Finance Research Letters 10 (2013) 82–92

Contents lists available at SciVerse ScienceDirect

Finance Research Letters

journal homepage: www.elsevier.com/locate/frl

The over-optimism of financial analysts and the long-run performance of firms following private placements of equity

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A R T I C L E I N F O

Article history:
Received 19 June 2012
Accepted 29 December 2012
Available online 12 January 2013

JEL classification:
G14
G17
G29
G32

Keywords:
Private equity placements
Financial analysts forecast
Over-optimism
Long-run performance

A B S T R A C T

We set out to determine whether the over-optimism of analysts has negative impacts on the subsequent long-run performance of firms following private placements of equity (PIPEs). Our results indicate that analysts do tend to make over-optimistic forecasts at the time of PIPEs, and that such over-optimistic forecasts can lead to investors erroneously overstating the value of placement firms, resulting in subsequent revisions of their valuations over time. We further infer that when firms announce their PIPEs, over-optimistic forecasts tend to lead to overstated valuations. The evidence shows that the long-run performance of PIPEs has a negative correlation with over-optimistic forecasts.

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1. Introduction

When seeking to raise capital within an environment of asymmetric information, overvalued publicly-traded firms may choose to raise equity capital either through a public offering or the private equity placement (PIPE). Public equity issues are underwritten, registered with the Securities and

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http://dx.doi.org/10.1016/j.frl.2012.12.001

Exchange Commission (SEC), and then sold to a large number of investors; in contrast, private equity issues are typically negotiated directly with a single investor or small group of investors without SEC oversight. Regardless of the method of issuance, Ritter (1991) and Loughran and Ritter (1995) suggest that in making the decision to issue equity, managers will attempt to take advantage of 'windows of opportunity', at times when the market is overly optimistic about the future prospects of the firm.

Since public firms engaging in the PIPE may communicate valuable information directly to private investors and incur greater monitoring by such investors, announcements of private sales of equity, on average, are associated with positive stock price effects (Wruck, 1989; Hertzel and Smith, 1993; Hertzel and Rees, 1998). Wruck (1989) suggests that the positive announcement effect is partially ascribed to changes in ownership structure of the firm where the new private investors are expected to exert value-enhancing monitoring and/or expert advice. Hertzel and Smith (1993) indicate that positive stock price reactions reflect favorable information about firm value and private placement discounts reflect information costs borne by private investors. In a similar vein, Hertzel and Rees (1998) suggest that private equity issues convey favorable new information to investors and that the information is about changes in the level of future earnings.

However, PIPE firms typically experience negative long-run performance following the placements. Hertzel et al. (2002) argue that this pattern is caused by investor over-optimism about the firm prospects at the announcement of a private sale. Since investors appear to be overly optimistic about the potential that the performance will improve in the future, they are then disappointed when such an improvement fails to materialize. While the poor post-announcement performance of PIPE firms is well documented, there is little direct evidence on the overly optimistic expectations explanation for this underperformance. To the extent that analysts' forecasts provide a better surrogate for market expectations (Fried and Givoly, 1982), this paper attempts to explore whether analyst forecasts at the time of PIPE are the source of over-optimism amongst investors and how they relate to the long-run performance of these firms. By so doing, we throw more light on the reason for the long-run underperformance of PIPE firms.

It is noted within the prior literature that analyst forecasts or recommendations are both valuable and informative to investors, since they help investors to reach their strategic investment decisions (Fried and Givoly, 1982; Lys and Sohn, 1990). Irvine (1994) documents a discernible increase in trading volume and brokerage market share after an investment report is released by a brokerage firm. Investors clearly appear to make adjustments for potential biases in the forecasts and recommendations provided by analysts.

There is, however, one concern for analyst forecasts. As argued in prior research (i.e., Abarbanell, 1991), analysts tend to make over-optimistic forecasts which are quite effective in generating retail trading volume. Investors can act on a positive buy recommendation, at relatively low cost, by buying the stock; in contrast, the ones who already own the stock or are willing to incur the additional costs of short selling can act on negative reports (Cowen et al., 2006). Since brokerage firms arguably link the compensation paid to analysts to the commission on the stocks that they cover, analysts are encouraged to provide optimistic forecasts to attract investors to purchase shares. Dugar and Nathan (1995) and Lin and McNichols (1998) argue that the over-optimism may be partially due to the fact that analysts work for investment banks which have a relationship with the firm being analyzed, and therefore issue optimistic forecasts for fear of jeopardizing the relationship. McNichols and O'Brien (1996) also argue that the over-optimism may stem from a selection bias, with analysts typically following stocks for which they have a preference.

Prior studies also indicate that the over-optimistic analyst forecasts may result in inferior subsequent performance. For example, Dechow et al. (2000) demonstrate that long-term forecasts by sell-side analysts are systematically overly optimistic around the time of the equity offerings. They also note that those analysts employed by the lead managers of the offerings will tend to make the most optimistic growth forecasts. Rajan and Servaes (1997) find that initial public offerings perform poorly in the long run when analysts are more optimistic about their long-term growth prospects. Teoh and Wong (2002) also suggest that when analysts readily accept the information provided by the equity issuers, their future earnings forecasts will tend to be over-optimistic, where investors who naïvely rely on such analyst forecasts will, in turn, overvalue the firms. Given the above evidence,

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