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Under new management: Equity issues and the attribution of past returns☆

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ABSTRACT

There is a strong link between measures of stock market performance and subsequent equity issues. We find that management turnover weakens the link between equity issues and the returns that preceded the new chief executive officer (CEO). Moreover, there is a discontinuity in the distribution of equity issues around the specific share price that the CEO inherited, while there is no discontinuity around salient share prices prior to turnover. The evidence suggests that capital allocation involves an attribution of past returns not only to the firm but also to its CEO. A corollary is that a firm with poor stock market performance may be better able to raise new capital if its current CEO is replaced.

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1. Introduction

There is a strong and positive link between measures of stock market performance and equity issues. The neoclassical explanation for this pattern is that past returns reflect improved investment opportunities, which must in turn be financed. Another traditional explanation is that the cost of external equity is unusually low, either for rational reasons related to adverse selection or investor risk aversion or irrational reasons related to market-wide or firm-specific misvaluation.[1] Putting these two together, firms with good performance require capital and have a lower cost of capital. Investors supply capital, believing that it will be put to good use. The identity of the management team does not figure prominently in either explanation. Whether the

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[1] For example, see Lucas and McDonald (1990) and Korajczyk, Lucas, and McDonald (1992) for an asymmetric information version of market timing, and Ritter (1991), Loughran and Ritter (1995), and Baker and Wurgler (2000) for an inefficient markets version.

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stock market performance came during the tenure of the current CEO is largely irrelevant.

In this paper, we ask whether equity issues are more sensitive to the value apparently *created* by the current CEO or the value *inherited* by the current CEO.[2] Our results suggest that CEO-specific performance plays an important role in predicting which firms will raise equity capital. Equity issues are roughly twice as sensitive to what we label the CEO-specific portion of value creation as they are to inherited stock price performance. We decompose Q, which we define as the market-to-book assets ratio, into three parts: an initial level, the change prior to the arrival of the CEO, and the change since. The unconditional probability of an equity issue is 4.5% per quarter. A unit increase in the initial level of Q or the change in Q prior to the arrival of the CEO increases the probability of an equity issue by 2.0–3.2 percentage points, while a unit increase afterward increases the probability of an equity issue by almost twice as much, or 4.0–4.6 percentage points. These differences are large in comparison to the mean issuance level.

While suggestive, these results have obvious limitations. Namely, we cannot distinguish CEO-specific value creation from merely recent value creation. For example, measurement error in our proxy for Q might mean that recent first differences better define investment opportunities or asymmetric information than first differences in the more distant past. As a result, our preliminary test may have nothing to do with the attribution of performance to the current CEO.

To address this problem, we assign each firm in the non-turnover group a random turnover date. We then take a differences-in-differences approach, albeit not one where we have an instrument for CEO turnover, looking at how the difference between recent changes in Q and more distant changes in Q vary across the turnover and non-turnover groups. In both groups, the more recent change in Q is more important for equity issuance, but the gap is larger when there is a turnover, increasing the probability of an equity issue by a further 1.3–1.7 percentage points.

While this suggests an attribution of past returns to the CEO, another explanation is that CEO turnover marks the sort of shift in firm strategy that breaks the link between past returns and equity issuance. Perhaps it is the underlying shift in strategy that causes the appointment of a new CEO and simultaneously the need for new capital, regardless of past performance. Capital is available to finance investment opportunities, but past returns are only an indicator of investment opportunity *conditional* on a strategic status quo. A related explanation is that a CEO transition puts all significant decisions on hold including raising new equity, while the new administration considers its options. This is effectively a transaction cost that delays the move toward neoclassical investment. The shift in personnel means that there is no need for new capital, again regardless of past performance. In both explanations, the identity of the CEO and the transition itself still matter, but for fundamental reasons.

We perform several additional tests to explore these alternative explanations. For example, we can quickly rule out the second alternative as the only explanation. Our main results do not come simply because the new CEO takes no immediate action in raising capital. The variance of equity issues is just as large after a CEO transition as in other periods. We can also rule out one version of the first alternative explanation. If the strategic shift involves improvements in investment opportunities, then debt issues and investment will behave like equity issues. Yet, we find no effect of CEO-specific returns on debt issues. And, we find no statistically significant results for the growth in long-term assets, capital expenditure, or profitability.

A broader interpretation is that the relevant opportunity is in restructuring liabilities, not increasing assets. CEO turnover typically coincides with poor performance. Equity issues in this context might be used to recapitalize a poorly performing firm after the arrival of a new CEO. Applying a double negative to our results, we might say that low, non-CEO-specific returns increase the probability of an equity issue.

However, we check whether our results come *only* from clear restructuring situations where the change in Q prior to CEO turnover was negative. They do not. In fact, the sensitivity of equity issues to value created prior to the current CEO's tenure is similarly small when the changes in Q are negative prior to the CEO's arrival as when the changes are positive; when the firm has or does not have leverage; when the turnover is forced or natural; or when the turnover involves an insider or outsider. We also find persistent effects even 12 or more months after turnover. In other words, distant past returns, which are arguably less important for immediate financing decisions, continue to have a differential effect.

Elaborate connections between CEO turnover and omitted firm characteristics are hard to cleanly rule out in a single test. But, in a third and final analysis to *rule in* the attribution story, we look for two types of discontinuity. These are cleaner, but less powerful, tests. Both the stock price at the arrival of the current CEO and the stock price of the prior stock offering if it is under the current CEO's control have a special effect on the decision to issue equity. There is a discontinuous jump in the distribution of follow-on offerings at these two stock prices. In contrast, the stock price of the prior stock offering, if it is not under the current CEO's control, generates no discontinuity. To the extent that past prices affect issuance, this process seems to start at the arrival of the CEO. The arrival price itself is discontinuously important, apparently generating a new reference point against which the CEO is judged. The price of the stock at the firm's last equity offering generally seems important in the decision to issue equity, in the sense that it generates a discontinuous jump in equity issues. And yet, this pattern is only visible if it occurs under the current CEO's tenure.

Taken together, our results document a selective attribution of past returns to the CEO. These findings complement a growing literature that emphasizes the importance of the identity of top management in financial

[2] It is worth noting at the outset that we take a fairly expansive view of equity issues in most of our empirical tests, most notably including equity issued in the context of mergers and acquisitions. We also consider a narrower and binary notion of equity issues by examining follow-on equity offerings.

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