

ABSTRACT

This dissertation investigates the effect of equity issues on stock prices. The announcement day price effect predicted by various theories can be grouped into three categories:

No Price Effect: Consistent with

Close substitutes - efficient markets hypotheses.

Negative price effect: Consistent with

- (1) Downward sloping demand for a firm's shares.
- (2) Capital structure hypotheses and tax effects.
- (3) Information effects associated with the sale of equity by insiders and agency theory effects.
- (4) Large transaction costs associated with equity issues.

Positive price effect: Consistent with

- (1) Favourable information effect associated with investment.
- (2) Value enhancing reduction in financial leverage (financial distress costs).

Various studies in the US markets reveal that the price of a stock drops immediately after the announcement of the issue offering. This dissertation studies the effect of the issue on the stock returns during the announcement period, announcement to issue period, and in the post issue period. The effect of various firm-related and issue-related factors on the returns is also investigated.

It is found that the stock price in the secondary market drops a little immediately following the announcement, and falls considerably after the issue offer is closed. Issue and

firm related factors such as size of the issue, the discount at which it is offered, the level of oversubscription and the variability of daily stock returns affect the price change in this period.

The evidence is consistent with the information asymmetry theories, the price pressure hypothesis and the agency theory arguments. There is evidence of price-rigging by the firms during this period and speculative activity in the post-issue period.

The problem is further studied from the point of an investor who has to choose between investing in the primary market and the secondary market. It is seen that the expected return for an investor is higher if he applies for the issue in the seasoned public offering than if he buys the stock in the secondary market.

A simple model is developed to determine the amount of discount required to induce an investor to buy the share in the seasoned public offering instead of the secondary market. This model is validated and the issuer's problem of determining the optimal offer price is discussed.