Journal of Financial Economics 57 (2000) 157–190
JOURNAL OF Financial ECONOMICS
www.elsevier.com/locate/econbase

Alternative flotation methods, adverse selection, and ownership structure: evidence from seasoned equity issuance in the U.K.☆

M.B. Slovin[a,b], M.E. Sushka[c,b,*], K.W.L. Lai[d]

[a]*College of Business Administration, Louisiana State University, Baton Rouge, LA 70803, USA*
[b]*HEC School of Management, Paris, France*
[c]*College of Business, Arizona State University, Tempe, AZ 85287, USA*
[d]*Department of Accounting and Finance, Lingnan University, Tuen Mun, Hong Kong*

Received 8 March 1996; received in revised form 26 October 1999

Abstract

We examine valuation effects of announcements of seasoned equity issuance and assess the impact of the choice of flotation method in the U.K. Rights offerings are predominant, but in 1986, British firms gained the flexibility to conduct placings, which are comparable to U.S. firm commitment offerings. A placing is a fixed-price bought deal that increases ownership dispersion. Placings generate significantly positive share price effects, whereas rights offerings have large negative valuation effects that become more adverse after 1985. We conclude that the option to conduct placings enhances the ability of firms to signal their quality and to use a seasoned equity offering to reduce ownership concentration. © 2000 Elsevier Science S.A. All rights reserved.

JEL classification: G24; G32; G15

Keywords: Equity issuance; Flotation method; Rights offerings; Placings; Ownership concentration

☆We are appreciative for the valuable suggestions and insights provided by Jarrad Harford (the referee). We also acknowledge the useful comments of G. William Schwert (the editor). This paper has benefitted from suggestions from colleagues and seminars at Louisiana State University, HEC, Paris, Hong Kong Polytechnic University, ESSEC, and University of Paris, IX.

* Corresponding author. Tel.: + 1-480-965-6581; fax: + 1-480-965-8539.

E-mail address: marie.sushka@asu.edu (M.E. Sushka).

PII: S0304-405X(00)00054-4

1. Introduction

We examine valuation effects for alternative methods of flotation at announcements of seasoned equity issuance in the United Kingdom. Our objective is to assess whether share price responses in the U.K. are consistent with contemporary finance theory and with empirical results for seasoned equity offerings in the United States. Our evidence indicates that alternative flotation methods have differential effects on firm value and that choice of flotation method conveys a different signal in the U.K. than in the U.S. Changes in London Stock Exchange regulations adopted in 1986 broadened the choice of flotation methods available to firms to raise seasoned equity. This increased flexibility enhanced the ability of British firms to use their choice of flotation method to signal firm quality and to alter firm ownership concentration.

Research on seasoned equity issuance focuses on American corporations conducting firm commitment public offerings. This offering strategy is the dominant flotation method in the U.S. Empirical studies document significantly negative announcement returns, indicating that equity issuance conveys unfavorable information about firm value. A rights offering is an alternative flotation method that allows current shareholders to purchase shares pro rata, that is, proportionate to their existing ownership position, at a specified exercise price until a designated expiration date. In a standby, or insured, rights offering, an underwriter guarantees to purchase any unsubscribed shares at the expiration date. An uninsured rights offering does not have a standby commitment. Based on U.S. data, rights offerings have lower direct costs than firm commitment offerings (Smith, 1977) and generate negative, but modest, announcement returns. Nevertheless, rights offerings have been rare in the U.S. since the early 1980s (Eckbo and Masulis, 1992), and in the 1960s and 1970s comprised less than five percent of the seasoned equity issued by firms listed on the NYSE or Amex (Smith, 1977). In the U.K., prior to the mid-1980s, rights offerings were effectively the only method of issuing seasoned equity. In the mid-1980s, deregulation allowed British firms to conduct placings, a non-rights method of flotation in which an underwriter purchases an equity offering from the issuing firm on the spot at a fixed price, and sells the shares to clients, typically institutions, and other outside investors. A placing is not a private placement, but a form of public securities issuance comparable to a firm commitment offering in the U.S. Insured rights offerings constitute a majority of seasoned equity issuance in the U.K., with placings the next most common method. In the U.K., there are few uninsured rights offerings.

We examine a sample of British firms that issue primary seasoned equity through insured rights, uninsured rights, and placings over a post-deregulation period, 1986 to mid-1994. We also analyze a sample of insured rights offerings over a pre-deregulation period, 1982–1985, to gauge the effects of allowing placings as an alternative flotation method. Event study methodology and