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Underwriters fuelling going public companies? Evidence of
Conflict of interest in the Brazilian 2004-2007 IPO Wave

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Motivations

Motivations for this paper

- The IPO timing and offer price of companies intending to go public can be affected by their ties with their underwriting banks
- Pre-IPO loans by underwriters may create perverse incentives, prompting banks to bring to stock markets companies without the financial soundness and organizational maturity expected
- This phenomenon is known as **equity kicking**, and includes both debt and equity boosts to the IPO company
- It may tempt banks to sell these companies at inflated prices, since the repayment of their lending is often associated with the success of the operation and the offering price of the stocks
- This potential conflict of interest could occur in Brazil due to a loose regulation: there was no prohibitions for banks to underwrite securities in firms where they had a significant equity or debt position
- Brazil has been into an IPO wave from 2004-2007, when 106 companies went public, providing an interesting case study

Goals

Main goals

- Our paper aims to evaluate the effect of underwriter banking relationships during the IPO wave in Brazil from 2004 to 2007, when 106 companies went public
- In particular, we assess the effect of pre-IPO financial leverage and underwriters' equity participation on post-IPO short and long term performance, measured by stock returns and market value indicators.
- Additionally, we provide a detailed overview of the Brazilian IPO market during the 2004-2007 IPO wave and present two illustrative cases, extracted from our sample, about companies that received pre-IPO loans and equity boots.

Contributions

Main contributions of the paper

- It is a pioneering exploratory research in this field in Latin America and the study can contribute to the international literature by providing empirical evidence from an large emerging country
- We present a detailed panorama with hand-collected data about the recent IPO wave in Brazil, examining corporate governance practices, ownership structure, and other corporate attributes of the firms involved
- We offer evidence on the potential conflicts of interest that may emerge due to the relationship between investment banks and their client firms in an environment with scarce IPO regulation, differently from the U.S. and other developed economies, where some of the practices we document are usually forbidden

Hypotheses tested

Hypotheses tested based on previous works on this line of research

- *H1*: Lending operations from the underwriter to IPO firms lead to a conflict of interest that can speed up the IPO process and inflate the prospects of the company to outside investors.
 - As a consequence, those borrowing firms will underperform both in the short (with a lower underpricing) and in the long run, comparatively with other going public companies.
 - Thus, we expect a negative influence of loans on all post-IPO performance variables.
- *H2*: Underwriters as relevant shareholders may have an interest in the long-run appreciation of the firm's shares due to the convergence of interests with other stockholders. However, this hypothesis only holds if they intend to maintain their stocks following the IPO.
- *H3*: The identity of underwriter, per se, should not generate significant differences on post-IPO performance indicators, since a significant influence on performance would be a consequence of the specific relationships with their going public clients.

Sample

Sample

- Our sample initially comprises all 106 IPOs that took place in the São Paulo Stock Exchange (BM&F-BOVESPA) from January 2004 through December 2007
- We excluded companies that we didn't have enough information to run our regressions and foreign companies that do not operate in Brazil
- After exclusions, we remain with 100 observations to compute descriptive statistics, 92 of them with complete data for long-run performance tests.
- All information regarding these IPOs was hand-collected from the following sources: IPO prospectuses, Economatica® database, and firms' quarterly financial statements available at the websites of CVM (Brazilian Securities and Exchange Commission) and BM&FBOVESPA.

Variables

Variables

- The main dependent variables are divided into two groups
 - 1) short-run performance, measured by the first-day stock return (or underpricing)
 - 2) long-run performance, measured by the price-to-book ratio (PBV) and the total stock return (TSR) on year after the IPO
- The key explanatory variables are related to the underwriter's identity, lending operations and its equity participation in the firm.
 - Dummies for Credit Suisse, UBS, Brazilian Underwriters and Other Foreign Banks
 - Lending operations: "LOANS" dummy, for companies who have received pre-IPO loans > US\$ 150,000 from their underwriters
 - Underwriters' equity participation: "SHAREHOLD" dummy, for firms whose underwriter owns +5% of total equity on the IPO date
- Other explanatory variables related to CG characteristics and corporate attributes are used as controls.

Empirical strategies applied

Empirical strategies applied

- We applied different multivariate OLS regression models to analyze the effects on short-run (underpricing) and long-run performance (PBV and Market-Adjusted Total Shareholder Return) of:
 - Underwriter's identity (dummies for Credit Suisse, UBS, Brazilian banks and Other Foreign Banks besides CS and UBS)
 - The sort of banking relationship: lending or equity ownership
 - Interaction of underwriter's identity dummy and banking relationships (lending and equity ownership)
- Additionally, we construct difference-of-means tests for:
 - Underpricing, TSR, PBV, ROA and ROE of firms with and without pre-IPO loans from their underwriters and equity boosts

Main empirical results (1/3)

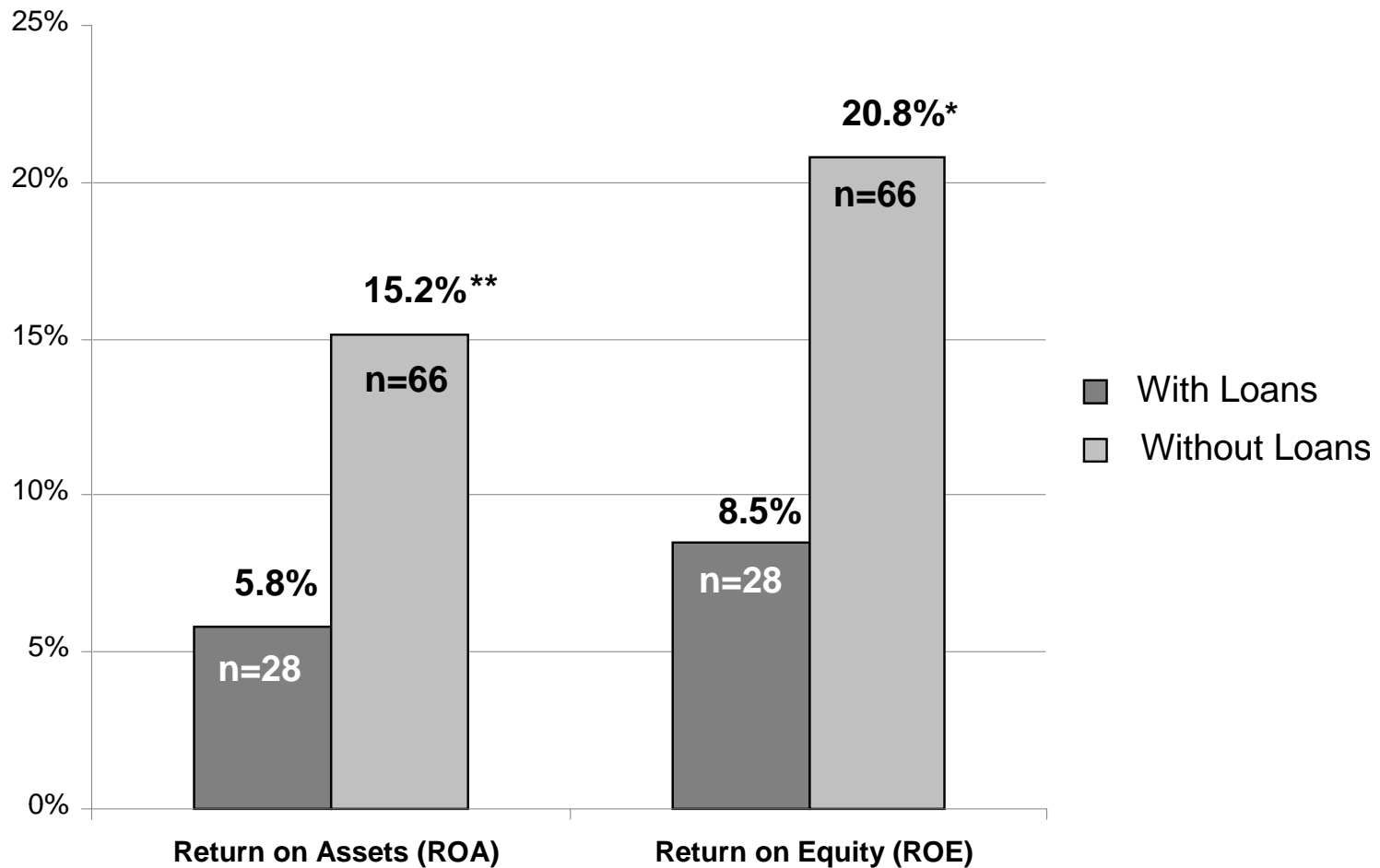
Part 1 – Panorama of the IPO wave in Brazil from 2004 to 2007

- Equity kickings are pervasive: 28% of all IPOs were carried out by companies receiving a significant ex-ante loan by their underwriter.
- We also observe that 16% of the IPO companies had investment banks simultaneously acting as underwriters and relevant shareholders (holding more than 5% of all outstanding shares).
- Overall, we note that 3/4 of all IPOs took place with underwriters with previous commercial or financial ties with going public companies.
- The mean value of pre-IPO lending operations is significant, ranging from an average of US\$ 31 MM to US\$ 82 MM.
- Overall, all underwriters lent about R\$ 3 billion (US\$ 1.67 billion) to the 29 companies that have used pre-IPO loans. This is around 10% of all money raised in the IPOs.

Empirical results

Main empirical results (2/3)

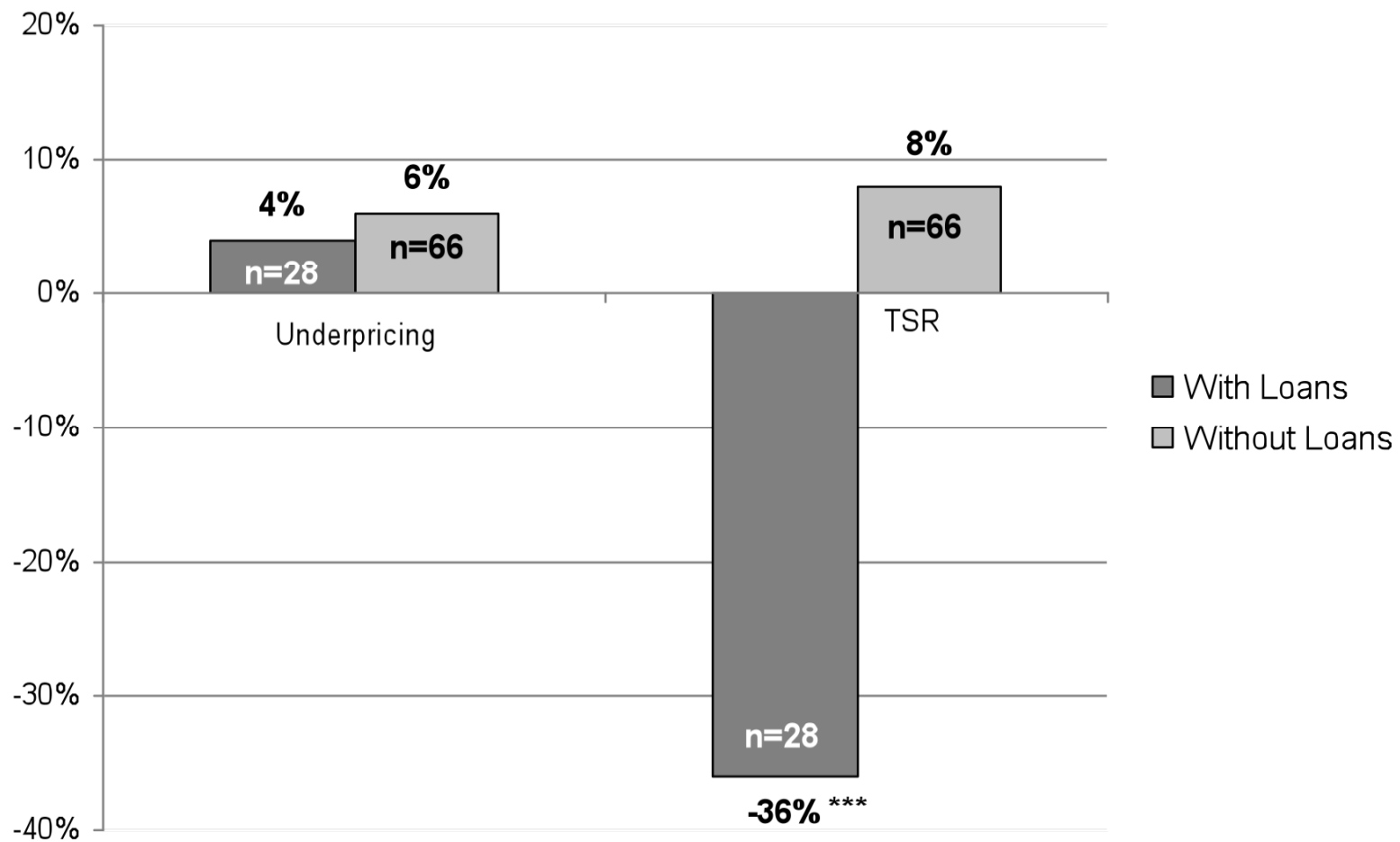
Financial ratios for companies with and without loans from their underwriters



Empirical results

Main empirical results (2/3)

Short and long term stock return for companies with and loans form their underwriters



Main empirical results (3/3)

Part 3 – OLS regression results

1. The lending practice by underwriters before the IPO is negatively related to long term performance, measured both by PBV and TSR
2. The presence of an underwriter as a relevant stockholder does not seem to positively influence the short or long run performance
3. No underwriter (or group of underwriters) per se is clearly associated with better or worse post-IPO performance
4. The model predicts that companies that go public using loans from underwriters would experience **an additional negative stock return of about 42% one year after their IPO**
5. Other explanatory variables have significant coefficients: Firms following the recommendations of the Brazilian CG code regarding the structure of BoD have a higher short term return; Firms from Novo Mercado have higher PBV in the long run

Wrap up

Wrap up

- Some banking relationships seems to affect both the timing and the offer price of an IPO, as well as the subsequent stock performance
- We investigate this possibility by analyzing pre-IPO capital injections by underwriting banks, in the form of loans or equity capital
- We find this practice was quite frequent: 28% of all going public companies received significant loans from their underwriters, and 16% had their underwriters simultaneously acting as relevant shareholders
- We find evidence that pre-IPO loans induce underwriters to take companies to the stock market at higher prices (with lower underpricing), and that these companies are probably on average less prepared than other IPO companies, leading them to lower valuations and stock returns one year after the event
- We predict that companies going public by using loans from underwriters would experience an additional negative cumulative stock return of about 42% one year after their IPO

Policy implications

Policy implications and recent regulation updates

- Our results have implications for both investors and regulators.
- For investors, they reinforce the need to question underwriters about their potential conflicts of interest during the IPO process (involving roadshows, bookbuilding and the preparation of the prospectus)
- Some conflicts may lead them to bring to the market unprepared companies at excessive stock prices
- For regulators, our results suggest the need for stricter rules on the relationship between underwriters and going public companies, in order to prevent the emergence of conflicts of interest that could harm investors, undermining the long term credibility of capital markets
- Recently, the Brazilian Association of Investment Banks (ANBID), released a new self-regulation code concerning the equity kicking practice: ‘When the lead underwriter owns **10%** or more of company’s shares or when the coordinating fees are higher than **20%** of the IPO proceedings, then the IPO must have the participation of an independent underwriter.’



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An Illustrative Case

Agrenco's IPO

Type of conflict: Firm pre-IPO leverage and Underwriter's equity participation

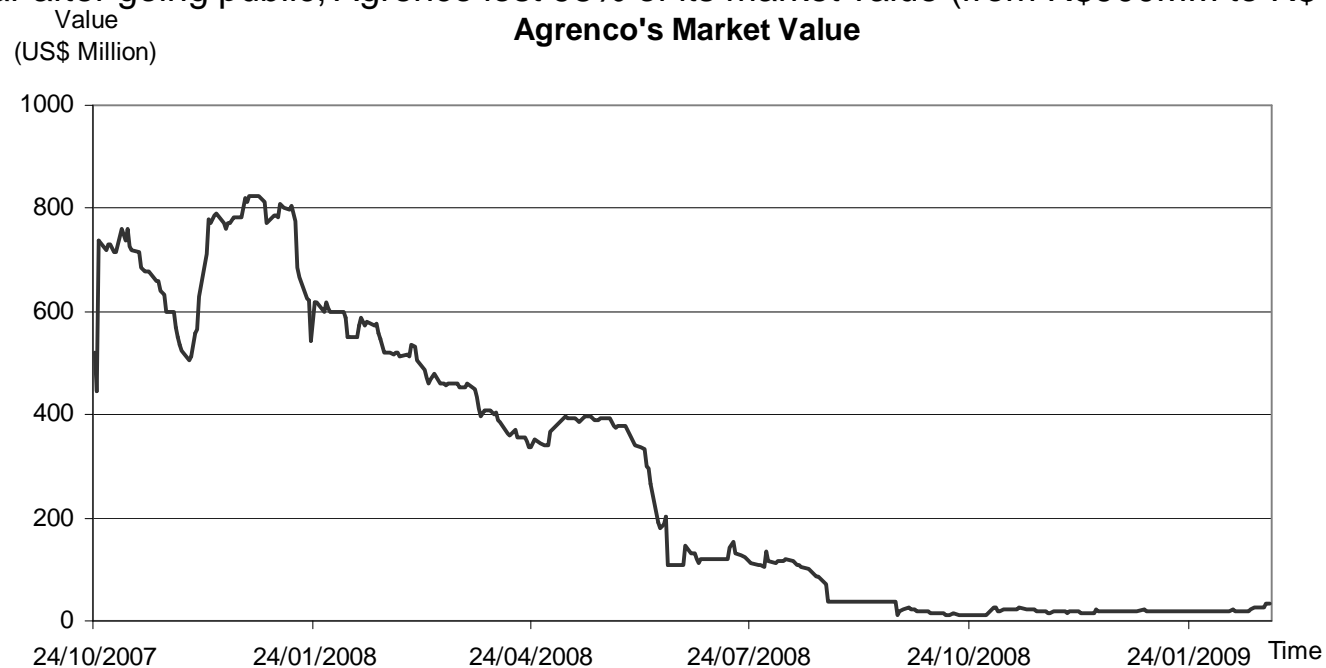
Industry: Agribusiness

IPO date: October 24th, 2007

IPO proceeds: R\$ 666 million (US\$ 370 million)

Underwriter: Credit Suisse (lead underwriter and sole bookrunner)

- Agrenco received approximately US\$ 210 million as loans from its underwriter and other banks.
- The underwriter was also a significant shareholder of the firm, owning 6.9% of total shares.
- In the first day of trading, Agrenco's BDRs closed at a 15% lower price – a rare case of overpricing
- One year after going public, Agrenco lost 98% of its market value (from R\$900MM to R\$ 60MM)



Previous works on this field

Previous works on this line of research

- IPO's surveys can be found in Ritter (1991), Pagano, Panetta and Zingales (1998), and Ritter and Welch (2002), among others.
- The relationship between underwriters and firms are a subject of increasing attention in different markets.
 - Papers in this area can be found in Schenone (2004), Yasuda (2005), Xie (2007) and Kutsuna et al. (2007).
 - A survey of conflicts of interest can be found in Mehran and Stulz (2006) and, more specifically about universal banking in Puri (1999)
- Most of the researches argue that if banks are able to underwrite securities for their borrowing firms, they may have incentives to hide or distort information about these firms' quality and risk.
- In this case, IPO proceeds can be used to repay the outstanding loans and the higher credit risk can be shifted to the uninformed public investors.
- This equity kicking practice can harm investors and firms, besides