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Issuing and repurchasing: The influence of mispricing, corporate life cycle and financing waves

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ABSTRACT

This paper examines the impact of mispricing, corporate life cycle, and financing waves on the debt/equity decision when firms (1) acquire funds and (2) repurchase funds by using a large international data set from 47 countries for the period 1984–2006. Our results support the mispricing hypothesis and the corporate life cycle hypothesis for both the acquisition of new funds and the repurchase of funds. However, our findings are consistent with the financing wave hypothesis only for repurchases of firms residing in common law countries as well as market-based countries.

1. Introduction

For a long time the trade-off and pecking order theories were the leading explanations for firms' financial policies. More recently, a number of other hypotheses have been advanced. This paper examines three of these relatively new approaches—mispricing, corporate life cycle, and financial waves on the decisions (1) to issue equity or debt and (2) to repurchase equity or debt.

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Of the three theories, mispricing has been studied the most, suggesting that managers take advantage of temporary deviations of a firm's stock price from its "true" value to implement financing policies. Managers issue (repurchase) stock when the stock price is viewed as abnormally high (low).

Researchers have noted high stock returns prior to stock issues and low returns after stock equity issues. Both facts are consistent with firms taking advantage of mispricing (Hovakimian et al., 2001; Baker and Wurgler, 2000, 2002; Kim and Weisbach, 2008; Loughran and Ritter, 1995).[2] Kim and Weisbach (2008) also note that firms with high market to book ratios keep a higher percentage of the proceeds from a seasoned equity offering in cash than firms with low market to book ratios. This suggests that firms with high market to book ratios are taking advantage of mispricing by issuing stock and using some of the funds later. Additional support for mispricing comes from the survey done by Graham and Harvey (2001) where executives state the importance of mispricing in equity issuance.

Researchers have documented low returns prior to repurchases and high returns subsequent to repurchases (Dittmar, 2000; Hovakimian et al., 2001; Skinner, 2008; Peyer and Vermaelen, 2009), results consistent with mispricing. The survey research by Brav et al. (2005) also documents the importance of mispricing to executives in the repurchase decision.[3]

While most of the evidence is in favor of mispricing, some studies minimize its importance. Schultz (2003) and Carlson et al. (2006) present models that explain the return behavior of IPOs that are not based on mispricing. DeAngelo et al. (2010) argue that firms issue SEOs to overcome liquidity issues and not principally to exploit mispricing. McLean (2011) posits that firms increasingly are issuing stock to save cash as their precautionary needs have increased.

The financial wave approach has been articulated as another theory to explain corporate financial policies. Dittmar and Dittmar (2008) propose that stock issues and repurchases are part of the same economic expansion period and have very little to do with misvaluation. Economic growth results in an increase in demand for funds and a relative (to debt) reduction in the cost of equity. Firms respond by issuing equity which occurs early during economic growth. In contrast, repurchases happen near the end of the same cycle when cash flows are still high but the need for new funds is generally less.

The corporate life cycle theory (discussed in DeAngelo et al., 2010) suggests that firms generally issue and repurchase at certain times of their life cycle. Young firms with lots of investment opportunities but little earnings issue stock. Older firms with fewer investment opportunities but greater cash flows will tend to fund internally and distribute funds as dividends and/or repurchases. DeAngelo et al. (2010) find some support for the corporate life cycle theory but they emphasize that this theory is not a stand-alone theory that can explain firms' issuance decisions.

Studies examining mispricing, financing waves, and corporate life cycle on share issuance or repurchase usually examine whether external equity increases or decreases as a result of certain external or internal events. We investigate mispricing, financing waves, and corporate life cycle hypotheses using a different approach. We ask instead whether external equity increases or decreases relative to changes in debt. Does the share of new external equity to total net new external funds change as a result of economic growth, prior or past returns, or the age of the firm? We feel that if mispricing, financing waves or the corporate life cycle can help to explain firms' issuance and repurchase decisions then they should be able to explain not only an absolute increase in equity but more importantly a relative increase in equity. If both debt and external equity generally increase during periods of economic growth, our findings can easily differ from previous studies if debt increases more than equity.

Our approach is as follows: We first divide all yearly firm observations into two separate groups—(1) firms that are net issuers of funds (the sum of net debt and net equity is greater than zero) or (2) firms that are net repurchasers of funds (the sum of net debt and net equity is less than zero). It is important to know whether a firm in a given year is a net issuer of funds or a net repurchaser because the motivations are clearly very different. In one case, the firm is acquiring additional funds and in the

[2] A related line of research studies the ability of stock issues to predict subsequent returns. Pontiff and Woodgate (2008) examine this issue for US firms while McLean et al. (2009) and Wang (2011) use an international sample. Collectively the research indicates that share issuance has a negative relationship with future returns. This line of research concentrates on the issuance/subsequent return while mispricing generally looks at returns prior to as well as post issuance or repurchase.

[3] For a recent study of European stock repurchases (abnormal returns and determinants of the size of the repurchases) for French, German, Italian, and British firms see Lee et al. (2010).