Global Finance Journal 24 (2013) 203–221

Contents lists available at ScienceDirect

Global Finance Journal

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

Private placement, share prices, volume and financial crisis: An emerging market study

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ARTICLE INFO

Article history:
Received 5 October 2011
Accepted 5 September 2013
Available online 29 October 2013

JEL classification:
G30
G32
G38

Keywords:
Private placement
Wealth and volume effect
Financial crisis
Ownership concentration
Information asymmetry
Long run performance

ABSTRACT

Firms are increasingly resorting to private placements in recent years, yet there is no published study of emerging markets. There is a unique opportunity to study this behavior during a severe financial crisis, when firms resorted to private placements to recover financially distressed firms. Our analysis using data over fifteen years shows (a) a significant 2–3% positive share price reaction, affirming asymmetric information effect, (b) a significant volume activity, and (c) the price impact is different across a period of a major financial crisis. If the proceeds from placement are earmarked for investment, share price is negatively (positively) correlated during the crisis (non-crisis) periods. Our finding on regulation is inconsistent with prior reports in developed markets: this is explained by the stricter restrictions on trading of private issues in emerging market. These results provide modest new contributions to the literature on private placements.

1. Introduction

Research on *private placement* disclosure effect on share returns has established a *positive* relationship in several developed markets. It is suggested that private placements – as opposed to rights issues – reduce agency costs-cum-information asymmetry thus leading to a positive share price reaction to such events: (Wruck, 1989). Hertzel and Smith (1993) assert that private placement signals issuing firm's undervaluation, which help to mitigate information asymmetry. Hence the observed positive price effect

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1044-0283/$ – see front matter
http://dx.doi.org/10.1016/j.gfj.2013.10.003

has become entrenched in studies using data from developed markets. Should share price behavior to private placements in emerging markets be identical to that in developed markets? Prior studies show that in most emerging markets, a positive price effect to rights issues has been observed, which is contrary to the well-known *negative* effect explained as due to an overvaluation of shares associated with rights issues.[1]

Next, should unique regulation in emerging markets on share trading by private equity providers distort share return behavior? Should share returns behave the same way during a severe financial crisis period, when private equity providers acted more as white knights to troubled firms, hence helping to reduce the cost of financial distress of firms?

Emerging markets selected for this study already had high share ownership concentration, so should Wruck's hypothesis be tested in such a concentrated share market? Individual Malaysian investors, who provided private placement funds, also increased an already high ownership concentration. These are issues that could be addressed by examining private placements in the emerging market of Malaysia. In short, should private placement effect be the same as in the developed markets; are there new research issues pertinent to emerging markets?

There is a specific rule in Malaysia that requires that parties buying private placements cannot trade their shares for up to three years from the date of purchase. This unique rule is likely to increase the behavior predicted by Wruck (1989) on information asymmetry given ownership concentration increases. During the Asian Financial Crisis of 1997/8, private placements were used as a means to rescue firms with financial distress: should share price effect be opposite to the effect in normal market condition?

The rest of the paper is organized as follows: Section 2 reviews selected relevant literature. The data set, test models, and hypotheses are explained in Section 3 while in Section 4 the reader is presented the findings. Section 5 concludes the paper. The findings reported in this paper extend our understanding of the price behavior of emerging markets by providing new results on some unanswered questions.

2. Private placement literature and institutional differences

2.1. Brief overview

Research on stock price reactions to private placement announcements has shifted in recent years to long-run behavior: see Billet, Flannery, and Garfinkel (2011); Anderson, Rose, and Cahan (2006); see also Anderson et al. (2006) for a test of private issue effect on share price. These studies also used data from developed capital markets. The original question of how stock prices in emerging markets behave is seldom researched despite some interesting research questions, we have shown, that could be addressed. A quick review of results from few selected private placement studies is summarized in Table 1. These studies suggest a significant positive cumulative abnormal return (CAR) to private placements.

The largest gain of about 3–8% during different test windows is found in Australia, where private placement as a dominant form of fund-raising accounts for 66% of equity funds raised during a recent ten-year period. The UK and the US also recorded significant but smaller CARs while New Zealand reported very small gain as is also reported for Hong Kong. Barclay, Holderness, and Sheehan (2009) find that private investors in the US are usually not active after private placement is made (perhaps due to some rules). Wu and Wang (2005) also find that private placements in Hong Kong do not appear to improve monitoring.

Judged against these facts and the fact that there are some 75 emerging markets, should the stock price reactions be the same as in developed market studies? Private placement as a source of funding has taken prominence during and since the Asian Financial Crisis of 1997: Ariff and Khalid (2005). Private placement raised 58% of funds in 2008 compared to just 1% in 1994 in Malaysia. Another aspect worthy of investigation is the traded volume behavior around private placements as to whether it supports an increased trading

[1] For just a selection of most cited papers on the positive price effect to rights issues, see Miller and Rock (1985), Myers and Majluf (1984), Smith (1977), Asquith and Mullins (1986). Against this there is also evidence that the share prices react positively in emerging markets and some developed markets as reported in Arsiraphongphisit and Ariff (2008) for Australia; Wu and Wang (2005) for Hong Kong; Anderson et al. (2006) for New Zealand; and, for the US, Hertzel and Smith (1993), Wruck (1989), Lee and Kocher (2001). Therefore, should share price reaction to private placements be the same as in developed markets it requires a further exploration.