Journal of Financial Economics 103 (2012) 61–87

Contents lists available at SciVerse ScienceDirect

Journal of Financial Economics

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

When do high stock returns trigger equity issues? ☆

Aydoğan Altı [a,*], Johan Sulaeman [b]

[a] University of Texas at Austin, United States
[b] Southern Methodist University, United States

ARTICLE INFO

Article history:
Received 18 March 2009
Received in revised form
14 January 2011
Accepted 21 March 2011
Available online 3 September 2011

JEL classification:
G32

Keywords:
Market timing
Seasoned equity offerings
Institutional investors

ABSTRACT

One of the most prominent stylized facts in corporate finance is that equity issues tend to follow periods of high stock returns. We document that firms exhibit such timing behavior only in response to high returns that coincide with strong institutional investor demand. When not accompanied by institutional purchases, stock price increases have little impact on the likelihood of equity issuance. The results highlight the importance of market reception for the timing of equity issues.

© 2011 Published by Elsevier B.V.

1. Introduction

It is well-known that equity issues tend to follow periods of high stock returns. A firm's recent stock return is, in fact, a better predictor of its equity issuance behavior than most other factors that are relevant for financial policy. These observations have led many researchers to suggest that firms' equity issue decisions are largely driven by market timing considerations. Indeed, equity market timing is often described as the practice of issuing shares following a substantial runup in the stock price.[1]

In this paper, we take a closer look at the timing of equity issues and find that issuers do not respond to stock returns per se. High stock returns trigger equity issues when coupled with strong demand from institutional investors. When not accompanied by institutional purchases, high returns have little impact on the likelihood of equity issuance. In other words, potential issuers appear to treat stock returns and institutional investor demand as highly complementary factors.

The broad motivation behind our analysis is to understand the timing considerations equity issuers face in practice. While studies on market timing primarily focus on the impetus from high stock prices, practitioners often cite "market reception" as a key factor in deciding when to issue equity. A receptive market is described as one where equity can be issued at or close to the prevailing stock price—that is, without moving the stock price significantly downward. Practitioners' notion of market reception is clearly related to adverse selection-based theories of equity issuance, a link we further discuss below. Our basic objective in this paper is to identify an operational measure of market reception that can help characterize issuance behavior in the data.

☆ We would like to thank Andres Almazan, Malcolm Baker, Ron Masulis (the referee), Jay Ritter, Sheridan Titman, Jeffrey Wurgler, and the seminar participants at the 2008 AFA Meetings, Stanford, Texas A&M, University of Illinois at Urbana-Champaign, University of Texas at Austin, Wharton, and Koc University for their helpful comments and suggestions.

* Corresponding author.
E-mail addresses: aydogan.alti@mccombs.utexas.edu (A. Altı), sulaeman@smu.edu (J. Sulaeman).

[1] See Section 2.1 for a review of prior empirical work on equity market timing.

0304-405X/$ - see front matter © 2011 Published by Elsevier B.V.
doi:10.1016/j.jfineco.2011.08.007

The specific measures that we utilize relate to institutional investor demand. We argue that recent institutional demand for a firm's stock is an important indicator of the market's likely reception of an equity issue by that firm. Institutional investors are generally considered to be sophisticated and better-informed; as such, their aggregate demand conveys information to the market. Strong institutional demand for a firm's stock reveals that several institutions have scrutinized the firm recently and then decided to buy its stock. This is likely to act as a certification regarding the firm's market valuation, alleviating adverse selection concerns and making the market more receptive to an equity issue at the prevailing stock price. Conversely, firms with attractive valuations but weak institutional demand may shy away from issuance, fearing that an issue decision may put substantial negative pressure on the stock price. These considerations motivate our focus on institutional investor demand as a potentially useful indicator of market reception.

Our empirical analysis concerns seasoned equity offerings (SEOs) and proceeds in two parts. In the first part we analyze the decision to conduct an SEO. As discussed above, our main finding in this regard is that high stock returns are more likely to trigger SEOs when accompanied by strong institutional investor demand. In particular, the issuance decision is highly sensitive to the strength of demand from new institutional shareholders (i.e., those that initiate positions in the stock). To give a sense for magnitudes, the unconditional per-quarter probability that a firm announces an SEO is 1.46% in our sample. When the previous-quarter stock return is in the top quintile of its distribution but new institutional holdings are in the bottom quintile of their distribution, the SEO announcement probability is 1.49%, which is close to the unconditional likelihood. However, when both the stock return and new institutional holdings are in their respective top quintiles, the SEO announcement probability jumps to 5.03%. Additional tests on other dimensions of the equity issuance decision confirm the positive response of issuers to institutional demand. Firms with higher values of new institutional holdings are not only more likely to announce SEOs, but also do so more quickly (i.e., announce earlier within a quarter), spend less time between the announcement and the offer, and raise substantially more in offer proceeds.

The findings discussed above are consistent with equity issues responding to institutional investor demand, but they may also reflect spurious correlations. A particular concern is that institutional demand is correlated with firm characteristics that affect the likelihood of equity issuance. While we control for a large set of observable firm characteristics in Probit regressions that predict SEO announcements, institutional demand may nevertheless reflect proprietary information that is not captured by observables. For example, it is possible that institutions identify firms with improving investment opportunities and purchase their stocks with the hope of profiting once firms' prospects become publicly known. It could then appear as if institutional demand predicts equity issuance, whereas in fact, both variables are driven by investment opportunities.

To address this potential concern we devise a number of tests. First, we analyze firms' investment expenditures and debt issuances in relation to institutional demand. If high-institutional demand firms are more likely to issue equity due to improved investment opportunities, then these firms should exhibit increased investment rates and possibly increased used of debt as well. We find that this is not the case; the strong institutional demand effect on equity issues does not carry over to changes in investment rates or debt issuance. Second, we replicate our main tests for (i) SEOs that are not intended for capital-raising purposes, and (ii) subsamples of firms that are unlikely to need external capital for financing investment. Examples of (i) are offers where the filing states non-investment purposes such as "shareholder use," or offers that include a high fraction of secondary shares owned by existing blockholders. An example of (ii) is the sample of firms with net financing surpluses. In all cases the findings parallel those from the base-case analysis.

Additional results shed further light on the relevance of institutional investor demand for the equity issuance decision. Equity issues respond strongly to spikes in new institutional holdings, but they do not significantly relate to the trading behavior of existing institutional shareholders. In an attempt to understand why new holdings matter, we analyze the size properties of these purchases. We find an increased frequency of large purchases during episodes of elevated new holdings. To the extent that they are regarded by the market as indications of informed trading, such large purchases may facilitate the certification role of institutional demand that we hypothesize.

We also explore how potential issuers obtain information about institutional demand. Anecdotal evidence suggests that firms utilize the help of their investment bankers in gauging demand conditions for their stocks. Investment banks that also provide prime brokerage services are of particular interest in this regard, since these banks have access to privileged information about their institutional clients' demand. Using a sample of firms with past underwriting relationships to prime broker investment banks, we analyze how the equity issuance decision responds to client versus non-client institutional demand. We find that new holdings by institutional clients of the firm's relationship bank do a much better job of predicting SEOs than new holdings by other institutional investors.

The second part of the analysis focuses on stock returns around and following the equity issuance decision. Of particular interest is the market's reaction to the SEO announcement, both immediate and during the announcement-to-offer period. Our main finding in this regard is that high-institutional demand issuers are able to sustain their stock prices at pre-announcement levels. As is well-known, SEO announcements generate negative stock price reactions, on average. This initial price reaction is negative in our sample as well, and similar for high- and low-institutional demand issuers. However, while stock prices continue to decline for low-institutional demand issuers until the offer date, they fully rebound from the initial negative reaction for high-institutional demand issuers. In other words, high-institutional demand issuers are able to complete their

Download English Version:

https://daneshyari.com/en/article/959583

Download Persian Version:

https://daneshyari.com/article/959583

Daneshyari.com