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Information conveyed by seasoned security offerings: evidence from components of the bid–ask spread

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Abstract

We examine the relationship between the degree of informational asymmetry surrounding a firm and the equity market's reaction to a firm's announcement to sell seasoned securities. We use the adverse-selection component of the bid–ask spread as a proxy for the informational asymmetry of a firm. For equity offers, we find that the greater the change in information asymmetry at announcement, the greater the decline in wealth. In addition, the largest decline in wealth for seasoned equity announcements is observed for firms with the largest level of pre-event adverse-selection components. For debt offers, the wealth decline is only significant for firms with the largest pre-event levels of asymmetric information. © 2000 Elsevier Science Inc. All rights reserved.

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1. Introduction

When firms issue seasoned equity, their stock prices, in general, fall. When firms issue seasoned debt, their stock prices, in general, are unchanged. This empirical regularity has been documented by several studies (see Asquith & Mullins (1986); Eckbo (1986);

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Masulis & Korwar (1986); Mikkelson & Partch (1986); Pettway & Radcliffe (1985)). Although this regularity is well-documented, an explanation for its persistence is not widely accepted.[2]

We provide new evidence on the relationship between the stock price reactions and debt and equity-offer announcements by examining the degree of informational asymmetry surrounding the offer announcement. We use the time-series behavior of the adverse-selection component of the bid–ask spread as a proxy for the market's perception of the information environment of the firm.

We find that firms announcing seasoned equity issues, or seasoned debt issues, have similar levels of asymmetric information prior to the announcement of the offer. This finding suggests that the security choice decision is not related to differences in the level of information asymmetry surrounding the firm.

We also examine the change in the adverse-selection component of the bid–ask spread surrounding the announcement of a seasoned offer of debt or equity. If equity offers convey more new information to markets than debt offers, then the change in informational asymmetry (specifically the adverse-selection component of the bid–ask spread) should be larger following announcements of equity offers than those following announcements of debt offers. We find that the adverse-selection component of the bid–ask spread decreases significantly in the short- and long-run for firms announcing equity issues, but does not change over either period for firms announcing debt offers. Miller and Rock (1985) and John and Williams (1985) suggest that it is the size of the unanticipated financing that is informative, not the type of the security chosen. However, the model of Myers and Majluf (1984) suggests that it is the type of security offered that is informative. Since debt offers are larger in size, this finding is inconsistent with Miller and Rock, and John and Williams, if the offer size is positively related to the size of the unanticipated financing. The finding that equity offers are more informative than debt offers is consistent with Myers and Majluf.

We also test whether a negative relationship exists between the stock price reaction at offer announcement and the degree of informational asymmetry of the firm at the time of the announcement. Following the model of Korajczyk et al. (1992), the stock price reaction at offer announcement should be inversely related to the degree of informational asymmetry.[3] For firms with low levels of informational asymmetry, the offer announcement should convey less new information to the market, so the stock price reaction should be less negative, and the change in informational asymmetry should be smaller in magnitude, when compared to firms with high levels of informational asymmetry. We find that the change in equity value for firms announcing

[2] Harris and Raviv (1991) discuss several models that have been developed to explain the differential stock price reactions to announcements of seasoned debt and equity offers.

[3] Korajczyk et al. (1991) find weak support for this relationship. Shyam-Sunder (1991) uses a firm's bond rating as a proxy for risk and does not find a relation between the equity price change at offer announcement and the rating of the bond. Dierkens (1991), however, does find a cross-sectional relation between the change in equity value at equity offer announcements and information asymmetry.