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Short-run price performance of venture capital trust in initial public offerings

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Abstract

This paper investigates the short-run price performance of venture capital trust (VCT) initial public offerings (IPOs). We find a very small positive first-day market-adjusted average abnormal return of 0.056% for VCT IPOs. This positive return is non-existent at the end of the seventh and twenty-first trading days. The abnormal returns for VCT IPOs are much smaller than those for non-financial IPOs over the sample period. Furthermore, we find no trading activities in the short-run aftermarket of VCTs.

Introduction

Entrepreneurs promote economic growth through innovation and competition (Wennekersand Thurik,1999). However, financing constraints are one of the biggest concerns impacting entrepreneurs around the world (Kerrand Nanda,2009). While mature companies turn to the stock market to raise debt or equity capital, very small companies usually rely on capital from the founders and often face financial constraints. Various approaches are taken by the governments in different countries to provide finance for entrepreneurs. For example, Shanghai government issued a regulation in January 2016 that the government would compensate the loss of venture capital and the compensation is up to around 6 million RMB. Russian government offers up to 10-year tax holidays for innovative firms domiciled in the Skolkovo technology center. UK government offers tax reliefs for the investors of venture capital trusts (VCTs). The introduction of VCTs, a form of publicly traded private equity listed on the London Stock Exchange, through the legislation of the UK Finance Act 1995, was a practical policy response to a perceived "capital gap", aiming to provide sufficient risk capital to smaller and younger UK companies with growth potential (Cumming, 2003, Cumming and Johan, 2013, Cumming and MacIntosh, 2007, Hayley, 2016, Yang and Hou, 2017). This study examines their short-run price performance in initial public offerings (IPOs).

By the end of June 2017, more than 280 VCTs had been floated on the London Stock Exchange's Main Market, with a market value of about £2100 million. David Hall, the managing director of YFM Equity Partners, suggested that Brexit may benefit VCTs schemes because the rules governing VCTs would be no longer influenced by European Union. He expected that greater freedom and a relaxation of the rules could be one of the opportunities that Brexit might bring.[1] Despite the importance of VCTs as an asset class, VCT IPOs remain under-researched. The most prominent characteristic of VCTs is that their individual investors can obtain a high rate of income tax relief if they buy VCT shares at the initial public offering (IPO) and continue to hold them for a minimum required period. If an individual investor invested £5000 in new VCT issues on 7th May 2005, he would have received £2000 in income tax relief if he had held the shares for 3 years. In addition to the income tax savings, the investor receives the majority of the returns as tax-free dividends during the life of the VCT. As indicated by Cummingand MacIntosh(2006), funds such as VCTs and LSIFs are expected to have higher agency costs and lower profitability than private venture capital funds. Therefore, to obtain the tax benefits from investing in VCTs, investors need to be able to afford the long-term investment risk and high agency costs.

The literature documents significantly high abnormal returns for non-financial issuing companies around the world in the short-run aftermarket (see Aggarwal, 2003, Bradley and Jordan, 2002, Derrien and Womack, 2002, Field and Sheehan, 2004, Loughran and Ritter, 2002, Ritter and Welch, 2002). Investors normally expect high abnormal returns when they rush to purchase non-financial IPO shares. AIC(2016) suggests that VCTs are continuously being expanded and are highly likely to continue to boost the UK economy by providing vital finance and expertise to smaller British companies and stimulating high levels of job creation. It is essential that investors wishing to make substantial profits from flipping IPO shares identify whether VCT IPOs are a good choice. It is also important that investors intending to obtain tax benefits by purchasing VCT IPO shares confirm whether taking on the high investment risk and agency costs rather than flipping shares is worthwhile. All of the above motivate us to investigate how VCT IPOs perform in the short-run aftermarket.

VCT IPO offerings are not underwritten and all the risk is borne by the issuers. Sponsors play a very limited role in the VCT floating process. The offer price of a non-financial firm is usually determined by the company's directors and their financial advisers. In comparison, most VCT IPOs have the same offer price of 100p, which may be due to the inability to value new VCT shares.

Due to the significant differences in pricing, the floating process, policy and structure, between VCTs and non-financial firms, we can predict that both the price performance and the trading activity of VCT IPOs in the short-run aftermarket should differ from those of non-financial issuing companies. Are there any flipping activities for VCT IPOs? Can VCT investors receive a first-day bonus at the end of the first trading day? To find these answers, we investigate the returns and trading for our sample of VCT IPOs at the end of their first, seventh and twenty-first days of trading in the short run. This study provides enlightenment for investors buying new shares in VCTs. In particular, the results help show whether VCTs represent a good choice for investors looking for initial high returns.

Section snippets

Data and sample

This paper uses 285 VCT IPOs quoted on the London Stock Exchange's Main Market from the first launching period of April 1995 to June 2017. To perform a comparative analysis, we also use a randomly selected sample of 157 small non-financial UK IPOs on London's Main Market from the same period. Our main source of data is the Datastream online service. Other sources are the London Stock Exchange website, KPMG New Issue Statistics and individual offer prospectuses from Thomson One Banker. Most VCTs …

Empirical results

We analyze the market-adjusted returns using the HGSC Index as a market benchmark, and later use the FT Small Cap Index as an alternative to test the robustness of the results. The results of using the HGSC Index benchmark are presented in Table2.

The average returns on the first trading day for the sample of non-financial IPOs are 6.253%, and the returns on the seventh trading day increase to 8.843% and further to 9.562% on the twenty-first day of trading. All these abnormal returns are…

Conclusions

This is the first study to provide evidence of the short-run price performance of VCT IPOs. We document significantly positive abnormal returns of 0.056% on the first day of trading for VCT IPOs, but the positive returns are non-existent at the end of both the seventh and twenty-first trading days. The abnormal returns for VCT IPOs are much smaller than those for non-financial IPOs over all three short-run time horizons. Moreover, most non-financial IPOs have high trading volumes in the first…

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2022, Finance Research Letters

> *Citation Excerpt :*
> …The reasons described above may be consistent with the idea that firms are more likely to underprice high-tech IPOs because R&D intensity induces more information asymmetry than non-high-tech IPO firms (Guo et al., 2006). In this regard, many financial studies on the underpricing have shown that venture capitalists play a key role in ameliorating information asymmetries (Megginson and Weiss, 1991; Logue et al., 2002; Yang et al., 2018; Peng et al., 2019). An early example is Megginson and Weiss (1991) who find that venture capitalists reduce IPO underpricing, because the market recognizes their quality because of their certification role to overcome information asymmetries between well-informed insiders and less informed outside investors.…

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