Private Placements to Owner-Managers: Theory and Evidence

Authors: M Subramanayam, R Ansuman, V Marieshetty

Discussant : Poonam Mehra

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Overview

- Private Placement/Preferential Allotment as a source of Capital

- Theoretical Model with Asymmetric Information
- Empirical Analysis: Indian Capital Markets (2001-09)

The Theoretical Model

- Extends the Myer – Majluf (1984) model of asymmetric information to allow for equity issue by owner-managers to themselves
- The model incorporates the regulatory constraint introduced by SEBI
- *Source of asymmetry*: Owner-Managers have private information about a hidden value, which the markets do not possess
- Allows for asymmetry in information regarding the new investment opportunity
- Allows for possibility of manipulation within regulatory constraint

Discussion

- Mitigates the under-investment problem
- Explicit inclusion of SEBI imposed regulatory constraint

- "No Conflict of Interest" Assumption
- Differential in Cost across private placement, rights issue and public equity

Empirical Analysis

- Develops testable hypothesis from the theoretical model to examine the stock price reaction to the announcement of private placement, referred to as *undervaluation hypotheses*
    - *Type of price path:* Low or High
    - *Types of Investor:* Owner, Private Equity, Bank and other financial institution
    - *Type of Firms:* Business Group or Stand Alone
- Impact of Manipulation
- Also examines
    - Certification Hypothesis (Hertzel and Smith 1993)
    - Monitoring Hypothesis (Wruck 1989)

Data

Dataset: Preferential Allotment by BSE Listed Firms

Period: 2001 – 2009

Firm level Data from CMIE

Sample Size : 164

Literature	Sample Size
Barclay et al (2007)	594
Wruck (1989)	48 and 128
Hertzel and Smith (1993)	106

Cut off Dates

- Disclosing dates of EGM to exchanges .
- Time difference between EGM and announcement date

- Example: Venus Power Ventures Private Placement 2010
  - EGM: August 25, 2010
  - Preferential Allotment: September 04, 2010 (Saturday)
  - No. of Trading Days: 7-8

Allotment to more than one type of Investors

- Cases of mixed allotment in the sample.
- Example:
- Venus Power Ventures Private Placement in 2010 and 2011 (proposed) to "promoters and persons other than promoters"

Results

- Empirical Evidence supports *Undervaluation Hypothesis* developed by the model
- Evidence suggests possibility of *manipulation* driven by asymmetric information
- No or little support for *Monitoring*, *Certification* and *Managerial Entrenchment* Hypotheses
- Long Term Stock Price Reaction *Positive*

Discussion

- Results of empirical evidence robust to possibility of manipulation

- No Control added for
  - Firm Performance
  - Internal Source of Finance
  - Growth Prospects

Further Implication of the Theoretical Model

- Comparison of price reaction to announcement of outside equity or rights offer and preferential allotment
- Cronqvist and Nilsson (2005) "The choice between rights offerings and private equity placements" *Journal of Financial Economics*)

Future of the Firm after Private Placements

- Theoretical Model to allow for impact of Private Placement on future financing in a dynamic game model
- Private Placement and M&A (Myers and Majluf (1984), Barclay et al (2007)
- Future financing may become easier

Folta and Janney (2004) "Strategic benefits to firms issuing private equity placements" *Strategic Management Journal*