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# Wealth transfers via equity transactions ☆

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ABSTRACT

Previous research indicates that firms issue shares when their stock is overpriced and repurchase shares when their stock is underpriced. Such transactions transfer wealth from transacting stockholders to ongoing stockholders. We quantify the magnitude of these wealth transfers and analyze their implications. Strikingly, we find that for the average firm-year, these wealth transfers approximate 40% of net income. We also find that these wealth transfers can be predicted using a variety of firm characteristics and that future wealth transfers are an important determinant of current stock prices.

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## 1. Introduction

Traditional approaches to equity valuation focus on the value of a firm's real investment opportunities, but ignore the value of the opportunity for a firm to transact in its own mispriced securities. For example, the standard textbook approach to equity valuation discounts the free cash flow from the firm's investment opportunities, subtracts the value of the firm's debt and divides by shares outstanding to arrive at equity value per share. Yet this approach to equity valuation ignores any value deriving from the ability of a firm to transact in its own mispriced equity securities. A growing body of academic evidence suggests that equity securities can be mispriced and that firms systematically transact in their own equity to exploit this mispricing. For example, firms with overpriced equity more frequently issue new shares.[1] Such transactions transfer wealth from the new stockholders to the old stockholders.

One of the largest and perhaps best-known examples of such a wealth transfer resulted from America Online's stock-swap financed acquisition of Time Warner. This acquisition was initiated at the height of the technology stock rally in 2000. At that time, America Online (AOL) was fundamentally a much smaller company than Time Warner, with less than 20% of the sales and insignificant

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[1] Ritter (2003) reviews the early literature finding that firms issuing equity have lower future stock returns. Subsequent extensions include Daniel and Titman (2006), Bradshaw, Richardson, and Sloan (2006), Pontiff and Woodgate (2008), and Dong, Hirshleifer, and Teoh (2012).

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cumulative profits. Yet AOL's market capitalization exceeded $120 billion, almost double that of Time Warner. Consequently, AOL's stock-swap financed acquisition of Time Warner resulted in the original AOL shareholders owning over half of the combined entity. Nine years later, AOL was spun-off from Time Warner and traded at a market capitalization of just $2 billion. In essence, the use of the inflated AOL stock price resulted in the transfer of half the value of Time Warner from the original Time Warner shareholders to the original AOL shareholders. We will use this example to illustrate our wealth transfer computations later in the paper (see Appendix A).

Our main objective in this paper is to provide the first comprehensive analysis of the magnitude of the value created for ongoing stockholders through such wealth transfers. We first introduce an approach for estimating the value of these wealth transfers. Using this approach, we quantify the magnitude of the wealth transfers for U.S. equities over the 36 years from 1973 to 2008.[2] We also identify the characteristics of firms in which these wealth transfers are particularly large and show that future wealth transfers are an important determinant of current stock prices. Finally, we outline the implications of these wealth transfers for equity valuation, corporate financial policy, and investment management.

Our findings indicate that wealth transfers via equity transactions are both economically large and statistically significant. Across U.S. equities markets, they amount to $2.8 trillion over the past 36 years. Averaged across our sample, the wealth transfers amount to 1.79% of market capitalization per firm-year. To put this number in perspective, annual earnings have averaged 4.42% of market capitalization per firm-year, implying that wealth transfers are approximately 40% as large as earnings. We predict and confirm that wealth transfers are greater for overpriced equity issuers than for underpriced equity repurchasers. For significant equity issuers, the average wealth transfer is 8.42% of market capitalization per firm-year, while for significant equity repurchasers, it is close to 0% per year. We also identify several ex ante determinants of wealth transfers. Wealth transfers for equity issuers tend to be greater for stocks with higher valuation multiples, higher past stock returns, higher return volatility, higher trading volume, and a history of engaging in more equity transactions. A subsample of equity issuers with high determinants exhibits subsequent wealth transfers averaging 13.54% of market capitalization per firm-year. Finally, we find that future wealth transfers are of similar importance to future earnings in explaining current stock prices.

Our findings have implications for several interrelated areas of finance. For equity valuation, our findings suggest that the value of a share of stock is a function of both the value of the firm's underlying investment opportunities and the value of expected future wealth transfers. An important implication is that traditional valuation techniques can significantly understate the value of a share of stock. For corporate financial policy, our findings suggest that significant value can be created for ongoing stockholders through strategic transactions in a firm's equity. Our results help to explain the significant costs that firms frequently incur to promote equity issues.[3] Our analysis also identifies the conditions under which strategic equity transactions are more likely to transfer wealth to ongoing stockholders.

Finally, for investors, our results imply that the dollar-weighted average returns that are actually realized by investors are less than the buy-and-hold returns that are typically documented in the existing literature on historical stock returns. This is because investors systematically buy new stock from firms when it is overpriced and sell stock back to firms when it is underpriced. Our findings complement Dichev's (2007) findings that aggregate dollar-weighted returns are less than aggregate buy-and-hold returns. Dichev shows that investors exhibit poor market timing. Our findings indicate that investors also exhibit poor stock selection. These findings mirror Bogle's (2014) observation that the dollar-weighted returns earned by investors in mutual funds have lagged the buy-and-hold returns reported by the funds themselves. Even ignoring transaction costs and other investment expenses, the average investor would have realized superior performance through a simple buy-and-hold strategy.

## 2. Motivation and research design

### 2.1. Motivation

Traditional approaches to equity valuation focus on the value of a firm's investment opportunities, but generally ignore the opportunity for a firm to create value for ongoing equity holders by transacting in its own mispriced equity. For example, the most common approach to equity valuation discounts the expected free cash flow from the firm's investment opportunities. The value of non-equity capital, such as debt, is deducted from this amount to arrive at the value of equity. The value of equity on a per share basis is then established by dividing by shares outstanding. Missing from this approach is the value of the opportunity for a firm to benefit ongoing stockholders by strategically transacting in its own mispriced stock.

A simple example illustrates this opportunity. Consider a firm with just $2 of cash, two shares of common stock, and only zero net present value (NPV) investment opportunities. The traditional approach to equity valuation would value each share at $1. But now consider the possibility that the firm is able to convince a new investor that it has positive NPV opportunities, such that the market price of its common stock, $P$, is greater than $1. In this case, the firm can create value for existing stockholders by issuing new shares of stock for $P$. If the firm issues $S$ shares of common stock for $P$, then the value of a

[2] We stop in 2008 because our research design requires five years of subsequent stock returns.

[3] Gao and Ritter (2010) show that issuers paying investment banks for fully marketed equity offerings experience less price pressure around the issuance. Our evidence identifies wealth transfers as an important benefit of stock offerings that helps to explain why firms frequently issue equity despite the significant price-pressure effects and investment banking fees involved.

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