Private Placements, Regulatory Restrictions and Firm Value: Theory and Evidence from the Indian Market*

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Abstract

We present an asymmetric information model to examine private placements issued to owner-managers. Our main conclusion is that allowing private placements to insiders can mitigate, if not eliminate, the underinvestment problem. Our model predicts that announcement period returns for private placements should be: (1) positive; (2) dependent on regulatory constraints that determine the issue price; (3) positively related to volatility; (4) negatively related to leverage; (5) negatively related to owner-managers’ shareholdings (6) related to proxies of manipulation; and (7) negatively related to illiquidity. We empirically test the model’s predictions on a sample of 164 preferential allotments (private placements) issued in the Indian capital markets during 2001-2009 and report empirical evidence largely consistent with the model. In addition to the predictions of our model, we also find that announcement period returns of: (8) firms affiliated to business groups are not lower than those of stand-alone firms and (9) private placements made to (active) private equity investors are not higher than those made to (passive) banks or financial institutions.

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