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COMMENT: PUBLIC OFFERINGS AND PRIVATE SALES OF SECURITIES

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A number of studies have examined public offers of securities, and several others document the stock market's reaction to the announcement of private placement of corresponding securities. The purpose of this Comment is to compare and contrast the market's reaction to announcements of public offers and private placements of similar securities.

It is interesting that public offers of common stock, and other securities convertible into common stock, evoke a large negative response from the stock market.¹ Myers and Majluf, among others, argue that managers are likely to sell common stock when it is overvalued.² The sale of undervalued stock dilutes the market value of pre-existing stockholders' equity and the market realizes that insiders have an incentive to issue overvalued equity. Accordingly, the market treats announcements of new equity offers as negative information. It is argued that securities convertible into common stock are quasi-equity and can be thought of as back door offers of equity. The stock market similarly treats announcements of convertible securities (convertible bonds or convertible preferred, convertible into shares of common stock) as negative information. The magnitude of the reaction to convertible offers, however, is slightly less negative.³ Offers of non-convertible (straight) debt are associated with a negative but relatively neutral response.

This set of market responses to public offers of securities is consistent with explanations offered by Myers and Majluf.⁴ It suggests that the investors are suspicious of sales of equity-like securities and

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¹ See *infra* Table 1.

² See Stewart C. Myers & Nicholas S. Majluf, *Corporate Financing and Investment Decisions When Firms Have Information That Investors Do Not Have*, 13 J. FIN. ECON. 187, 194-95 (1984).

³ See Larry Y. Dann & Wayne H. Mikkelson, *Convertible Debt Issuance, Capital Structure Change and Financing-Related Information: Some New Evidence*, 13 J. FIN. ECON. 157, 184-85 (1984).

⁴ See Myers & Majluf, *supra* note 2, at 214-15.

treat the associated announcements as a release of negative information. On the other hand, announcements of private placement of common stock and securities convertible into common are associated with significantly positive stock price reactions. It has been argued that smart institutional investors agree to a private purchase of a security only if they have performed due diligence and are satisfied with the prospects of the firm. Additionally, large investments made by a relatively small group of institutional investors assure the investing public that the issuing firm will be monitored. By agreeing to subject themselves to increased monitoring by sophisticated investors, managers are signaling that they are unlikely to misuse the free cash flows of the firm. Thus, reduced agency costs will also be a positive signal to the investing public. Accordingly, announcements of private placements of equity and quasi-equity securities are associated with a positive reaction.⁵

This evidence is consistent with announcements of firms entering into a bank loan agreement. It is argued that banks have expertise in information collection processing and monitoring of firms' ongoing activity. Thus, when firms announce that they are entering into a bank loan arrangement, these announcements are met with a positive stock market response.⁶ It is argued that the presence of a sophisticated monitoring agency (namely the bank) reduces the agency cost for the remaining investors and results in increased stock price.

As in the case of public offers of non-convertible (straight) debt, the private placement announcements are also met with a negative but relatively neutral market response.

CONCLUSION

Public offers of equity and quasi-equity securities evoke a negative response from the stock market. In contrast, private placements of these same securities are associated with a positive reaction. It is argued that public offerings of common stock and convertibles are viewed as a sale of overvalued securities and are accordingly treated as negative information. Private placements signal increased monitoring by sophisticated investors and arguably reduce agency costs. Therefore, the reaction is positive. Pub-

⁵ See Karen Wruck, *Equity Ownership Concentration and Firm Value: Evidence from Private Equity Financings*, 23 J. FIN. ECON. 3, 23 (1989) ("The announcement of a private sale of equity . . . increases shareholder wealth by 4.5% on average."); see also L. Paige Fields & Eric L. Mais, *The Valuation Effects of Private Placements of Convertible Debt*, 46 J. FIN. 1925, 1926 (1991) (hypothesizing that private placement announcements create positive reactions because of the effects of such placement on ownership structure, tax situation, and information regarding future cash flow).

⁶ See Christopher James, *Some Evidence on the Uniqueness of Bank Loans*, 19 J. FIN. ECON. 217, 226 (1987) ("The positive stock price response to bank loan agreements contrasts with the non-positive response to public offerings of securities reported by other researchers.").

lic and private sales of non-convertible (straight) debt are viewed as an informationally neutral event.

Table 1

A Summary of Announcement Period Common Stock Average Abnormal Returns, Recorded Across Studies, for Public Offerings and Private Sale of Common Stock, Convertible Debt, Straight Debt, and Bank Loans

Security Type	Public Offer	Private Placements
Common Stock	-3.14% ⁷	4.5% ⁸
Convertible Debt	-2.31% ⁹	1.80% ¹⁰
Straight Debt	-0.26% ¹¹ (not regarded by the author as statistically significant)	-0.91% ¹²
Bank Loans	n/a	1.93% ¹³

⁷ Clifford W. Smith, *Investment Banking and the Capital Acquisition Process*, 15 J. FIN. ECON. 3, 5 (1986).

⁸ Wruck, *supra* note 5, at 23.

⁹ Dann & Mikkelson, *supra* note 3, at 171.

¹⁰ Fields & Mais, *supra* note 5, at 1925.

¹¹ Smith, *supra* note 7, at 5; *see also* B. Espen Eckbo, *Valuation Effects of Corporate Debt Offerings*, 15 J. FIN. ECON. 119, 148 (1986) ("Straight debt offerings have a non-positive impact on the issuing firm's common stock price . . ."); Wayne H. Mikkelson & M. Megan Partch, *Valuation Effects of Security Offerings and the Issuance Process*, 15 J. FIN. ECON. 31, 51 (1986) ("The average price reaction to the announcement of . . . straight debt . . . is small and not significant . . .").

¹² James, *supra* note 6, at 225; *see also* Mikkelson & Partch, *supra* note 11, at 58 (finding no statistically significant difference in the reactions to straight debt financing through public offering or private placement).

¹³ James, *supra* note 6, at 225.

