Capital structure, equity issues and asymmetric information: research proposal

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1. Abstract

The financial crisis of 2008-2009 forced financial economists to look critically at capital structure theory because the problems faced by many companies stemmed from their financing policies. This project builds on pecking order theory (POT) of capital structure directly related to asymmetric information. POT is considered as Top 2 most important theories of capital structure. However, it lacks empirical support. The proposed research seeks to examine the effect of long-term asymmetric information on firm's decisions to issue equity and more generally their capital structure policy. We are going to offer a new model of issuing equity in the conditions of asymmetric information where POT emerges as a special case.

2. Capital Structure

A Firm Balance Sheet

Assets	Liabilities & Equity
Short-term assets	**Short-term debt**
Fixed assets	**Long-term debt**
	Preferred Stock
	Common Equity

3. Shortcomings of existing theories and main objectives of present research

Existing theories (POT and signalling theory)	Empirical evidence and our research objectives
Firms always prefer debt to equity	Firms may prefer equity to debt
Cannot explain why firms issuing equity outperform non-issuing firms in short term after issue	Firms issuing equity outperform non-issuing firms in the short term after issue
Cannot explain the difference between short-term operating performance and long-term operating performance	Firms issuing equity underperform in the long term
The extent of asymmetric information reduces the incentive to issue equity	The extent of asymmetric information does not necessarily reduce the incentive to issue equity

4. Some facts: long-term underperformance of firms issuing equity

	Three years after IPO			Three years after IPO	
	Operating Return on Assets	Operating Cash Flow on Assets		Operating Return on Assets	Operating Cash Flow on Assets
Median change (%)	-9.09	-6.44	**Median change (%)**	-9.09	-6.44
Median industry - adjusted change (%)	-6.81	-4.72	**Median industry - adjusted change (%)**	-6.81	-4.72

5. Short-term performance of firms issuing equity

	Operating Return on Assets		Operating Cash Flow on Assets	
	Year 0	Year 1	Year 0	Year 1
IPOs (%)	17.5	14.0	6.5	2.9
Industry sample (%)	13.0	12.0	4.0	3.5

6. Approach

Existing theories	Our approach
Firms have private information about their value	Firms have private information about their value and earnings profile over time
Static models: one-stage investment	Dynamic model: multistage investment
Industries do not differ in forms of asymmetric information	Industries differ in the form of asymmetric information
Mostly US Data	China- high degree of asymmetric information

7. Facebook IPO

"Let's turn the chart upside down and go home."

Despite boasting more than 845 million users across its network, Facebook says in its S-1 document that it expects its active user growth rate ***to decline over time*** as it achieves higher market penetration and increased competition. These signs are already starting to show.

While the number of users in Brazil and India continues to climb -- representing increases of 268% and 132%, respectively -- growth in the U.S. has slowed to 16%. Facebook's ability to increase its user base is critical to revenue growth by influencing the number of ads that the site shows, the value of those ads and the number of payment transactions that occur.

8. Facebook should Underperform !!!

- Negative performance of recent IPOs
- Groupon (GRPN), Zynga (ZNGA).
- Firms issuing equity underperform in the long-run as compared to non-issuing firms.

9. Technology IPOs