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An agency theory explanation of SEO underperformance: Evidence from dual-class firms

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ABSTRACT

Using a sample of U.S. dual class companies, we empirically investigate the effects of the divergence between insiders' voting and cash flow rights on market reaction to seasoned equity offerings (SEOs) and long-run stock performance following SEOs. We find that SEO announcement returns and long-run stock performance following SEOs are negatively related to measures of the divergence between insiders' voting and cash flow rights. Our results support the view of agency theory as a plausible explanation of SEO underperformance. Misalignment of interests between insiders and outside shareholders can create managerial incentives to undertake value-destroying investments to extract private benefits, ultimately leading to a reduction in firm value.

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1. Introduction

The market reaction to seasoned equity offerings (SEOs) has been the focus of a number of empirical studies, the overwhelming evidence suggesting a negative stock price reaction to SEO announcements. The existing literature offers several explanations for this negative reaction. The Leland and Pyle (1977) signaling theory suggests that sales of shares by insiders signal that they believe that the shares are overpriced. Myers and Majluf (1984) extend this theory by arguing that issuing equity should be the least preferred choice of firms to raise capital since the mere act of issuing equity conveys a negative signal about the true value of the firm. Jung et al. (1996) provide a theory of agency costs for the negative

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reaction. They argue that when interests of managers and shareholders are not aligned, managers may pursue value-destructive investments to increase their private benefits, which decrease firm value. Therefore, investors react negatively to SEO announcements due to the concern about the potential misuse of funds raised in the SEOs.

In this paper, we explore the effect of the divergence between insiders' voting and cash flow rights on the market reaction to seasoned equity offering (SEO) announcements and long-run stock performance following SEOs. We focus on the SEOs by dual-class firms since they provide a unique framework where we can disentangle the effect of insiders' voting and cash flow rights on firm value. To the extent that investors are concerned about agency problems and the potential misuse of funds raised in the SEOs, we expect that market to react more negatively to SEO announcements as the divergence between insiders' voting and cash flow rights becomes larger. Moreover, the misalignment of interests between insiders and outside shareholders can create managerial incentives to pursue private benefits and undertake value-destroying investments, which decreases firm value. Therefore, we expect that the long-run stock performance following SEOs be negatively related to the divergence between insiders' voting and cash flow rights.

The agency theory explanation of SEO underperformance can be traced back to the early and seminal work of Jensen and Meckling (1976), who argue that high managerial equity ownership in firms foster a better alignment of managerial interests with those of shareholders and helps in alleviating the agency problem associated with the separation of ownership and control. They argue that managers bear a larger proportion of the costs of shirking, consumption of perquisite and other value-destructive actions as their ownership increases. Their paper focuses primarily on cash flow rights that are inherent in equity ownership. However, higher control or voting rights due to increased ownership can entrench management, resulting in a lower alignment of interests between managers and minority shareholders and thus increase agency cost (Gompers et al., 2008). Since the effects of cash flow rights and control rights are not easily separable, researchers face a challenging task in investigating empirically the effect of managerial ownership on firm value.

The unique ownership structure of dual-class firms, which usually implies significant divergence between voting rights and cash flow rights, allows us to examine the different effects of voting (or control) rights and cash flow rights. To the extent that the wedge between voting and cash flow rights reflect agency cost, analyzing SEOs by dual-class firms allows us to relate SEO underperformance to a measure of agency cost.

In a typical dual-class firm, there are two classes of stocks, which are a publicly traded inferior class of stock with one vote per share and a non-publicly traded superior class of stock with multiple votes per share. The superior class of stock is usually held by management. The divergence between insiders' voting and cash flow rights implies that managers' interests are less aligned with shareholders interests thus creating incentives for managers to extract private benefits at the expense of shareholders, ultimately leading to a reduction in firm value. Consistent with this line of reasoning, Gompers et al. (2008) and Masulis et al. (2007) show that the divergence between insiders' voting and cash flow rights exacerbates the agency problems between managers and shareholders.

When it comes to a comparison between single and dual-class firms, Megginson et al. (2008) argue that signaling and agency theory provide conflicting predictions regarding SEO announcement returns. They argue that signaling theory predicts that markets react more negatively to single-class SEO announcements since SEOs by single-class firms make the insiders incur the cost of diluting voting rights at a faster rate and thus signal more overvaluation than SEOs by dual-class firms. On the contrary, agency theory predicts that market react more negatively to dual-class SEO announcements because of the misaligned interests between insiders and outside shareholders in dual-class firms. Since both of these confounding effects could occur simultaneously, the comparison of SEO market reactions between single and dual class firms remains ultimately an empirical question. Megginson et al. (2008) find no significant difference in SEO announcement returns between single and dual-class firms.

We find that SEO announcement returns are negatively related to the divergence between insiders' voting and cash flow rights. We also find that three year abnormal buy-and-hold returns following SEOs are also negatively related to the divergence between insiders' voting and cash flow rights. Finally, we find that the zero-cost investment strategy that bought firms that had below median value of the

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