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Share issuance and cross-sectional returns: International evidence ☆

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ABSTRACT

Share issuance predicts cross-sectional returns in a non-U.S. sample of stocks from 41 different countries. Issuance predictability has greater statistical significance than either size or momentum, and is similar to book-to-market. As in the U.S., the international issuance effect is robust across both small and large firms. Unlike the U.S., the effect is driven more by low returns after share creation rather than positive returns following share repurchases. Issuance return predictability is stronger in countries with greater issuance activity, greater stock market development, and stronger investor protection. The results suggest that the share issuance effect is related to the ease with which firms can issue and repurchase their shares.

1. Introduction

Loughran and Ritter (1995) and Spiess and Affleck-Graves (1995) report long-run negative returns following seasoned-equity offerings (SEOs). This finding has been broadened by the recent studies of Daniel and Titman (2006) and Pontiff and Woodgate (2008), who show that there is a negative cross-sectional relation between aggregate share issuance and the returns of U.S. firms. In this paper, we study the cross-sectional return predictive ability of share issuance in international markets. Our analysis is divided into two parts. In the first part we test whether the issuance effect is present among non-U.S. firms and compare our results to those reported in U.S. studies. In the second part we investigate whether proxies for equity market development, investor protection, and other country characteristics can explain cross-country differences in the issuance effect.

The use of international data enables a better understanding of whether sources of return predictability identified in the U.S. pose challenges to asset pricing, or whether they are statistical artifacts from data-mining.

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Previous research in this vein includes Rouwenhorst (1998) who studies momentum effects in 12 European markets, and Fama and French (1998) who examine non-U.S. value effects. A non-U.S. investigation is particularly important for share issuance, since Pontiff and Woodgate (2008) find that the relation between issuance and returns is insignificant in their pre-1970 sample, suggesting that the issuance effect may be sample specific. Our analysis of non-U.S. firms provides a useful out-of-sample test of the issuance effect.

We use a large sample of firms drawn from 41 non-U.S. countries and examine the existence of an international issuance effect over a 25-year period between 1981 and 2006. Using a net issuance measure that reflects both share issuance and repurchases, we find a significant issuance effect in international markets. Similar to the recent U.S. evidence, international share issuance has strong return-predictive ability. A one standard deviation difference in annual share issuance is associated with a 0.14% difference in subsequent monthly returns in non-U.S. markets, which is about half the magnitude of the post-1970 U.S. findings reported in Pontiff and Woodgate (2008). Issuance predictability is more statistically significant than either size or momentum, and is of the same magnitude as book-to-market. We also find that the issuance effect is robust across both small and large firms, which is consistent with the U.S. findings in Fama and French (2008).

Our findings add insight to the previous long-run return international issuance literature that has focused on specific issuance events such as repurchase announcements (and completions), SEOs, and stock mergers. Broad inference is difficult since each study concentrates on a specific issuance event within a specific country. Moreover, the results produce contradictions. For example, Kang, Kim, and Stulz (1999) find negative long-run abnormal returns following share issuance in Japan, while Marsh (1979) finds positive abnormal returns following share issuance (from rights offerings) in the U.K. Ikenberry, Lakonishok, and Vermaelen (2000) find negative abnormal returns following SEOs in Canada, but statistically insignificant returns following Canadian stock-financed acquisitions. Eckbo and Norli (2005) find statistically insignificant long-run abnormal returns following SEOs in Norway. Ikenberry, Lakonishok, and Vermaelen (2000) find evidence of positive long-run abnormal returns following repurchases in Canada, while Rau and Vermaelen (2002) find the opposite result in the U.K.

In the second part of our analysis we examine cross-country differences in the issuance effect. We consider share issuance activity, stock market development, short sale constraints, buyback restrictions, investor protection laws, and earnings management as potential determinants of the issuance effect across countries. We find that the issuance effect is stronger in countries with greater issuance activity, more developed stock markets, stronger investor protection laws, and less earnings management. Taken in their entirety, the results suggest that the issuance effect is stronger in countries where it is less costly for firms to issue and repurchase shares.

These cross-country results are consistent with market timing, where the benefit of market timing is of second-order importance to other capital structure motives. Firms market time by purchasing and/or selling shares in response to either mispricing (in an inefficient market) or changes in exposure to priced risk (in an efficient market).[1] In more developed markets, issuance costs are lower, enabling firms to frequently issue shares for both primary and market timing reasons. In less developed markets, where share issuance is more costly, the benefits of market timing are exceeded by issuance costs, and share issuance occurs only for primary reasons. This framework implies that share issuance will be both more frequent, and more highly correlated with future returns in well-developed markets. This interpretation is consistent with the U.S. evidence in Pontiff and Woodgate (2008), who show that pre-1970 in the U.S. there was no issuance effect, but that post-1970 there is a strong issuance effect, and that the frequency of issuance activity more than tripled between those periods.

The remainder of the paper is organized as follows. Section 2 discusses data and estimation procedures. Section 3 presents regression results using continuous measures of share issuances, and Section 4 provides results based on issuance portfolios that allow us to study positive and negative share issuance effects separately. Section 5 studies the issuance effect across countries. Section 6 concludes.

2. Data, variables, and estimation

2.1. Data

The data used in this study were obtained from Thomson Datastream. In the first part of the study (Sections 3 and 4) our sample consists of 41 non-U.S. countries, which are listed in Table 1. In the second part of the study (Section 5) we include U.S. firms. We select common stocks listed on each country's major stock exchange(s) from both active and defunct research files of Datastream in order to avoid survivorship bias. We screen the data for coding errors via the methods of Ince and Porter (2006). We winsorize each of the variables within country at the top and bottom 1% to eliminate the effects of outliers. The only variables that we do not winsorize are the non-U.S. holding period returns. With holding period returns we trim our sample within country at the top and bottom 1%, as many of these extreme observations appear to be the result of coding errors.[2]

Due to the availability of firm book values in Datastream, our regression analysis begins in July of 1981 and

[1] Two examples of this in an efficient market context are Sagi, Spiegel, and Watanabe (2008) and Carlson, Fisher, and Giammarino (2006). Sagi et al. develop a model where firm share issuance activity tracks shocks to capital, and in turn, expected returns. In Carlson et al. equity issuance occurs when growth options are converted to assets-in-place, reducing expected returns.

[2] The decision to winsorize or delete extreme non-U.S. holding return observations does not affect the paper's findings. We do not delete or winsorize U.S. holding period returns.