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Outside shareholders should benefit when the firm issues common stock through a private placement. Our propositions are (1) that the private issue of common equity creates a value-maximizing insider that has the incentive and ability to monitor and discipline, and thereby reduce agency costs and (2) investors can reduce uncertainty about the value of thinly traded stock by observing the share price negotiated by the well-informed buyer. Both of these benefits are especially applicable to small firms. Our empirical evidence supports hypotheses based on these propositions.

The implementation of SEC Rule 144A in April 1990 has drawn attention to the private placement market. The rule allows a large institutional investor, holding a security with a value exceeding $100 million, to trade with other similar institutions without registering with the SEC or holding the securities more than two years. The new rule should foster improved liquidity for securities that were privately placed with large investors. The popular financial press has given some anecdotal evidence that the improved liquidity is increasing the number of private placements of debt and preferred stock (both convertible and non-convertible).

The long standing market for small firms issuing common shares to private investors has received less attention in the press; whether Rule 144A has changed the breadth of this market is a question that can only be answered after some time has passed. Milligan [7] predicts that 144A equity markets will be small until participants have access to a fully developed computer based trading network such as ones under consideration by the NYSE and AMEX. Regardless of the recent dynamics, small firms have found private common stock financing to be beneficial. After a brief discussion of the nature of those benefits, this paper focuses on the valuation effects on the outside public investors in those firms that privately place common stock.

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BACKGROUND OF PRIVATE PLACEMENTS

A private placement is a debt or equity transaction requiring no registration with the SEC. To qualify as a registration exempt offering, the private placement must meet several criteria:

1. there are a limited number of purchasers,
2. the purchasers have access to all important information concerning the issuer and the issue,
3. the offering is made through direct communication and negotiation with the offerer; there is no general advertising,
4. the securities issued are not redistributed by the purchasers, except after specific holding periods have passed or the purchasers have registered the securities. Rule 144A modifies this regulation for large institutional traders.

These four rules summarize the general requirements for private placements. Since 1982, Regulation D (and later amendments) has given more detailed information governing private placements.

The principal purchasers of privately placed fixed income securities and packages of fixed income securities tied to option-type securities are insurance companies and pension funds. The purchasers of privately placed common equity securities are more likely to be venture capitalists, wealthy individuals and partnerships of wealthy investors. The investors in privately placed securities are motivated by the higher total expected rate of return relative to investments in traded securities. A security may be privately placed at a deep discount to market value, and the issuer may give a substantial portion of equity. For example, Taylor [13] states placing shares to start up or expand a small firm requires relinquishing 40 to 70% of equity.

Issuers find private placement to have several advantages. Private placement has the benefits of being faster than registration and public offer and of avoiding the investment banking fees of public offer.[1] Financing through private investors allows for flexibility in that terms might be renegotiated more easily when dealing with a few investors. Private companies that use private placement maintain confidentiality concerning their operations and financial affairs. Small firms may gain access to financing that is pragmatically unavailable through other financial markets. Lewis [4], citing an investment banker, says that public debt offerings less than $50 million and public equity offerings less than $5 million are impractical and not cost efficient. Although the data are becoming dated, Smith [11] found that public equity issues less than $5 million have underwriting fees ranging from about 10 to 16%.

Some equity issuers may use private placement to attempt to avoid the typical adverse market reaction (Smith [10] synthesizes this to be 3.14%) to seasoned common stock offerings. Whether this is an advantage to private placement is moot. Theorists believe that the adverse reaction is caused by the offering revealing unfavorable asymmetric information about the issuer. If the information were not revealed by the offering, it would become known to investors sooner or later. Thus, the value loss will occur regardless of whether the equity is issued. On the other hand, practitioners believe that the adverse reaction is caused by increasing the supply of shares in the face of limited demand.[2] Thus, the share price decrease associated with seasoned offerings can be avoided by private placement. Both sides of the controversy cite empirical observations to support their points of view.

There are also disadvantages to firms using private placements as financing sources. The high return to investors, mentioned above, translates to a high cost of capital to the issuer and the pre-financing common shareholders. The issuer is still likely to have to pay substantial investment banking costs as well as legal fees; nevertheless, these expenditures are generally less than for an equivalent public offering. Especially in the case of a private placement of common shares, management may find reduced flexibility in operations because of having "someone watching ... over its shoulder" (Gibson [2]).

THE VALUE-MAXIMIZING INSIDER HYPOTHESES

Our hypotheses and empirical work concentrate on the narrow case of the effect on outside shareholder wealth of private common stock placement by a public company. We define an outside shareholder to be a shareholder who can influence corporate policy firm only by voting shares. Each outside shareholder holds too few shares to discipline management, and mechanisms, such as creating a voting trust with other outside shareholders, to collectively influence corporate policy are prohibitively costly. Outside shareholders, along with debtholders, suffer the consequences of agency costs. Inside shareholders are segmented into two categories. First are managerial inside shareholders who ultimately determine corporate policy and who benefit from agency costs. Second are value-maximizing inside shareholders who receive no benefit from agency costs. Because they hold large blocks of common shares, value-maximizing insiders can influence corporate policy and reduce managerial consumption of perquisites. Since their shares will be eventually sold on the market or put[3] to the issuer at market value, the private investor's motivation in exercising its influence is to maximize share value.

As cited above, equity issues of less than $5 million are better placed privately than issued publicly. Equity issuances this small are likely to be by small corporations. Secondly, thinly traded stocks are more likely to be the equity of small firms. Thus, from a practitioner's point of view, a public issue of seasoned common stock would require a significant discount from currently quoted bid prices. A private issue of the seasoned equity could reduce the discount.

Our proposition is that outside shareholders, and thus investors from the market in general, should view the purchase of shares by a value-maximizing insider favorably. A weak form of the proposition is that the benefits to outside shareholders reduce the unfavorable effects caused by the signalling of asymmetric information. A stronger proposition is that the benefits to outside shareholders are large enough to elicit a positive effect on stock price.

The proposed benefits are from several sources. First, the advent of a value-maximizing inside shareholder forces management to reduce agency costs. The saving may be significant, because small firms, the likely issuers of privately place common equity, have high agency costs. Many small corporations were family-founded, so that there continues to be agency costs related to nepotism. The small firm may be less subject to market discipline because it has only simple bank debt supported by collateral. Because fewer analysts "follow" the small company, management may not feel the market is keeping their activities under close scrutiny.

The ability of the value-maximizing insider to monitor and discipline is considerable. In negotiation of the transaction, this investor will demand a full audit of the operations and full disclosure of other pertinent facts about the issuer. The negotiated agreement will require periodic disclosures to the investor beyond the normal financial statements. In many cases, the investor will permanently have a representative on the board of directors. If management is acting inconsistently with shareholder wealth maximization, the value-maximizing insider has the knowledge, the incentive and the wherewithal to form a coalition with the outside shareholders to obtain voting control of the firm. Although the purpose of buyers of private placements is not a takeover, the threat of managerial turnover via voting fiat should be enough to influence managers to heed the value-maximizing insider. Thus, outside shareholders should react favorably to the advent of a value-maximizing insider, because potential agency costs are high and the insider has the power and incentive to reduce them.

The second benefit to outside shareholders is that they will have less uncertainty about the stock's value. The bid-ask prices for thinly traded shares are set by a market maker. The market maker has much less information, of the kind that can be gleaned from market activity, than its specialist

counterpart on an exchange. The market maker may also manage several securities and will expend less effort in researching the price of a slow mover. Thus investors do not fully trust the price set by the market maker. The value-maximizing insider, at the time of the transaction, has incentive to see that the price paid for shares is not too high and requires that the corporation reveal more information than the market maker or the outside shareholders can obtain.[4] Investors are not likely to have the kind of information available in investment newsletters and stock tip columns, when the stock is thinly traded. The value-maximizing insider will find the expense of research from non-company sources to be cost effective. Thus, the market will improve its estimate of the value of the shares by observing the price (and allowing for the discount) paid by the well-informed value-maximizing insider. The market should react favorably to the decreased uncertainty about the stock price.

The proposition is similar in force to the "certification" story associated with initial public offerings. A number of authors, including Ritter [9], think that some potential IPO investors have less information than others. The less informed investors coping with their ignorance causes the issuers to suffer from investment banker underpricing and thus higher issuance cost. Megginson and Weiss [5] suggest that if the IPO issuer is partially owned by a venture capitalist (whose position corresponds closely to the value-maximizing insider), the IPO results in less underpricing and lower total costs of going public, because the existence of the venture capitalist owners certifies the validity of information released about the issuer. Megginson and Weiss' empirical findings support the certification theory.

Our propositions lead to three major testable hypotheses. First, the consummations of a private common equity placements should elicit abnormal returns greater than the abnormal returns other researchers have found for public issuances of common stock. Second, the consummations of a private common equity placements should elicit positive abnormal returns. Third, because of the reduced uncertainty about share value, consummations of private common equity placements should be accompanied by reductions of volatility of the issuers' stock prices. The tests of the hypotheses are refined by analysis of reactions to issuers with very thin markets and less thin markets and to issuers trading OTC and those listed on exchanges.

DATA AND METHODOLOGY

We obtained the consummation dates of private common equity placements from three sources: 90 issuances from Standard & Poors Corporation Records,

20 from a computer based data bank UUMI/Data Courier), and two from the *Wall Street Journal Index*. After elimination of contaminated events and issuing firms whose price data were unavailable, 52 issuances by 48 corporations remained. Of these, 38 corporations gave the precise date of the consummation, and 14 gave only the month of consummation. The 38 events comprise the initial sample for analysis.

Price data were from Standard & Poors Daily Stock Prices. We used "close" prices when available, and "bid" prices otherwise. Prices were adjusted for splits and reverse splits where appropriate.

Standard event study methodology[5] employed an estimation period from 150 through 31 days before the event day. The examination period was 30 days before through 30 days after the event day. The event day (t_0) was the date the issuing company stated that the common stock private placement was consummated. Abnormal returns (ARs) were based on the S&P500 as a market proxy.

TESTS AND RESULTS

The Full Sample

The first test is to analyze the market reaction to common stock private placements for the entire sample of 38 issuers. Although the standard error of the average abnormal returns for the estimation period is of no specific statistical importance by itself, we are struck by its magnitude of 1.132%. The standard error is high for a naive portfolio of this breadth, but consistent with the subjective notion that the firms that use private equity placements are less well-established, and thus more risky than more typical firms.

The abnormal returns for t_{-10} through t_{+10} appear in Table 1. The only statistically significant one-day ARs are a positive AR on t_{-24} and a negative AR on t_{-20} (these do not appear in Table 1). There is no apparent causal link between these data and the equity placement event. Closer to the event date, one finds four consecutive positive ARs: 1.306% on t_{-1}, 1.094% on t_0, 0.724% on t_{+1}, and 2.184% on t_{+2}.

Frequently, in studies of this kind, the analyst concentrates on the cumulative abnormal return (CARs) for days t_0, to allow for cases where the market received information about the event while the exchanges are open, and t_{+1}, to allow for cases where the market received the information after exchanges close. The $CAR_{0,+1}$ for the full sample for private common stock issuances is 1.818% percent with a t-statistic of 1.136. While this return is not statistically different from 0.0 by the two-tail test, one is struck by its magnitude compared to the −3.14% AR Smith [10] found for public issues

Table 1
Private Issues of Common Stock Event Study Results

Day	[$n = 38$] *Abnormal Returns*[a] *Full Sample*	[$n = 20$] *Abnormal Returns "Thin" Sample*	[$n = 18$] *Abnormal Returns "Not Thin" Sample*	[$n = 29$] *Abnormal Returns OTC Sample*	[$n = 9$] *Abnormal Returns NYSE & AMEX Sample*
-30 through					
-11	-3.328	-2.209	-4.571	-4.188	-0.555
-10	-0.727	-2.875	1.659	-1.321	1.186
-9	0.289	2.425	-2.084	0.492	-0.364
-8	0.969	1.066	0.861	0.914	1.146
-7	0.991	1.858	0.027	0.596	2.262
-6	-0.947	-2.514	0.795	-1.752	1.649
-5	0.464	0.061	0.910	0.457	0.483
-4	-0.441	-1.246	0.454	-0.741	0.527
-3	-0.914	-1.741	0.004	-0.938	-0.838
-2	-1.201	-0.993	-1.431	-0.955	-1.993
-1	1.306	1.483	1.110	1.712	-0.002
0	1.094	1.351	0.808	1.348	0.274
+1	0.724	0.704	0.747	1.039	-0.292
+2	2.184	4.164*	-0.017	3.004*	-0.460
+3	-1.770	-2.450	-1.014	-1.082	-3.984
+4	0.127	1.167	-1.028	0.210	-0.138
+5	-0.407	-0.473	-0.334	-0.714	0.583
+6	0.090	0.509	-0.376	0.470	-1.136
+7	-0.020	1.117	-1.282	-0.266	0.774
+8	0.754	1.826	-0.438	0.891	0.310
+9	-0.469	-1.170	0.311	0.079	-2.232
+10	-0.858	-0.618	-1.125	-1.640	1.661
+11 through					
+30	1.372	8.740	-6.814	1.966	-0.543
$CAR_{0,+1}$	1.818	2.055	1.554	2.387	-0.018
$CAR_{-1,+2}$	5.308*	7.702*	2.647	7.104*	-0.010
s_{-21}	1.433	2.569	0.898	1.847	1.278
s_{+21}	0.499	0.750	0.563	0.607	1.020
F-stat	8.241***	11.737***	2.546**	9.256***	1.571
s'_{-21}	1.134				
s'_{+21}	0.228				
F-stat	4.972***				

Notes: [a] All returns are stated as percents.
* This datum has a *t*-statistic significant at the 0.05 level.
** Significant at the 0.05 level.
*** Significant at the 0.01 level.

of seasoned common stock. In fact, when one tests the hypothesis $CAR_{0,+1} > -3.14\%$, one finds a t-statistic of 3.09, significant at the 0.01 level by the one-tail test; thus, the data infer that private issues of common stock elicit an AR less unfavorable than public issues.

The four-day cumulative abnormal return, $CAR_{-1,+2}$, is 5.308% with a t-statistic of 2.345, significant at the 0.05 level. For the AR on t_{-1} to have economic relevance, some portion of the market would have to anticipate the consummation of the stock issuance a day before it occurs. This circumstance is at least possible, since insiders could leak information about the event. Less likely, from the viewpoint of the efficient market hypothesis, is the relevance of the AR on t_{+2}. Some portion of the market would have to become aware of the event a day (or two) late or have to realize a day (or two) late the importance of the private common stock issuance. Pragmatically, since many of the issuing companies are small and not widely followed, the delayed awareness of the event is also at least possible. Thus, the large positive $CAR_{-1,+2}$ could suggest that outside investors view a private placement of common stock favorably.

Lease, Masulis and Page's [3] sample of public common stock issuance announcements has a 0.10% decrease in standard deviation between a period before the announcement and an equally long period after the announcement. They propose that the lower volatility is because the information signalled by the event decreases uncertainty about the issuer. We performed a similar test of volatility, comparing the standard deviation of the first 21 days (roughly one trading month—appears as s_{-21} in Table 1) of the examination period to the last 21 days (s_{+21} in Table 1) of the examination period. This method reduces bias that occurs from the volatility caused by the event itself. The standard deviation for the first 21 days is 1.433%, and for the last 21 days is 0.499%. These two statistics produce an F-statistic of 8.241, significant at the 0.01 level. Figure 1 gives visual evidence of how the volatility decreases after the consummation date.

For further evidence on volatility, we expanded the sample to include the 14 issuers for whom only the month of private equity placement is known. The 120-day estimation period for the expanded sample (52 events) is immediately before the first of two examination periods. The first examination period is 21 days previous to the 15th of the calendar month before the private placement month. The second examination period is 21 days after the 15th of the calendar month after the private placement month. The standard deviation (s'_{-21} in Table 1) of the ARs in the first examination period is 1.134%, and the standard deviation in the later examination period (s'_{+21}) is 0.228%. These two statistics yield an F-statistic of 4.972, significant at the 0.01 level. A similar test of raw returns over the same examination

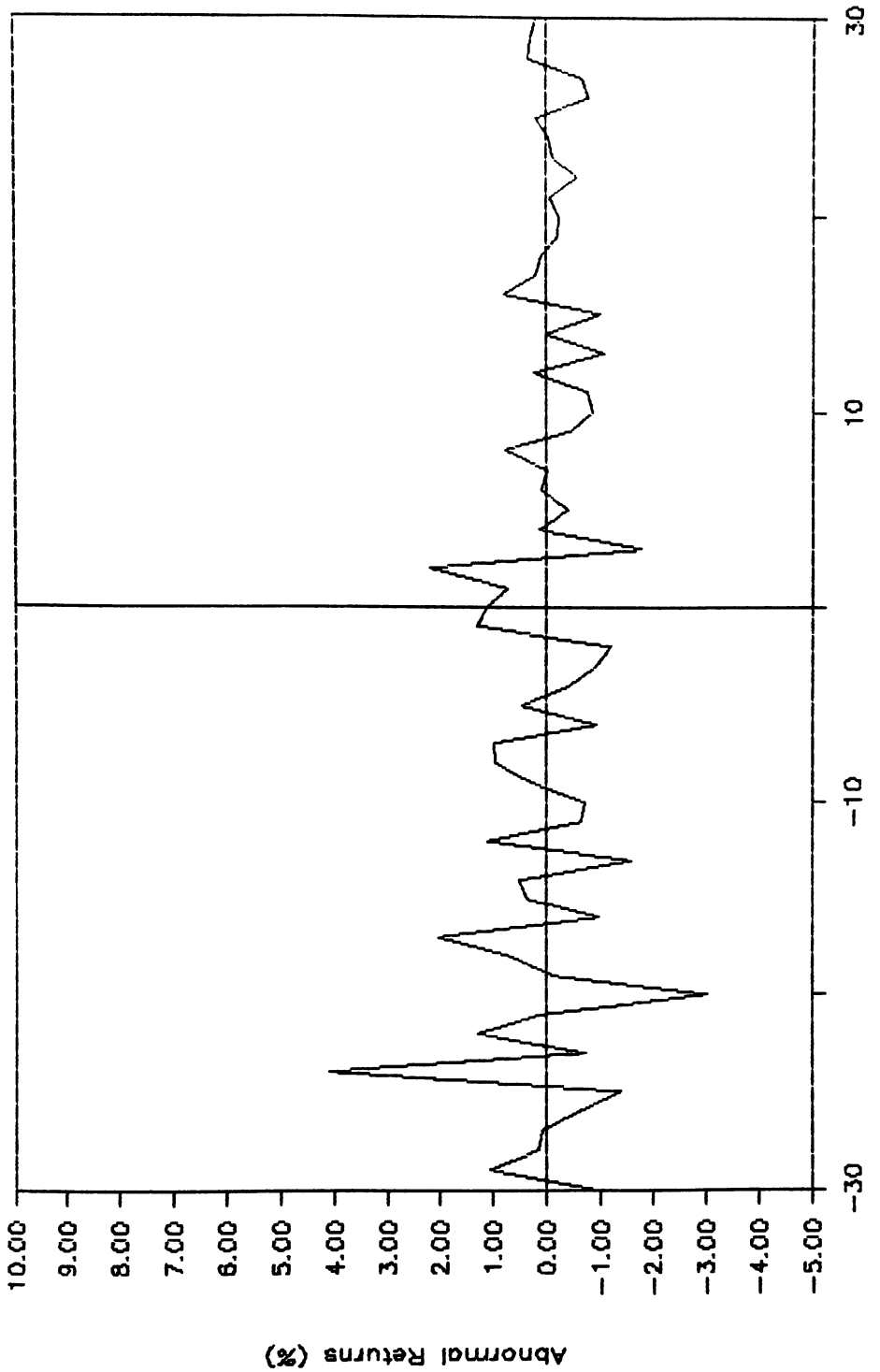

Figure 1. Abnormal Returns of 38 Private Issues

periods yields an earlier standard deviation of 1.139% and a later standard deviation of 0.269%. Their *F*-statistic is 4.227, significant at the 0.01 level.

The evidence strongly suggests that volatility decreases in response to private placements of common stock. However, Lease, Masulis and Page propose that the unfavorable information signalled by public common stock issuances reduces uncertainty stemming from asymmetric information, and thus price volatility decreases. In contrast, the data from the samples of private common stock issues show positive ARs in the proximity of the consummation day. Any asymmetric information signalled by private common stock placements cannot be explained by the implied cash flow hypothesis (Miller and Rock [6]) or the adverse selection hypothesis (Myers and Majluf [8]). We proposed that increased confidence in the validity of share prices is caused by investors inferring the inside knowledge of the value-maximizing insider from the price the insider negotiated in the private placement.

Thinly Traded Shares versus Broadly Traded Shares

The arrival of a value-maximizing insider not only has agency cost reduction significance, but also should make outside shareholders, as well as others who are observing the stock as a potential investment, more confident about the accuracy of the shares' price relative to the firm's economic value. This is especially true for stocks that are thinly traded, where the market could perceive that the quoted bid-ask prices are influenced more by the market maker's assessment than by an auction process among buyers and sellers. Thus, we segmented the sample into a "thin" subsample and a "not thin" subsample to test whether thinness is a factor in the market's reaction to common stock private placements.

Since market thinness is a relative term, we chose to classify a stock as thin if there were days within the estimation and examination periods on which no trades occurred. Thus, the original sample of 38 issuers was divided into 20 issuers deemed to experience thin trading and 18 issuers deemed to not experience thin trading. The $CAR_{0,+1}$ for the subsample of thin stocks is 2.055% with a *t*-statistic of 0.855, and the $CAR_{-1,+2}$ is 7.702% with a *t*-statistic of 2.266, significant at the 0.05 level. The AR on $t+2$ is 4.164%, with a *t*-statistic of 2.451, significant at the 0.05 level. The standard deviation for the first 21 days of the examination period is 2.569%, while the standard deviation of the last 21 days is 0.750%. These last two statistics yield an *F*-statistic of 11.737, significant at the 0.01 level. These results parallel the results from the full sample with the CARs being larger and the difference in the standard deviations being larger. Thus, the data from the thin stocks provide some evidence that the market reacts favorably to private issues of thinly traded

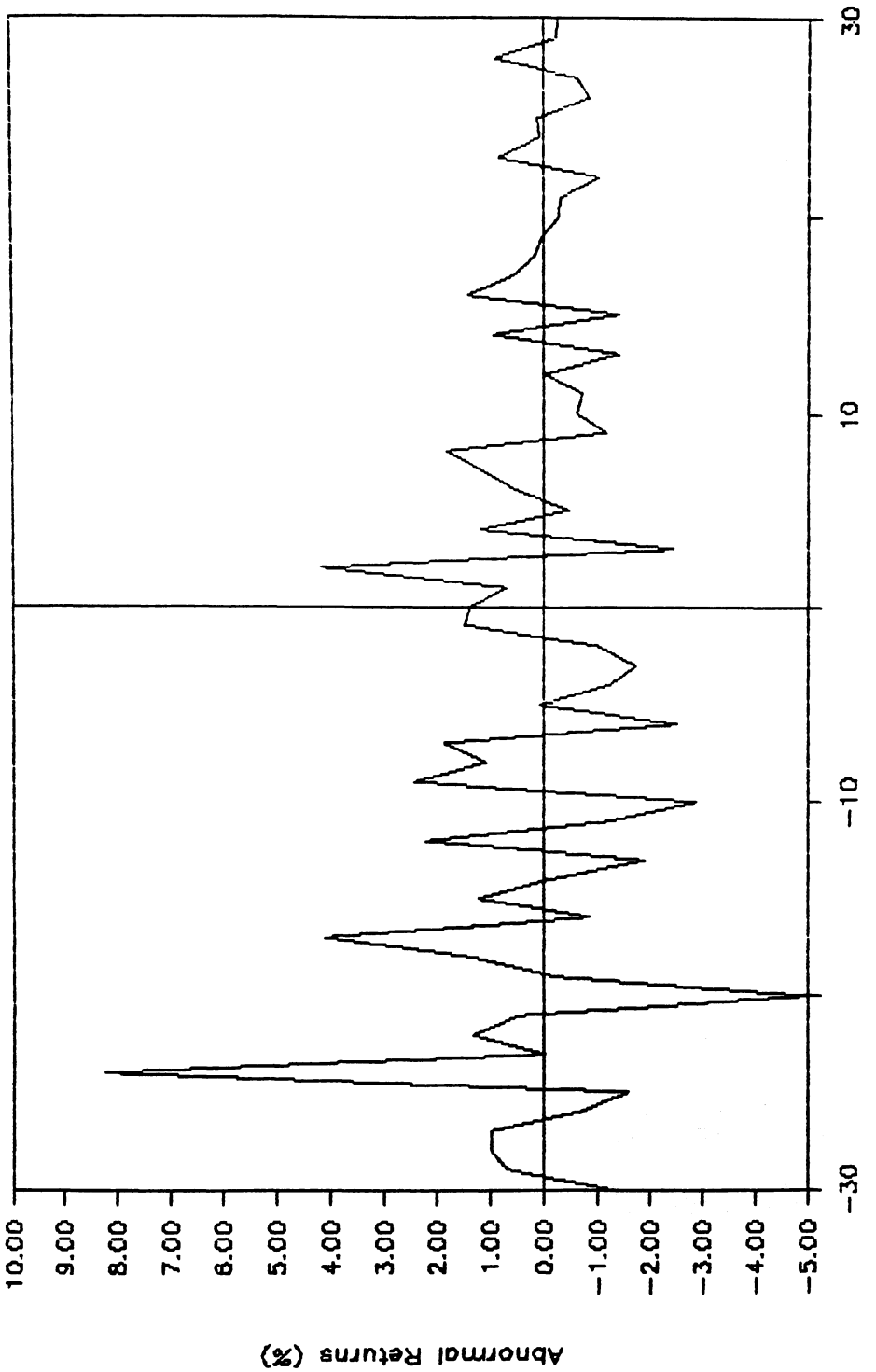

Figure 2. ARs of 20 Thinly Traded Private Issues

common stock and that market volatility of thinly traded stocks decreases after a private placement. Since thinly traded stocks are generally small firms, the evidence intimates that private placements by small firms receive favorable market attention.

The subsample of stock not subject to thin trading exhibits similar signs for the analyzed statistics, but the magnitudes are smaller and the level of statistical significance is also less. $CAR_{0,+1}$ is 1.554% with a *t*-statistic of 0.900, and $CAR_{-1,+2}$ is 2.647% with a *t*-statistic of 1.083. $CAR_{0,+1}$ is 4.69% less than Smith's −3.14% for public common stock issuances—the one-tail test of whether private placements of common stock that are not subject to thin trading have a return greater than −3.14% yields a *t*-statistic of 2.72%, significant at the 0.01 level. The ARs for first 21 days of the examination period have a standard deviation of 0.898%, while the standard deviation for the last 21 days is 0.563%. These two standard deviations yield an *F*-statistic of 2.546, significant at the 0.05 level. Thus, the evidence gives no statistically significant support to the hypothesis of ARs (positive or negative) in response to private placements of common stock that are not thinly traded. The evidence does give statistically significant support to the hypothesis that price volatility falls after private placements of common stock.

OTC Private Issuances versus Listed Stock Private Issuances

Given that our definition of thinness in the preceding tests is subjective, we further test the data by segmenting the private common stock issuers into those whose shares traded over the counter at the time of private issue and those that traded on AMEX or NYSE. Generally, companies traded over the counter are more representative of small firms than those traded on an exchange. Specifically, all OTC issuers in our sample (with the exception of Blockbuster Entertainment) are small compared to the typical AMEX and NYSE listed stock. The sample of 38 private common stock issuers is composed of 29 OTC and nine exchange traded—three AMEX and six NYSE.

For the OTC subsample, $CAR_{0,+1}$ is 2.387% with a *t*-statistic of 1.245, and the $CAR_{-1,+2}$ is 7.104% with a *t*-statistic of 2.620, significant at the 0.05 level. Day t_{+2} has an AR of 3.004%, with a *t*-statistic of 2.216, significant at the 0.05 level. The ARs for the first 21 days of the examination period have a standard deviation of 1.847%, while the last 21 days have a standard deviation of 0.607%. These two standard deviations yield an *F*-statistic of 9.256, significant at the 0.01 level. The data for the OTC subsample give some evidence that the market reacts favorably to private placements of common equity and strong evidence that volatility decreases after a private issuance of common stock.

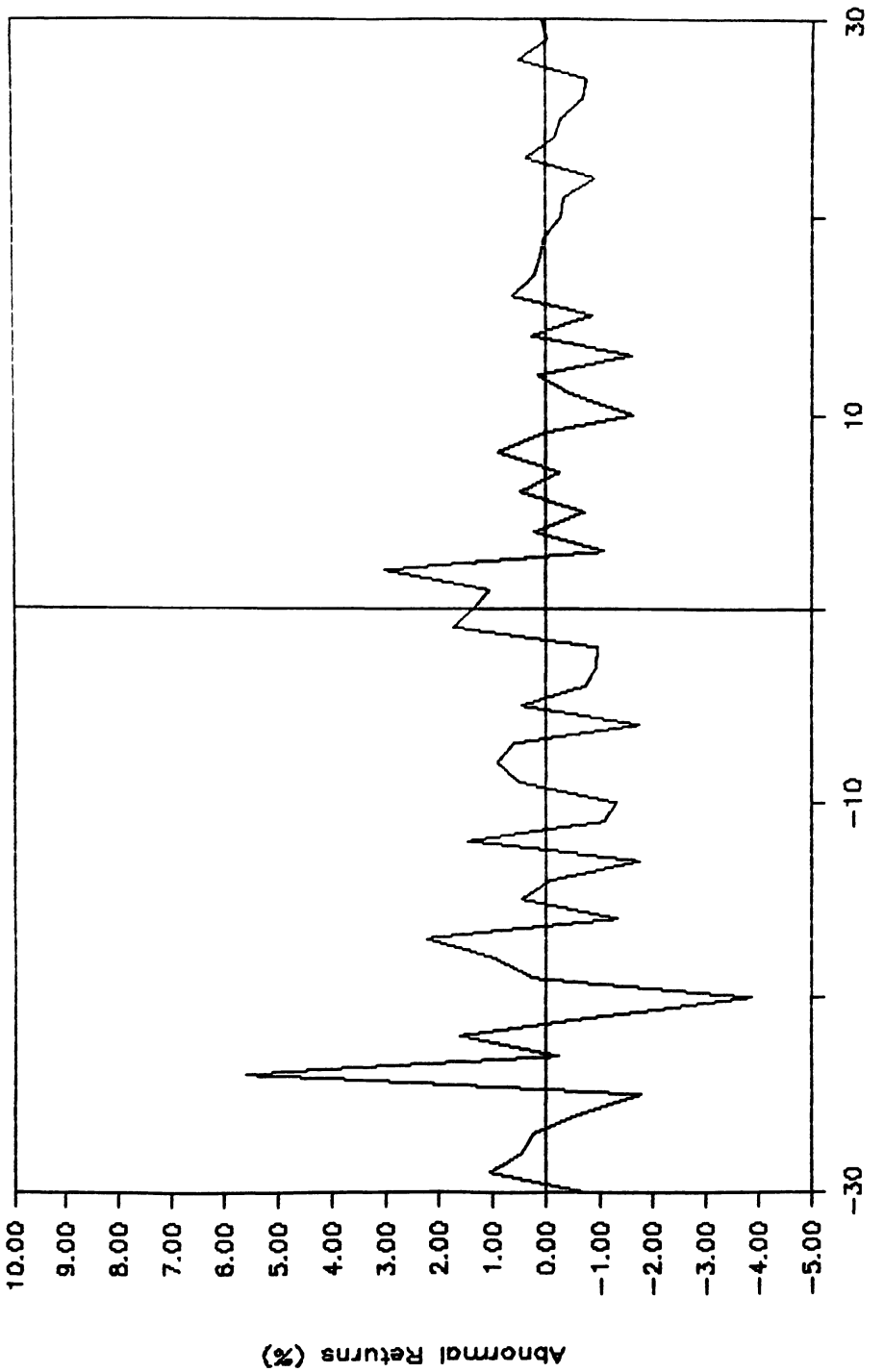

Figure 3. ARs of 29 OTC Private Issues

Although the sample of exchange traded stocks is small, the degree to which the results differ from our previous findings is remarkable. Each AR for t_{-3} through t_{+4} is negative except for t_0 where the AR is 0.274%. $CAR_{0,'1}$ is −0.018% with a t-statistic of −0.010, and $CAR_{-1,+2}$ is −0.480% with a t-statistic of −0.188%. The signs of these data are consistent with the signs for market reactions to seasoned public issuances of common stock, but the magnitudes of the ARs in response to exchange traded issues are far from significant. The standard deviation of the ARs for the first 21 days of examination period is 1.278% and greater than the standard deviation for the last 21 days, 1.020%, but the difference is not statistically significant. Thus, this small sample provides no support for a hypothesis that the market reacts to private common stock issuances by exchange traded issuers.

Signs Tests

To augment the tests above, we apply the non-parametric Signs Test to $CAR_{-1,+2}$ for the full sample and each subsample. Table 2 shows that the results allow the rejection of the hypothesis that the number of positive $CAR_{-1,+2}$s equals the number of negative for the full sample, for the sample of thinly traded stocks and for the sample of OTC stock. The hypothesis is not rejected for the other two subsamples. These results lend further support to the proposition that private placements are viewed favorably by the market, especially so for thinly traded or OTC stocks.

Table 2
Results of the Signs Test as Applied to $CAR_{-1,+2}$ in Response to Consummations of Private Placements of Common Stock

	$CAR_{-1,+2} > 0$	$CAR_{-1,+2} < 0$	*Z-statistic*	*Level of significance*
Full sample (38)	23	15	2.596	0.05
Thin sample (20)	13	7	2.683	0.05
Not thin sample (18)	10	8	0.943	none
OTC sample (29)	19	10	3.343	0.01
NYSE/AMEX sample (9)	4	5	-0.667	none

CONCLUSION

Outside shareholders should benefit when the firm issues common stock through a private placement. This transaction creates a value-maximizing insider that has the incentive and ability to monitor and discipline, thereby reducing agency costs. Investors can reduce uncertainty about the value of thinly traded shares by inferences from the price negotiated by the well-informed buyer. Both of these benefits are especially applicable to small firms.

The empirical evidence strongly supports the hypothesis that private common stock placements engender greater abnormal returns than public offerings of seasoned common equity. There is weaker supporting evidence that the private issues elicit positive abnormal returns and strong evidence that volatility decreases after a private common stock placement. Our subsamples for thinly traded stock yielded similar results, as did our subsample of only OTC stock. Thus, we conclude a private placement of common equity seems to be more beneficial to outside shareholders of small corporations.

NOTES

1. Blackwell and Kidwell [1], in one of the few academic journal studies of public placements, find the costs of publicly sold debt exceed those of privately placed debt in some cases and are nearly the same in other cases.
2. Theorists believe the demand curve for shares is horizontal, since investors are concerned only with risk and return and therefore can find perfect substitutes for the shares of any firm. Practitioners believe that investors are concerned with firm characteristics that go beyond just risk and return.
3. Spragins [12] reports that a "prenegotiated [sic] 'put'" requires some private common stock issuers to repurchase the investor's shares at a price based on fair market value.
4. When the issuer's shares are traded OTC, outside shareholders' ignorance of the firm's status is exacerbated by the lack of information that might have been inferred had the firm been listed and met listing requirements.
5. The authors will provide equations for this method upon request.

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