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Motivations for public equity offers: An international perspective ☆

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Abstract

This paper examines the motivations for public equity offers, using a sample of 17,226 initial public offerings and 13,142 seasoned equity offerings from 38 countries between 1990 and 2003. We estimate the uses of funds raised in both initial and seasoned offerings. Firms appear to spend incremental dollars on both R&D and capital expenditures, consistent with the investment financing explanation of equity issues. However, consistent with the mispricing explanation, high market to book firms tend to save more cash and offer a higher fraction of secondary shares in SEOs than low market to book firms.

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1. Introduction

The relation between equity markets and firms' real decisions is an old and still extremely important topic in finance. Understanding this relation is complicated by the fact that there are a number of channels through which equity markets can affect firms. First, firms can raise capital to finance investments by selling equity in the public market. Additionally, if equity prices are higher than warranted by firms' fundamentals, then by issuing equity, firms can increase the value of existing shares at the expense of new

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shareholders.[1] Finally, when firms sell equity for the first time in an initial public offering, the firm changes in a number of ways that increase the liquidity of insiders' portfolios and the firm's access to capital. Thus, there are at least three potential, though not necessarily mutually exclusive, motives for equity offerings: to finance investments, to transfer wealth from new shareholders to existing shareholders, and to increase liquidity for both insiders and the firm.

The academic literature has yet to distinguish fully among these explanations. The only empirical paper we know of that addresses the question of the motivation for initial offerings is Pagano, Panetta, and Zingales (1998). These authors find that for a sample of Italian IPOs, the predominant reason firms go public is to rebalance their capital structure and to exploit mispricing, rather than to raise capital for financing investments. In contrast, a number of recent papers examine seasoned equity offers and find considerable support for the mispricing explanation. Loughran and Ritter (1995, 1997) and Baker and Wurgler (2000) find that equity offers lead to subsequent negative abnormal returns in the U.S., while Henderson, Jegadeesh, and Weisbach (2006) find similar results internationally. Greenwood (2005) documents that higher cash holdings lead to lower future returns at the aggregate level, consistent with firms issuing equity when their shares are overvalued rather than when they have a particularly high demand for capital. Finally, Baker and Wurgler (2002) present evidence suggesting that market timing of equity offers is so prevalent that it is an important determinant of firms' observed capital structures.

However, none of these papers provide an empirical link between equity issues and subsequent firm-level investments. Indeed, the literature is remarkably silent on the fundamental question underlying equity issues (and other capital-raising activities): How is the money raised in the offering used by the firms that raise it?

This paper provides systematic evidence on this question, as well as other potential motives for issuing publicly traded equity. It relies on a sample of 17,226 initial public offerings and 13,142 seasoned equity offerings from 38 countries over the 1990–2003 period. The focus is on the ultimate use of the capital raised, how this use varies with firm valuation, and the extent to which this variation is consistent with alternative motivations for equity offers.

To understand the reasons for equity offerings, it is important to distinguish between equity offerings that raise capital and those that do not. One aspect of equity offerings not emphasized by the corporate finance literature is the fact that firms have a choice of what kind of shares to offer.[2] Firms can issue new, primary shares, or they can offer existing shares held by insiders, which are known as secondary shares. Only primary share issuances can be used to finance investments, since they lead to capital inflows to the firm. In contrast, the proceeds from the sale of secondary shares go to the insiders who sell them.[3]

To examine the effect of equity offerings on investment, we consider a variety of alternative accounting variables designed to capture the uses of the capital raised in the equity offering. While it is almost tautological that new capital into the firm has to show up somewhere on the books, there are a number of alternative possible uses for the capital. We examine increases in total assets, inventory, capital expenditures, acquisitions, R&D, cash holdings, and long-term debt reduction. We measure the increases in each variable over a variety of time intervals, ranging from one year to four years, and formally estimate the increase in the accounting variables that represent possible uses of the capital raised following IPOs. In doing so, we control econometrically for other sources of funds and firm size, and include year and country fixed effects as well.

Our estimates indicate that the largest increase occurs in cash holdings; for every dollar raised in the IPO, cash holdings rise by 49.0 cents in the year after the IPO. This estimated increase in cash decreases to 38.8 cents when the equation is estimated over a four-year period after the IPO, presumably because the money is spent on various projects. Firms spend substantial amounts on R&D and capital expenditures, which increase by 18.5 cents and 9.9 cents, respectively, per dollar raised in the year following the IPO, and by 78.0 cents and

[1]Discussion of the possibility of selling overvalued equity to finance investments goes back at least to Keynes (1936, p. 151). For further discussion and tests related to this idea, see Fischer and Merton (1984), Barro (1990), Blanchard, Rhee, and Summers (1993), Stein (1996), and Baker, Stein, and Wurgler (2003).

[2]One exception is Huyghebaert and Van Hulle (2006), who examine the factors that affect the proportion of primary and secondary shares in a sample of Belgian IPOs.

[3]Existing theoretical models on IPOs do not incorporate the two types of shares simultaneously. For example, Chemmanur and Fulghieri (1999)'s model considers the sale of primary shares to fund a new investment project, while Zingales (1995) and Mello and Parsons (1998) focus on the sale of secondary shares and do not model new investment and production activity.