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Foreign issuers in the U.S. PIPE market

K. Stephen Haggard*,[1], Ying Jenny Zhang[1]

Department of Finance and General Business, College of Business Administration, Missouri State University, 901 S. National Ave., Springfield, MO 65897, United States

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ABSTRACT

We document that the use of private investment in public equity (PIPE) by foreign firms listed on U.S. exchanges is growing even faster than its use by U.S. firms. On average, foreign firm PIPE stock deals represent a similar proportion of the firm's market capitalization to U.S. firm PIPEs, but suffer less of a share price discount than U.S. firm PIPE issuances, a relation that is robust to consideration of exchange, deal size, share turnover and return volatility. We document that hedge funds are only small investors in foreign firm PIPEs issued in the U.S., which tend to be purchased by pensions, government funds and corporations. PIPE, in combination with the reverse merger method of going public, provides a cost-effective means for foreign firms to raise capital in the U.S. capital market.

1. Introduction

Private investment in public equity (PIPE) has surpassed seasoned equity offerings (SEOs) as a means of raising equity in both dollar volume and number of transactions in the U.S. market (Chen et al., 2010). In this paper, we document that the use of PIPE among foreign firms listed on U.S. exchanges is growing even faster than its use among U.S. firms. On average, foreign firm PIPE stock deals represent a similar proportion of the firm's market capitalization to U.S. firm PIPEs, but suffer less of a share price discount than U.S. firm PIPE issuances.

* Corresponding author. Tel.: +1 417 836 5567; fax: +1 417 836 6224.
E-mail addresses: SHaggard@MissouriState.edu (K.S. Haggard), YJennyZhang@MissouriState.edu (Y.J. Zhang).
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Further, we document a trend of increasing foreign participation in U.S. equity markets and show that the growth in foreign PIPE issuances outstrips the growth in the proportion of U.S. market capitalization represented by foreign firms. The accelerating trend of foreign firms listing on U.S. exchanges (Cowan, 2009) portends increased growth in the proportion of all U.S. PIPE issuances attributable to foreign firms.

Finally, we document a difference in the investor bases between PIPE deals for foreign firms and those for U.S. firms. Hedge funds are likely to be large investors in PIPEs of U.S. firms, but play only a small role in PIPEs of foreign firms. Pensions, government funds and corporations play a much larger role in foreign PIPE issuances than in the PIPE issuances of U.S. firms.

2. Literature review

PIPE financing has only recently become an important means of raising equity. As Dai (2010) points out, the number of PIPE deals recorded by Sagient Research, the premier provider of PIPE data, has quadrupled over the period from 1996 to 2007. Thus, the literature on PIPE remains small with mostly recent cites. We provide a brief review of the PIPE literature here. For a more comprehensive review, please see the excellent survey of Dai (2010).

Anson (2001) provides a comprehensive yet concise description of PIPE financing, including some excellent examples of PIPE deals. PIPEs differ from regular private placements of equity in at least one important aspect. The shares purchased in a PIPE transaction can be sold in the public securities market after their registration by the issuer with the appropriate regulatory authority. Therefore, shares obtained through PIPE deals are more liquid than equity obtained through traditional private placements once the PIPE shares are registered.

Anson (2001) also explains the difference between structured PIPEs and traditional PIPEs. Securities associated with structured PIPEs include reset convertibles, floating convertibles, convertible preferred stock with resets and common stock with resets. All of these instruments are designed to protect the investor from negative movements in the issuer's stock price following completion of the deal. Traditional PIPEs provide no such price protection to investors. In these transactions, the investors purchase either common equity or preferred stock with a fixed common share conversion ratio. Investors usually receive a discount (negative premium) to compensate them for the lack of liquidity they face prior to completion of the registration process.

Unfortunately, structured PIPEs provide opportunities for stock price manipulation. As a result, the use of these PIPEs has decreased significantly in recent years. Chaplinsky and Haushalter (2006) document a drop in the dollar volume and number of floating rate convertible PIPEs and attribute this drop to the bad publicity regarding these securities, which are also referred to as "toxic converts," and to the National Association of Securities Dealers (NASD) Rule 4350, which was implemented in March 2002. Most PIPE issuers are listed on the NASDAQ exchange, which places them under the regulatory oversight of NASD. According to Chaplinsky and Haushalter (2006), under Rule 4350,

> "the issuance of certain PIPEs requires a vote by shareholders if the lowest possible conversion price is below the book or market value of the stock at the time of issuance or if investors can receive more than 20% of the shares upon conversion from such low prices. To eliminate the need for shareholder approval, an issuer can place a cap on the number of shares that can be issued upon conversion to 20% of the common stock before the issuance of the PIPE or place a floor on the conversion price. See the Federal Register, Vol. 67, Number 45, March 7, 2002." (p. 10)

Brophy et al. (2009) examine U.S. PIPE deals between 1995 and 2002, and show that issuers suffering from high information asymmetry and poor fundamentals tend to receive funding through hedge funds. As other investors tend to avoid such firms, hedge funds become their "investors of last resort." Hedge funds investing in these firms protect themselves with large discounts (negative premiums) on their original purchase of the equity, by demanding repricing rights, and by shorting public shares of these firms. Since their sample period covers from 1995 to 2002, it contains a substantial amount of structured PIPEs, which begin to decline in popularity only after 2002. Their study also shows that