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Earnings management, market discounts and the performance of private equity placements

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ABSTRACT

Private equity placement data allow us to determine whether sophisticated investors can uncover the true value of firms. This can be done by defining sophisticated investors as those who meet the stringent participation requirements of the private equity market. Our results show private equity issuing firms overstate their earnings in the quarter preceding private equity placement announcements and that sophisticated investors do not ask for a fair discount when purchasing the shares of the private issuing firms. We also find evidence showing that the reversal of the effects of pre-issue earnings management is a significant determinant of the long-term performance of private issues. Results further show that post-issue stock performance and operating performance of firms using "aggressive" earnings management significantly underperform those using more "conservative" earnings management.

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1. Introduction

Valuation of corporate securities can influence the decision and timing of firm's financial transactions. Extant studies in the securities issuance literature (Myers and Majluf, 1984) argue that when raising capital in the presence of information asymmetry, overvalued firms may choose to raise equity capital. Ritter (1991) and Loughran and Ritter (1995) argue that windows of opportunity exist when a firm's equity is overpriced with respect to managers' private information. They claim that long-run stock underperformance may result from the selling of overpriced equity and the failure of market participants to incorporate all information conveyed in the announcement. However, unlike the public offerings that have both negative short-term and long-term abnormal stock returns, private equity placements have better short-term but poor long-run stock returns (Hertzel et al., 2002; Krishnamurthy et al., 2005).[1] Hertzel et al. (2002) find that the mean three-year buy-and-hold abnormal return after private equity placement is −23.78%. The negative long-run abnormal stock returns are so large that one wonders why investors[2] buy these stocks. By defining sophisticated investors as those who meet the stringent participation requirements of the private equity market, private equity placement data combined with accurate measures of earnings management allow us to determine whether sophisticated investors can uncover the true value of firms and whether information asymmetry exists in the private equity market where participants are "sophisticated".

Previous studies find that the reversal of the effects of preceding earnings management is a significant determinant of long-term stock performance. Teoh et al. (1998a,b), Shivakumar (2000), and Kao et al. (2009) find that equity issuers who adjust discretionary current accruals to report higher earning before the public offerings have lower post-issue long-run abnormal stock returns. Chen and Cheng (2002) find that investors and analysts cannot detect managers' motivations, and thus fail to incorporate the implication of abnormal accruals into their earnings forecasts and stock prices. Louis (2004) shows that stock swap acquiring firm's post-merger

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[1] One possible explanation for this anomaly, suggested by Hertzel et al. (2002), is that the poor long run performance may be caused by the overvaluation at the time of the private placements. Other possible explanations for the post-placement underperformance include: (1) agency problems (Barclay et al., 2007) and (2) overoptimism (Marciukaityte et al., 2005).

[2] In contrast to public equity issues, which are registered with the Securities and Exchange Commission, and sold to a large number of investors, private equity placements are typically restricted to a small group of sophisticated investors—with minimum income or wealth requirement.

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long-run stock performance is significantly negative related to the pre-merger discretionary accruals.

The existing literature provides much direct evidence on the relationship between overvaluation and earnings management. The theoretical relationship between overvaluation and earnings management is consistent with Jensen's (2005) agency-costs-of-overvalued-equity prediction. Direct empirical evidences on this relationship were provided in Chi and Gupta (2009). Teoh et al. (1998b) provide evidence for this relationship using IPO. Rangan (1998) and Teoh et al. (1998a) show this for SEOs. Shleifer and Vishny (2003) provide a theory on the relationship between earnings management and overvaluation using acquiring firms in stock deals. According to their framework, firms have strong incentives to get their equity overvalued through various means including earnings manipulation. Louis (2004) provides evidence on this relationship using acquiring firms involved in mergers. The review article of earnings management literature by Healy and Wahlen (1999) also mentions that some of the overpricing observed for firms that sell new equity may be attributable to earnings management prior to the issue. Xie (2001) provides empirical evidence on the relationship between overvaluation and earnings management by showing that firms that managed earnings upward show subsequent stock declines. Sloan (1996) uses a trading test to demonstrate the relationship between overvaluation and earnings management by showing that a trading strategy of taking a short position in firms that display relatively high levels of upward earnings management generates positive abnormal returns.

Earnings management can also be used to induce undervaluation. Unlike traditional IPOs, where managers are net sellers of equity and have incentives to increase earnings, managers of demutualizing firms are net buyers of equity, resulting in incentives to decrease earnings prior to the offering. Using a sample of mutual depository IPOs, Adams et al. (2009) find that managers of mutuals use discretionary choices to reduce reported earnings prior to the demutualization to help justify a lower initial valuation for demutualizing firms.

The relationship between earnings management and private equity placements has not yet been analyzed in the literature. Focusing on private equity placement data allow us to answer an interesting question of whether or not sophisticated investors can uncover the true value of firms. Earnings management, which boosts earnings relative to cash flows, can make private equity placements overpriced. When high pre-issue earnings are not sustained, disappointed investors revalue the firm down to a level justified by fundamentals. Thus, if errors in the market's assessment of earnings management by private equity issuers reverse in the subsequent years, we expect a negative relationship between the degree of pre-issue earnings management and the long-run stock performance of private equity placements.

Private placements are typically priced at substantial discounts from current market value. The existing literatures view these discounts as compensation to the block purchasers either for (1) expected monitoring service or expert advice (Wruck, 1989), (2) the illiquidity associated with holding unregistered stock (Silber, 1991), and (3) costs incurred to assess firm value (Hertzel and Smith, 1993). Hertzel et al. (2002) provide another argument that private placement discounts may reflect overvaluation. Krishnamurthy et al. (2005) and Barclay et al. (2007) find some evidence showing that participating investors buy the shares at a discount that compensates them for the subsequent decline in stock prices.

In this study, we make use of the operating performance near the announcement of private placements and examine its consistency with earnings management. In theory, if a private equity issuer boosts current earnings before private equity placements, the resulting improvement in operating performance prior to issue should be accompanied with a stock price run-up. This is not consistent with the results of Hertzel et al. (2002), who find that private equity issues tend to follow periods of relatively poor operating performance. However, a major weakness of their study is that their results are based on operating performance measured by *year* relative to private equity placements. This, combined with the fact that stock run-ups are usually more pronounced during the six-months prior to the private placement,[3] suggests that detailed analysis using nearer announcement operating performance may yield results more in line with theory. To address this issue and to better capture the effect of possible earnings management, this study makes use of *quarterly* operating performance near the private equity issuance date.

Our results show that current accruals tend to be abnormally high before and after private equity placements. Results also show post-issue stock price underperformance to be especially pronounced for issuers that aggressively manipulate pre-issue discretionary current accruals. We further find private placement discounts to be not significantly affected by the manipulation of abnormal current accruals. That is, although private issuers indeed tend to boost their earnings by manipulating accounting accruals, we find evidence that "sophisticated" private equity investors do not ask for fair compensation in buying shares of these overpriced firms.

Finally, we find evidence indicating that the quarterly operating performance of private equity issuing firms relative to that of control firms improves before but deteriorates after private equity placements. This evidence is consistent with the behavioral explanation that long-run underperformance is the result of investors overweighting recent experience when forming expectations. We also find that after private equity placements, the quarterly operating performance of firms that manage their earnings more "aggressively" significantly underperform those using more "conservative" methods. Moreover, "aggressive" firms tend to invest more than "conservative" firms both before and after the issuance.

The organization of the remainder of this article is as follows. In Section 2, we describe the sample selection procedure and the data. Section 3 describes research design. The empirical results are presented in Sections 4 and 5 concludes the paper.

2. Data

Our sample comprises of common stock private placement announcements by companies listed on NYSE, AMEX or NASDAQ from 1997 to 2003. The announcement dates and related issuance details are obtained from the Securities Data Corporation (SDC) database, the *Lexis/Nexis* computer database and *The Wall Street Journal*. The sample further satisfies the following requirements:

(1) The private placement does not involve warrants and other securities with common stock issues.
(2) Utilities (SIC codes 4910-4949) and financial institutions (SIC codes 6000-6999) are excluded.[4]
(3) We exclude from the sample those equity issues that are known at the time of the announcement to be takeover related.
(4) All additional placements by the same firm during the 3 year period before a private equity placement that enters the sample are excluded.
(5) The issuing firms must have quarterly accounting data on Compustat and stock returns on CRSP.

[3] Hertzel et al. (2002) and Krishnamurthy et al. (2005) show that firms placing their equity privately exhibit significant stock run-ups in the months prior to private equity issue.

[4] We remove utilities and financials since these firms operate in a regulated environment and their characteristics differ substantially from non-regulated firms.

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