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Journal of Accounting and Economics 42 (2006) 53–85
JOURNAL OF Accounting & Economics
www.elsevier.com/locate/jae

The relation between corporate financing activities, analysts' forecasts and stock returns ☆

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Available online 13 July 2006

Abstract

We develop a comprehensive and parsimonious measure of corporate financing activities and document a negative relation between this measure and both future stock returns and future profitability. The economic and statistical significance of our results is stronger than in previous research focusing on individual categories of corporate financing activities. To discriminate between risk versus misvaluation as explanations for this relation, we analyze the association between our measure of external financing and sell-side analysts' forecasts. Consistent with the misvaluation explanation, our measure of external financing is positively related to overoptimism in analysts' forecasts.

JEL classification: G10; M4

Keywords: External financing; Sell-side analysts; Capital markets; Market efficiency

☆We thank I/B/E/S and First Call for analyst data. We are also grateful for the comments of Patricia Dechow, Espen Eckbo, S.P. Kothari, Richard Leftwich (the referee) Tom Lys (the editor), Doron Nissim, Stephen Penman, Jay Ritter, Irem Tuna, and workshop participants at University of Alabama, Arizona State University, Barclays Global Investors, UCLA, Columbia University, Dartmouth, Emory University, University of Illinois, University of Iowa, London Business School, University of Michigan, University of New South Wales, University of North Carolina, Temple University, University of Virginia, the Boston College Finance Conference, the Information, Markets, and Organizations Conference at the Harvard Business School, and the 2004 Journal of Accounting and Economics Conference.
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0165-4101/$ - see front matter
doi:10.1016/j.jacceco.2006.03.004

1. Introduction

A large body of evidence documents a negative relation between external financing activities and future stock returns. Future stock returns are unusually low in the years following initial public offerings (Ritter, 1991), seasoned equity offerings (Loughran and Ritter, 1997), debt offerings (Spiess and Affleck-Graves, 1999) and bank borrowings (Billett et al., 2001). Conversely, future stock returns are unusually high following stock repurchases (Ikenberry et al., 1995). Ritter (2003), in a recent review of this literature, notes that this relation holds across a broad range of corporate financing activities. He concludes that despite the large expenditure of resources on analyst coverage, there is little academic work emphasizing the importance of analysts' role in marketing corporate financing activities. In this paper, we provide a comprehensive analysis of the relation between corporate financing activities, stock returns and analysts' forecasts.

A key innovation of our research design is the use of statement of cash flows data to construct a comprehensive and parsimonious measure of the net amount of cash generated by corporate financing activities. In contrast to previous research that has focused on individual categories of corporate financing transactions, this feature of our research design allows us to simultaneously investigate the relation between a firm's entire portfolio of corporate financing activities and stock returns. A second innovation in our research design is that we analyze the properties of a comprehensive set of analyst forecasting variables, including short-term earnings per share (EPS) forecasts, long-term EPS growth forecasts, buy/sell recommendations and target prices. This feature of our research design enables us to develop and test hypotheses concerning how the properties of analysts' forecasts vary by type of corporate financing activity.

Our results can be summarized as follows. First, we document a strong negative relation between our comprehensive measure of net external financing and future stock returns. For example, a long–short investment strategy based on net external financing generates a 15.5% average annual return over the 30 years covered by our study. The returns to this strategy dominate the returns to strategies based on individual categories of external financing activities. Second, we show that there is a negative relation between net external financing and future profitability. This relation is present for both equity and debt financing, though it is stronger for equity financing. Third, we show that there is a strong positive relation between net external financing and overoptimism in analysts' forecasts. This relation holds for short-term EPS forecasts, long-term EPS growth forecasts, buy/sell recommendations and target prices. For example, firms in the top financing decile have 1-year (2-year) ahead earnings forecast errors that are 1.7 (2.2) times as optimistic as those for the bottom financing decile. We also find that the degree of overoptimism in specific forecasting variables is systematically related to the type of corporate financing activity. For debt transactions, overoptimism is concentrated in short-term EPS forecasts. For equity transactions, overoptimism extends to long-term EPS growth forecasts, buy/sell recommendations and target prices. Finally, we show that external financing activity dominates investment banking affiliation as a determinant of analyst optimism.

Our findings have several implications. First, our analysis of analyst forecast errors helps discriminate between risk and misvaluation as explanations for the predictable stock returns following corporate financing activities. Consistent with the misvaluation hypothesis, the predictable stock returns are directly related to predictable errors in analysts' earnings forecasts. Additionally, we find that analysts set significantly higher