

Institutional Investors and the Performance of Private Placements

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Abstract

Recent research has documented the long-run negative post-announcement stock price performance of equity issuers including that of firms that place equity privately. In this study, we document that this negative long-run stock under-performance is limited to firms that experience a decrease in institutional ownership around the private placement. Firms that increased their institutional ownership do not underperform their portfolio benchmarks in the three years following the private placement. We also find that operating performance declined significantly in the two years following the private placement, in firms that experienced a decrease in institutional ownership around the private placement. We find no such decline in the sample of firms that experienced an increase in institutional ownership. This difference in long term performance does not appear to be driven by activism on the part of the institutions. We do not find any significant difference in corporate governance changes between those firms that experienced an increase in institutional ownership and those that experienced a decrease. The results in this paper provide strong evidence for the “smart money” hypothesis. Institutions are better able to identify superior private placements, at the the time of the placement, and increase their holdings in these firms accordingly.

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1 Introduction

The ability of institutional investors to select superior investments when compared to other investors is actively debated in the finance community. Institutional investors spend millions of dollars collecting and analyzing information about equities. Many money managers use their superior ability to pick stocks as a selling point to attract billions of dollars from retail investors. However, evidence on the ability of institutional investors has been mixed. Grinblatt and Titman (1993) find evidence that mutual fund earn higher gross returns and that mutual fund performance is persistent. In contrast, Malkiel (1995) finds that mutual funds earn normal gross returns but net inferior returns when adjusted for expenses. Carhart (1997) attributes the persistence in mutual fund performance to momentum.

Performance around equity issues, such as initial public offerings (IPOs), seasoned equity offerings (SEOs) and private placements represents a natural way to test the selectivity and performance of institutional investors. Equity issues are accompanied by large amounts of information disclosure in a short period time, as companies do their best to convey information about their future prospects to potential investors. Firms also direct a large part of the marketing of their securities to institutional investors. Thus, these events represent a unique opportunity for institutions to use their access to information and extensive information processing resources to select better equity issues than other investors. This idea, dubbed the “smart money” hypothesis by Gibson, Safieddine, and Sonti (2004), contends that institutions use their information advantage to selectively invest in equity issues with better future prospects.

A number of studies have examined the ability of institutional investors to identify SEOs with better prospects, than other investors. Gibson, Safieddine, and Sonti (2004) find that firms associated with an increase in institutional ownership around their SEO outperform their portfolio benchmarks in the year following the offering, and also outperform those firms associated with a decrease in institutional ownership around the offering. Using a dataset of institutional trades, Chemmanur, He, and Hu (2005) also find that institutional investors obtain larger allocations in SEOs with better long-term prospects.

Other studies have examined institutional selectivity in the context of IPOs. Boehmer, Boehmer,

and Fische (2006) find that institutions obtain larger allocations in IPOs with better long term prospects. Similarly, both Dor (2004) and Field and Lowry (2005) find that IPOs with the greatest institutional ownership right after the offering, outperform those with the least institutional ownership. Taken together, these results suggest that institutions have an advantage over other investors in selecting IPOs and SEOs with better long-term prospects.

The choice of equity issues as a natural experiment to study the superior selectivity of institutional investors is also interesting in another respect. One of the puzzles in corporate finance has been the long run underperformance of firms following equity issues. Starting from Ritter (1991) which documents the long-run negative stock performance following initial public offerings (IPOs), other studies have documented negative stock performance following other kinds of equity issues. Loughran and Ritter (1995) and Spiess and Affleck-Graves (1995) document negative long-run performance following seasoned equity offerings (SEOs). Similarly, Hertzfel, Lemmon, Linck, and Rees (2002) find negative stock price performance following private placements of equity. The long-run underperformance of IPOs and private placements are especially puzzling because they follow positive announcement returns.

In this paper, we focus on private placements, and examine the relationship between institutional ownership and the long-run performance of private placements. It is not immediately apparent that institutions will have an advantage over other investors in selecting those private placements with better future prospects. In contrast to public equity issues (SEOs and IPOs) which involve a lot of investors, private placements are negotiated with just a few investors and is accompanied by selective private information disclosure to each of these investors. So, it is reasonable to assume that all the parties involved in a private placement have the same information and that institutions have no information advantage. However, any information disclosed still has to be processed and institutions can use their scale of information processing to identify private placements with better prospects. Institutions can also use their relationships with underwriters to obtain even more information than the firm chooses to disclose or to obtain larger allocations in favorable private placements. Thus, the ability of institutional investors to use their access and information advantage to select private placements with better long-term prospects is an open empirical

question that we examine in this paper.

We use a sample of 357 private placements announced between 1980 and 1996 for which we are able to identify total institutional ownership in the quarters preceding and following the quarter in which the private placement was announced. From this sample we are able to identify 204 private placements accompanied by an *increase* in institutional ownership and 153 accompanied by a *decrease* in institutional ownership.

We find that, while firms that experience a decrease in institutional ownership around the private placement exhibit negative long-run stock underperformance, those associated with an increase in institutional ownership do not underperform their portfolio benchmarks in the three years following the private placement. Firms that experience an increase in institutional ownership significantly outperform those that experience a decrease. Over the three-year period following the announcement of the private placement, the returns of the sub-sample of firms that experienced an increase in institutional ownership around the private placement, is 21.26% higher than the returns for the sub-sample of firms for which institutional ownership decreased.

We also investigate the post-issue operating performance of our sample. Loughran and Ritter (1997) document a decline in operating performance of issuers in the four years following an SEO. We find that operating performance declines significantly in the two years following the private placement, for firms that experience a decrease in institutional ownership around the private placement. The median return on assets (ROA) for the sub-sample of firms that experienced a decrease in institutional ownership declines by 7.16% in the two years following the issue. Again, we find no such decline in the sub-sample of firms that experience an increase in institutional ownership.

We examine the possibility that the better performance of firms with increased institutional ownership is due to the increased activism by institutions after the placement, as opposed to institutions having an information advantage at the time of the placement. Wruck (1989) suggests that the positive price reaction to private placement announcements is due to anticipation of increased monitoring. One way this might manifest itself is in the form of activism on the part of institutions. Indeed a number of authors have documented the increase in shareholder activism by institutions, especially since 1990 (see surveys by Gillan and Starks (1998), Karpoff (1998), Romano (2001)).

Similarly, Barclay, Holderness, and Sheehan (2001) argue that block trades and private placements in which the investor subsequently becomes active in firm management outperform those where the investor remains passive.

We identify the firms where the private placements were associated with an increase in ownership by institutions (mostly pension funds) that have been most explicitly associated with activism.¹ We find that the long term performance of this subset of private placements is no different from the long term performance of the other placements associated with an increase in total institutional ownership. We also do not find any significant difference in board changes between those firms that experienced an increase in institutional ownership and those that experienced a decrease.

Our paper is the first to examine the relationship between institutional investors and the subsequent performance of private placements. Overall, the results in this paper provide strong evidence for the “smart money” hypothesis. Our findings suggest that institutions are better able to identify private placements with better long-term prospects and increase their holdings in these firms accordingly. We do not find any evidence that the long-run performance of firms associated with an increase in institutional ownership at the time of the placement is due to increased activism on the part of the institutions.

Our focus on private placement is in the spirit of two other recent studies. Krishnamurthy, Spindt, Subramaniam, and Woidtke (2005) also investigate the relationship between the long-term performance of private placements and the identity of the investor; however they focus on whether or not the investor is affiliated with the company, and find that private placements to affiliated investors outperform others. Our study differs from theirs by focusing on total institutional ownership in general. Brophy, Ouimet, and Sialm (2005) also study the investor identity/performance relationship of private placements and focus on the role of hedge funds (rather than institutional investors). They find that private placements where hedge funds were the primary investors underperform the benchmarks in the two years following the placement. This result actually supports our findings in this paper, since the private placements to hedge funds would most likely fall in the sub-sample of firms that experience a decrease in institutional ownership around the private

¹see Larcker, Richardson, and Tuna (2005)

placement.

The rest of the paper proceeds as follows. In Section 2, we describe the sample used in our study as well as our research methodology. In Section 3, we present and discuss our results from our tests of long run stock and operating performance. In Section 4, we examine the possibility that our results might arise from institutional activism-driven governance changes. Section 5 concludes and discusses possible extensions of the study.

2 Data and Research Methodology

2.1 Data

Through *Dow Jones News Retrieval Service* searches, we initially identify 952 announcements of equity private placements from the 1980 to 1996 period by firms that existed on the Center for Research in Security Prices (CRSP) NYSE/AMEX/Nasdaq monthly stock files at the year-end prior to the private placement announcement. To avoid potential problems with low-price stocks, we exclude 209 firms with a price less than two dollars at the time of the private placement announcement. We also eliminate 124 firms that had completed a private placement within the preceding three years (the firm's first private placement is included in the sample), leaving us with an intermediate sample of 619 equity private placements.

Our institutional ownership data comes from the Thomson Financial (TFN) database. The database compiles mutual fund and institutional ownership in U.S. equities and reports this on a quarterly basis. From our final sample of 619 private placements, we eliminate 262 placements by firms for which there is no institutional data for the quarters immediately before and immediately after the private placement was announced. This leaves us with a sample of 357 private placements.

We divide the sample of private placements with institutional data into two sub-samples according to whether institutional ownership (as a proportion of total equity) increases or decreases from the quarter before the private placement was announced, to the quarter after the private placement. We refer to these sub-samples as *institutional increase* and *institutional decrease* respectively. There are 204 firms in the *institutional increase* sub-sample and 153 firms in the *institutional decrease*

sub-sample.²

Table 1 summarizes the characteristics of firms and private placements in the two sub-samples. Panel A shows that both the *institutional increase* and the *institutional decrease* have a broad range of firms across a wide range of industries. The distribution of firms across industries is about the same in both samples. For example, 18.6% of the firms in the *institutional increase* sample are in the chemical and allied products industry (SIC Code 28) compared with 18.3% of the *institutional decrease* sub-sample.

[Table 1 here]

Panel B of Table 1 also show that there is little difference in the characteristics of the private placements of both samples. The mean (median) dollar proceeds from the *institutional increase* and the *institutional decrease* are \$9.38 (\$5.00) and \$9.52 (\$3.88) million dollars respectively. Both sub-samples have significantly positive announcement returns of 1.9% and 1.8% respectively and the book-to-market values are 0.58 and 0.55 respectively. Two-sample *t*-tests and Wilcoxon *p*-tests do not reveal any differences between the *institutional increase* and the *institutional decrease* sub-sample, for any of the variables in Panel B of Table 1. This is especially important as it implies that there is no significant size, book-to-market or industry difference between the two sub-samples.

Table 2 reports the institutional holdings in both the *institutional increase* and *institutional decrease* sub-samples. In the period from the quarter before the announcement of the placement, to the quarter right after the placement (−1 to 1), institutions increase their holdings in our *institutional increase* sub-sample by 5.12%. In the same period, institutions decrease their holdings in the *institutional decrease* sub-sample by 3.48%. These changes in institutional ownership are not trivial and are significantly different from each other at the one percent level ($p < 0.01$).

[Table 2 here]

²There we no firms where the percentage of institutional ownership was unchanged from the quarter before the private placement to the quarter after

2.2 Research Methodology

We measure the long run stock performance following the private placements using two methods: The buy-and-hold abnormal returns (*BHAR*) approach discussed in Barber and Lyon (1997) and the calendar time portfolio approach introduced by Jaffe (1974) and Mandelkar (1974), and used in Loughran and Ritter (1995) as well as Mitchell and Stafford (2000).

2.2.1 The buy-and-hold abnormal returns (*BHAR*) approach

A T -month *BHAR* for event firm i is given by:

$$BHAR_i(t, T) = \prod_{t=1}^T (1 + R_{i,t}) - \prod_{t=1}^T (1 + R_{c,t}) \quad (1)$$

where R_i is the monthly return on sample firm i , R_c is the return on a non-sample control firm that is matched to sample firm i . The mean *BHAR* for the sample of N firms will be given by:

$$BHAR_N = \left(\frac{1}{N}\right) \sum_{i=1}^{i=N} BHAR_i \quad (2)$$

We identify control firms and calculate the BHAR using two matching algorithms:

1. Identifying a firm closest to the event firm on the basis of size and industry
2. Identifying a firm closest to the event firm on the basis of size and book-to-market

In our analysis we calculate the *BHAR* for our sample over the thirty-six month period following the announcement of the private placement (i.e. $T = 36$).

2.2.2 The calendar time portfolio approach

We use the calendar time portfolio approach to estimate stock return performance of our sample over the the thirty-six month (three-year period) following the announcement of the private placement. Each month, we form portfolios of all sample firms that have announced a private placement in the previous three years, which were accompanied by a change in institutional ownership. We

calculate the excess return of the portfolio that is formed. The resulting time series of monthly excess returns ($R_p - R_f$) is regressed on three factors from Fama and French (1993): the excess return on the market ($R_m - R_f$); the return difference between a portfolio of “small” and “big” stocks (SMB) and the return difference between a portfolio of “high” and “low” book-to-market stocks (HML). We augment this with a momentum factor as proposed by Carhart (1997) which is the return difference between a portfolio of stocks with high returns in the past year and a portfolio of stocks with low returns in the past year (UMD). Thus, we run time-series regressions of the form:

$$R_{pt} - R_{ft} = \alpha + \beta_m(R_{mt} - R_{ft}) + \beta_sSMB_t + \beta_hHML_t + \beta_uUMD_t + \epsilon_t \quad (3)$$

The intercept (α) measures monthly abnormal return given the model in (3).

2.2.3 Measuring operating performance

Operating performance is measured by return on assets (ROA). ROA is defined as operating income before depreciation (COMPUSTAT item #13) divided by fiscal year-end total assets (COMPUSTAT item #6). For every firm in our sample, we compute an industry-adjusted ROA which is obtained by subtracting the median industry ROA from the individual firm’s ROA.

3 Results

3.1 Buy-and-hold abnormal returns ($BHAR$)

Panel A of of Table 3 reports the three-year buy-and-hold returns for our sub-samples. The mean three-year BHAR for the *institutional increase* sub-sample is 0.93% and -1.62% relative to the size/industry matched and size/book-to-market matched portfolios respectively. Both of these numbers are insignificantly different from zero.

The mean three-year BHAR for the *institutional decrease* sub-sample is -22.82% and -21.03% for the size/industry matched and size/book-to-market matched portfolios respectively; both of these negative abnormal returns are statistically different from zero at the five percent level. The difference between the three year BHAR returns of the *institutional increase* sub-sample and the

institutional decrease sub-sample is also significant; using a size/industry matched reference portfolio, private placements that experienced an increase in institutional ownership around the private placement, earn a return 17.05% more those that experienced a decrease in institutional ownership in the three years after the private placement.

[Table 3 here]

3.2 Calendar time abnormal returns

The difference in the long-term performance of the *institutional increase* sub-sample and the *institutional decrease* sub-sample is further illustrated by the results of the calendar time portfolio regressions in Panel B of Table 3. The monthly abnormal return (α) for the *institutional increase* sub-sample is -0.28% and is insignificantly different from zero (t -statistic = -0.98). In sharp contrast, the monthly abnormal return (α) for the *institutional decrease* sub-sample is -1.02% and is significantly different from zero at the one percent level (t -statistic = -3.14). The difference between both sub-samples is also statistically and economically significant. A portfolio that buys the firms in the *institutional increase* sub-sample and shorts the firms in the *institutional decrease* sub-sample earns a monthly abnormal return (α) of 0.72% ; this returns is statistically significant at the five percent level (t -statistic = 1.89). This implies that private placements that are associated with an increase in institutional ownership around the private placement, earn a return 21.26% more those that experienced a decrease in institutional ownership in the three years after the private placement.³

3.3 Operating performance

Table 4 reports the median industry adjusted return on assets (ROA) for our sub-samples. We report ROA over the over a six year period, starting from two years before the private placement (Year -2) to three years after the private placement (Year 3). Year 0 is the year the private placement was

³The implied 3-year AR $[(1 + \alpha)^{36} - 1]$ is the estimated average buy-and-hold return from earning in the intercept return every month for thirty-six months

announced. Prior to the private placement, there is no significant difference between the operating performance of the *institutional increase* sub-sample and the *institutional decrease* sub-sample. However, while the median ROA of the *institutional increase* sub-sample remains unchanged after the private placement, that of the *institutional decrease* sub-sample starts to decrease. The median return on assets (ROA) for the sub-sample of firms that experienced a decrease in institutional ownership declines by 7.16% in the two years following the issue (p -value = 0.07). Two years after the private placement, the ROA of the *institutional decrease* sub-sample is a significant 8.10% lower than that of the *institutional increase* sub-sample (p -value = 0.03).

[Table 4 here]

Taken together, the long-term superior stock and operating performance of the *institutional increase* sub-sample over the *institutional decrease* sub-sample strongly suggests that institutions are better able to identify those placements with superior long-term prospects than are non-institutional investors, and that they increase their holdings in these firms accordingly. The evidence we uncover provides strong evidence to support the “smart” money hypothesis of Gibson, Safieddine, and Sonti (2004).

3.4 Prior stock performance and institutional selection

The inference from long-run studies discussed in the previous studies is sensitive to the model of risk adjustment or expected returns we choose⁴. While the *BHAR* and calendar time approaches go a long way towards adjusting for risk, it is possible that the difference between the *institutional increase* and the *institutional decrease* sub-samples might arise from unobserved risk factors. This could be a problem if the unobserved risk factors are correlated with the selection of institutional investors. One way to eliminate this possibility is to compute the risk-adjusted abnormal returns for a window outside the one we have used for our study of long-term performance. To do this we compute the abnormal returns for two-year window just *prior* to the announcement of the private

⁴See Kothari and Warner (2005) for an extensive discussion of the econometrics of long-run event studies

placement.

Table 5 reports the pre-announcement period returns to investors for the two year period up to two months before the announcement of the private placement. Panel A reports the *BHAR* for our sub-sample. The mean *BHAR* is positive and significant for both the *institutional increase* and the *institutional decrease* sub-samples. More importantly, there is no significant difference between the *BHARs*, unlike in the post-private placement period.

A similar picture emerges from the results of the calendar time portfolio regressions in Panel B of Table 5. Again, we find that there is no significant difference between the monthly abnormal return (α) for the two sub-samples. We conclude from this that prior stock performance is not related to the choice of the institutional investors and that the difference in the stock price performance for the two sub-samples in post private placement period is not related to any unobserved risk differences between the two sub-samples.

[Table 5 here]

3.5 Analysts' forecasts

The results from previous sections suggests that institutional investors are able to avoid those firms whose subsequent decline in operating performance “surprise” other (non-institutional) investors. Institutional investors can use their superior access to information (or superior information processing ability) to avoid those firms that subsequently have what other investors would regard as “unexpectedly” poor operating performance. If this is the case then we would expect the sample of firms in which institutions decrease their ownership to be associated with *negative* earnings surprises.

Core, Guay, and Rusticus (2006) suggest that forecasts of net income by sell-side analysts are the most widely available measures of expected operating performance. Thus as a proxy for the long-term earnings expectations of the non-institutional investors, we use the consensus two-year ahead analysts' forecasts. We define analysts' forecast errors (AFE) as the difference between I/B/E/S

actual earnings per share and the two-Year ahead consensus forecast, deflated by total assets per share. The consensus forecast is the mean forecast just before the announcement of the private placement.

Table 6 shows the mean AFE for both our *institutional increase* and *institutional decrease* subsamples. Unfortunately, we are able to obtain long-term (two-year ahead) analyst forecasts for slightly less than a third of our full sample. Thus the results are merely indicative. Nevertheless, the results provide additional evidence of the smart money hypotheses, and that institutional investors select placements with better long term prospects based on private or superior information. For sixty firms where institutional ownership increases around the private placement, the two-year AFE is insignificantly different from zero even at the ten-percent level ($AFE = -0.10, p = 0.16$). However, for thirty-nine firms in which institutional investors decrease their ownership, the AFE is significantly negative at the five percent level ($AFE = -0.16, p = 0.03$).

[Table 6 here]

The results from Table 6 suggest that on average, institutional investors are able to avoid private placements by those firms whose long-term earnings significantly eventually underperform market-wide earnings expectations.

4 Long-run performance of private placements: Does institutional activism play a role?

It is possible that cross-sectional differences in the long-term performance of firms that place equity privately is due mostly to the increased activism of the new investors. One major difference between private placements and other equity issues (IPOs and SEOs) is that there are fewer investors. This means that private placements can lead to the creation of relatively large ownership blocks. If these blockholders are active they can effectively monitor management in ways to improve the value of the firm.

Larcker, Richardson, and Tuna (2005) identify a number of institutional investors, mostly pension funds that have been most explicitly associated with shareholder activism.⁵ From our original sample of 357 private placements, we are able to identify 46 placements where ‘activist’ institutional ownership increased from the quarter before to the quarter after the private placement was announced.

Table 7 reports the long-term stock price performance for the subset of private placements associated with an increase in activist institutional ownership. We find that the three-year BHAR and calendar time portfolio intercept (α) for these placements is not significantly different from those obtained for the total *institutional increase* sub-sample reported in Table 3. The cross-sectional difference between the long-term performance of the *institutional increase* sub-sample and *institutional decrease* sub-sample is not driven by ‘activist’ institutions. This finding suggests that the superior performance of private placements associated with an increase in institutional ownership is not due to any increased activism on the part of these institutions.

As an additional check on the role of activism in the long-term performance of private placements, we use changes in board size, board composition and board leadership as proxies for activism-induced governance change. As discussed in the introduction, the board of directors is often the target of shareholder activism. Activists often sponsor proposals to limit board size, limit the number of insiders and force firms to separate board chair and CEO roles.

The data for board size, composition and leadership comes from the Compact Disclosure database. Unfortunately, this information is only available from 1990, so we only have board information for a subset of our sample. We select firms for which we have board variables for the fiscal year before the private placement and two years after the private placement. We end up with board data for 72 firms that experienced an increase in institutional ownership and 62 firms that experienced a

⁵Larcker, Richardson, and Tuna (2005) classify the following public pension funds as activists (TFN manager number): California Public Employees Retirement System (12000), California State Teachers Retirement (12100 and 12120), Colorado Public Employees Retirement Association (18740), Florida State Board of Administration (38330), Illinois State Universities Retirement System (81590), Kentucky Teachers Retirement System (49050), Maryland State Retirement and Pension System (54360), Michigan State Treasury (57500), Montana Board of Investment (58650), Education Retirement Board New Mexico (63600), New York State Common Retirement Fund (63850), New York State Teachers Retirement System (63895), Ohio School Employees Retirement System (66550), Ohio School Employees Retirement System (66610), Ohio State Teachers Retirement System (66635), Texas Teachers Retirement System (82895 and 83360), Virginia Retirement System (90803), State of Wisconsin Investment Board (93405)

decrease in institutional ownership.

Table 8 summarizes the changes in board size, composition and board leadership for both our *institutional increase* sub-sample and *institutional decrease* sub-samples. Board size refers to the total number of directors (insiders and outsiders), board composition is the number of outsiders relative to insiders and board leadership refers to whether the CEO is also the chairman of the board or not. For the bulk of the firms, there is no change in any of the variables of size, composition and leadership. 59.72% of the *institutional increase* sub-sample and 54.83% of the *institutional decrease* sub-sample experienced no change in these variable over the two year period from the year before the placement to two year after the placement. Only 12.50% and 11.29% of the firms in the *institutional increase* and *institutional decrease* sub-sample respectively, experienced a change in all three board variables following the private placement. The most important thing to observe from Table 5 is that there is little differences in board changes in either the *institutional increase* sub-sample or the *institutional decrease* sub-sample. Increased institutional ownership does not appear to have a significantly different effect of the board structure of firms that place equity privately.

Overall, these results suggest that activism-induced board changes do not seem to have contributed to the difference in the performance between the the *institutional increase* sub-sample or the *institutional decrease* sub-sample. Of course, there is a large caveat to any inference that can be drawn from the results in Table 8. Boards of directors represent only one of many aspects of firm governance and only of many possible targets of shareholder activism. Nevertheless, this analysis suggests that activism is not driving the superior performance of the firms in which institutional investors increase their holdings around private placements.

5 Conclusion

In this paper, we test the hypothesis that institutional investors are able to use their access to information and extensive information processing abilities to pick superior investments in private placements of equity. The evidence we uncover suggests that this is indeed the case. Firms whose private placements are associated with an increase in institutional ownership around the private placement subsequently outperform those associated with a decrease in institutional ownership.

In addition, the operating performance of firms whose private placements are accompanied by a decrease in institutional ownership is significantly lower two years after the private placement, when compared to the year before the private placement. We find no such decline in the sub-sample of firms that experience an increase in institutional ownership.

We examine the possibility that has been raised by a number of authors that the cross-sectional difference in the long term performance following private placements is due to enhanced monitoring, or activism, by institutions that become shareholders in these firms. However, we find that the long term stock performance of those private placements most closely associated with institutions that have been explicitly linked with activism, is not superior to that of placements that show an increase in total general institutional ownership. In addition, using changes in board size, composition or leadership as a proxy for activism, we find no difference between those firms for which there was an increase in institutional ownership around private placements and those for which there was a decrease. Shareholder activism does not appear to be driving our results. This reinforces our conclusion that institutional investors are better able to identify those private placements with better future prospects, at the time of the private placement itself.

One possible extension of this study is to investigate the effect of RegFD on the selectivity of institutional investors. RegFD compels firms to disclose all pertinent information to all investors and reduces any privileged access that big institutional investors have over small investors. The sample used in this study and numerous others have been from the pre-RegFD period; it would be interesting to see if the results hold for the post-RegFD period.

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Table 1
Sample Characteristics of Firms with Changes in Institutional Ownership Around Private Placements

Through Dow Jones News Retrieval Service searches, we identify 619 private placements over the 1980 to 1996 period, by firms that had not had a private placement in the previous three years and where the price after the placement was at least two dollars. Using the Thomson Financial (TFN) Ownership database, we eliminate firms for which we were unable to obtain total institutional ownership in the quarters before and after that in which the private placement was announced, leaving a sample of 357 private placements from 1980 to 1996. **Institutional Increase** is the sub-sample of firms for which institutional ownership *increased* from the quarter before, to the quarter after the private placement was announced. **Institutional Decrease** is the sub-sample of firms for which institutional ownership *decreased* from the quarter before, to the quarter after the private placement was announced.

Panel A: Distribution of Sample Firms Across Two-Digit SIC Codes				
	SIC Code	Institutional Increase	Institutional Decrease	Full Sample
		Sample Size		
Chemical and allied products	28	38	28	60
Instrument and related products	38	20	14	34
Banking	60	20	9	29
Industrial machinery and equipment	35	12	13	25
Electric and electronic equipment	36	12	11	23
Business services	73	10	10	20
Holding and other investment offices	67	10	8	18
Oil and gas extraction	13	6	5	11
Motion pictures	78	5	4	9
Wholesale trade - durable goods	50	5	3	8
Others		66	48	114
Total		204	153	357

Panel B: Sample Characteristics of Private Placements with Changes in Institutional Ownership		
	Institutional Increase	Institutional Decrease
	Mean (Median)	
Dollar proceeds (millions)	\$9.38 (\$5.00)	\$9.52 (\$3.88)
Fraction placed (% of shares after private placement)	30.6% (11.9%)	26.7% (12.2%)
Market value of equity (millions, before private placement)	\$144.1 (\$53.7)	\$176.9 (\$43.9)
Book-to-market (before private placement)	0.58 (0.55)	0.55 (0.49)
Discount (% of market price at month end prior to announcement)	9.33% (10.79%)	6.06% (15.66%)
Announcement period abnormal return: Days -2 to $+1^a$	1.9% (0.9%)	1.8% (0.3%)

^a Announcement period returns are significantly different from zero at the ten percent level for both samples.

Table 2
Changes in Institutional Ownership around Private Placements

The table reports institutional ownership in our private placement sample in the quarters around the private placement. Quarter 0 is the quarter in which the private placement was announced. Through Dow Jones News Retrieval Service searches, we identify 619 private placements over the 1980 to 1996 period, by firms that had not had a private placement in the previous three years and where the price after the placement was at least two dollars. Using the Thomson Financial (TFN) Ownership database, we eliminate firms for which we were unable to obtain total institutional ownership in the quarters before and after that in which the private placement was announced, leaving a sample of 357 private placements from 1980 to 1996. **Institutional Increase** is the sub-sample of firms for which institutional ownership *increased* from the quarter before, to the quarter after the private placement was announced. **Institutional Decrease** is the sub-sample of firms for which institutional ownership *decreased* from the quarter before, to the quarter after the private placement was announced. Panel A reports mean (median) institutional ownership as a percentage of total institutional ownership. Panel B reports the mean change in institutional over each of the quarters surrounding the private placement. The *p*-values reported in brackets are for the null hypothesis that the change in institutional ownership for the **Institutional Increase** sub-sample and **Institutional Decrease** sub-sample are equal.

Panel A: Mean (median) level of institutional ownership (in %)					
	Quarter				
	-2	-1	0	1	2
Institutional Increase	14.54 (8.73)	14.21 (8.79)	17.86 (11.37)	19.33 (12.42)	19.54 (13.43)
Institutional Decrease	17.98 (12.02)	19.22 (12.33)	17.53 (12.14)	15.74 (9.95)	17.53 (12.31)

Panel B: Mean change in institutional ownership					
	Between quarters				
	-2 to -1	-1 to 0	0 to 1	1 to 2	-1 to 1
Institutional Increase	-0.33	3.65	1.47	0.21	5.12
Institutional Decrease	1.24	-1.69	-1.79	1.79	-3.48
Difference	-1.57	5.34	3.26	-1.58	8.60
<i>p</i> -value	[0.30]	[< 0.01] ^a	[< 0.01] ^a	[0.02] ^b	[< 0.01] ^a

^{a, b} *p*-values significant at the one percent and five percent level respectively

Table 3
Long-Run Returns Following Private Placements accompanied by Changes in Institutional Ownership

Through Dow Jones News Retrieval Service searches, we identify 619 private placements over the 1980 to 1996 period, by firms that had not had a private placement in the previous three years and where the price after the placement was greater than two dollars. Using, the Thomson Financial (TFN) Ownership database, we eliminate firms for which we were unable to obtain total institutional ownership in the quarters before and after that in which the private placement was announced, leaving a sample of 357 private placements from 1980 to 1996. **Institutional Increase** is the sub-sample of firms for which institutional ownership *increased* from the quarter before, to the quarter after the private placement was announced. **Institutional Decrease** is the sub-sample of firms for which institutional ownership *decreased* from the quarter before, to the quarter after the private placement was announced. Panel A reports buy-and-hold adjusted returns (BHAR) for the sample firms relative to control firms, for the three year following the month after the announcement of the private placement. Cross-sectional *t*-statistics are reported in brackets and *p*-values are reported in parentheses. Panel B reports results from calendar time portfolio regressions where the dependent variables are event portfolio returns, R_p , in excess of the risk-free rate, R_f . Each month, we form portfolios of all sample firms that have announced a private placement in the previous three years, which will be accompanied by a change in institutional ownership. We calculate the excess return of the portfolio that is formed. The resulting time series of monthly excess returns ($R_p - R_f$) is regressed on three factors from Fama and French (1993): the excess return on the market ($R_m - R_f$); the return difference between a portfolio of “small” and “big” stocks (*SMB*) and the return difference between a portfolio of “high” and “low” book-to-market stocks (*HML*). We augment this with a momentum factor as proposed by Carhart (1997) which is the return difference between a portfolio of stocks with high returns in the past year and a portfolio of stocks with low returns in the past year (*UMD*). The intercept (α) measures monthly abnormal return given the model. Calendar months with less than ten observations are excluded. The *t*-statistics are reported in brackets, and the number of monthly observations is reported in parentheses. The implied 3-year AR $[(1 + \alpha)^{36} - 1]$ is the estimated average buy-and-hold return from earning the intercept return every month for thirty-six months.

Panel A: Three-Year Buy-And-Hold Returns						
	BHAR (in percent)					
	Institutional Increase		Institutional Decrease		Difference	
	Size/Ind	Size/BM	Size/Ind	Size/BM	Size/Ind	Size/BM
	Matched	Matched	Matched	Matched	Matched	Matched
Mean	0.93	-1.62	-22.82	-21.03	23.75	19.41
Median	1.43	-1.17	-15.62	-16.16	17.05	14.99
<i>t</i> -statistic	[0.09]	[-0.13]	[-2.48] ^b	[-2.20] ^b	[1.68] ^c	[1.25]
<i>p</i> -value	(0.93)	(0.89)	(0.01)	(0.03)	(0.09)	(0.21)

Panel B: Calendar-Time Portfolios						
$R_{pt} - R_{ft} = \alpha + \beta_m(R_{mt} - R_{ft}) + \beta_s SMB_t + \beta_h HML_t + \beta_u UMD_t + \epsilon_t$						
	Institutional Increase		Institutional Decrease		Difference	
	α	Adj. R^2	α	Adj. R^2	α	
	[<i>t</i> -stat]	(<i>T</i> -obs)	[<i>t</i> -stat]	(<i>T</i> -obs)	[<i>t</i> -stat]	
	Matched	Matched	Matched	Matched	Matched	Matched
Calendar-Time Portfolio	-0.28	0.757	-1.02	0.702	0.72	
	[-0.98]	(187)	[-3.14] ^a	(175)	[1.89] ^b	
Implied 3-year AR (%)	-9.60		-30.86		21.26	

^{a,b,c} *t*-statistic significant at the one percent, five percent and ten percent level respectively

Table 4
Operating Performance Around Private Placements accompanied by Changes in Institutional Ownership

Panel A reports industry adjusted operating performance for sample firms. **Institutional Increase** is the sub-sample of firms for which institutional ownership *increased* from the quarter before, to the quarter after the private placement was announced. **Institutional Decrease** is the sub-sample of firms for which institutional ownership *decreased* from the quarter before, to the quarter after the private placement was announced. Operating performance is measured by Return on Assets (*ROA*). *ROA* is defined as operating income before depreciation (COMPUSTAT item #13) divided by fiscal year end total assets (COMPUSTAT item #6). Year represents the firm's fiscal year relative to the announcement of the private placement (Year 0 is the year the private placement was announced). *N* is the number of observations with available COMPUSTAT data. *p*-values of the difference, based on two sample Wilcoxon tests are reported in parentheses. Panel B reports the change the change in *ROA* over the three year period from the year before the private placement is announced (Year -1) to two years after the private placement was announced (Year 2).

Panel A: Industry Adjusted Performance (Sample Median - Industry Median)						
Year	Institutional Increase		Institutional Decrease		Difference	
	<i>N</i>	<i>ROA</i> (%)	<i>N</i>	<i>ROA</i> (%)	<i>ROA</i> (%)	(<i>p</i> -value)
-2	171	-5.58	124	-7.91	2.33	(0.43)
-1	177	-6.07	129	-6.77	0.70	(0.27)
0	170	-7.88	124	-10.99	3.11	(0.17)
1	171	-4.30	119	-8.53	4.23	(0.19)
2	156	-5.83	105	-13.93	8.10	(0.03) ^a
3	137	-4.85	92	-5.63	0.78	(0.24)

Panel B: Change in Industry Adjusted Performance (<i>ROA</i>), Around Private Placement (2, -1)		
	Institutional Increase	Institutional Decrease
$\Delta ROA_{(2, -1)}$	0.24%	-7.16%
(<i>p</i> -value)	(0.14)	(0.07) ^b

^{a, b} *p*-values significant at the five percent and ten percent level respectively, based on two sample Wilcoxon tests

Table 5

Pre-announcement Returns to Investors not Participating in the Private Placement

Institutional Increase is the sub-sample of firms for which institutional ownership *increased* from the quarter before, to the quarter after the private placement was announced. **Institutional Decrease** is the sub-sample of firms for which institutional ownership *decreased* from the quarter before, to the quarter after the private placement was announced. Panel A reports buy-and-hold adjusted returns (BHAR) for the sub-sample firms relative to control firms, for the two-year period prior to the month before the announcement of the private placement. Cross-sectional *t*-statistics are reported in brackets and *p*-values are reported in parentheses. Panel B reports results from calendar time portfolio regressions where the dependent variables are event portfolio returns, R_p , in excess of the risk-free rate, R_f . Each month, we form portfolios of all sub-sample firms that will announce a private placement within the following two years, which will be accompanied by a change in institutional ownership. We calculate the excess return of the portfolio that is formed. The resulting time series of monthly excess returns ($R_p - R_f$) is regressed on three factors from Fama and French (1993): the excess return on the market ($R_m - R_f$); the return difference between a portfolio of “small” and “big” stocks (*SMB*) and the return difference between a portfolio of “high” and “low” book-to-market stocks (*HML*). We augment this with a momentum factor as proposed by Carhart (1997) which is the return difference between a portfolio of stocks with high returns in the past year and a portfolio of stocks with low returns in the past year (*UMD*). The intercept (α) measures monthly abnormal return given the model. Calendar months with less than ten observations are excluded. The *t*-statistics are reported in brackets, and the number of monthly observations is reported in parentheses. The implied 2-year AR $[(1 + \alpha)^{24} - 1]$ is the estimated average buy-and-hold return from earning the intercept return every month for twenty-four months.

Panel A: Returns Prior to Private Placements (Month -25 through -2, in %)						
	BHAR (in percent)					
	Institutional Increase		Institutional Decrease		Difference	
	Size/Ind	Size/BM	Size/Ind	Size/BM	Size/Ind	Size/BM
	Matched	Matched	Matched	Matched	Matched	Matched
Mean	26.13	27.28	37.11	37.21	-10.98	-9.93
Median	18.08	16.21	8.33	7.69	9.75	17.11
<i>t</i> -statistic	[3.63] ^a	[3.71] ^a	[1.94] ^b	[1.82] ^c	[-0.54]	[-0.46]
<i>p</i> -value	(< 0.01)	(0.05)	(0.05)	(0.12)	(0.59)	(0.65)

Panel B: Calendar-Time Portfolios (Month -25 through -2)					
$R_{pt} - R_{ft} = \alpha + \beta_m(R_{mt} - R_{ft}) + \beta_s SMB_t + \beta_h HML_t + \beta_u UMD_t + \epsilon_t$					
	Institutional Increase		Institutional Decrease		Difference
	α	Adj. R^2	α	Adj. R^2	α
	[<i>t</i> -stat]	(<i>T</i> -obs)	[<i>t</i> -stat]	(<i>T</i> -obs)	[<i>t</i> -stat]
Calendar-Time Portfolio	0.52	0.609	0.47	0.667	-0.04
	[1.09]	(138)	[1.01]	(118)	[-0.06]
Implied 2-year AR (%)	13.26		11.91		1.35

^{a,b,c} *t*-statistic significant at the one percent, five percent and ten percent level respectively

Table 6**Cross-sectional difference in Two-Year Ahead Analysts' Forecasts (AFE) Errors**

This table reports the cross-sectional differences in the two-year ahead analysts' forecast errors (AFE) for our sample of firms. Analysts' forecast errors (AFE) are defined as the difference between I/B/E/S actual earnings per share and the two-year ahead consensus forecast, deflated by total assets per share. The consensus forecast is the mean forecast just before the announcement of the private placement. **Institutional Increase** is the sub-sample of firms for which institutional ownership *increased* from the quarter before, to the quarter after the private placement was announced. **Institutional Decrease** is the sub-sample of firms for which institutional ownership *decreased* from the quarter before, to the quarter after the private placement was announced. Cross-sectional *t*-statistics are reported in brackets and *p*-values are reported in parentheses. ^a represents significance at the 5% level

Analyst Forecast Errors (AFE)		
	Institutional Increase	Institutional Decrease
Mean AFE	-0.10	-0.16 ^a
<i>t</i> -statistic	[-1.44]	[-2.17]
(<i>p</i> -value)	(0.16)	(0.03)
<i>n</i>	60	39

Table 7
**Long-Run Returns Following Private Placements accompanied by Increase in ‘Activist’
Institutional Ownership**

Through Dow Jones News Retrieval Service searches, we identify 619 private placements over the 1980 to 1996 period, by firms that had not had a private placement in the previous three years and where the price after the placement was greater than two dollars. From this sample, we use the Thomson Financial (TFN) Ownership database, to identify 46 firms where ‘activist’ institutional ownership *increased* from the quarter before, to the quarter after the private placement was announced. Activist institutions are as defined in Larcker, Richardson, and Tuna (2005). Panel A reports buy-and-hold adjusted returns (BHAR) for the sample firms relative to control firms, for the three year following the month after the announcement of the private placement. Cross-sectional *t*-statistics are reported in brackets and *p*-values are reported in parentheses. Panel B reports results from calendar time portfolio regressions where the dependent variables are event portfolio returns, R_{pt} , in excess of the risk-free rate, R_{ft} . Each month, we form portfolios of all sample firms that have announced a private placement in the previous three years, which will be accompanied by a change in institutional ownership. We calculate the excess return of the portfolio that is formed. The resulting time series of monthly excess returns ($R_{pt} - R_{ft}$) is regressed on three factors from Fama and French (1993): the excess return on the market ($R_{mt} - R_{ft}$); the return difference between a portfolio of “small” and “big” stocks (SMB) and the return difference between a portfolio of “high” and “low” book-to-market stocks (HML). We augment this with a momentum factor as proposed by Carhart (1997) which is the return difference between a portfolio of stocks with high returns in the past year and a portfolio of stocks with low returns in the past year (UMD). The intercept (α) measures monthly abnormal return given the model. Calendar months with less than ten observations are excluded. The *t*-statistics are reported in brackets, and the number of monthly observations is reported in parentheses. The implied 3-year AR $[(1 + \alpha)^{36} - 1]$ is the estimated average buy-and-hold return from earning the intercept return every month for thirty-six months.

Panel A: Three-Year Buy-And-Hold Returns		
	BHAR (in percent)	
	Size/Ind	Size/BM
	Matched	Matched
Mean	-47.50	-74.95
Median	-19.30	-19.30
<i>t</i> -statistic	[-2.41] ^b	[-2.62] ^a
<i>p</i> -value	(0.02)	(0.01)

Panel B: Calendar-Time Portfolios		
$R_{pt} - R_{ft} = \alpha + \beta_m(R_{mt} - R_{ft}) + \beta_s SMB_t + \beta_h HML_t + \beta_u UMD_t + \epsilon_t$		
	α	Adj. R^2
	[<i>t</i> -stat]	(<i>T</i> -obs)
Calendar-Time Portfolio	-0.89	0.407
	[-0.98]	(66)
Implied 3-year AR (%)	-27.52	

^{a,b,c} *t*-statistic significant at the one percent, five percent and ten percent level respectively

Table 8
Changes in Board Size, Composition and Leadership Around Private Placements with
Changes in Institutional Ownership

Panel A reports changes in board size, composition and leadership over the three year period from the year before the private placement was announced to two years after the private placement was announced. Using the Compact Disclosure database, we obtain information on board structure for 138 firms out of the sample of 357 firms that had a private placement accompanied by a change in institutional ownership between 1980 and 1996. **Institutional Increase** is the sub-sample of firms for which institutional ownership *increased* from the quarter before to the quarter after the private placement was announced. **Institutional Decrease** is the sub-sample of firms for which institutional ownership *decreased* from the quarter before to the quarter after the private placement was announced. Board size is the total number of directors (insiders and outsiders). Board composition is defined as the proportion of insiders on the board. Board leadership refers to whether or not the CEO is also the chairman of the board of directors. Panel B reports the summary of changes in board size, structure and leadership.

Panel A: Changes in board size, composition and leadership (from year before the private placement to two years after the private placement)				
	Institutional Increase (<i>N</i> = 76)		Institutional Decrease (<i>N</i> = 62)	
	<i>N</i>	% of Sample	<i>N</i>	% of Sample
Firms with change in board size	26	36.11	21	33.87
Firms with change in board composition	31	43.06	21	33.87
Firms with change in board leadership	10	13.89	11	17.74

Panel B: Summary of Changes in board size, composition and leadership (from year before the private placement to two years after the private placement)				
	Institutional Increase (<i>N</i> = 76)		Institutional Decrease (<i>N</i> = 62)	
	<i>N</i>	% of Sample	<i>N</i>	% of Sample
No change in board size, composition or leadership	43	59.72	34	54.83
One or more change in board size, composition or leadership	33	45.83	28	45.16
Two or more changes in board size, composition or leadership	25	34.72	23	37.10
Three changes in board size, composition or leadership	9	12.50	7	11.29