An empirical study on seasoned equity choice between qualified institutional placements and rights issues in India

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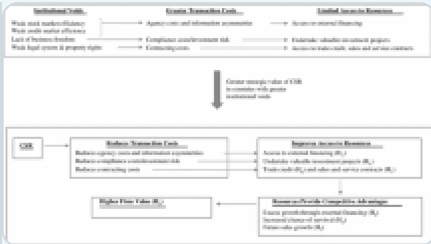
Abstract

This paper empirically examines the factors that determine the choice between qualified institutional placements (QIPs) and Rights issues for raising seasoned equity capital by selected BSE listed firms in India from 8th May 2006 to 31st December 2010. By conducting multivariate logit regression analysis, the study finds that firms placing equity privately on QIP basis tend to be bigger in size, more costly in terms of direct issue expenses and have considerable growth opportunities than Rights offering firms. In contrast to the extant studies, the study finds conclusive evidence that QIP firms have higher cash flows, more earnings from operations, and greater institutional investors' following vis-à-vis firms going for Rights issues. The findings suggest that QIPs, as a method for issuing subsequent equity, find favor with seasoned players in the market.



Notes

1. The other mode of raising capital on private placement basis is by way of preferential allotment for which listed companies have to comply with the provisions of Chapter VII of SEBI (ICDR) Regulations (2009).

2. In an information asymmetric world, managers have more information about the value of the firm's assets and future growth opportunities than the outside investors. In the presence of asymmetric information, the equity of firms with high intrinsic value is commonly underpriced by potential investors. Fear of underpricing propels managers of undervalued firms to forgo projects with positive net present value (NPV) by not issuing common shares to public. This tendency to forgo investment opportunities is known as the 'underinvestment problem' (Myers and Majluf 1984).

3. Armitage and Snell (2002) interpret pure rights issue as an issue of the type envisaged by Myers and Majluf (1984). They assume that since rights are renounceable in a rights offering, process of selling new shares through rights is similar to a Myers–Majluf issue.

4. In a standby rights offer, the underwriter guarantees the portion of the issue that is not taken up by existing holders. Issue proceeds in private placements are also fully guaranteed. In case of uninsured rights, there is no guarantee that all rights will actually be exercised by the existing shareholders which could leave the issuer undercapitalized.

5. Eckbo and Norli (2004) assume that the direct costs of private placements are lower than those of standby rights. This reflects the fact that the registration process for private placements is simpler (less costly) and does not require the issuer to administer the rights subscriptions. According to them, indirect costs due to wealth transfer to new investors might be significant in private placement. Direct issue costs are assumed to be lowest for uninsured rights as this method is selected when shareholder concentration is high or when a large block holder is willing to guarantee subscription.

6. Rights offer may fail if the stock price at the expiration of the right is less than the subscription price. Penalty costs include costs of foregone positive NPV investments and costs of acquiring emergency interim financing to cover unsatisfied commitments due to failure to obtain financing.

7. Private benefits of control accrue exclusively to the controlling shareholders like officers, directors and members of founding families. Examples of private benefits are prestige, consumption of perquisites, excessive salaries or sale of assets below market value to another firm fully owned by the insider. They are intrinsically difficult to measure because their true value is large inside information.

8. New equity issues are referred to as underwritten offers in which allotment of new shares is largely at the discretion of the underwriter. As a result, considerable new shares may be allotted to new block holders. Such control diluting new issues would result in loss of private benefits to the controlling shareholders.

9. It is intuitive that the more institutional investors follow the firm, the more information is discovered and less asymmetric information the firm suffers.

10. Because absolute issue size is likely to be highly correlated with firm size, issue size is also measured by percentage of fraction placed.

11. See Wruck (1989) and Hertzel and Smith (1993) for evidence on large offer discounts in case of private placements in US.

12. The study considers the same measure of Tobin's q as used by Petrova et al. (2008).

13. For banks and companies dealing in financial services, sales figure is substituted by income from financial services. R&D expenses are set to zero if they are found missing.

14. It is found that out of 174 issues reported by Prowess, only 153 are QIPs. Of

the remaining 21 issues, 18 are preferential allotments, one is employee stock option plan and two are wrongly given. Further, it is noticed that Prowess failed to report as many as 19 QIPs though they stand included in the list of QIPs posted under Information Memorandum on the BSE website. Cross-check reveals that in respect of these 19 issues, the private placement documents are also filed on the companies' website. The study thus reports 172 (153 + 19) QIP issues made by 150 listed companies during the sample period.

15. Prowess results depict a total of 156 issues during the sample period. However, detailed analysis reveals that out of these, 25 issues were unlisted at the time of making rights issues, two have been wrongly repeated and one has turned out to be a preferential issue. Since for the purpose of data collection, the study also needs to obtain information from the letter of offer of all the rights equity issues made during the sample period, it is found on examination that one right issue does not figure in the list obtained from prowess database. Thus, the study is confined to 129 (156 − 28 + 1) rights issues made by 123 listed companies.

16. Prowess database provides information about equity ownership of major investors (i.e. those with a shareholding of more than one percent) on a quarterly basis. The study measures the data on number of major institutional investors at the end of the quarter immediately prior to one year before the equity issue date.

17. For as many as 28 QIP issues, it is found that the data on the estimated issue expenses are not available in the placement documents. Therefore, the data have been sought from the annual reports of the companies of the years pertaining to the QIP issue. It is noticed that in the annual reports, QIP issue expenses are either written off from the securities premium account on the liabilities side of the balance sheet or are shown under cash flow from financing activities in the cash flow statement.

18. In contrast to Rights issues, offer document for QIPs did not provide a break up of estimated issue expenses into fees of lead manager and auditors, printing and stationery expenses, statutory expenses and all other incidental and miscellaneous expenses.

19. $E\,(Y_i\,|X_i) = \Pr\,(Y_i = 1|X_i) = P_i$. That is, the expected value is $1^* P_i + 0 * (1 - P_i) = P_i$.

20. If the predicted probability is greater than .50 (that is, when the estimated logit or the estimate of the latent variable is positive), then the prediction is that the outcome is 1 (the event happened); otherwise, the outcome is predicted to be 0 (the event did not happen).

21. It is important to point here that coefficient of variation of book value of total assets for rights offering firms is about three times larger than that of QIP firms. That is, higher mean value of total assets of rights offering firms could be due to extremely high variability.

22. Average values of gross proceeds scaled by market capitalization are smaller because market capitalization (i.e. the denominator) of QIP firms is larger vis-à-vis Rights offering firms.

23. Balachandran et al. (2013) find that in UK, SEO price discount is largest for rights offerings with an average of around 20 % (median around 17 %).

24. Debt to equity ratio is found to be negative for eight stocks during the sample period. In fact, all these stocks are of rights issues. Therefore, this proxy is not considered in the floatation method choice between QIPs and Rights.

25. In China, Li-mei and Wei-xi (2009) also find that gross proceeds raised

through private placements of equity are considerably larger than rights issues during their study period from May 2006 to December 2008.

26. If the market share price were to fall below the rights issue price, the issue would not have much chance of being a success since shareholders could buy the shares at cheaper rates in the market than subscribing to their rights.

27. In the present study also, it is noticed that in almost all cases, rights issues are not underwritten. This is observed by checking the letter of offer for every rights issue made during the sample period. It is found that only in case of four rights issues (out of 129 issues made), standby fees is paid to underwriters.

28. While it takes five to six days for raising funds through QIP issue, it takes about a month and a half for concluding rights issues. It is important to mention that in order to make rights issues more attractive for companies and investors, SEBI shortened the time taken to complete the rights issue process from 109 days to 43 days in September 2008.

29. In case of Rights issues, shareholders can renounce their rights to other issuers. This process involves lot of paperwork. Further, it requires time to account for postal delays. Unlike QIPs, there is a regulatory requirement of pre-issue filing of draft letter of offer with SEBI through the lead merchant banker.

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