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Post-IPO capital expenditures and market feedback

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Abstract

This paper presents an empirical test of the 'market feedback hypothesis', a theory suggesting that information aggregated in the IPO process is used for the firm's investment decision. We examine the relation between post-IPO unexpected capital expenditures and feedback generated during the IPO process for 1543 IPOs between 1987 and 1995. Feedback is measured by (i) the unexpected price adjustment made at the end of the waiting period and (ii) the unexpected initial return. Consistent with the hypothesis, we find that positive feedback is followed by positive abnormal capital expenditures. A long-term event study finds no significant difference in stock returns between positive and negative feedback IPOs. This suggests that firms should not ignore market feedback as there is no evidence for a feedback related bias in post-IPO stock prices.

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1. Introduction

The premise that managers are often better informed than outside investors seems reasonable to many practitioners as well as academics. As a result, numerous

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signaling models have been developed to predict the implications of this information asymmetry for corporate decision making and equilibrium security pricing.

In this paper, we argue that when managers of newly listed firms make their post-IPO investment decisions, they take into consideration the market's opinion about the value of the firm. Thus, in contrast to the signaling literature, we assume that managers of recently listed firms realize that, at the time of the IPO, outside investors may—on aggregate—be better informed about the present value of the firm's growth opportunities. [1] As a result we predict that if managers receive negative feedback from the market, they will reduce their planned capital expenditures and vice versa. In particular we focus on the market's assessment of the value of an IPO firm during two consecutive stages of the floatation: the bookbuilding stage and the final offering stage.

During the bookbuilding stage the underwriters "sound out the market" by asking their largest clients for their prospective demands for the issue. This stage of information production and collection ultimately results in a final offer price for the issue. Hence, the first observable variable that reflects market information is the final adjustment of the offer price relative to the non-binding preliminary price range filed with the Security and Exchange Commission. The final offering stage corresponds to the first day of trading of the IPO firm, when it becomes possible to observe the second variable that aggregates market information: the trading price or the initial return of the issue.

This paper is the first to examine the relation between post-IPO investment levels and market reactions during the offering process. The main research question is whether IPO firms adjust their investment plans in response to two proxies for market feedback: the final price adjustment and the initial return. The analysis is based on a sample of 1543 US firms that went public between 1987 and 1995.

In order to perform the empirical test, we have to relate unplanned capital expenditures to unexpected final price adjustments and unexpected initial returns. Therefore we first develop a model that specifies planned capital expenditures of the IPO firm as a function of contemporaneous economy and industry factors, Tobin's Q, age, and firm size. Second, to extract the unexpected part of the final price adjustment, we regress this variable on the return of the equally weighted ASDAQ-AMEX-NYSE market portfolio during the bookbuilding period. Finally, as there is no shortage of empirical and theoretical studies explaining IPO underpricing, we estimate the expected initial returns using results reported by others.

Consistent with the market feedback hypothesis, we find that unexpected capital expenditures during the year after the IPO are significantly positively correlated with the unexpected price adjustment and unexpected initial return. The relations are both statistically and economically significant. Ceteris paribus, companies that re-

[1] This argument was first made by Rock (1986, p. 190) who noted that "while the investment banker is the one agent best suited to priced the offering, his information and expertise are inferior to the pooled talents and knowledge of all the agents". The assumption that the investment community holds more information than managers was recently used by Boot and Thakor (1997), Subrahmanyam and Titman (1999), and Maksimovic and Pichler (1999), among others.