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Corporate control, expected underpricing, and the choice of issuance mechanism in unseasoned equity markets

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Abstract

Using unique Australian data we examine the choice of issuance mechanism for unseasoned equity (between initial public offers and direct placements) prior to exchange listing. Controlling for liquidity in the decision to go public and incorporating interrelated decisions, we find that corporate control concerns and expected underpricing differences between initial public offers and direct placements play an important role. Also the probability of an initial public offer (direct placement) decreases (increases) with information asymmetry and the reputation of the issuer. Further, the choice of issuance mechanism and the underpricing, issue size and ownership retention decisions are interrelated.
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1. Introduction

Although there is an extensive empirical literature on reasons for going public and the underpricing of initial public offers,[1] little research has been undertaken on the choice of issuance mechanism[2] in unseasoned equity markets. This is attributable, in part, to the U.S. Security and Exchange Commission's Rule 144 which limits privately issued equity from being publicly traded for 2 years.[3] Consequently, the choice of issuance mechanism for unseasoned equity in the U.S. is conditional on the exchange listing decision (Lerner, 1994; Corwin and Harris, 2001).

However, Australia provides a unique opportunity to study the choice of issuance mechanism in an environment that does not inhibit the trading of privately distributed equity. Upon listing, both initial public offers and direct placements may be traded in the Australian secondary market.[4] Consequently, the regulatory environment allows an examination of the choice of equity issuance mechanism while controlling for exchange listing and secondary market liquidity.[5]

Although there is an extensive literature dealing with the choice of issuance mechanism in debt markets,[6] unique features of the equity markets may influence this decision. For example, Brennan and Franks (1997) suggest that the choice of issuance mechanism in unseasoned equity markets is affected by the desire of owners to protect or reinforce their

[1] See Ritter (2003) for an extensive review of this literature.

[2] That is the choice between making an initial public offer or a private placement.

[3] Securities and Exchange Commission (1997), Release No. 33-7391.

[4] These mechanisms are similar to those reported in France (Husson and Jacquillat, 1989; Leleux and Paliard, 1996) and the United Kingdom (Jenkinson and Mayer, 1988; Brennan and Franks, 1997) where firms may privately place shares and seek exchange listing subject to satisfying listing requirements concerning spread of shareholding, profitability, and capitalization.

[5] To provide a contextual setting for the choice of distribution mechanism, we describe two cases using a direct placement and an initial public offer, respectively. Hastings Deering Corporation Limited was listed on the Main Board on August 29, 1985, having supplied pre-listing documentation to the stock exchange in a memorandum dated August 20, 1985. It was a well-established firm with a number of automotive, heavy equipment, aviation and waste disposal activities that had been trading successfully since 1935. Prior to listing it had 931 employees and approximately 5000 shareholders, well in excess of the minimum requirements for main board listing. It also had a history of significant turnover, profitability and dividend distribution. In the 6 months prior to listing, it used a direct placement to issue 50,373,821 shares at $1.12 to raise $56.4 M. Total assets upon listing were $141.5 M. The issue was not underwritten and at the close of the first day of trading was priced at $1.11. The memorandum did not disclose the use of proceeds.

Tasmanian Atlantic Salmon Limited was listed on the Main Board on November 6, 1986, having released a prospectus dated September 19, 1986. It was a small company, with less than ten employees, engaged in the sea farming of Atlantic salmon in southern Tasmania. The company raised $3 M in a fully underwritten public issue of 6 million shares. Total assets immediately after the issue and prior to listing amounted to the value of the equity raised in the IPO. Two-thirds of the proceeds were to be applied to the full acquisition of an existing operating business, Salmon Enterprises of Tasmania Pty Ltd, which was incorporated on February 15, 1985. The remaining proceeds were used for setup and share issue costs and working capital. With all pre-float shareholders of the preceding company being bought out of the new company, the public issue facilitated the spread of ownership necessary for listing. On the first day of trading, the last trade price was equal to the price subscribers paid for the offer.

[6] See Diamond (1991), Easterwood and Kadapakkam (1991) and Esho et al. (2001).

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