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Long-run abnormal return after IPOs and optimistic analysts' forecasts

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Abstract

This empirical study examines whether the optimistic forecasts of analysts explain the long-run abnormal return following initial public offerings (IPOs). Consistent with prior research, this paper concludes that the analysis of earning forecasts for firms going public has an upward bias. While the usually calculated buy-and-hold abnormal return is not significantly negative on average, a proper control for risk confirms the long-run underperformance hypothesis for the 1-year period following IPOs. The risk-adjusted return is positively correlated to the surprise effect and earning forecast revisions, and appears to be the response to new information about the true earnings perspectives.

JEL classification: G14; G24
Keywords: Initial public offerings; Long-run abnormal return; Financial analysts' forecasts; Overoptimism

1. Introduction

Many empirical studies have consistently documented evidences of a long-run underperformance phenomenon (Aggarwal & Rivoli, 1990; Chahine, 2001; Loughran & Ritter, 1995,etc.).[1]

Based on the ''impresario'' hypothesis, Shiller (1990) argues that investment banks (the impresarios) undervalue firms going public to attract investors. Long-run underperformance will result from a selling activity of stocks with the highest initial returns. Rajan and Servaes (1995) explain that investment banks underprice initial public offerings (IPOs) to

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[1] Loughran and Ritter (1995) find a long-run underperformance of 7.4% over 3 years and 7% over 5 years following IPOs.

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protect themselves from potential feedback traders, selling short IPOs with an offer price higher than the expected first trading price.

Miller (1977) suggests that the divergence of opinion between optimistic and pessimistic investors explains the stock price path after an IPO. A positive initial day abnormal return may then result from optimistic valuations[2], and long-run underperformance may be due to the arrival of information about the true value of the firm.

While most IPO studies have used U.S. data, this study includes a sample of 168 small- and medium-sized IPOs completed in the French market between 1996 and 1998. By considering corporate earnings per share (EPS) as a major determinant of stock prices, and a main proxy for analysts' expectations, this paper explores whether the analysts' forecasts established at the time of the IPO are optimistic, and whether they contribute to the explanation of the long-run abnormal return.

The new contributions of this paper are twofold. First, whereas previous studies suppose that the control sample of nonissuing firms adjusts for the true risk characteristics of IPO firms, this paper proposes, as in Eckbo, Masulis, and Norli (2000), a proper control for risk, based on prespecified macroeconomic factors such as term structure and default risks. Second, this study uses a combination of the methodologies of Bauman and Miller (1997) and Jain and Kini (1994), verifies the analysts' optimistic forecast hypothesis at the IPO date, and compares the forecasted earnings errors of value, normal, and growth stocks in the French market.

Like Jain and Kini (1994), this study points out the financial analysts' optimism towards IPOs. The EPS observed at the end of the 1st year following the IPO is, on average, equal to 80% of expectations. Moreover, similar with the findings of Bauman and Miller (1997), a sample division into three equal parts according to the price-to-earnings ratio (P/E) criteria shows the financial analysts' optimistic forecasts, especially for growth stocks compared with value stocks. In fact, upward bias is larger for high-P/E stocks over the 1st year following IPOs. The increase of upward bias for low- and medium-P/E stocks during the 2-year period suggests a high level of uncertainty faced by financial analysts over long periods, whatever the size of the stock. A comparative analysis to a control sample of 168 listed companies in the French market shows that analysts' forecasts for IPO firms are more biased than non-IPO firms' earning forecasts.

Although French IPOs exhibit an averaged negative long-run buy-and-hold abnormal return, it is not statistically significant. The estimation of a risk-adjusted return using six prespecified macroeconomic variables confirms the long-run underperformance phenomenon. There is a negative and significant monthly abnormal return over the 1-year period following the IPO date. The risk-adjusted return of issuing firms is positively related to the market return and to the return spread between French treasury bonds with 30- and 1-year maturities (30 y-1 y). It is negatively related to the return spread between 90- and 30-day treasury bills (Tbill) and to the difference in the monthly yield change on BAA- and AAA-rated corporate bonds (BAA-AAA).

[2] There is international evidence of a positive abnormal return in the first day of IPOs (Ibbotson, Sindelar, & Ritter, 1994; Loughran & Ritter, 1995; Loughran, Ritter, & Rydquist, 1994; Ritter, 1991, etc.).