



Sailing in rough water: market volatility and corporate finance

Michael J. Schill*

Darden Graduate School of Business Administration, University of Virginia, Charlottesville, VA 22901, USA

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Abstract

This paper examines how market volatility affects corporate financing transactions. Firms face substantial uncertainty with respect to the price, demand, and after-market costs associated with raising public capital. The ability to effectively hedge this risk is critical to the efficient financing of firm capital needs. Using monthly US equity-related financing transactions from 1970 to 1998, I find that market volatility dampens financing transactions, particularly among small or unseasoned firms. Periods of above normal market volatility are associated with a significant 13% decline in the frequency of initial public offering (IPO) transactions and a 21% decline in the number of IPO dollars raised. Increased market volatility generates greater underwriting fees but does not affect IPO underpricing. The findings are most consistent with Mandelker and Raviv's [J. Finance 32 (1977) 683] model of costly distribution risk bearing.

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1. Introduction

In August 1998, Goldman Sachs announced its plans to proceed with an initial public offering of its own shares. Over the subsequent weeks, market equity prices dropped sharply and price volatility increased as markets incorporated bearish worries over a deepening and continuing economic crisis in Asia and other developing markets. In late September, co-chairmen and CEOs, Jon Corzine and Henry Paulson, announced the decision to withdraw Goldman's public offering, explaining that "our executive committee

* Tel.: +1-434-243-7736; fax: +1-434-243-7676.

E-mail address: schill@virginia.edu (M.J. Schill).

made this difficult decision after giving full consideration to the *volatile state* of global financial markets and the disproportionately negative impact on the financial services sector. . . . When market conditions improve, the executive committee may propose a new plan of incorporation and public offering to the partnership for its approval” (CNNfn, September 29, 1998; italics added). In the case of Goldman Sachs it is understandable that concerns regarding ownership dilution have an adverse effect on IPO timing following a sudden decline in market prices. It is less obvious, however, why an increase in volatility would affect the IPO decision of a firm that certainly has the capability to hedge market risk. The statement that volatility was a factor in the decision to withdraw the IPO for a financially sophisticated firm, such as Goldman Sachs, raises the question of how influential is market volatility in financing decisions for the economy at large.

This paper examines how market volatility impacts corporate financing transactions. Using the standard net-present-value rule, managers fund new projects when the present value of future cash flows exceeds the value of claims sold to finance the project. In practice, however, managers face considerable uncertainty forecasting the value of claims sold to fund such projects. Corporate financing transactions are not single point in time events. The securities registration process often takes months to effect. Firms must begin a financing transaction not knowing the final price and demand for the securities offered, as well as the impact the financing will have on future financings. Since the value of claims sold to finance the project can change substantially over an extended contracting period, financing uncertainty can have an important effect on the financing decision.

Underwriting contracts for security offerings provide a partial solution to this uncertainty. A variety of underwriting contracts are designed to accommodate preferences for structuring financing risk exposure. In a firm-commitment contract, the underwriter fully assumes the risk of distributing the securities. Price increases allow the underwriter to generate extra profits by exercising the overallotment option now common to underwriting contracts. Price declines require the underwriter to hold the unsold and stabilization shares in inventory (see Ellis et al., 2000). In contrast, best-efforts underwriting contracts or self-distribution contracts assign the distribution risk to the issuing firm. Other contract forms, such as stand-by contracts or Dutch-auction offerings provide hybrid forms of distribution risk exposure (see, Sherman, 1999). Uncertainty with respect to the after-market performance of the offering also maintains generates important implications for transaction parties. Strong price performance builds a favorable reputation among investors for both the underwriter and issuing firm for follow-on offerings (see Beatty and Ritter, 1986; Booth and Smith, 1986 for underwriters and Welch, 1989 for issuing firms). Weak price performance not only jeopardizes the demand for follow-on offerings by the firm, but also increases the probability of legal liability for the underwriter (see Booth and Smith, 1986; Tinic, 1988).

Since Mandelbrat's (1963) initial work on price variation, there has been considerable evidence that stock market volatility varies over time.¹ Although the implications of time-varying volatility have been extensively studied in the asset pricing literature, there is little

¹ Recent additions to this literature include Bekaert and Harvey (1997), Bollerslev and Mikkelsen (1996), Braun et al. (1995), and Hamilton and Gang (1996).

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