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Overreaction in the thrift IPO aftermarket

Geoffrey C. Friesen [a,*], Christopher Swift [b]

[a] Department of Finance, University of Nebraska-Lincoln, 237 CBA, Lincoln, NE 68588-0490, United States
[b] Department of Business, Accounting, and Economics, Nebraska Wesleyan University, 5000 St. Paul Ave. Lincoln, NE 68504-2794, United States

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ABSTRACT

We study the initial returns and long-run performance of a unique sample of thrifts that have recently converted from mutual to stock form. In addition to a full claim on all IPO proceeds, new investors in a converted thrift also receive a claim on all pre-conversion market value at no cost. Thus, the average firm in our sample has a degree of underpricing automatically built into its offer price. We find that after removing the large initial returns, cumulative excess returns for the firms in our sample are positive for 12 months after the IPO. Beginning in the second year after the IPO, the average firm in our sample undergoes a significant price correction that lasts approximately 18 months and which produces negative cumulative abnormal returns for up to 5 years post-issue. Differences in risk-adjusted returns also indicate negative long-run returns, with poor performance concentrated in the second and third years following the IPO. The return differences are most pronounced among the small thrifts in our sample, and are broadly consistent with investor overreaction at the time of the IPO that continues for 6–12 months before prices begin reverting back to fundamental value.

1. Introduction

The IPO market is a natural place to examine aggregate investor behavior following a large, discrete stock price change, since the average IPO has a first day return of between 10% and 20% (depending on the time period examined). The cause of the large initial returns is not well understood. Some suggest that the large initial returns result from initial undervaluation, in which case the first-day return simply reflects an adjustment from the offer price to the fundamental value. Others suggest that initial returns reflect investor overreaction to new information on the first day of trading.[1]

Ritter and Welch (2002) document that positive first-day returns are followed by long-run underperformance. One explanation is that negative long-run returns are the result of overreaction to new information on the initial day of trading: Overreaction drives prices above fundamental value, but in the long-run prices converge to fundamental value, and the long-run abnormal returns (excluding the first-day return) are negative.[2]

However, negative long-run returns can be attributed to investor overreaction only if one knows that the IPO was not initially overvalued. Recent work by Purnanandam and Swaminathan (2004) suggests that IPOs are actually overvalued at issue by as much as 50%. In light of this statistic, one cannot attribute negative long-run returns to post-IPO investor overreaction, since the negative returns may simply result from initial overpricing.

We contribute to the study of post-IPO investor overreaction by studying the long-run return properties of a unique set of 221 thrifts that converted from the mutual to stock form of ownership between 1993 and 2000. When thrifts convert from mutual to stock ownership, the original owners (depositors) lose their ownership rights and their entire claim on pre-conversion equity is transferred to the IPO investors at no cost.[3]

Thus, the new shareholders have ownership rights that include all IPO proceeds plus all of the pre-conversion market value of the thrift. In contrast, the new shareholders in a typical IPO have a claim on only a proportion of the pre-conversion market value. If we

* Corresponding author. Tel.: +402 472 2334; fax: +402 472 5144.
E-mail addresses: gfriesen2@unl.edu (G.C. Friesen), cls@nebrwesleyan.edu (C. Swift).

[1] We do not equate "underpricing" with the initial return, as is commonly done in the literature. We refer to first day returns as such, and use the term "underpricing" only to refer to situations where the IPO price is known to be below the firm's fundamental value (described in more detail below).

[2] Ritter and Welch (2002) suggest it may also reflect a failure to adequately control for firm characteristics.

[3] Prior to conversion, mutual thrift depositors are fixed claimants with apparent ownership rights to residual equity. However, Smith and Underwood (1997) discuss that although the residual profits of a mutual thrift belong collectively to depositors, they are individually unable to exercise their rights as equityholders. In other words, mutual depositors are unable to withdraw the mutual thrift's residual profits. If the thrift converts to a stock organization using the sale-of-stock method, depositors have priority in purchasing shares in proportion to their deposited assets. Depositors who choose not to purchase shares are no longer owners but simply fixed claimants with no ownership rights.

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assume positive pre-conversion market value, then by construction the converting thrift IPO is underpriced. In other words, it is not possible for the valuation to be 'correct' since IPO investors always receive assets (IPO proceeds plus pre-conversion market value) worth more than the IPO proceeds. Peter Lynch once remarked that from the perspective of the IPO investor, this was equivalent to buying a house, moving in, and finding the seller had left the sale proceeds in the house for the buyer to keep (Wilcox and Williams, 1998). Many investors understand *ex ante* that this underpricing exists and is unique to thrift demutualizations, although the exact magnitude is not observable. It is not a feature of standard IPOs, bank IPOs or insurance company demutualizations.

The following example illustrates how the built-in underpricing is unique to mutual-to-stock thrift IPOs. Assume two thrifts that are identical except one is privately held and one is organized as a mutual. Without loss of generality, assume the private firm has 100,000 shares; mutual thrifts do not have ownership shares. Further assume that both firms have $500,000 of book value equity prior to their IPO and that both firms will raise capital by selling 400,000 shares to outside investors. The key difference is that the new shareholders of the mutual thrift have a claim on all pre-conversion equity while the new shareholders of the private thrift have a claim on only a proportion of pre-conversion equity.

The current owner of the private thrift owns all 100,000 shares and will sell 400,000 new shares (80% of the company) for expansion resulting in 500,000 shares after the offering. Investment bankers assist the owner in determining the market valuation of the company and estimate the post-conversion market value to be approximately $5,000,000; the IPO is fairly priced by setting the issue price at $10 per share. This means the company will collect approximately $4,000,000 when the shares are sold (less investment banking fees), and the tangible per share book value of the firm will rise from $5.00 prior to the IPO to $9.00 after.[4] Moreover, assuming that the estimated market value of $5,000,000 is correct, the post-conversion per share market value equals the initial price of $10.

The mutual-to-stock IPO involves selling 400,000 shares at the IPO price of $10, with stock proceeds (less fees) of approximately $4,000,000. In contrast to the private-to-stock conversion, the original owners (depositors) have no shares in the converted firm and are effectively stripped of their claim on pre-conversion equity. The pro forma tangible book value per share following the IPO is $11.25 which represents an immediate increase of $1.25 or 12.5% to new shareholders. A post-conversion market value of $5,000,000 results in a share price of $12.50, and the IPO is therefore underpriced at issue by approximately 25%. In other words, a mutual-to-stock thrift conversion results in a direct transfer of wealth to new shareholders at the expense of the original owners (depositors). In fact, as long as the pre-conversion market value of the firm is positive at the time of conversion, Colantuoni (1998) demonstrates that the IPO will be underpriced and a transfer of wealth will occur regardless of the IPO offer price.

The above example illustrates why we know the average issue is not overpriced and why our sample of firms is uniquely suited to test for investor overreaction. For example, since negative abnormal returns can occur only after price rises above fundamental value, any negative long-run risk-adjusted returns observed in our sample must result from investor overreaction to information at some point after the IPO, assuming the thrift was solvent prior to conversion. In particular, negative long-run returns relative to the first-day closing price indicate investor overreaction on the initial trading day. In contrast, if investors initially underreact to information, all long-returns will be positive when measured relative to the first-day closing price. Overreaction after the initial trading day will produce negative returns only during the later, post-issue sub-periods when prices correct.

We find that our sample of converting thrifts demonstrates large first day excess returns of 17.9%; however, even the large magnitude of this initial return need not imply investor overreaction or initial underpricing. Thus, we examine post-IPO cumulative abnormal returns (which exclude the large initial return) to gauge whether investors overreact on the day of the IPO. We find positive cumulative abnormal returns over the first 12 months following the IPO, but negative cumulative abnormal returns at all horizons longer than that. The results suggest that investors overreact on the initial day and possibly during the subsequent 12 months of trading, which is consistent with the results of Purnanandam and Swaminathan (2004).

If prices eventually converge to fundamental value, any overreaction must be followed by negative sub-period returns during a corrective phase. Therefore, analyzing sub-period returns provides insight into the specific timing of overreaction and subsequent correction. We examine returns over 6 month sub-periods for 5 years post IPO, looking at both market adjusted excess returns and alphas from the various factor models mentioned above. Excess returns are significantly positive for the first 6 months after the IPO, and approximately zero in the subsequent 6-month period. This suggests that overreaction continues for approximately 6 months beyond the initial day of trading. It is worth emphasizing that although investors overreact during the first 6 months of trading, nearly all of the overreaction occurs on the initial day of trading.

However, within 12 months following the IPO, the average thrift begins to experience a price correction or mean-reversion towards fundamental value, as measured by negative excess sub-period returns. This correction lasts for approximately 18 months, after which time the sub-period excess returns are approximately zero. Thus, the thrifts in our sample appear to go through a cycle of overreaction and subsequent correction after the IPO. The initial day of trading, as well as the first 6 months after the IPO, are characterized by investor overreaction. Prices stabilize during the following 6-month period then begin a correction process which lasts about 18 months. We also examine differences in risk-adjusted returns. While the statistical significance of these results is somewhat weaker, they also demonstrate that the long-run abnormal returns are negative, and that the poor performance is concentrated in the second and third years following the IPO. In addition, the return differences are most pronounced among the smaller thrifts in the sample.

Our study is among the first to examine the long-run performance of these converted thrifts in detail[5] and is similar to recent

[4] This represents an immediate increase in pro forma tangible book value of $4.00 per share to the existing shareholder and an immediate dilution of $1.00 per share to new shareholders. Thus, new shareholders are investing approximately $1.00 in the present value of growth opportunities of the thrift. While smaller in magnitude, this is consistent with the results of Chung et al. (2005) who document that a large percentage of the IPO offer price reflects the present value of growth opportunities.

[5] Two exceptions are Ritter (1991) and Houge and Loughran (1999), though neither of those studies analyzes the returns for thrifts separately from other financial institutions. Ritter (1991) documents long-run overperformance over a 3-year holding period for financial institutions (banks and thrifts) that went public during the period 1975–1984. In contrast, Houge and Loughran (1999) found that a sample of banks and thrifts that went public from 1983 to 1991 significantly underperformed over a 5 year holding period. In addition, initial thrift returns have been examined by Pettigrew et al. (1999) and Wilcox and Williams (1998). Maksimovic and Unal (1993) study the relation between IPO pricing, first-day returns, and depositor and insider purchases, and find that greater insider ownership predicted higher initial returns. Esty (1997) and Kroszner and Strahan (1996) examine regulatory incentives to convert to stock form. Unal (1997) looks at the appraisal process and how it relates to initial IPO windfall gains. Masulis (1987) looks at probability a firm will convert as a function of thrift size, recent growth and non-interest income. Cole and Mehran (1998) study the performance of converted thrifts before and after expiration of anti-takeover amendments.