Title: The Impact of CEO Connections for Equity Issuing Firms

Keywords: Executive connections; External financing; Seasoned equity offers

ABSTRACT:
We study the impact of CEOs’ personal connections on the cost of issuing equity. Using fixed effect estimations and an instrumental variables approach, we report that CEOs with a greater degree of social, work, and educational connections are able to negotiate lower gross underwriting spreads and smaller offer price discounts in their firm’s seasoned equity offers. Further tests reveal several channels through which CEO connectedness reduces SEO issuance costs, including institutional buying, analyst following, and underwriter reputation. We argue that these channels lead to increased demand and reduced information asymmetry. Our results emphasize the benefits of broader CEO connectedness and provide support for the hypothesis that personal connections facilitate information flow enabling better corporate decision making, which is recognized by investment banks, investors, and lenders.

MOTIVATION:
There is a growing literature that examines the impact of executives’ personal connections (social, work, and educational) on corporate policies and shareholder value. An important open question is whether such connections enable firms to obtain external financing on cheaper terms. Few studies, however, tackle this research question. One reason for this gap in the literature is that it is difficult to establish a causal link between greater connectedness and better financing terms — essentially, it is hard to rule out an endogeneity problem whereby both greater connections and cheaper financing are caused by a third, unobserved variable. We have thought a lot about this problem in the context of CEO connections and SEO issuance costs, and have developed a set of instruments that address the problem and clearly establish causality.

EXECUTIVE SUMMARY:
We study the impact of executive connections on the cost of issuing new stock via seasoned equity offers (SEOs). Our central premise is that CEOs with more extensive networks can negotiate smaller offer price discounts and lower gross underwriting spreads. Our key network variable, CEO Network, reflects the CEO’s overall degree of connectedness through social, work, and educational connections provided by the BoardEx database. In fully specified models that include a battery of control variables and fixed effects for issue year and industry,
the estimates imply that increasing CEO Network by one standard deviation decreases the offer price discount by 37 basis points. This figure implies a savings of roughly $570,000 for a typical sample offer. The findings are not driven by direct relationships between SEO issuing firms and their underwriters; the results hold when we control for connections between the CEO of the issuing firm and the firm’s lead underwriter.

A potential concern is the possibility of reverse causality; i.e. that a CEO gains connections as a result of lower SEO issuance costs. This concern is largely mitigated by the key feature of our data that CEO connections are established over many years and therefore a large number of connections are already in place several years before any sample SEOs take place.

Another concern is that an omitted variable is associated with both increased CEO connections and lower SEO issuance costs. We address this concern by implementing an instrumental variables approach. A successful instrument should influence the extent of a CEO’s network but affect SEO costs only via its effect on the CEO’s network. We use a combination of three instruments: a binary variable indicating that the CEO holds an MBA degree, a binary variable indicating that the CEO holds any graduate degree, and the natural logarithm of the number of industries in which the CEO has worked. We find that each of these variables has a positive influence on CEO Network and importantly both meet the exclusion criteria for an acceptable instrument. The instrumented value of CEO Network has a negative effect on both SEO offer price discounting and gross spreads, and the Hansen J statistic indicates that the instruments do not affect discounting beyond their effect through CEO connections. This result continues to support our underlying hypothesis that more connected CEOs can acquire external equity financing on cheaper terms.

Why are larger CEO networks associated with lower SEO issuance costs? We conjecture that greater CEO connectedness is associated with (i) increased demand for newly issued shares, (ii) better information flow resulting in reduced information asymmetry, and (iii) more complete underwriter certification, all of which can reduce issuance costs. First, we argue that well-connected CEOs have exceptional interpersonal and communications skills and are therefore more likely to have relationships with institutional investors who are potential buyers of the offered SEO shares. To this extent, SEOs by firms with more connected CEOs are likely to be associated with greater increases in institutional ownership. The increased demand for new shares can serve to increase the offer price (smaller offer price discount) and lessen the
marketing and placement effort by the underwriter (lower gross spread). Second, the size of the CEO network can arguably influence issue costs through better information flow. CEOs with larger networks are likely to be more visible and to have more direct communication with investors and analysts. As a result, SEOs by more connected CEOs are arguably associated with increased demand for information and therefore are likely to exhibit larger increases in analyst coverage leading to greater transparency. Third, prior literature finds that CEO connections facilitate information flow between corporations and therefore the adoption of best practices in operations. This effect increases the likelihood that CEOs with larger networks have access to more reputable underwriters, whose presence in the issue can help certify the offer and lead to lower issue costs.

Our empirical tests support these arguments. We provide evidence that institutional buying, analyst following, and underwriter rank are channels through which CEO networks lower SEO issuance costs. More specifically, we find that firms with greater CEO connectedness exhibit greater increases in institutional ownership around the issuance and greater increases in the number of new institutions that hold shares after the SEO but did not hold shares before the SEO filing. Moreover, we report that firms with more connected CEOs exhibit greater increases in analyst following from pre- to post-SEO. Finally, these SEO issuers employ more highly ranked investment banks. We estimate the predicted value of each channel variable from a model that includes CEO Network and controls; i.e., we take the fitted value from an estimation of the channel variable as a function of CEO Network and controls. In a second stage estimation, we find that a higher predicted value of a particular channel variable (change in institutional ownership, the number of new institutions, change in analyst following, or underwriter rank) is associated with lower SEO issuance costs, measured by gross spreads and offer price discounts. The results suggest that increased demand, reduced information asymmetry, and more credible certification serve as channels through which CEO connectedness translates to lower issuance costs.

We further show that the effect of CEO connections on external financing costs goes significantly beyond direct relationships. Our tests control for direct connections between CEOs and the SEO underwriting firm, although in our sample of SEO firms there is a very low incidence of direct CEO-underwriter relations. As an additional test, we study how overall CEO
connectedness affects loans spreads. We find that a larger CEO network reduces the spread on syndicated loans, after controlling for a direct issuer-lender connection.

This study also contributes to a large SEO literature that examines the determinants of SEO issuance costs. It is well-established that lower information asymmetry and increased demand are associated with lower issuance costs. Our results suggest that a firm who employs a well-connected CEO can reduce SEO issuance costs by increasing demand by institutional investors, improving information flow; i.e. reducing information asymmetry, and improving issue-related certification. In essence, we provide a mechanism through which firms can capitalize on the known benefits of increased demand and low information uncertainty. Overall, the results of this study are important and suggest that firms who hire CEOs with more extensive personal networks can reduce external financing costs, thereby increasing shareholder value.