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Does market timing persistently affect capital structure? Evidence from stock market liberalization

I-Hsiang Huang *

Department of Finance, National University of Kaohsiung, No.700, Kaohsiung University Road, Nan-Tzu District 811, Kaohsiung, Taiwan, ROC

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ABSTRACT

Utilizing stock-market liberalization, we test whether managers exploit favorable market conditions to time their firms' IPOs, and whether or not the timing will have a persistent, negative impact on leverage. Using a sample of 235 Taiwanese IPOs over the 10-year period surrounding the first liberalization in the Taiwan stock market, a high-volatility, high-turnover, high-individual-trading emerging market, we first show that liberalization substantially reduces the cost-of-equity capital. We then provide evidence that the going-public decision for post-liberalization IPOs is consistent with equity market timing, but that it fails to influence the debt ratio.

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1. Introduction

While managers tend to time the equity market when they believe their firms' equity is overpriced (for a survey, see Eckbo et al., 2007), the impact of such timing on capital structure is the subject of current debate. In an influential study, Baker and Wurgler (2002) find that external finance weighted-average market-to-book ratios (EFWAMB) have a persistently negative impact on debt ratios, and thus conclude that capital structure is the cumulative outcome of past attempts to time the equity market; this timing is referred to as the market-timing hypothesis of capital structure. This hypothesis apparently contrasts with the trade-off hypothesis, which asserts that firms will maintain an optimal capital structure that balances various benefits and costs of debt and equity, and with Myers's (1984) pecking-order hypothesis, which predicts that firms first finance new investment from internal cash flows, then by safe debt, followed by risky debt, and that only during financial duress will investment funds be taken from equity.

As to whether equity market timing persistently affects capital structure, mixed empirical evidence fuels this debate. However, a closer look at the evidence, mainly based on samples of U.S. firms operating in a

* Tel.: +886 7 5919499; fax: +886 7 5919329.
E-mail address: ihhuang@nuk.edu.tw.

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well-developed market, indicates that the degree of success in measuring managers' timing attempts is central to achieving convincing tests of the market-timing hypothesis. In this regard, several recent papers (Alti, 2006; Elliott et al., 2007; Kayhan and Titman, 2007; Huang and Ritter, 2009) are devoted to developing new market timing measurements; however, the evidence remains inconclusive. Furthermore, a growing number of studies (Booth et al., 2001; Giannetti, 2003; Fan et al., 2012) provide evidence that institutions have an important influence on firms' capital raising and leverage choices, but so far very little is known about the impact of market timing on leverage in emerging markets with less-developed institutions. Without testing the robustness of the market-timing hypothesis outside the U.S. market, it is hard to determine whether or not debt ratio is indeed driven by equity market conditions.

In light of these issues, this paper attempts to start filling this gap by performing an out-of-U.S.-sample test using stock market liberalization, an experiment that is theoretically associated with a decrease in the cost of equity capital. In particular, we aim to contribute to the literature by testing whether managers of emerging-market firms time their firms' initial public offerings (IPOs) to take advantage of favorable market conditions induced by stock market liberalization and whether this timing, in turn, will have a persistently negative impact on capital structure.

Our focus on emerging market's liberalization helps to shed additional light on the ongoing debate for three reasons. First, allowing managers to engage in equity market timing requires a long period of time for experiencing a significant run-up in stock prices. Equity market liberalization provides just such an environment because much of the relevant literature argues that it may reduce the liberalizing countries' costs of equity (Errunza and Losq, 1985; Merton, 1987; Stulz, 1999). Furthermore, using a market level analysis, Martell and Stulz (2003) provide evidence that investors in emerging markets may be overly optimistic about the liberalization-induced reduction in the cost of equity, thus offering an ideal window of opportunity for managers of firms in liberalizing markets to time the equity market. Using firm-level data, our evidence strongly supports this conjecture, which constitutes the basis of our study. As a result, the market timer we identify in this way directly depends on equity market conditions, and is at the forefront in the testing of the market-timing hypothesis. Our focus on IPO firms to test the equity market timing hypothesis follows Baker and Wurgler (2002) and Alti (2006), who argue that going public should be the single most important equity financing event in the life of a public firm; timing attempts are nowhere more apparent than in the IPO market.

Second, using liberalization to represent an exogenous shock that lowers the equity costs could insulate our empirical work against the endogeneity issue that a firm's IPO decision may be determined endogenously (Ritter and Welch, 2002). Our empirical approach alleviates some of the difficulties in constructing a precise structural equilibrium model, which accounts for the endogeneity of a firm's IPO decision; hence, it offers the possibility of more clear results.

Third, our analysis focuses on ascertaining whether managers perceive the one-shot liberalization-induced decrease in the costs of equity as overpriced; this approach prevents our test from making debatable assumptions as to whether the stock market is inefficient or whether managers can systematically forecast future market returns. Consequently, equity-market liberalization creates an ideal subject for testing the market-timing hypothesis.

Our empirical logic is as follows. As liberalization leads equity market conditions to become more advantageous than they were before, managers' timing attempts should be intuitively stronger for firms going public after liberalization than for firms going public before liberalization. Thus, if managers of post-liberalization IPOs view the equity-cost-decreasing effect of liberalization as overvalued, the market-timing hypothesis predicts that they should time their firms' IPOs to exploit it; this, in turn, will result in a greater decline in their firms' cumulative leverage changes since the pre-IPO year, compared to that of pre-liberalization IPOs. Alternatively, if the trade-off hypothesis holds, then post-liberalization IPOs should issue sufficient debt to offset the leverage-decreasing effects of additional equity issuance motivated by timing intention. As a result, the difference in the cumulative leverage changes between pre- and post-liberalization IPOs after the IPO will not differ from zero; accordingly, equity market timing will fail to influence capital structure.

Using a sample of 235 Taiwanese IPOs that went public from 1986 to 1995, a 10-year period surrounding Taiwan's first stock-market liberalization starting in January 1991, we perform the empirical test in three steps. In order to determine whether liberalization provides an ideal window of opportunity for managers to time their firms' IPOs, we begin by showing that liberalization substantially lowers the cost-of-equity capital for Taiwan-listed firms.

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