G Model
MULFIN-529; No. of Pages 22
ARTICLE IN PRESS

J. of Multi. Fin. Manag. xxx (2017) xxx–xxx

Contents lists available at ScienceDirect

Journal of Multinational Financial Management

journal homepage: www.elsevier.com/locate/econbase

Determinants of underwriting spreads internationally: Evidence from SEOs

Manu Gupta*, Puneet Prakash, Nanda K. Rangan

Department of Finance, Insurance and Real Estate, Virginia Commonwealth University, Richmond, VA, United States

ARTICLE INFO

Article history:
Received 6 October 2016
Received in revised form 3 May 2017
Accepted 6 May 2017
Available online xxx

Keywords:
Political economy
Legal enforcement
Equity and bond markets
Securities litigation
Stock market valuation
Seasoned equity offering

ABSTRACT

We examine the effect of country-level factors on gross underwriting spreads in seasoned equity offerings. Controlling for issue, issuer and underwriter characteristics, we find that primary legal factors that impose direct court costs on underwriters significantly increase spreads. However, secondary legal, economic, and governance factors do not impact spreads significantly. We provide corroborative evidence that preemptive rights lower spreads, and thus, rights offering price concession is a form of transaction cost. We conclude that the non-primary legal factors not captured by market risk are likely incorporated at the time of underwriter-issuer contracting.

1. Introduction

There is ample evidence that legal mechanisms influence the development and size of financial markets across nations.[1] An important component of a firm's investment and capital structure decision is the cost of raising equity. This component is yet to be explored in a cross-country setting. More capital is raised through seasoned equity offerings (SEOs) than initial public offerings (IPOs).[2] Cost of raising capital through SEOs therefore have notable implications for a firm's cost of capital, and its competiveness. We examine how the direct cost of raising equity capital through SEOs is influenced by the country-level factors. The direct cost component of raising capital through SEOs for the issuer is the underwriting spread (difference between the price paid by underwriters and the offer price), while underpricing and discounting of the equity issue are the indirect cost in terms of money left on the table. We focus on the direct cost in this paper. By not considering indirect costs, we abstract away from price run-ups and other market imperfections that may become magnified in an international setting due to the heterogeneous nature of the markets in our study.

Prior studies of SEOs that examine underwriter spreads have mostly been confined to within-country samples, thereby limiting their generalizability to cross-country analysis. The development of country-level risk proxies that have significant applications in finance provides an opportunity to isolate the effects of sovereign risk on the equity issue spread in a cross-

* Corresponding author.
E-mail addresses: mgupta2@vcu.edu (M. Gupta), pprakash@vcu.edu (P. Prakash), nkrangan@vcu.edu (N.K. Rangan).

[1] See Gupta et al. (2011) for literature review.

[2] Kim and Weisbach (2008) report that across the world more than $1 trillion were raised though SEOs and $620 billion through IPOs during between years 1990 and 2003.

http://dx.doi.org/10.1016/j.mulfin.2017.05.006

Please cite this article in press as: Gupta, M., et al., Determinants of underwriting spreads internationally: Evidence from SEOs. J. Multinatl. Financial Manage. (2017), http://dx.doi.org/10.1016/j.mulfin.2017.05.006

country setting. Our study provides empirical evidence on cross-country variation in SEO spreads in an attempt to fill this gap in the literature.

The single country studies, nevertheless, provide us with a good beginning. Altınkılıç and Hansen (2000), Carter and Manaster (1990), Corwin (2003), Eckbo et al. (2007), and Lee and Masulis (2009) identify factors that affect spreads, and are broadly classified under issue, issuer, and underwriter characteristics. However, our study is about the effect of country-level factors on underwriting spreads above and beyond the effect of the issue, issuer, and underwriter characteristics. We refer to the *incremental effect* of country factors on the underwriting spread after issue, issuer, and underwriter factor effects have been removed from gross spreads, as *country underwriting spreads* or simply *underwriting spread*.

We consider broadly three country-level factors – legal, economic and governance. The legal risk factor is further categorized into legal-primary (involving courts) and legal-secondary (involving a supervisor/regulator such as the Securities Exchange Commission (SEC) in the United States). The need for this sub-categorization is rooted in Tinic (1988) and Gillette and Krier (1990). In essence, the legal risk factors have the potential to identify specific actors and impose costs on them. The factors for our study are primarily gleaned from La Porta et al. (1998), La Porta et al. (2006), Kaufmann et al. (2004), Djankov et al. (2008) and other sources described in the data section.[3] The economic factors determine the level of economic activity and need for capital. The governance factors in our study are those that affect the general environment of doing business in a nation, and do not comprise those legal factors that impose costs on specific individuals, groups, or entities. Thus, our governance class lacks specificity. Overall, our classification may be considered a relook and refinement of different classes of factors and not a contradiction of earlier typologies, for example, Denis and McConnell (2003) who split governance into internal mechanisms, those emanating from within the firm and external mechanisms, the ones that depend on nation's legal and regulatory environment. Our study contributes to the literature by further classifying external governance factors.

Our results indicate that the primary legal factors that necessarily involve going to courts and incurring legal costs have a positive and significant effect on the country underwriting spreads. Secondary legal factors that are primarily under the control of the administrator (supervisor) do not have any effect on the underwriting spreads, by and large. Among the economic factors, the access of a wide variety of firms to equity markets, rights of shareholders against the firm's directors, and market development exhibit weak association with underwriting spreads. However, when we control for the market risk, only the market capitalization to GDP ratio has a significant negative effect on the underwriting spreads. Because the relation of this variable to market development is tenuous at best, we test if developed countries (G7 or OECD nations) have significantly different underwriting spreads than developing countries. We find no evidence that this is the case. Because the weak effects of economic factors disappear after market risk is controlled for, it is possible that the economic risks are captured entirely by volatility of the markets.

We find similar results when we test for the governance factors. Without controlling for market risk, the efficiency of the judiciary and markets (captured by a variable that serves as a proxy for how much a shareholder could benefit from insider information) appears to have a significant and negative impact on the country-specific spreads. However, when we control for the market risk, the effects disappear. We find no significant effect of public enforcement, corruption levels, and bureaucratic inefficiency on underwriting spreads. Because market volatility is also statistical insignificant in a majority of regression models involving country governance variables, we conclude that governance effects on underwriting spreads are likely captured in the issue, issuer and underwriter characteristics, and there is no incremental effect of governance factors on spreads. Interestingly, we also find no evidence that English common law has any significant effect on underwriting spreads.

We also conduct robustness tests for our results using a different set of variables for each factor. None of our main results are significantly affected by inclusion of these new variables. Alternate proxies for a country's stock market risk also do not affect our results.

Our study contributes to the literature on equity offerings in several ways. First, we shed light on an unexplored area by conducting a cross-country analysis of the equity underwriting spread. We find that while country underwriting spreads in SEOs are associated with underwriter's primary legal risk, they are not related to the secondary legal risk. Second, we find that most of the economic factors that can potentially affect underwriting spreads are effectively captured by a country's market risk and/or the issue, issuer and underwriter characteristics. Finally, we report that country governance factor related to business environment is endogenized in the issuer-underwriter matching process and that there is no incremental effect of these variables on underwriting spreads.

Our research offers insights regarding equity issuance cost and legal environment to policy makers, investment bankers, firms and academics. All else equal, firms with smaller cost of raising capital have a competitive advantage. Nations with financial market conditions that favor a lower cost of raising capital thus afford a natural competitive advantage to the firms that raise capital in those nations. As the efficiency of a market improves, most of the environmental factors, including the supervisory and governance ones, are endogenized into underwriting costs in a bilateral contract between two economic agents, namely the issuer and the underwriter. The greater the probability that cash flows out of this two-agent supervised financial system to an outside third party, namely the courts, the greater is the direct cost of underwriting. Thus, underwriting costs can be reduced with more complete contracting that minimizes the chance of this outflow.

[3] Unlike the bottom up approach of constructing factors using variables that may result in impossible to define factors (factor analysis), we take a top down approach where we define meaningful factors first and then identify variables corresponding to each factor.