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The influence of investor identity and contract terms on firm value: Evidence from PIPEs

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ABSTRACT

Financial relationships can alleviate the adverse effects of asymmetric information and agency costs on outside stakeholders. We examine announcement returns to PIPE transactions, conditional on the contract terms and identity of the investor. We find that the influence of contract terms on announcement returns depends on investor identity. For PIPEs with hedge fund investors, the inclusion of control terms associates with much larger announcement returns. In contrast, announcement returns for PIPEs, involving strategic investors, are less dependent on the existence of control terms. We find the opposite for liquidity terms. Namely, announcement returns are dramatically different for strategic investors with and without liquidity terms, while inclusion of liquidity terms is less influential when PIPEs involve hedge funds. Our findings suggest that investor identity and contract terms jointly influence market reactions to PIPEs.

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1. Introduction

Prior studies show that financial relationships can benefit outside equity holders by mitigating the adverse effects of asymmetric information and agency conflicts. Such benefits arise when the investor

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possesses superior monitoring and/or information-production ability. While investor ability is a necessary ingredient to generate these benefits, ability alone may be insufficient. The investor must also have an incentive to engage those abilities; if a contract payoff is insensitive to the condition of the firm, then the investor may have little incentive to monitor or produce information, and the value of the financial relationship will be invariant to the investor's ability. In a similar vein, incentives will have little influence if the investor lacks inherent ability.

We explore how contract terms and investor identity influence shareholder wealth using a newly available dataset on private equity investments in public companies (PIPEs) over the period 2001–2010. We measure the value of the financial relationship as the stock market reaction to the announced PIPE financing, and relate this wealth effect to both investor identity and contract terms. We focus on two distinct investor identities intended to capture differences in investors' abilities: strategic/long-term investors (who likely have an information and/or monitoring advantage), and arms-length/short-term investors. Based on prior studies (Anderson and Dai, 2010; Bengtsson and Sensoy, 2011) and on our own analysis (discussed below), strategic/long-term investors include venture capitalists (VCs), private equity firms, and corporations; arms-length/short-term investors include hedge funds. We focus on two key contract terms: control terms and liquidity terms. *Control terms* will influence the investor's incentives to engage in monitoring and/or information production. (For our primary tests, the key control term is board seat requests.) *Liquidity terms* allow an investor to exit the relationship rather than engaging with the firm directly. (We use requests for pre-registered securities, which allow the investor to sell his/her claims immediately as our key liquidity term.)[1]

We explore the influence of investor identity and contract terms on shareholder wealth by comparing groupings of PIPE transactions across both investor identity and contract terms. We find that when PIPEs contain board seats, there is no difference in abnormal returns when the lead PIPE investor is a strategic investor versus a hedge fund. Analyzing pre-registered terms reveals a similar finding: While the use of pre-registered terms negatively influences the reactions to the PIPE for financings with both strategic investors and hedge funds, the incremental effect is far worse in the case of strategic investors.

One challenge for our study, as well as prior studies in this area, is the joint nature of financing characteristics (i.e., terms and identity) and firm characteristics. When a firm's condition/situation is observable, we can include firm characteristics as control variables to address this concern. However, if there is an unobservable, omitted variable correlated with the financing variables then the results may be biased. Given many firms engage in multiple PIPE transactions, we are able to include fixed effects to address this concern. We find that differences between the announcement effects for hedge fund-led versus strategic investor-led PIPEs (which are large and significant in OLS regressions), become insignificant when we include firm fixed effects. Moreover, with fixed effects, we find identity only matters *conditional* on contract terms.

We also exploit PIPE sequences, namely the sample of PIPEs issued by the same firm and close together in time. This should help if an omitted variable is time varying but sticky across these relatively short time windows. These PIPE sequences allow us to isolate the effects of changes in financing features when the firm is unlikely to have fundamentally changed. In both of these sets of tests (multivariate regressions including firm fixed effects and examination of PIPE sequences), we find strong evidence that the value relevance of contract terms depends on investor identity.[2]

[1] These two terms are the most frequently used ones by both strategic-led and hedge fund-led PIPEs. Moreover, PIPEs tend to include one or the other, but not both. In Appendix B, we show that among the PIPEs containing board seat requests only, 1.7% also include a pre-registered stock request. In general, we find negative correlations between inclusions of control and liquidity terms, we find low conditional probabilities of having liquidity terms when the contracts contain control terms (and vice versa).

[2] An alternative explanation for our results could be that specific investors associate with particular contractual terms, i.e., some investors may only use control terms while others may only use liquidity enhancing terms, which would make it difficult to identify whether the results are attributable to contract terms or the specific investor. To see if this is the case, we examine PIPE transactions for specific 109 PIPE investors who lead at least 10 PIPE deals. For these 109 investors, we find 22 use liquidity enhancing terms exclusively; 0 exclusively use control terms; and 87 use both, *at least once*, among their PIPE deals. Further, we include specific investor name fixed effects in one of our regressions. This isolates the variation in the contract terms to be within investor name. We continue to find that the influence of contract terms is conditional on investor type.

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