Private Placements to Owner-Managers: Theory and Evidence

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Overview

- Private Placement/Preferential Allotment as a source of Capital
- Theoretical Model with Asymmetric Information
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

<table>
<thead>
<tr>
<th>Literature</th>
<th>Sample Size</th>
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<tbody>
<tr>
<td>Barclay et al (2007)</td>
<td>594</td>
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<td>Wruck (1989)</td>
<td>48 and 128</td>
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<tr>
<td>Hertzel and Smith (1993)</td>
<td>106</td>
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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

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