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Bought deal gets high marks

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The bought deal, an arrangement whereby an underwriter agrees to purchase a block of stock from an issuer before a preliminary prospectus is filed, is a Canadian invention.

It has been around for a quarter of a century and came into effect after regulators allowed certain companies faster access than before to the capital markets.

Ari Pandes, a PhD student in finance at the Schulich School of Business at Toronto's York University, has put the bought deal under the microscope. And Pandes likes what he has analyzed. "Overall, the savings from the abnormal stock price effect of the bought deal outweigh the higher direct costs, lending support to the overwhelming use of the bought deal in Canada." His research is based on financings done from January, 1993, to December, 2005. He looked at bought deals done using a short-form prospectus and those done via a so-called firm commitment, again with a shortform prospectus. For his analysis, he focused on 450 bought deals (which raised a total of $35-billion) and 148 firm-commitment deals via shortform prospectus ($24-billion). And he looked at the direct costs of issuing equity -- the offer price discount and the underwriting fees -- and the indirect costs (the so-called announcement effect).

His analysis was based on four hypotheses:

-Bought deals are associated with a lower negative stock price reaction than firm commitment issues around the announcement of new equity issues.

-Stock prices react more positively to higher levels of information asymmetry for bought deals than firm commitment offerings.

-Bought-deal issues and issuers with greater information asymmetry are associated with larger offer price discounts.

-Bought deal issues are associated with lower underwriting fees.

Pandes compared bought deals done via a short-form prospectus and firm commitment deals done via a shortform prospectus. "That's the relevant control sample," he said. Here's what he found:

-On average, firms issuing shares through a bought deal have a lower offer price, offer fewer shares and receive less in terms of gross proceeds.

-Bought deals do provide faster access to the capital markets. On average, it takes 20.1 days for a bought deal to be completed and 27.7 days for a firm-commitment short-form prospectus issue.

-The average fee for firm-commitment issues (4.9% of gross proceeds) is larger than the 4.5% fee for bought-deal issues, an expected result, Pandes argues, "because underwriters in a bought deal exert less distribution effort since there are generally fewer buyers, a less timely marketing process, and generally more focus on selling to institutional investors."

-That conclusion was made without taking into account the so-called offer price discount -- the difference between the recent closing price and the price of the new equity. That discount is a cost to the issuer but a benefit to the underwriter. Pandes showed that the "sum of the underwriting fee and the discount for bought deals are significantly larger than for firm commitment issues."

When everything is considered, Pandes calculates the indirect cost savings of a bought deal are 2.29%, offset by higher direct costs of 0.83%.

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