Available online at www.sciencedirect.com
SCIENCE DIRECT®

Journal of Banking & Finance 30 (2006) 85–110

Journal of BANKING & FINANCE

www.elsevier.com/locate/jbf

Investment banker reputation and two-stage combination carve-outs and spin-offs

Thomas H. Thompson, Vince Apilado *

Department of Finance and Real Estate, College of Business Administration, UTA Box 19449, University of Texas at Arlington, Arlington, TX 76019, USA

Received 27 February 2003; accepted 27 December 2004
Available online 18 March 2005

Abstract

This study examines whether investment banker reputation impacts the initial period returns of two stage combinations (carve-outs followed by spin-offs). All prior literature regarding investment banker reputation is based on single-stage events (IPOs). An analysis is conducted of all completed two-stage carve-outs/spin-offs from 1981 to 2002. Findings indicate that underwriters for two-stage combinations retain their reputation in contrast with the single-stage findings of Carter et al. [Carter, R.B., Dark, F.H., Piwowar, M.S., 2002. IPOs and underwriter reputation: Redeeming the value of reputation. Working Paper, Iowa State University] that investment bankers redeemed (cashed-in) their reputation. Also, this study finds that the Carter et al. reputation factors dominate the Loughran and Ritter [Loughran, T., Ritter, J.R., 2002. Why don't issuers get upset about leaving money on the table in IPOs? The Review of Financial Studies 15 (2), 413–443] reputation factors.

JEL classification: G24; G32; G34

Keywords: Investment banking; Financing policy; Capital and ownership structure; Restructuring; Corporate governance

* Corresponding author. Tel.: +1 817 272 3840; fax: +1 817 272 2252.
E-mail address: apilado@uta.edu (V. Apilado).

0378-4266/$ - see front matter
doi:10.1016/j.jbankfin.2004.12.001

1. Introduction

1.1. Problem

In recent years the public image of investment bankers has been tarnished by scandals such as the Enron and Worldcom debacles and by dishonest security analysts. A recent Harris poll (Harris Interactive, 2002) reinforces the low public esteem of investment bankers – stockbrokers rank below lawyers in prestige – but the public, however, still realizes the importance of investment bankers in raising equity capital. The demise of the accounting firm Arthur Anderson reminds us of the EF Hutton (Chambers, 1998) and Drexel Burnham Lambert (Paltrow, 2002) situations in which two prestigious firms lost their identity in most part due to scandals. In addition, the Financial Modernization Act, 1999 allows banks and insurance companies to acquire brokerage firms (12CFR225). Several mergers between banks and brokerage firms have ensued and competition for investment bankers has increased. Thus, financial improprieties and deregulation have formed an unusual alliance exacerbating the necessity for investment bankers to reaffirm their ability to evaluate new security issues to maintain their market share. The firms with the higher reputations generally underwrite the offerings such as carve-outs/spin-offs that have lower discounts or underpricings than initial public offerings (IPOs) (Vijh, 1999). One intention of this paper in a broader sense is to determine whether this decline in public image has been accompanied with a similar decrease in professional reputation.

1.2. Motivation for COSOs and investment banker reputation

This study evaluates the impact of investment banker reputation on the carve-out returns of two-stage combinations (carve-outs followed by spin-offs – COSOs). All prior literature regarding investment banker reputation is based on single-stage offerings (IPOs). Prior to 1990, Carter and Manaster (1990) found that investment banker reputation varied inversely with returns (reputation was retained). However, for the post-1990 period, Beatty and Welch (1996) and Carter et al. (2002) observed that investment banker reputation was redeemed – varied with returns – for IPOs. Moreover, Vijh (2002) reports that pure carve-outs have lower parent company announcement period returns and lower subsidiary initial period returns than for IPOs, but that carve-outs that are followed by spin-offs have parent company announcement period returns that are 2% greater than for parents of carve-outs without a subsequent spin-off. Thus, COSOs with apparently low risk have unexpected high returns.

Against the backdrop of these unique COSO returns, we investigate the factors contributing to the difference in initial period returns between COSOs, pure carve-outs, and pure IPOs.[1] They concern differences in the percentage of subsidiary

[1] Carve-outs, as IPOs, are regulated by the Securities Act (1993) that requires information for new issues to be registered with the government and published in a prospectus (17CFR230).