

Chapter 2

Literature Review

Abstract In this chapter, I summarize and comment on the literature related to private placement. I start from reviewing studies on private benefits of control and tunneling. Then I focus on private placement and summarize the literature along four lines: the choice among equity refinancing methods, discount determination, announcement effect, and long-run performance. Finally I discuss the absence of treatment of tunneling in the private placement literature.

Keywords Private placement • PIPE • Discount • Abnormal return • Market reaction • Tunneling

Extant studies on private placements focus on four aspects. The first is characteristics of private shares issuers, or why a firm conducts a private equity offering instead of a public one such as SEO or rights offering. The second and the third are factors that determine offering discount and announcement-period abnormal return respectively. The fourth is the long-run stock price behavior and operating performance of the issuer.

There is almost no discussion on whether tunneling is present in private placements in the existing literature, although researchers have been documenting that firms issuing private shares are of high ownership concentration, namely the existence of influential large shareholders.¹ The controlling shareholder may dilute holdings of other shareholders by offering private shares to itself, even if the firm is not in need of refinancing. Even if the firm does need additional funding, the controlling shareholder may arbitrarily lower the offering price and purchase as many shares as possible for a given amount of capital. Tunneling is especially important for a study related to corporate governance in China. Cheung et al. (2006) find that in Hong Kong's stock market, connected-party transaction as a form of tunneling is more prevalent in listed companies whose ultimate controller can be traced back to Mainland China. My study in part is an extension of the literature on private

¹ It's not unfair to say that ownership structure is concentrated in most economies of the world.

benefits of control and tunneling; therefore I review literature on large-percentage shareholding (and private benefits of control and tunneling that are inherent therein) before proceeding to literature on private placements of equity.

2.1 Private Benefits of Control and Tunneling

Berle and Means (1932) make great contribution to our understanding of the principal-agent problem between shareholders and firm management. The other form of agency problem, which results from interest conflicts between large shareholders and other shareholders,² did not catch economists' attention until decades later. To identify the ultimate shareholder of large corporations in 27 economies around the globe, La Porta et al. (1999) find few of these firms featured by diffused ownership. They suggest, "The principal agent problem in large corporations around the world is that restricting expropriation of minority shareholders by the controlling shareholders, rather than of restricting empire building by professional managers unaccountable to shareholders".

Large shareholding is generally motivated by shared benefits of control and private benefits of control. Jensen and Meckling (1976) and Shleifer and Vishny (1986) argue that the existence of block-holders helps mitigate the agency problem between shareholders and firm management, providing non-exclusive benefits to all shareholders. An incentive problem naturally arises: How can the block-holder be adequately motivated to monitor the management if resulting benefits are to be shared with minor shareholders, a phenomenon called free-riding in incentive theory. Barclay and Holderness (1989) provide the first evidence that there are exclusive benefits to block-holders. They find blocks of shares are traded at an average of 20 % premium to prevailing market price. The premium reflects private benefits of control and is confirmed by Mikkelsen and Regassa (2000), Nicodano and Sembenelli (2004) and Dyck and Zingales (2002).³

² In 1983, a special issue of *Journal of Financial Economics* was dedicated to the principal-agent problem between diffused shareholders and firm management. 5 years later, in 1988, another special issue of the same journal focused on the agency problem between large-percentage shareholders and small shareholders.

³ Nicodano and Sembenelli (2004) document even larger premium of block trading in Italy than in the US and purport that the less restraining the legal system is, the more private benefits of control. Dyck and Zingales (2002) use the same method of measuring premium in block trading and document that the average value of control is 14 % across 39 countries of concern. Researchers have also attempted to determine private benefits of control via another method making use of the fact that some stocks are endowed with voting rights while some are not. Chung and Kim (1999) find that private benefits of control in Korea, measured by the premium enjoyed by the voting stock over the non-voting stock, is about 10 % of equity value. According to Claessens et al. (2002), private benefits of control also exist as a result of the discrepancy between cash flow rights and control rights of the controlling shareholder.

Private benefits of control to the controlling shareholder are not necessarily harmful to non-controlling shareholders.⁴ Johnson et al. (2000) coin the term *tunneling* as the part of private benefits of control that is harmful to non-controlling shareholders. As they put, tunneling can take the form of related-party transactions including outright theft, pricing advantage in asset transfers, loan guarantee and so on, or the form of financial transactions such as intentionally diluting small shareholders' holdings and insider trading. Tunneling through related-party transaction has been extensively studied since Johnson et al. (2000). Baek et al. (2006) find evidence of tunneling in Korean business groups as Cheung et al. (2006) do for Hong Kong. In the case of China, Jian and Wong (2003) find that business groups as controlling shareholders tunnel more than holdings companies.

Some works propose that it is unfair to always blame the controlling shareholder for tunneling: The controlling shareholder can also prop the firm in financial distress. Bai et al. (2004) argue that entities with strong financial condition are willing to compete for the position of controlling shareholder of a STed⁵ firm and help it regain financial strength. Peng et al. (2011) find that in China, when a firm is financially healthy, connected-party transactions are used to tunnel while if the firm is in trouble, such transactions are used to prop. However, authors of both studies concede that propping is just a cost for benefits of tunneling in the future.

2.2 The Choice Among Equity Refinancing Methods

A listed firm can issue additional shares privately or publicly, and to existing or new shareholders. Generally, the firm has three options of increasing cost if it decides not to pursue a private placement: Non-underwritten rights offering, underwritten rights offering and bookbuilt offering in which underwriters are employed to create prospectus and market shares.⁶ In a rights offering, the firm sells shares to existing shareholders on a pro rata basis. If a substantial number of shareholders do not purchase new shares allotted to them, the firm is not able to raise the amount of capital as planned. In a non-underwritten rights offering, this is called the *lack of guarantee* problem. In an underwritten rights offering, however, the underwriter agrees to buy all shares not wanted by existing shareholders. Such a guarantee comes at the expense of underwriting fees. In bookbuilt offerings, shares are offered to all investors, although incumbent shareholders enjoy priority in allotment if shares are oversubscribed.

⁴ For example, the controlling shareholder may derive pleasure and a sense of privilege out of its control position. This does no harm to other shareholders.

⁵ ST is the abbreviation of Special Treatment. A listed firm in China's Shanghai and Shenzhen stock markets is said to be under Special Treatment if it shows negative financial abnormality. ST can be used as a verb in the same manner. Bai et al. (2004) provide a detailed description of ST.

⁶ Gao (2008) provides an excellent investigation into more recent developments, such as accelerated offering, in seasoned equity offering. For the purpose of this study, I stop short of accelerated offerings.

A vast amount of literature are dedicated to explain the so called *Equity Refinancing Paradox*, which can be phrased in two parts: Why would a firm hire underwriters to do rights offering or bookbuilt offering while it can by itself do a non-underwritten rights offering for free; and why would a firm hire the underwriter for bookbuilt offering while the underwriting fee for rights offering is lower. Smith (1977) is the first to document the first part of *Equity Refinancing Paradox*: Although the cost of non-underwritten rights issue is substantially lower than public offering that is underwritten by default, 90 % of US firms employ the latter method for equity refinancing. Booth and Smith (1986) theorize that underwriters play a role of certification in equity offerings. Hansen (1998) addresses the second part of *Equity Refinancing Paradox* and proposes that underwritten rights offerings, although requiring lower underwriting fees, are associated with substantial transaction costs that do not happen to bookbuilt offerings.

Eckbo and Masulis (1992) posit that the choice of equity-refinancing method is dependent on the degree of information asymmetry between firm insiders and the public, characteristics of shareholders and the cost of direct financing. They argue that underwriting by investment banks and active subscription by existing shareholders are the main means of solving information asymmetry and avoiding wealth transfer from existing shareholders to potential shareholders. To maximize firm value in the presence of information asymmetry, firm management has to employ equity-refinancing methods of certain costs, which are costs of adverse selection due to information asymmetry.

Information asymmetry is also employed to explain why firms choose private placement instead of seasoned public offering. Using a sample of listed US high-technology firms, Wu (2004) finds the value of a firm conducting private placement is more uncertain than that of a bookbuilt-offering firm. Cronqvist and Nissson (2005) make a comparison between firms conducting private placements and rights offerings in Sweden and show that a typical firm resorts to non-underwritten rights offering, underwritten rights offering and finally private placement in order as the degree of information asymmetry on firm value goes higher. Marciukaityte et al. (2005) study a sample of 513 US firms that undertook private equity placement between 1979 and 1996 and find a large percentage of them to be young, small, and high-R&D-expenditure firms whose value is hard to evaluate. This lends strong support to the information-asymmetry explanation of why firms choose private placements.

Besides information asymmetry, the literature has also examined the choice of private versus public offering from the angle of ownership structure. According to Shleifer and Vishny (1986), private placements that result in a more concentrated ownership will lead to more monitoring on management and increase firm value. Moreover, since private placed shares are restricted from resale for a certain period after the placement, outside investors are not able to 'vote by feet' but are incentivized to monitor firm management (Kahn and Winton 1998). Wruck (1989) is the first to explain the choice of private placement by higher ownership concentration. Hertznel and Smith (1993) support such an explanation, but subsequent studies pose serious challenge to it. Wu (2004) find that investors of privately placed shares are no more active in monitoring than those of public offerings. What's more, Cronqvist

and Nisson (2005) find that controlling shareholders in Sweden prefer rights offering to private placement because the former does not induce any decrease in their control rights or increase in outsider monitoring. They also find that even if the controlling shareholder chooses private placement, it not infrequently issues shares to itself so as to strengthen entrenchment and evade more monitoring from outside investors. Therefore, it seems that private placements are chosen over public offerings mainly due to information asymmetry, but not more monitoring.

Cronqvist and Nisson (2005) also find firms employ private placements to establish business relations with potential industrial partners. By privately issuing shares to firm B whose supplier is firm A, firm A can align B's interest with its own and get rid of the hold-up problem, a type of moral hazard.

In sum, extant studies on the choice of private placement against public offering stress the role of information asymmetry and the need to form business alliance, but challenge the ownership structure perspective.

2.3 Discount Determination

Since privately placed shares are generally restricted from resale for a certain period,⁷ it is easy to understand, according to Silber (1992), that lack of liquidity can explain part of the discount. There are three more hypotheses that have been proposed to explain the discount.

Monitoring Hypothesis. It claims the discount is what purchasers of privately placed shares are paid for shared benefits of control from higher ownership concentration after the private placement.

The pioneer work of Wruck (1989) observes an increase of share ownership from 31 to 37 % by managers, directors and the controlling shareholder.⁸ Wruck thus hypothesizes that the discount serves as compensation to participating investors for increased monitoring efforts on the management team after a private sale of shares. In other words, participants in the private placement are awarded a discount for reducing the principal-agent problem between shareholders and the management. Using data of private placements in Hong Kong, Wu et al. (2005) find that higher ownership concentration does lead to better use of investment opportunities.

There are two problems with the *Monitoring Hypothesis*. The first is its underlying assumption that shared benefits of control surpass private benefits of control. Cronqvist and Nisson (2005) pose a challenge by showing that firms controlled by families are prone to use private offering to avoid monitoring. This implies that for participating investors, private offering of equity may be a channel of strengthening private benefits of control, but not sharing benefits with other shareholders. Barclay et al. (2007) and Wu (2004)'s studies on

⁷ There is no such restriction in New Zealand.

⁸ Wruck (1989) treats 5 % as the threshold between substantial and non-substantial shareholders, i.e., if a shareholder owns more than 5 % of a firm, then it is counted in when calculating the ownership concentration measure.

US firms reveal that participants of private placements do not necessarily provide better monitoring. The other problem with this hypothesis is it does not explain the discount of private placements after which ownership concentration does not increase. Hertz and Smith (1993) propose the *Information Cost Hypothesis* as part of the solution to this problem.

Information Cost Hypothesis. This hypothesis says that investors buy private placed shares at a discount because they need to be compensated for costs induced in the process of making investment decisions. Such investment-decision process involves studying the firm's ability to grow to a larger size, to generate a higher return with the current asset size, or to take advantage of investment opportunities.

Hertz and Smith (1993) extend Myers and Majluf (1984)'s model and propose that the fact firm management chooses private placement and investors are willing to purchase shares signals to the market that the firm is undervalued. Using a different sample set of the US from that of Wruck's (1989), Hertz and Smith (1993) on the one hand supports the *Monitoring Hypothesis*, and on the other hand argues that the discount can be explained to a larger extent by information cost. Firms in their sample are smaller than these in Wruck (1989), so their finding that *Monitoring Hypothesis* is of secondary importance is consistent with Morck et al. (1988) that ownership structure is more important for large firms. Hertz and Smith (1993) do not distinguish growth in firm size (scale) and growth upon current size (productivity). Wu et al. (2005) find that in Hong Kong information cost is mainly induced to verify the issuer's potential to grow to a larger size, but not growth per se.

The *Information Cost Hypothesis* is unable to explain why the controlling shareholder who should know the true value of the firm for free is offered a discount. This is not the whole picture, however. Both the *Monitoring Hypothesis* and the *Information Cost Hypothesis* purport that after a private placement, non-participants are better off. They may benefit from a better-monitored management or harder working by the management to realize good investment opportunities. Barclay et al. (2007) propose the *Passive Investor Hypothesis* and prove empirically that private placement of equity may do non-participants no good.

Passive Investor Hypothesis. This hypothesis claims that in a private sale of equity, management of the issuer offers shares at a discount to passive investors⁹ who will not interfere with firm management after the issue and facilitate management entrenchment. The discount is regarded as compensation to passive investors for keeping silent about firm management.

Dann and DeAngelo (1983) are the first to offer evidence on this hypothesis. They find that private placement is in the management's toolkit to defend potential takeovers. Barclay et al. (2007) study the long-term performance of firms that undertake private placements and find that passive investors won't have positive long-term abnormal returns unless they purchase shares at a big discount at the private placement. Given their finding that shareholders of the firm who do not

⁹ Barclay et al. (2007) define investors who do not reportedly interact with the issuer after a private placement as passive investors.

participate in the private offering experience long-term loss, they argue that the loss is due to management entrenchment facilitated by passive investors.

2.3.1 Announcement Effect

Positive abnormal return around the announcement period is widely documented in private placement literature. Researchers have proposed three effects to explain positive short-run market reaction.

Monitoring Effect. This is the sister version of *Monitoring Hypothesis* in explaining discount. Public investors react positively to the announcement of a private placement because they believe higher ownership concentration leads to more monitoring on the management. Wruck (1989) first proposes this effect, followed by Wu et al. (2005). Chen et al. (2003)'s study on private placements in Singapore is the only one to document negative announcement effect, but they argue, in favor of *Monitoring Effect*, that this is due to decrease in ownership concentration.¹⁰

More monitoring after the private placement may come not from the controlling shareholder, but new block-holders: The market may also react positively to the fact that among investors participating in the private placement, there are active ones who will interfere with the management and help increase firm value.¹¹ Wruck and Wu (2002) find that higher announcement effects follow private placements whose investors include these that are newly connected to the issuer. They argue that these newly acquainted investors will do a better monitoring job than familiar investors. Barclay et al. (2007) find that in the US the positive announcement effect is mainly driven by private placements offered to active investors.

Signaling Effect. As the sister version of *Information Cost Hypothesis* in explaining discount, this effect says the market believes a private placement signals that the issuing firm can grow to a larger size, gain higher earnings power with the current size, or make profitable uses of investment opportunities. Hertz and Smith (1993) find the positive market reaction is mainly from the belief that an issuer can either grow larger or earn more without growth of asset size. Tan et al. (2002) argue that in Singapore the announcement effect is positively related to issue size that is an indicator of the issuer's investment opportunity. Wu et al. (2005) find in Hong Kong, positive market reaction of private placements can be partly attributed to the belief that the issuer has growth potentials. Anderson et al. (2006) point out that in New Zealand, the announcement-day effect of placements whose proceeds are used for capital expenditure or new projects is positive while that of placements whose proceeds are used for working capital or refinancing is negative or insignificant.

¹⁰ In Singapore, privately placed shares are not allowed to be purchased by existing block-holders, so ownership concentration is destined to be lower after a private placement.

¹¹ This is different from *Monitoring Effect* in which monitoring is exerted by the controlling shareholder.

Janney and Folta (2006) show that in the Biotechnology Industry, the more renowned the investor is, the higher announcement effect following a private placement. Krishnamurthy et al. (2005) observe that the market reacts more favorably to private placements offered to affiliated investors that know better about firm value than those offered to unaffiliated investors.¹² Finally, Anderson et al. (2006) document premiums rather than discounts in private placements in New Zealand. They purport these premiums are credible signals showing the market that issuers are undervalued.

It's worth noting that in both effects mentioned above, the market does not necessarily only react to credible signals. The fact that ownership is more concentrated after a private placement does not necessarily mean firm value will increase. The fact that institutional investors have incurred costs in studying the firm's true value does not mean their judgment is right. The news that proceeds of the private issue will be used in making new investments does not credibly convey the idea that the issuer can make good uses of these investment opportunities.

Projection Effect. This effect says the more optimistic investors are at the time of private placement, the higher announcement-period abnormal return. The projection argument in Marciukaityte et al. (2005) says that investors are prone to forecast the performance of firms whose values are much uncertain on the basis of market condition: The more firms performing beyond investors' expectation now, the more optimistic investors are about uncertain firms' prospects. They use the number of beyond-expectation firms before a private placement as indicator of investor over-optimism and find that most of the firms in their sample are of uncertain firm values and that the more optimistic investors are, the higher the short-run market reaction to the issuer's stock.

There are two other perspectives that should be noted in any study on the announcement-period abnormal return of equity refinancing. The first is *Price Pressure Effect*, introduced simultaneously by Scholes (1972) and Kraus and Stoll (1972). Assuming that the demand curve for securities is downward sloping, this hypothesis claims an increase in the supply of a stock due to seasoned offering causes downside pressure on stock price. Anderson et al. (2006) do trace significant price pressure effect for private placements in New Zealand.¹³ The second is *Wealth Transfer Effect* widely cited in the literature on M&A, managerial compensation, and dividend and share repurchase announcements [see, for example, DeFusco et al. (1990) and Handjinicolaou and Kalay (1984)]. In the case of equity refinancing, this hypothesis says that seasoned equity makes leverage of the issuer lower and that wealth is transferred from stockholders to bondholders. For private

¹² Krishnamurthy et al. (2005) define affiliated investors as officers, directors and affiliated institutions.

¹³ Not all private placements in New Zealand are featured by a discount. In Anderson et al. (2006), downside price pressure only appears in these private placements in which shares are offered at a discount.

placement, however, no evidence supporting this hypothesis is found in either Singapore or New Zealand (Tan et al. 2002; Anderson et al. 2006).

2.4 Long-Run Performance

A vast amount of research focusing on the long horizon has shown that compared to control firms, firms that conduct seasoned public offerings perform worse, in both stock price and operating performance. For example, Spiess and Affleck-Graves (1995) not only document inferior operating performance of issuers, but also find stocks of such firms underperform stocks of non-issuing controls by as much as 31.2 % in a 5-year horizon. The same pattern is also documented in Loughran and Ritter (1997). At least for SEOs in the US, it is established that there are negative excess returns in both the short and long horizons.

Two hypotheses are proposed to coordinate the dual negativities. The first is *Under-reaction Hypothesis*. Assuming investors are conservative, this hypothesis posits that investors do not react fully to undesirable information released around the announcement period but only adjust gradually towards the long end. The second is *Over-optimism Hypothesis*. It says, for some reason, investors are over-optimistic when bad information is published but are able to make neutral judgments given enough time. Loughran and Ritter (1997) offer the first evidence for *Over-optimism Hypothesis*. They apply Kahneman and Tversky (1982)'s proposition that human beings give recent experience more weights than distant experience in making judgments and purport that investor over-optimism arises from enhanced firm financial performance immediately prior to the issue. They also develop the notion of 'window of opportunity' and argue that firm management is able to time the SEO at when investors are over-optimistic. Negativity of abnormal return in the short run and the same in the long run for SEOs become compatible under the *Over-optimism Hypothesis*.

Hertzel et al. (2002) and Chou et al. (2009), the only two pieces of study on private placement's long-run behavior and both drawing insights from *Under-reaction Hypothesis* and *Over-optimism Hypothesis*, yield different results. The former study documents negative long-term abnormal return but find it impossible to reconcile with positive announcement-period effect. *Under-reaction Hypothesis* does not apply since it implies positive long-run abnormal return. *Over-optimism Hypothesis* cannot hold either: The authors unfortunately find deteriorating operating performance of issuers immediately before private placements and are unable to justify over-optimism as Loughran and Ritter (1995) do.

On the other hand, Chou et al. (2009) claim that growth opportunity plays a vital role in validating *Over-optimism Hypothesis*. Empirically, they find only stocks of growth firms (indicated by high Tobin's Q) earn negative long-run abnormal returns. Theoretically, referring to Li and Lu (2010) and Barberis and Huang (2008), they argue that such negativity may arise from overinvestment by growth firms, positive skew-ness of small firms' stock return, or over-optimism on growth prospect. Evidence supports the last point.

2.5 Back to Tunneling: A Critique on the Literature

From the corporate governance point of view, tunneling should be seriously considered in any study on private placement. Firstly, there is ownership concentration. Not only are large shareholders influential over the decision of whether to place shares privately, they may also purchase shares and act as participants of influential negotiating power in an issue. Secondly, by default, participants of a private placement negotiate privately, without the monitoring of minor shareholders.¹⁴ Thirdly but not finally, large shareholders may not share the same interests with small shareholders. All these concerns strike a sharp contrast against the lack of treatment of tunneling in extant studies.

Let's consider a possible scenario that the largest shareholder arbitrarily lowers offering price so as to purchase shares and gain more control rights at an unfairly low cost. Three factors contribute to researchers' indifference (or inability to identify tunneling) under this scenario. The first is information asymmetry problem. It can be plausibly declared that, since there is so much uncertainty about firm value that institutional investors are not willing to offer enough capital as the firm needs, the largest shareholder has to contribute capital and thus be given a low price for the sake of undertaking extraordinary risks. Existing studies are not able to falsify such a claim. The second is liquidity problem. Since privately placed shares are not allowed for resale for a certain period after the transaction, the largest shareholder can always claim that such a low price accurately reflects compensation to illiquidity of the holdings. It's impossible to price illiquidity in existing studies. The third is negative long-run performance. The controlling shareholder can claim it deserves the discount as the discount compensates its loss in the long run.

Baek et al. (2006) make the first and remarkable endeavor to reveal tunneling in private placements. As they put, 'the incentive for controlling shareholders to tunnel therefore tends to be strong in PSOs,¹⁵ offering a natural context for powerful and convincing tunneling activity'. They study private placements in which both the purchaser and the issuer are listed firms belonging to the same business group, and find that upon announcement of an issue, the purchaser's stock price enjoys positive abnormal return while the issuer's price dips, evidence that wealth is tunneled from the issuing firm to the purchasing firm. Their study benefits from the unique business group structure in Korea and is able to circumvent the three problems aforementioned.

¹⁴ There is a section at Wind's terminal dedicated to collect information on private placements that are proposed by the board of an issuer but not carried out in the end. This section, however, is empty, implying that in China the shareholders' meeting seldom rejects the board's proposal.

¹⁵ PSO is the abbreviation for Private Securities Offering.

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<http://www.springer.com/978-3-642-55092-8>

Private Placement of Public Equity in China

Song, P.

2014, XVI, 80 p. 3 illus., Softcover

ISBN: 978-3-642-55092-8