rate environments and finds that debt-financed repurchases have increased substantially in recent years, especially in the presence of relatively low interest rates. Firms that make these repurchases tend to be bigger, more levered and make larger repurchases – a phenomenon that is especially pronounced in the years following the Global Financial Crisis. This study suggests that managers may time debt markets in order to repurchase stock when the prevailing cost of debt is relatively low.

Keywords: *Debt Market Timing; Debt-financed Repurchases; Low Interest Rates; Buybacks*

1. INTRODUCTION

Since the early 2000s, there has been a substantial increase in the amount of stock repurchases. For example, in 2000, there were 3,737 firms that repurchased a total of $203 billion in stock. Since then, both the number of firms and total amount of repurchases has risen steadily. By 2014, there were 4,545 firms that repurchased a total of $534 billion in stock. Using inflation adjusted values, this represents a 162% increase over the value of repurchases in 2000. This dramatic increase in stock repurchases over recent years has led to repurchases being considered the dominant form of payout (Skinner, 2008).

Financial news outlets have speculated that companies in recent years are paying for their expanding share buyback and dividend programs by issuing bonds (Niu, 2015). The reduced cost of debt caused by the Fed's decision to keep interest rates low since 2008 may incentivize managers to attempt to time the market, especially if managers believe that the current interest rate environment is temporary and want to capitalize on historically low rates. Building on the findings of Graham and Harvey (2001), Stephens and Weisbach (1998) and many others, it is reasonable to assume that managers utilize a low interest rate environment as an opportunity to repurchase stock, especially if managers also believe that their stock is underpriced in today's market. Stock repurchases are a way for managers to signal undervaluation of their stock price to the market (Vermaelen, 1981). Borrowing money in an environment of historically low interest rates to pay for buybacks may be an inexpensive way for managers to "return" money to shareholders without having to dip into internal cash.

Much of the finance literature related to share repurchases raises the questions that this paper seeks to answer. That is, is there a measurable tendency for a firm to execute a repurchase using debt financing in low interest rate environments?

Results of this study confirm that, in recent years, the phenomenon of firms utilizing debt to finance share repurchases has increased substantially. Both the number of repurchasing firms and the size of the average repurchase have increased over the sample period, and the typical debt-financing repurchasing firm is larger, has more cash on hand and is more leveraged than other firms that make repurchases. Furthermore, this study shows that prevailing market interest rates may play a role in firms' decisions to finance a repurchase with debt.