
The effect of external financing actions on future stock returns

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Abstract

The thesis analyzes short- and long-run abnormal stock returns following external financing actions on the Swiss stock market during the period 1997-2009. The external financing actions covered in this thesis are IPOs, SEOs, stock buybacks, debt offerings and early debt repayment. In the short run, this analysis finds statistically significant results suggesting that the offering of securities leads to negative, whereas the repurchasing leads to positive abnormal returns. In the long-run two different measures are used: The buy-and-hold abnormal returns approach yields insignificant results and the calendar-time portfolio approach results in significant negative monthly abnormal returns following IPOs and SEOs.

Executive Summary

Hypothesis

According to the irrelevance theory developed by Modigliani and Miller, the market value of a company is not affected by its capital structure. Therefore, the announcement of a pure capital structure change does not affect the market value of the issuing firm (Eckbo (1986)). The irrelevance theory implicitly assumes stock market efficiency (Baker and Wurgler (2000)), where public information gets quickly and completely incorporated into the stock price. On the contrary, most of the recently published event studies reject the efficient market hypothesis.

Two theories explain the cause of abnormal returns: The mispricing and the signaling theory. The mispricing theory argues that the firm acts upon a perceived misvaluation of their stock. For example, if in their view the stocks are overvalued, the firms time the market through the offerings of equity. On the other hand, the signaling theory is developed by Myers and Majluf (1984) and argues that the reasons for abnormal stock returns result from the asymmetric information between the firm and the market. Since external financing actions are costly, the announcement of such an event acts as a valuable signal to the market. They further assume that the abnormal returns are larger following equity actions, given their higher risk of mispricing.

To add to the existing literature, this thesis analyzes the stock returns following five external financing actions: IPOs, SEOs, equity repurchases, debt offerings and debt repurchases. The hypotheses state that external financing actions lead to abnormal future stock returns in the short- as well as in the long-run. The different types of financing actions are expected to result in different abnormal returns. Following the issuance of equity or debt, the subsequent stock returns of the issuing firms are expected have negative abnormal stock returns, whereas the repurchase of equity or debt is anticipated to result in positive abnormal stock returns following the action.

Methodology

This thesis covers the five external financing actions on the Swiss market for the years 1997-2009. The short- and long-run abnormal returns are analyzed with the most common event study methods. The short-run returns are measured as a cumulative abnormal return over a three-day period surrounding the announcement day, using the market model as a proxy for expected returns. On the other hand, the long-run returns are measured over a three-year period with two different approaches: The buy-and-hold abnormal returns approach and the calendar-time portfolio approach. The buy-and-hold abnormal returns approach captures the difference between a portfolio strategy of investing into stocks experiencing financial actions and investing into a benchmark of similar firms not experiencing financing actions. The calendar-time portfolio approach tries to capture abnormal return as the difference between the excess return of an event firm over the risk free rate and the expected return of the market given the Fama-French three factor model.

Results

In the short-run, significant abnormal returns are found for SEOs, equity repurchase and debt offerings, supporting the hypotheses. Over the three-day period the respective cumulative abnormal returns are -1.54%, 0.84% and -0.53% respectively. Measuring the long-run returns using the buy-and-hold abnormal returns approach leads to insignificant results taking the individual industry sector as a benchmark. The calendar-time portfolio approach shows significant negative monthly abnormal returns following IPOs and SEO of 1.36% and 0.48% respectively supporting the hypothesis. The results on equity repurchase, debt repurchase and debt offering lead into the anticipated direction, but are not significant.

Conclusion

In line with previous literature, evidence is found that in the short-run, external financing actions lead to abnormal stock returns. In the long-run only the calendar-time portfolio approach shows evidence of long-run negative abnormal

stock returns following IPOs and SEOs. The short-run returns support the hypotheses tested in the thesis, for the long-run returns only the offering of initial and seasoned equity support the hypothesis. The long-run results are partly in line with the mispricing theory and the short-run results are in line with both, the signaling and the mispricing theory.