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# Do underwriters matter? The impact of the near failure of an equity underwriter

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## ABSTRACT

The financial crisis provides a natural experiment for testing theoretical predictions of the equity underwriter's role following an initial public offering. Clients of Bear Stearns, Lehman Brothers, Merrill Lynch, and Wachovia saw their stock prices fall almost 5%, on average, on the day it appeared that these institutions might collapse. The decline was more than 1% lower than the abnormal return of other newly public companies, representing a loss in equity value of almost \$3 billion. The price impact was worse for companies with fewer monitors, suggesting that underwriters play an important role in monitoring newly public companies. The abnormal return is more negative for clients that are also lending clients, but is not significantly associated with the role of the underwriter as market maker or counterparty to investors.

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## 1. Introduction

Firms pay high fees to banks that underwrite their initial public offerings.<sup>1</sup> Beatty and Ritter (1986) and Carter and Manaster (1990) propose that these fees are compensation for underwriter reputation to certify the offer price. Hansen and Torregrosa (1992) suggest that firms also pay for monitoring after the IPO, which underwriters undertake in order to protect their reputation. However, if banks become financially distressed, clients will suffer from the loss of underwriter monitoring. Furthermore, if banks are too weak to commit credibly to monitor newly public companies, access to equity finance may be negatively impacted. It is difficult to verify whether underwriting fees contain compensation for

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<sup>1</sup> Jenkinson and Ljungqvist (2001) cover aspects of IPOs in detail. Specifically, Chen and Ritter (2000) document spreads of 7% for equity offerings and Hansen (2001) finds evidence for 7% as an efficiently contracted price. Ritter (2003) tabulates initial returns ranging from 6.3% to 256.9% for 38 countries and of 18.4% in the US.

post-IPO monitoring because it is impossible to directly observe the monitoring component of the fee, which could be related to the certification component, and the choice of underwriter and fee are jointly determined.

In this paper, I report results from testing for underwriter monitoring using the collapse of Bear Stearns, Lehman Brothers, Merrill Lynch and Wachovia in the financial crisis of 2008 as a natural experiment. Because these failures (and near failures) were largely unanticipated, the monitoring hypothesis predicts that clients of these firms should suffer unanticipated losses from the unexpected end of post-IPO underwriter monitoring. Event date returns are thus a plausible measure of the value of underwriter monitoring, and show how banks' financial distress can be costly for their clients. However, this measure may understate benefits of monitoring because it leaves out benefits that could occur closer to the IPO and because monitoring done by individual investment bankers may continue when they move to other employers.

I find that troubled underwriters' clients stock prices fell by almost 5% when it appeared that their IPO underwriter might collapse. Market model predicted single day abnormal returns are 1% lower for troubled underwriter clients than for other newly public companies.<sup>2</sup> Excess equity value losses associated with underwriting clients of Bear Stearns, Lehman Brothers, Merrill Lynch and Wachovia amount to more than \$3 billion, in total. This compares to a total of at most \$2.5 billion in gross equity underwriting fees earned by these underwriters on these companies' IPOs.<sup>3</sup> This implies that post-IPO underwriter monitoring is worth more than the initial IPO underwriting fees earned.

There is variation in the amount of clients' underperformance. The amount of underperformance is related to cross-sectional differences in the importance of underwriter monitoring. Firms which need less monitoring, such as firms with high institutional investor ownership or large blockholders, have less negative returns. Abnormal returns are also less negative for clients the longer the time elapsed since the client's last equity issuance. This is consistent with the theoretical model of Hansen and Torregrosa (1992). Post-IPO monitoring is more than just equity analyst coverage, because companies with analyst coverage from but not underwritten by these troubled investment banks do not underperform by as much.

The amount of underperformance also is associated with some proxies for clients' dependence on equity financing. Event day returns are less negative for companies with more cash. This finding is similar to James (1992) who proposed that underwriters possess relationship-specific information similar to that of commercial banks and auditors.

The loss of an equity underwriter appears to be more important than the possible loss of other services provided by the troubled underwriters. Event date returns for market making and lending clients of these banks are not consistently or statistically significantly negative. It is only equity underwriting clients that have statistically significant negative abnormal returns. This result is complementary to Fernando et al. (forthcoming) detailed analysis of the failure of Lehman Brothers, in which they find that the only clients affected by its failure were equity underwriting clients. Within IPO underwriting clients, companies that borrowed from their IPO underwriter have more negative returns, although returns for IPO clients that did not borrow from their underwriters are still negative and statistically significant. While Aragon and Strahan (forthcoming) find reduced liquidity for investments of hedge funds that had Lehman Brothers as their prime brokers, IPO underwriting clients owned by prime brokerage clients of Lehman Brothers and Bear Stearns do not have disproportionately lower returns.

If negative event day returns reflect investors' reassessment of quality due to underwriters' distress, there should be no positive price impact from the resolution of this distress. While it appeared on the event dates that Bear Stearns, Lehman Brothers, Merrill Lynch and Wachovia might cease operations, each equity underwriter subsequently was acquired. Client firms' abnormal returns were more than

<sup>2</sup> Expanding the event window to include -1 and 0 results in a cumulative abnormal return (CAR) of -0.7% vs. the DGTW characteristics model and -2.8% vs. the Fama French three-factor model. Expanding the event window to include -1, 0 and +1 results in a CAR of -1.5% vs. the DGTW characteristics model and -2.5% vs. the three-factor model. Expanding the event window to include -2, -1 and 0 results in a CAR of -1.2% vs. the DGTW characteristics model and -3.9% vs. the three-factor model. In each case the difference between the CAR and 0 is statistically significant.

<sup>3</sup> Detailed fee information was not available from SDC for every offering. Assumes underwriters earned 7% of gross IPO proceeds of \$48 billion for the sample companies, divided by an average of 1.35 book underwriters per IPO. Fees earned by these underwriters are likely lower because aggregate fees are split among the underwriting syndicate, not just book underwriters.

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