2 Literature review and previous studies

Because a subsequent repair issue is such a new phenomenon, we have not been able to uncover any literature on the topic. Instead, seeing as the repair issue is a combination of a private placement and a seasoned equity offering, we have looked at the existing literature on these two topics. After presenting previous literature on both seasoned equity offerings and private placements, we will shortly summarize what we find most relevant for our thesis.

2.1 Seasoned Equity Offerings

As previously mentioned, a seasoned equity offering is when an already publicly-traded company issues new equity. Below we review important research in this field emphasizing how information asymmetry might have an impact on the choice of flotation method and, hence, the announcement effect. We will start by exploring an underinvestment problem, which is a basis for much of the later research.

Mayers and Majluf (1984) show that when we have information asymmetry, better informed managers issue common stock only when they believe their stock is overvalued. Thus the market reacts negatively to a stock issue announcement. To avoid a wealth transfer from old to new stockholders, they show that the managers of undervalued firms with little financial slack will choose to forgo a profitable investment opportunity in order to avoid issuing common stock. Due to this managers actually underinvest. We call this the underinvestment problem.

Masulis and Korwar (1986) are one of the first to document a statistically significant fall in the value of common stock on the announcement of stock offerings. Furthermore, they prove that larger pre-announcement stock price run-ups are associated with larger stock price drops on the offering announcement.

The research of *Eckbo and Masulis (1995)* is supportive of Masulis and Korwar's findings. They find that the market reaction to equity issues is the most negative for firm commitment offers and that standby right issues result in a significantly negative two-day announcement effect. Rights issues on the other hand have only an insignificant announcement effect.

Flotation method choices of seasoned equity stock differ substantially across countries. While 99% of all issues by U.S. companies in 1980 chose the firm commitment method *(Eckbo and Masulis 1995)*, equity issuers in smaller capital markets continue to use rights offers *(Bøhren, Eckbo, and Michalsen 1997)*.

According to *Bøhren, Eckbo, and Michalsen (1997)*, rights with standby underwriting (standby offers) have become the dominant flotation method on the Oslo Stock Exchange (OSE). The firm commitment method, on the other hand, is not observed for public offerings on the OSE. They provide evidence on expected shareholder subscription as a determinant of the flotation method, a central variable in the asymmetric information framework of *Eckbo and Masulis (1992)*. They find that the probability that the issuer selects to underwrite a rights offer increases significantly as expected shareholder take-up decreases. Moreover, they find little evidence of managerial reluctance to issue rights with a deep discount, and do not detect any significant evidence that a deep discount signals negative information about equity value, as opposed to *Heinkel and Schwartz (1986)*.

Furthermore, *Bøhren, Eckbo, and Michalsen (1997)* find, contrary to the U.S. evidence, that the two-day announcement effect of rights offers is significantly positive and greater for uninsured rights than for standbys. The effect is more negative the greater the issue size. They also find the effect more negative the greater the pre-announcement run-up in the issuers' stock price, and more positive the greater the proportion of the voting stock held by board members and the CEO prior to the issue. These results are consistent with other research in smaller capital markets and support the hypothesis that issue markets reflect information asymmetries, which again possibly influence the choice of flotation method.

2.2 Private Placements

We will now take a look at the most important findings from some of the research done on private placements. The two first articles we will go through both show positive announcement effects when a private placement is announced, but they

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Preliminary thesis

- Reparasjonsemisjoner -

Exam code:

GRA 19002 Preliminary thesis report

Admission date:

17.01.2011

Master of Science in Business and Economics: Finance

Norwegian School of Management Oslo

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Executive Summary

In our thesis we would like to explore the recent development of a special type of subsequent offerings in Norway, called “reparasjonsemisjon”.

We start by looking at what a” reparasjonsemisjon” actually is by defining this phenomenon and looking at common characteristics. Then we proceed by looking at existing literature. Seeing as this a relatively new phenomenon, with little or no research done in the area, we have so far focused on reading existing articles on Seasoned Equity Offerings (SEOs) and Private Placements. On the topics of SEOs and Private placements, there is a general consensus that they in fact have opposite announcement effects. While the announcement of a SEO has a negative effect on the stock price performance, an announcement of a private placement has a positive effect. However, in the long run both underperform.

Then we continue by formulating our research questions. Based on the existing literature, we come up with two interesting questions that we would like examine; namely the incentives companies have for conducting a “reparasjonsemisjon,” and the announcement effect and long-term performance of these offerings.

We plan to make use of both qualitative and quantitative data. Having the first research question in mind, we hope we will get the chance to interview companies that actually have issued these relatively new offerings and banks that have facilitated them. When it comes to the second research question, we plan to use gathered data on “reparasjonsemisjoner” and private placements from Øyvind Norli. The data set contains data on Norwegian issues conducted at Oslo Stock Exchange.

At the end we hope to get a thorough insight into why the “reparasjonsemisjon” is an increasing phenomenon in Norway.

1 Introduction

The phenomenon "reparasjonsemisjon" has become relatively common in Norway over the last years. Studying the prospectus for companies that have issued shares in a "reparasjonsemisjon," we find that they use the term subsequent offering to explain "reparasjonsemisjon" in English. We will be using both terms throughout this paper. Thus, we define a "reparasjonsemisjon"/subsequent offering as a planned seasoned equity offering *following* a private placement.

To understand the definition, we need to know what a private placement and a seasoned equity offering is, namely two different ways of issuing equity. When we have an equity issuance, we have a sale of new stock or equity by a firm to investors. It can be done as a private placement, where we have a direct transaction between the firm and one or a small group of investors. Or it can be done publicly where the firm registers the securities with the authorities and the sale take place in an organized market (secondary market) where any registered investor can invest. A seasoned equity offering is a common type of public equity issuance; it entails that an already publicly-traded company issues new equity. We will later take a closer look at what it entails in the context of the subsequent offering.

By looking at the prospectus of the companies which have conducted a subsequent offering we can see a couple of similarities in the processes. Common for all, is that the subsequent offer is only offered to those who hold shares in the company at the time of the private placement, and did not participate in the actual private placement. Each eligible shareholder then gets subscription rights according to the amount of shares they hold at the date of the private placement. For example, in Clevis Parma's subsequent offering (20.07.09) every eligible shareholder received 1 subscription right for every 4,282582 share held.

From the different firm's prospectus we observe that the time between the private placement and the subsequent offer varies from company to company. The subscription periods of most of the subsequent offerings start about a month after the private placement is performed. However, there are some that start just a week after the private placement, while others are up to 3 months after. The lengths of the subscription periods are also varying, but two weeks seems to be a common length. We also see that the amounts of shares offered in the subsequent offerings are of a much lower number than the amount offered in the private placement.

The reason we believe this is a very interesting topic is because it is such a new phenomenon, that possibly no one has looked at the reasons behind contemplating a “reparasjonsemisjon” and the financial impacts of doing so. In other words, since “reparasjonsemisjon” has become a new trend, we are very motivated to get an insight into why companies switch from regular equity offerings to these new offerings. In addition, seeing that “reparasjonsemisjon” is a typical Norwegian phenomenon, it motivates us even more since we are especially interested in the Norwegian stock market.

2 Existing literature

Because a ”reparasjonsemisjon” is such a new phenomenon, we have not been able to uncover any literature on the topic. Instead, seeing as a “reparasjonsemisjon” is a combination of a private placement and a seasoned equity offering, we have looked at the existing literature on those two topics.

2.1 Seasoned Equity Offerings

As mentioned above, a seasoned equity offering is when an already publicly-traded company issue new equity. Below we review important research in this field emphasizing how information asymmetry might have an impact on the choice of flotation method and, hence, the announcement effect. Finally, we look into the research on post-offering performance.

Masulis and Korwar (1986) document a statistically significant fall in the value of common stock on the announcement of stock offerings. Furthermore, they prove that larger pre-announcement stock price run-ups are associated with larger stock price drops on the offering announcement.

The research of *Eckbo and Masulis (1995)* is supportive of Masulis and Korwar's findings. They find that the market reaction to equity issues is most negative for firm commitment offers, standby rights issues results in a significantly negative two-day announcement effect, while rights issues have only a an insignificant announcement effect.

Flotation method choices of seasoned equity stock differ substantially across countries. While 99% of all issues by U.S. companies in 1980 chose the firm commitment method *(Eckbo and Masulis 1995)*, equity issuers in smaller capital markets continue to use rights offers *(Bøhren, Eckbo, and Michalsen 1997)*.

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Furthermore, *Bøhren, Eckbo, and Michalsen (1997)* find, contrary to the U.S. evidence, that the two-day announcement effect of rights offers is significantly positive and greater for uninsured rights than for standbys, and the effect is more negative the greater the issue size. They also find the effect more negative the greater the pre-announcement run-up in the issuers' stock price, and more positive the greater the proportion of the voting stock held by board members and the CEO prior to the issue. These results are consistent with other research in smaller capital markets and support the hypothesis that issue markets reflect information asymmetries, which again possibly influence the choice of flotation method.

Spiess and Affleck-Graves (1994) conclude that post-offering performance for SEOs is similar to that of IPOs. They find that long-term negative abnormal returns are a general feature found in all common stock offerings. Furthermore, they claim that these results are "consistent with managers being able to take advantage of firm-specific information to issue equity when the firm's stock is overvalued."

Research from the U.S., mentioned above, shows a fall in the value of common stock on the announcement of SEOs. Thus, announcing a SEO can be interpreted as a sign of an overvalued stock, and may cause a negative announcement effect.

Loughran and Ritter (1997) find that issuers continue to invest heavily even while their performance deteriorates post-offering. This occurs even in the fourth and fifth year of underperformance. They suggest that the managers are just as overoptimistic about the issuing firm's future profitability as are investors.

2.2 Private Placements

We will now take a look at the most important findings from some of the research done on private placements. To begin with, we will take a look at the underinvestment problem, which is a basis for later research.

Mayers and Majluf (1984) show that when we have information asymmetry, better informed managers issue common stock only when they believe their stock is overvalued. Thus the market reacts negatively to an earnings announcement. To avoid a wealth transfer from old to new stockholders, they show that the managers of undervalued firms with little financial slack will choose to forgo a profitable investment opportunity in order to avoid issuing common stock. This is called the underinvestment problem.

The two next articles we go through both show positive announcement effects when a private placement is announced, but they provide different explanations as to what gives this positive effect; ownership concentration and information-signaling.

Wruck (1989) found that the positive announcement effect of a private placement is highly correlated with the resulting change in *ownership concentration*.

Assuming no other changes in share ownership, a private sale puts a block in place and dilutes the voting power of existing blocks. On the other hand, a public sale simply dilutes the voting power of existing shareholder blocks.

Over half of the private placement purchasers are not previously affiliated with the firm they purchase shares in, meaning they have not been managers or previous shareholders in the firm. Thus, when a well-informed non-management investor buys a security block this is expected to give the market a positive signal, whereas a public offering is expected to give a negative signal.

Increased ownership concentration increases firm value if it helps align the incentives of the owners and the shareholders. Although, it can also decrease firm value if the private sale allows entrenchment. Wruck's results show that for low levels (0% to 5%) and high levels (≥ 25%) of ownership concentration after the sale the changes in firm value at announcement are positively associated with the change in ownership concentration. However, in the middle range (5% to 25%) this relationship is negative.

Hertzel and Smith (1993) provide an *information-signaling* explanation of the value gains associated with private placement announcements. Their model extends the model of Myers and Majluf and allows for the possibility that, at some cost, private placement investors can correctly estimate the firm's true value through their negotiations with the management. Thus the investor's willingness to commit funds to the firm, in addition to the management's decision to forgo a public issue, will convey a signal to the market that the firm is undervalued.

Having looked at some of the reasons for the positive announcement effect, we will now move on to the long-term stock performance of the issuing firm.

Rees et al. 2002 show that public firms that perform private placements experience positive announcement effects and negative post announcement stock price performance. This finding is inconsistent with the underreaction hypothesis, and instead suggests overoptimism about the issuing firm's prospects. However, in contrast to public offerings, private issues tend to follow periods of poor operating performance. Thus, the overoptimism at the time of the issue is not due to the behavioral tendency to overweight recent experiences.

Chou, Gombola and Liu (2009) conclude that the post-offering performance of private equity issuers is related to growth opportunities. They find significant long run underperformance in stock returns following private placements only for firms with high Tobin's q. In addition, these high Tobin's q firms also have poor operating performance. They investigate three potential explanations and find that the results are consistent with the view that investors are overly optimistic about the prospects of high growth firms.

Having looked at both the previous research on SEOs and Private Placements and seeing their traditionally opposite announcement effects and same long-run underperforformance, we take a look at one last article which looks at characteristics of the issuing firms.

Lee and Kocher (2001) compare the firm characteristics of firms issuing common stock through private placements and those using public offering methods. Their results show that the private placements are smaller in size, have more growth opportunities and thus have a greater degree information asymmetry than public offering firms. Additionally, private placement firms have less financial slack than public offering firms, giving them a greater need for external capital. Due to all this, the firms issuing stocks through private placement are more likely to be driven by their needs for external capital, rather than being motivated by an overvaluation in their stocks. These findings are consistent with the information hypothesis.

3 Research question

Looking at the existing literature on SEOs and Private Placements, we have found two main questions we would like to answer with our research:

1. *Why do companies chose to undertake a "reparasjonsemisjon"?*
2. *What are the announcement effect and the long-run performance of a "reparasjonsemisjon"?*

We would like to take a look at why this type of offering has become more common the recent years. What incentives does a company have to go through with a “reparasjonsemisjon”? Thus far, we have thought about three possible reasons. One reason is based on fairness. Seeing as a private equity issue is mostly directly negotiated with a single or a small group of investors, many or maybe all the existing shareholders are left out of this issuing. A “reparasjonsemisjon” can therefore be a way of pleasing the existing shareholders, by letting them also have the opportunity to be included in a possible company value increase. In addition, it can prevent dilution of the current stockholders’ shares after the first issuing.

We have already found some data supporting this reason in the prospectus from the equity issuance:

- In the prospectus of Star Reefers (12.03.10) they explain that: “In order to treat all shareholders in the Company equally and secure that all shareholders are given the possibility of maintaining their relative ownership shares in the Company, shareholders that were not offered to participate in the Private Placement will be offered to participate in the Subsequent Offering” (www.sebenskilda.no).
- Scandinavian Property Development (23.07.09) had two objectives when implementing their subsequent offering: “(i) the shareholders of the Company as of 26 June 2009 who were not offered to participate in the Private Placement are given the opportunity to, as far as possible, maintain their relative shareholding in the Company following the Private Placement and the Subsequent Offering, and (ii) the shareholders of the Company as of 25 June 2009 who participated in the Private Placement, but who had their subscription reduced to a number of Placement Shares which was lower than their pro rata share of the Private Placement, are given the opportunity to subscribe for and, as far as possible, be allocated a number of Offer Shares equal to the number of Placement Shares by which their subscription was reduced.” (www.sebenskilda.no)
- Rocksource (03.06.10): “The main purpose of the Subsequent Offering is to enable Shareholders who were not allocated Shares in the Private Placement the ability to subscribe for Shares at the same price as in the Private Placement and to limit dilution from the Private Placement.”

The second possible reason for going through with a “reparasjonsemisjon” could be money demand. It may be a kind of “safety net” in case the private placement does not provide the needed amount, thus the “reparasjonsemisjon” is a second chance of raising enough equity to follow through with a company’s plans. However, seeing as the secondary offerings usually contain much less shares for sale than the private placement, our first reason may be more plausible.

A third reason for conducting a private placement before the secondary equity offering might be that the companies see this as a faster and more “secure" way to access the equity needed. However, if it is the speed that is the factor here, why do they go through with a secondary offering afterwards? And if getting hold of the money fast enough actually is a factor, are the companies that perform a “reparasjonsemisjon” in a worse state financially than other firms?

In addition to our first question, it would be interesting to compare the announcement effect and the long-run performance of a “reparasjonsemisjon” to the effects and long-run performance of the SEOs and Private Placements, as a “reparasjonsemisjon can be considered a “hybrid” of the two. Considering the fact that the phenomenon is as new as it is, long-run performance may be difficult to determine.

Throughout the process of writing the thesis, these two research questions might be reconsidered and possibly narrowed down a little.

4 Data

4.1 Qualitative data

Regarding our first research question: “Why do firms undertake a “reparasjonsemisjon”?” we plan on getting this information through qualitative data. We would like to set up interviews with several companies which have carried out such a “reparasjonsemisjon” to get an insight as to why they chose this form of equity issuing. Another possible source it would be interesting to interview would for example be DnB Nor Markets or SEB Enskilda, which have facilitated several subsequent offerings. In addition, we have started looking at the firm's prospectus, where they often supply a reason for the subsequent offering. This too can be a useful information source.

4.2 Quantitative data

The second question will be answered by empirical tests of the gathered data from Øyvind Norli. We have data on both private placements and seasoned equity offerings, and we have gone through the seasoned equity offerings to identify which of these were in fact secondary offerings.

5 Methodology

In addition to setting up interviews with companies issuing equity through secondary offerings and the banks who facilitate the sales, we need to perform empirical tests to find the financial effects of a "reparasjonsemisjon".

To find out the announcement effect of the subsequent offering, we need to examine the stock-price performance both before and after the sale is announced. Before, to get an insight into the circumstances around the time the managers chose to issue and after, to reveal whether the changes in shareholder value are permanent or transitory. We would like to use our data to check whether we have any abnormal performance and will use a standardized test statistic to determine whether the mean abnormal return is significantly different from zero. The benchmark we will compare the returns with will be both firms which have not performed any equity issuing, in addition to companies which have performed a regular seasoned equity offering with no private placement on beforehand.

Determining whether we have any abnormal performance as a consequence of announcing a subsequent offering will be our starting point. In case we find that mean abnormal returns are significantly different from zero, we would find it interesting to investigate what determinants that causes the announcement effect. For instance, is it well documented that issue size is a determinant that influences the announcement effect; the greater the issue, the more negative announcement effect. The fact that a subsequent offering usually is of a smaller issue size than a private placement and a regular seasoned equity issue can be an explanatory factor in case of a different announcement effect.

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