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ABSTRACT

We study the consequences of a US deregulation allowing small firms to accelerate their public equity issuance. Post-deregulation, affected firms double their reliance on public equity and transition away from private investments in public equity compared to similar untreated firms. The net effect is a 5.7 percentage point or 49% increase in the annual probability of raising equity. This is accompanied by a reduction in equity issuance costs, an increase in investment, and a decrease in leverage. Our findings provide evidence that reducing equity issuance barriers benefits issuers even in highly developed markets.

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1. Introduction

In recent decades, corporations have drastically changed the way they raise equity. Until the late 1990s, the vast majority of equity offerings were traditional fully marketed public seasoned equity offerings (SEOs). These offerings involved a month-long US Securities and Exchange Commission (SEC) review and underwriter marketing process.¹ Around 2000, firms began transitioning toward quicker is-

suance methods involving less regulatory delay. Large firms started to use shelf registrations to accelerate public SEO issuance. Smaller firms, which the SEC prohibited from using shelf registrations, turned to private investments in public equity (PIPEs) for quick equity financing. This transition toward financing technologies with fewer regulatory frictions raises the possibility that equity issuance barriers have economically meaningful effects on corporate outcomes. Yet, empirically identifying these effects is complicated because financing technologies develop slowly over time and firms choose their financing strategy partially based on unobservable covariates.

This study provides new evidence on the effect of issuance barriers on capital acquisition, investment, and capital structure by exploiting a financial deregulation granting firms access to shelf-registered equity offerings. In 2008, the SEC began allowing exchange-listed firms with public floats of less than \$75 million to raise equity via

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¹ We define equity offerings of registered shares as public equity offerings. These are generally referred to as SEOs in the academic literature and follow-on offerings in practitioner circles. We refer to offerings

of unregistered shares as private equity offerings or private investments in public equity (PIPEs).

shelf registrations for the first time.² The goal of this change was to allow smaller companies to conduct accelerated SEOs, which provide quicker access to capital than do traditional SEOs and which regulators argue provide lower issuance costs compared with both non-accelerated SEOs and PIPEs.³ Whether this deregulation relaxes a binding financing constraint for small public firms is an empirical question. For example, the effects of the deregulation will be limited if it remains optimal for most small firms to continue relying on the more flexible PIPE contracts, which Wu (2004), Cronqvist and Nilsson (2005), and Chaplinsky and Haushalter (2010) argue are more capable of mitigating agency problems and information asymmetries.

To study the consequences of this deregulation, we focus on a set of firms near the \$75 million threshold used in the 2008 SEC rule. We use a difference-in-differences strategy to compare the pre- and post-deregulation outcomes of firms below the \$75 million cutoff that gain access to shelf registrations in 2008 (treated firms) and firms between \$75 million and \$150 million in public float with access to shelf registrations throughout our 2002 to 2012 sample period (untreated firms). This sample of firms with less than \$150 million in public float contains approximately 40% of US exchange-listed firms, which are responsible for more than 55% of equity offerings.

Fig. 1 shows that treated firms dramatically change the amount of public equity they raise, relative to untreated firms, once they are granted access to shelf registrations. Prior to 2008, only 4% of treated firms conducted public follow-on offers in any given year, compared with more than 10% of untreated firms. Since 2010, however, firms on both sides of the \$75 million line raise public equity with similar frequency.

Difference-in-differences estimates further show that treated firms experience a sharp transition away from PIPEs toward shelf SEOs following the 2008 deregulation. Our estimates also indicate that this transition toward public SEOs is accompanied by a 5.7 percentage point or 49% increase in the probability of raising equity each year. These ordinary least squares (OLS) results suggest that the deregulation had a significant effect on the absolute level and composition of equity issuances conducted by treated firms, compared with untreated firms. Logistic regression analyses further show that the absolute changes were accompanied by a change in the relative odds of treated firms raising equity, particularly public equity, relative to untreated firms. Following the deregulation, the odds of treated firms raising equity in a given firm-year increase by 79% compared with the odds of untreated firms raising equity. Furthermore, conditional on raising equity, the

odds that treated firms raise public equity increased four-fold relative to untreated firms.

We find that treated firms experience an 8.4 percentage point drop in offering discounts relative to untreated firms following the deregulation. This drop implies an approximate 1 percentage point reduction in the cost of equity for an equity-financed firm with a 12% cost of capital.⁴ This result demonstrates how transitioning away from PIPEs in favor of public shelf SEOs can lower equity issuance costs. One limitation to this portion of our analysis is that we cannot easily quantify many other costs and benefits to PIPEs. For example, Wruck (1989) and Hertz and Smith (1993) provide evidence that the investors in PIPEs provide valuable monitoring and due diligence services, and Chaplinsky and Haushalter (2010) show that an important cost to PIPEs is reset and warrant provisions. Nevertheless, the overall increase in issuance and the decrease in issue discounts raise the possibility that issuance barriers are an important determinant of corporate behavior.

Two aspects of corporate behavior that are likely to be affected by the documented changes in issuance behavior are investment and leverage. We expect that conducting more and lower cost equity offerings will be accompanied by increased investment and decreased leverage. Our evidence supports these predictions. Treated firms increase their capital expenditures by approximately 20% and reduce their leverage by 11% relative to untreated firms. All three of our main findings—the transition from private to public equity issuance, the increased investment, and the reduced financial leverage—are robust to methods isolating within-firm variation, are not driven by distressed firms, and are not present in placebo specifications.

Our findings extend the securities issuance literature by showing that the benefits to shelf-registered SEOs are more pervasive than previously suggested. Despite evidence that small firms should be less likely than large firms to benefit from accelerated SEOs relative to either PIPEs (Chaplinsky and Haushalter, 2010; Gomes and Phillips, 2012) or non-accelerated public offerings (Denis, 1991; Gao and Ritter, 2010), we show that many small firms use and benefit from the option to accelerate public equity issuance. We also add to recent research on the determinants of firm capital structure decisions that has identified the first order effect of taxes on capital structure and investment (Becker, Jacob, and Jacob, 2013; Doidge and Dyck, 2015; Graham 2000; Heider and Ljungqvist, 2015) as well as the importance of market timing (Baker and Wurgler, 2002), stock appreciation (Welch, 2004), macroeconomic conditions (Korajczyk and Levy, 2003), and industry peer effects (Leary and Roberts, 2014) in determining capital structure. We show that barriers to equity issuance are likewise important inputs into firms' investment and capital structure decisions.

² Public float is the part of traded equity not held by insiders, such as managers and blockholders. It is on average half of the market value of the equity for small firms.

³ Bortolotti, Megginson, and Smart (2008), Henry and Koski (2010), and Gustafson (2016) all show that acceleration is associated with lower issuance costs on various dimensions compared with traditional public SEOs. Gao and Ritter (2010) find a trade-off whereby accelerated SEOs have lower fees but larger price discounts. They show that accelerated SEOs are particularly attractive for issuers with elastic demand for equity and those making small offers. The unique costs of PIPEs relative to SEOs are also well established (see, e.g., Wruck, 1989; Silber, 1991).

⁴ The precise pretax cost of equity reduction attributable to the reduced discount depends on the level of SEO issuance costs and the cost of capital. For example, a firm with pre-transaction costs of equity of 12% and issuance costs of 5% has an effective pretax cost of equity of 12%/0.95 or 12.63%. Increasing issuance costs by 8.4 percentage points raises the pretax cost of equity to 12%/0.87 or 13.86%.

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