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journal homepage: www.elsevier.com/locate/jfecThe role of institutional investors in seasoned equity offerings[☆]Thomas J. Chemmanur^{a,*}, Shan He^b, Gang Hu^c^a Carroll School of Management, Boston College, Chestnut Hill, MA 02467, USA^b E. J. Ourso College of Business, Louisiana State University, Baton Rouge, LA 70803, USA^c Babson College, Babson Park, MA 02457, USA

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ABSTRACT

Do institutional investors possess private information about seasoned equity offerings (SEOs)? If so, do they use this private information to trade in a direction opposite to this information (a manipulative trading role) or in the same direction (an information production role)? We use a large sample of transaction-level institutional trading data to distinguish between these two roles of institutional investors. We explicitly identify institutional SEO allocations for the first time in the literature. We analyze the consequences of the private information possessed by institutional investors for SEO share allocation, institutional trading before and after the SEO and realized trading profitability, and the SEO discount. We find that institutions are able to identify and obtain more allocations in SEOs with better long-run stock returns, they trade in the same direction as their private information, and their post-SEO trading significantly outperforms a naive buy-and-hold trading strategy. Further, more pre-offer institutional net buying and larger institutional SEO allocations are associated with a smaller SEO discount. Overall, our results are consistent with institutions possessing private information about SEOs and with an information production instead of a manipulative trading role for institutional investors in SEOs.

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1. Introduction

The importance of institutional investors in financial markets and in equity offerings in particular has increased dramatically in recent years. For example, institutional investors in 2003 controlled 59.2% of the equity outstanding in the US (\$7.97 trillion), compared with only 28.4% or \$376 billion in 1980.¹ Further, investment banks often allocate equity in initial public offerings (IPOs) predominantly to institutional investors (Aggarwal, Prabhala, and Puri, 2002). Reflecting the importance of institutional investors, considerable research has been done on the role of institutional investors in IPOs. In particular, starting with Rock (1986) and Benveniste and

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* Corresponding author.

E-mail address: chemmanu@bc.edu (T.J. Chemmanur).

¹ See Gompers and Metrick (2001) and the 2005 Institutional Investment Report: US and International Trends—Report 1376, The Conference Board.

Spindt (1989), a number of papers in the theoretical IPO literature analyze the role of informed institutional investors in IPOs. More recently, significant empirical research also has focused on the role of institutional investors in IPOs (see, e.g., Aggarwal, Prabhala, and Puri, 2002, on institutional share allocation in IPOs; Chemmanur and Hu, 2006, on institutional trading around IPOs; and Ritter and Welch, 2002, for a review of the IPO literature). Surprisingly, however, considerably less research, especially empirical, has been done on the role of institutional investors in seasoned equity offerings (SEOs).² The objective of this paper is to fill this gap in the literature by analyzing empirically, for the first time, the role of institutional investors in SEOs, making use of a large sample of transaction-level institutional trading data.³

SEOs differ from IPOs in two important ways. First, SEOs are made by firms that have matured beyond the IPO, having a significant track record of financial and operating performance at the time of the SEO. Second, the issuing firm's shares already trade in the equity market prior to the SEO, unlike in the case of an IPO, where no such trading takes place in most countries. These two differences have several important consequences for an economic analysis of SEOs relative to IPOs. First, given that more information is available to all outside investors about firms making SEOs, the extent of information asymmetry facing uninformed (retail) investors about the prospect of SEO firms is likely to be smaller compared with that about firms making IPOs. This means that any informational advantage of institutional investors over retail investors could be lower in the context of SEOs compared with IPOs. Second, assuming that institutional investors possess private information about firms making SEOs as well as IPOs, significant differences arise in the manner in which they could exploit this private information for profit. In particular, informed investors can trade on their private information in the pre-offer market in the case of SEOs but cannot do so in the case of IPOs (given that such pre-offer equity market trading is absent in IPOs). In other words, while institutional investors can exploit their private information in both the pre-offer market and the equity offering itself in the case of SEOs, they can do so only in the equity offering in the case of IPOs.

Third, given the above likelihood that at least some of the information possessed by institutional investors is

reflected in pre-offer market prices (and trading volume) due to institutional investors exploiting their information through pre-offer trading in SEOs, issuers can use these variables to infer this information and potentially use it to set their firm's SEO offer price. This contrasts with the IPO situation, in which (as modeled by Benveniste and Spindt, 1989, and others) issuers need to rely solely on various information revelation mechanisms to extract institutional investors' private information. Fourth, the possibility of issuers inferring institutional investors' private information from pre-offer equity market prices and trading volume in the context of SEOs brings up the possibility of attempts at SEO price manipulation by institutional investors by trading in the pre-offer market against their private information (for example, by selling shares in SEO firms about which they have favorable private information).⁴ Clearly, given the absence of a pre-offer equity market in IPOs, such price manipulation is not a concern in IPOs. Fifth, given that, unlike in IPOs, institutional investors can acquire shares in the firm making an SEO in the pre-offer market, the relation between institutional share allocation across various categories of SEOs, SEO pricing, and institutional trading in the SEO firm's equity after the offering are likely to be different from the corresponding relations in IPOs. Finally, the existence of pre-offer equity market trading in the context of SEOs gives rise to an important SEO phenomenon, namely, the SEO discount; i.e., the fact that the offer price in SEOs is set, on average, below the closing price on the previous day (a phenomenon that clearly does not exist in the case of IPOs, given the absence of pre-offer trading).

The important economic differences between SEOs and IPOs and the role played by institutional investors in these equity offerings give rise to three sets of interesting empirical research questions. The first set of research questions pertains to whether institutional investors have private information about SEOs and the consequences of this private information on share allocation.⁵ In other words, are institutional investors able to identify and obtain more allocations in better SEOs? The second set of research questions pertains to how institutions make use of their private information, if any, to trade in the equity of SEO firms before and after the SEO, and the profitability of such trading. In particular, what is the relation between pre-offer institutional trading, institutional SEO share allocations, and post-offer institutional trading? What is

² An extensive literature exists on seasoned equity offerings in general. There are several strands in this literature. The first strand is the literature on the announcement effect of SEOs. See, e.g., Myers and Majluf (1984) and Giammarino and Lewis (1989) for theoretical models and Asquith and Mullins (1986) for an empirical analysis. The second strand is the literature on the SEO discount and the SEO offering process. The third strand on the long-term post-issue underperformance of SEOs. See, e.g., Carlson, Fisher, and Giammarino (2006) for a theoretical analysis and Loughran and Ritter (1995) and Brav, Geczy, and Gompers (2000) for empirical analyses.

³ There is a growing literature on the role of institutional investors around other corporate events. See, e.g., Parrino, Sias, and Starks (2003), who study the role of institutional investors around forced CEO turnovers.

⁴ In an attempt to minimize such market manipulation, the Securities and Exchange Commission (SEC) recently approved a rule change barring the purchase of shares in an offering by anyone who sold the shares short during a restricted period (Wall Street Journal, 2007).

⁵ The incentives of outsiders to produce information are considerably greater in the context of an SEO compared with that in a general market trading situation. In general market trading, the tendency of the market price to reveal the private information held by market participants depresses the incentives of investors to produce information, as discussed by Grossman and Stiglitz (1980). This problem is considerably mitigated in the context of SEOs, given that the SEO offer price is not fully adjusted according to the demand for shares in the offering, so that the offer price is not invertible to reveal outsiders' private information.

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