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Controlling shareholders and market timing in share issuance ☆

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ABSTRACT

We examine market timing in the equity issuance of firms controlled by large shareholders using a hand-collected data set of controlling shareholders' ownership stakes in Chile between 1990 and 2009. When a firm issues shares, the controlling shareholder can either maintain or change his ownership stake depending on how many of the new shares he subscribes. Issuance predicts poor future returns and is preceded by high returns, but only when the controlling shareholder's stake is significantly reduced. Consistent with market timing, the results are stronger in the absence of institutional investors and in hot issuance markets.

1. Introduction

Most corporations in continental Europe, Asia, and Latin America have large controlling shareholders (Barca and Becht, 2001; Claessens, Djankov, and Lang, 2000; Faccio and Lang, 2002; La Porta, López-de-Silanes, and Shleifer, 1999). Large shareholders can mitigate the agency conflict between managers and shareholders, but they can also pursue interests that are at odds with those of minority shareholders (Burkart, Gromb, and Panunzi, 1997; Grossman and Hart, 1980; Shleifer and Vishny, 1986). Expropriation of minority shareholders or tunneling can take many forms, from the most obvious ones such as outright fraud or theft to less obvious (and harder to detect) forms such as transactions with related parties at inflated prices (Johnson, La Porta, López-de-Silanes, and Shleifer, 2000).

In this paper, we study another form of opportunistic behavior by controlling shareholders: market timing in equity issuance or the sale of overpriced shares to outside investors. The market timing hypothesis rests on three assumptions. First, the controlling shareholder is better informed than outside investors. Second, some outside investors are naive in the sense that, faced with an

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issuance, they do not perceive themselves as being at a disadvantage. Third, those outside investors who do interpret the controlling shareholder's intentions correctly face limits to arbitrage.

The controlling shareholder has incentives for the firm to issue overpriced shares because, although his proportional ownership falls with issuance, the overall value of his stake increases. Simply put, the result for the controlling shareholder is a smaller fraction of future dividends, but these dividends are of higher value. The main prediction of the market timing hypothesis is that returns following issuance are poor because outside shareholders are not immediately able to perceive the overvaluation or act against it. As information is gradually incorporated into prices or as investor optimism fades, the overvaluation disappears and returns are poor. The critical implication of this hypothesis is, however, that future returns are poor conditional on issuance with dilution of the controlling shareholder and not simply conditional on any issuance. Other types of issuance as, for example, when the controlling shareholder subscribes the new shares at pro rata indicate that the company is not overvalued and, therefore, do not predict poor returns.

In this paper, we study post-issuance return predictability according to the stake of the controlling shareholder. The quality of the data available for Chile allows us to determine the ownership stake of the controlling shareholder of all listed firms over a period of 20 years (1990–2009). Our data are unique not only because of the long period covered but also because they allow us to identify the controlling shareholder by name and the size of his stake in a precise way. This process requires intimate knowledge of many firms intertwined through pyramidal structures and other control mechanisms (Morck, Wolfenzon, and Yeung, 2005). Moreover, under Chilean law, all shareholders possess preemptive rights, allowing them to subscribe new issues on a pro rata basis. This implies that, contrary to the typical assumption of the market timing literature, the size of the equity issuance per se is not a proper measure of dilution. To measure dilution we need to know how many of the new shares are subscribed by the controlling shareholder.

We find that share issuance in general predicts low future returns, as previously shown by Pontiff and Woodgate (2008) and McLean, Pontiff, and Watanabe (2009). However, consistent with the market timing hypothesis, we find that all of this predictive power comes from equity issues that imply substantial dilution of the controlling shareholder. Monthly dollar returns are on average 0.81% for diluting-issuers as compared with 2.46% for nonissuers. This implies that minority shareholders who buy shares of diluting-issuers, instead of investing in nonissuers, lose on average 20% in a year. Other issuances have a negligible impact on future returns. For instance, monthly returns are on average 2.31% after equity issues when the controlling shareholder's stake does not change (i.e., when the controlling shareholder subscribes the issue at pro rata).

The alternative to the market timing hypothesis is that shares are issued at fair price and low post-issuance returns reflect the relatively low risk of these companies. We address the risk-based explanation in two ways. First, all of our tests control for the standard risk factors identified in the asset pricing literature such as size, value, and momentum (Fama and French, 1992, 2008). Second, we explore changes in risk around issuance. For example, Carlson, Fisher, and Giammarino (2010) find that market betas decrease after US seasoned equity offerings (SEOs), which they interpret as a sign of issuance going hand-in-hand with a decrease in risk. In our sample, we instead find that, contrary to the risk-based explanation, the market betas of poor-performing issuers increase after issuance.

Consistent with the second assumption of the market timing hypothesis, we find that the under-performance of diluting issuers is more pronounced among firms that do not have institutional investors (e.g., private pension funds) in their shareholder base. Institutional investors are arguably more sophisticated than retail investors and less prone to irrational optimism. Similarly, the under-performance is stronger if the firm issues equity in a hot issuance market. According to the behavioral literature, hot markets are dominated by naive, optimistic investors (Baker and Stein, 2004), which explains the differential impact of issuance in these periods. Finally, we show that no return under-performance is evident following instances of dilution when the controlling shareholder reduces its stake by selling old shares (a block sale) instead of issuing new shares. In block sales, the opportunity for overvaluation is limited not only by the fact that outside investors are likely to be wealthier and more sophisticated but also because the controlling shareholder's intentions are more apparent. In a block sale, the controlling shareholder receives the proceeds directly, and, in an equity issuance, they go to the firm, probably to finance new projects. It is easier to disguise overpricing with share issuance rather than block sales precisely because share issuance involves investment. If investors are optimistic about the firm's prospects, they like the firm to issue shares for investment, but no reason exists for block sales except overpricing.

In terms of pre-issuance characteristics, we find that the dilution of the controlling shareholder is preceded by high returns and high stock liquidity, which are both typical features of overvaluation (Helwege, Pirinsky, and Stulz, 2007). Dilution is followed by more capital expenditures, although profitability (return on equity, ROE) is lower than after other equity issues and, if investors are disappointed by the company's poor cash flows, this could explain why overvaluation eventually fades away.

Our results contribute to the literature on large shareholders. First, we highlight that, in most firms around the world, it is essential to focus on the controlling shareholder to understand financing policy. Our study of equity financing complements other dimensions of corporate policy in relation to large shareholders including dividend policy (Chetty and Saez, 2005; Faccio, Lang, and Young, 2001; La Porta, López-de-Silanes, Shleifer, and Vishny, 2000; Shleifer and Vishny, 1986), the cost of borrowing (Lin, Ma, Malatesta, and Xuan, 2011), chief executive officer (CEO) compensation (Bertrand and Mullainathan, 2001; Burkart, Gromb, and Panunzi, 1997), board compensation