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Corporate governance and long run performance of seasoned equity issuers

Wassim Dbouk[a], Ahmad Ismail[b,*]

[a] Suliman S. Olayan School of Business, American University of Beirut, Lebanon
[b] College of Business and Economics, United Arab Emirates University, P.O. Box 17555, Al-Ain, United Arab Emirates

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ABSTRACT

This paper examines the effect of corporate governance on the likelihood of issuing Seasoned Equity Offerings (SEO) between 1990 and 2005. It also examines the long-run post-issue performance using operating and stock return measures. Our results suggest that well-governed firms are less likely to issue equity. Nevertheless, when they do so, they outperform both matching non-issuers and issuers with minimal shareholders' rights from pre- to post-issue—with the highest operating out-performance occurring in the two post-issue years. A negative correlation exists between the post-issue performance and the anti-takeover measures, primarily, the protection associated with management entrenchment. Nonetheless, measures of board structure do not appear to affect the post-issue operating performance. Overall, corporate governance appears to be an effective internal control mechanism that restrains managers' incentives to either take an SEO issuance decision that does not serve the interests of shareholders or invest the capital raised in value-destroying projects.

1. Introduction

The long-run underperformance of seasoned equity offerings (SEOs) has received wide attention in academic research. Information asymmetry between managers and outsiders and/or expectations of decline in future earnings are two suggestions that scholars have advanced in order to explain equity-

* Corresponding author. Tel.: +971 3 7133162.
E-mail addresses: phd98ai@yahoo.com, ahmadismail@uaeu.ac.ae (A. Ismail).

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issuance decisions that are value-destroying (Myers and Majluf, 1984; Miller and Rock, 1985). Jung et al. (1996) have a different perspective and argue that agency problems are the most powerful factors pushing managers to make suboptimal decisions to issue equity over debt. In fact, the unfavorable reaction to SEOs and the subsequent underperformance are found to be associated with management entrenchment (Fields and Mais, 1994) and agency problems of free cash flow that induce managers to accept negative net present value (NPV) projects (McLaughlin et al., 1996). Teoh et al. (1998) at least partly attribute the underperformance to the manipulative behavior of managers observed prior to the SEOs. This deceptive behavior translates into having managers borrowing future returns to inflate current earnings prior to the issue. Such earnings management, according to Jensen (2004, 2005), is attributable to agency costs of overvalued stock which induce managers to inflate earnings in order to keep up with the expectations of investors and analysts which are often exploited to issue shares at premium prices (Jensen, 1986).

The benefits of corporate governance extend to a general framework where the incorporation of internal control mechanisms that monitor managers' activities and limit their power can align managerial decisions with the interests of shareholders. Bryan et al. (2004), Niu (2006) and Cornett et al. (2008) document the role of these practices in the scrutiny of the financial reporting process, improvement of the quality of earnings and reduction of the amount of earnings management. In the absence of provisions that reinforce the protection and power of managers, firms also see improvements in operating performance and superior valuations (Gompers et al., 2003; Brown and Caylor, 2004; Bebchuk et al., 2004). Even investors have been reported using the existence of good governance practices as an important criterion in selecting stocks.

Nevertheless, it remains unclear whether corporate governance structures are effective in mitigating the severe agency problems faced by SEO issuers. In light of the documented long run underperformance of SEO firms, we find it important to investigate whether corporate governance prevents managers from issuing SEOs and investing the proceeds in value-destroying projects. To capture the effect of the governance structures, we used two measures: The first is the G-index introduced by Gompers et al. (2003) that accounts for the level of shareholder rights in a firm. The second is the GOV7 index introduced by Aggarwal et al. (2009) who identified seven important governance attributes of which many are related to the board structures. The decision to investigate the effect of the GOV7 index is mainly due to the concern that the G-index, as a general governance index, may fail to account for many board structure measures. Thus, this paper examines the impact of governance on the probability of SEO issuance and the subsequent long-run post-issue performance. We base our research on operating long-run performance given that Gompers et al. (2003) show that investors do not always properly understand the relationship between the value of the firm and its governance structure. Core et al. (2006) used the same reasoning to propose that operating performance is a more representative measure for investigating corporate governance and performance. Moreover, many earlier studies such as Brav et al. (2000) and Eckbo et al. (2000) find no relationship between the long term stock returns and SEO issuance.[1]

Our results suggest that when governance structures – as captured by the G-index – are in place, managers are less likely to issue an SEO. But even if such a decision is made, it is more likely to lead to a higher operating performance in the future: strong governance structures are often associated with positive abnormal changes in post-issue performance. Furthermore, these abnormal changes in performance outweigh those of weakly governed issuers, particularly in the year following the seasoned offering. We also find a negative relation between the G-index rank and the post-issue abnormal performance after controlling for factors previously documented to influence SEO performance. The observation that each component group of the G-index affects the post-issue performance of SEO firms strongly argues in favor of the effectiveness of corporate governance in mitigating agency costs,

[1] We have investigated the relationship between the governance structure and stock return for SEO issuers. Our results show that there is no relationship between the holding period returns over the long run and G-index. However, we do not report our results because they add too much length to the paper. These results are consistent with the notion that investors fail to understand fully the relationship between the governance structure and the value of the firm. For instance, Gompers et al. (2003) show that investors can generate abnormal returns by buying firms that are not well governed. Also, investors can reap abnormal returns by selling well governed firms.