Journal of Financial Economics 56 (2000) 209–249
JOURNAL OF Financial ECONOMICS
www.elsevier.com/locate/econbase

Is the abnormal return following equity issuances anomalous?

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Received 19 October 1998; received in revised form 10 August 1999

Abstract

We examine whether a distinct equity issuer underperformance anomaly exists. In a sample of initial public offering (IPO) and seasoned equity offering (SEO) firms from 1975 to 1992, we find that underperformance is concentrated primarily in small issuing firms with low book-to-market ratios. SEO firms, that underperform these standard benchmarks have time series returns that covary with factor returns constructed from nonissuing firms. We conclude that the stock returns following equity issues reflect a more pervasive return pattern in the broader set of publicly traded companies. © 2000 Elsevier Science S.A. All rights reserved.

JEL classification: G1; G2

Keywords: Seasoned equity offerings; Initial public offerings; Long-run performance; Anomalies

1. Introduction

Tests of long-run stock returns have become increasingly common within the academic finance literature. Papers purporting to demonstrate long-run anomalous returns include Asquith (1983), Agarawal et al. (1992), and Loughran and

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0304-405X/00/$ - see front matter
PII: S0304-405X(00)00040-4

Vijh (1997), who examine underperformance in stock returns following mergers; Michaely et al. (1995), who document poor returns following dividend omissions; and Dharan and Ikenberry (1995), who explore underperformance following exchange listing changes. Ikenberry et al. (1995), on the other hand, find overperformance following share repurchases. In addition, Ritter (1991), Loughran and Ritter (1995), and Spiess and Affleck-Graves (1995) show that stock market performance subsequent to initial public offerings (IPOs) and seasoned equity offerings (SEOs) is poor. Both sets of authors attribute underperformance to the effects of investor sentiment on returns: investors who purchase shares in IPO and SEO firms systematically over-value the shares at the time of an equity issue.[1]

We show that the poor long-run stock returns following equity issues are not unique. In event time performance tests we show that IPO issuer returns are similar to benchmarks matched on firm size and book-to-market ratios, although SEO returns still show some underperformance relative to various benchmarks. We calculate abnormal performance using both buy and hold returns and cumulative abnormal returns, and show that using buy and hold returns tends to magnify the underperformance of IPOs and SEOs.

We also utilize time-series factor models to test underperformance, finding that Fama and French's (1993) three-factor model can capture joint covariation of IPO returns, while the addition of Carhart's (1997) momentum factor is needed to capture the covariation of SEO returns. The covariation of equity issuer returns with a wider class of stock returns is potentially consistent with either a risk-based or a behavioral model. Fama and French (1993) interpret covariation of portfolio returns with their three factors as measures of a firm's riskiness. Our results are also consistent with behavioral models as presented in Black (1986); De Long et al. (1990); Lee et al. (1991); and Shleifer and Vishny (1997), in which noise traders drive stock prices away from fundamental values. Since these misvaluations tend to cluster in specific time periods, the joint covariation that we document may be driven by such market-wide misvaluations rather than by risk. We demonstrate that the low average return on equity issuer stocks is not a distinct anomaly; rather it is a manifestation of a broader pattern in returns.

In addition, evidence is provided showing that tests of long-run abnormal returns suffer from model misspecification, a concern raised by Fama (1998a). We show that reasonable changes to Fama and French's (1993) three-factor model significantly improve its explanatory power. Much like Fama and French's original model specification, our modifications are based on empirical return patterns and are designed to uncover underlying common effects.

[1] Other papers that examine long-run stock returns subsequent to issuances of corporate securities include Jegadeesh (1998), Brous et al. (1998), Mitchell and Stafford (1998), and Eckbo et al. (2000) for equity and Spiess and Affleck-Graves (1999) for debt.