

# **Equity Financing in a Myers-Majluf Framework with Private Benefits of Control**

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This version: January 2004

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## **Abstract**

This paper generalizes the Myers and Majluf (1984) model by introducing an agency cost structure based on private benefits of control. This new model predicts that many corporate finance variables each have opposing effects on under- and overinvestment. Interestingly, private benefits exacerbate overinvestment but a small amount of private benefits can enhance firm value by alleviating underinvestment. Likewise, an increase in insider ownership alleviates overinvestment but aggravates underinvestment. When private benefits are small, the adverse effect of insider ownership on underinvestment tends to dominate. When there are considerable private benefits, the incentive-alignment effect of insider ownership is pronounced. Additionally, this model reconciles the existing equity financing theories about announcement effects. It helps resolve the puzzle that small growth firms do not seem to have the asymmetric information disadvantage in new equity issues.

Key words: Equity Financing, Private Benefits of Control, Under-investment, Over-investment, Announcement Effect

JEL Classification Code: G14, G31, G32

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## 1. Introduction

The finance literature has long recognized that market imperfections such as information asymmetries and agency conflicts affect corporate finance and investment. For example, the classic adverse-selection model of Myers and Majluf (1984) predicts that asymmetric information between informed managers and the public market causes underinvestment. On the other hand, Jensen and Meckling (1976) suggest that managers have an incentive to make their firms to grow beyond an optimal size, and predict agency conflicts due to managers' selfishness give rise to overinvestment. Both under- and overinvestment bring about losses of firm value.

These two lines of literature imply, however, opposite value effects of many corporate finance variables. For example, Jensen (1986) argues that free cash flows are likely to be wasted by managers on bad projects, in sharp contrast to the prediction of the Myers-Majluf model that financial slack plays a value-enhancing role in mitigating the underinvestment problem. While the later finance literature has shown how corporate cash positions have opposing effects on under- and overinvestment (e.g., Stulz, 1990), it seems to be warranted to further address how a wide range of corporate finance and governance variables affect under- and overinvestment in a coherent theoretical framework.

This paper attempts to examine how the market concerns on both under- and overinvestment *jointly* affect firm value through a range of corporate finance and governance variables. To this end, we extend the model of Myers-Majluf (1984) by introducing an agency cost structure based on private benefits of control. More precisely, we assume that managers maximize the managers/controllers' self-interested wealth, which includes both the security benefits according to their entitled equity claims (i.e., insider ownership) and the private benefits derived from undertaking new projects (e.g., self-dealing). Private benefits of control arise when cash flow rights do not really coincide with control rights, a situation that occurs even in "one-share-one-vote" structures (see Grossman and Hart, 1988; Harris and Raviv, 1988).

One of the key assumptions in the original model of Myers and Majluf (1984) is that managers only undertake positive NPV projects because they are assumed to maximize the existing shareholders' wealth. This assumption automatically rules out any overinvestment possibility in the Myers-Majluf model's predictions. But the recognition of the self-interest of managers has recently gained importance in the corporate finance literature, as Myers (2000) put it: "Sooner or later the theory of corporate finance must deal generally with the self-interest of corporate managers..."

Private benefits of control are an important reason for agency conflicts.<sup>1</sup> In the Anglo-American corporate governance culture, managers have far more power, possibly cemented by sufficient managerial ownership, than do usually diffuse shareholders. In contrast, in many other countries, either developed or developing, listed firms are controlled by a small group of shareholders or families (Shleifer and Vishny, 1997). In the Anglo-American setting, managers' consumption of perquisites and empire-building highlight the agency problem (Jensen and Meckling, 1976; Jensen, 1986), while in the corporate governance structures with controlling shareholders, expropriation from outside shareholders becomes the focus of the agency problem (La Porta, Lopez-de-Silanes and Shleifer, 1999). Of course, the outright transfer of corporate funds and assets is likely to be legally challenged in many countries. Yet almost everywhere, the so-called self-dealing by managers/controlling shareholders can be easily covered up under the cover of "business decision rules". Sweet deals with friends and other firms that the managers/controlling shareholders own are only too common. The existence of private benefits of control appears evident even in the U.S. in terms of premiums paid for blocks of shares and shares with superior voting power (see Barclay and Holderness, 1989; Barclay, Holderness and Sheehan, 2001; DeAngelo and DeAngelo, 1985; Lease, McConnell and Mikkelsen, 1983). Private benefits can be on a large scale in countries with weak legal protection of minority shareholders (see Zingales, 1995, for an example in Italy). In short, private benefits are prevalent.

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<sup>1</sup> There is another kind of agency problem: managers may avoid good but risky projects, as suggested by the principal-agent theory. The Myers-Majluf tradition uses information asymmetries rather than managerial shirking due to a project's high risk to explain underinvestment. How to incorporate managers' shirking is beyond the scope of this paper.

With an explicit agency cost structure, our generalized model substantially enriches the economic environment of Myers and Majluf (1984) and is able to offer new and important insights into corporate finance and governance. The model predicts that the *ex ante* loss of firm value comes from the concerns over overinvestment as well as underinvestment, unlike in Myers and Majluf (1984) or in Jensen (1986) where either over- or underinvestment is completely ignored. Yet in our framework, the probability of managers/controllers' undertaking bad projects will not be rampant, because a very bad project may cause a detrimental effect on their entitled equity claims so severe as to outweigh the private benefits they would obtain from undertaking the bad project. Thus, the existence of private benefits of control in our setting does not always lead managers to overinvest.

The model shows how a range of factors affect under- as well as overinvestment. For example, more asymmetric information about assets-in-place aggravates underinvestment but mitigates overinvestment. More financial slack tends to facilitate overinvestment but mitigate underinvestment. The opposing effects of financial slack can lead to interior firm valuation optimality, consistent with the static tradeoff views of cash holdings supported in the literature (see Stulz, 1990; Kim, Mauer and Sherman, 1998; Opler, Pinkowitz, Stulz and Williamson; 1999). Our analysis also shows that an increase in issue/investment scale aggravates underinvestment but only a moderate scale aggravates overinvestment. One factor that does help cure both the under- and overinvestment problems is growth prospects.

The model is able to offer new insights into the corporate governance literature. In particular, we show how corporate governance variables such as the amount of private benefits and the level of insider ownership affect firm value through their underlying effects on both under- and overinvestment. We find that an increase in private benefits exacerbates overinvestment but alleviates underinvestment. In the presence of severe underinvestment, a small amount of private benefits can add value to the firm, just as a dose of corruption may help facilitate economic development when very inefficient bureaucracies are in the way (Leff, 1964). Likewise, insider ownership also has opposing effects on under- and overinvestment. When private benefits are small, an increase in insider ownership alleviates overinvestment but aggravates underinvestment. While an optimal ownership structure like in Morck,

Shleifer and Vishny (1988) is theoretically possible, the incentive-alignment effect of insider ownership is likely to be confounded by the adverse effect of insider ownership on underinvestment. In contrast, when private benefits are large, the alignment effect of insider ownership becomes pronounced because large private benefits alone are able to dispel the market concern over underinvestment.

Additionally, the model reconciles major existing models of seasoned equity offerings (SEOs) about announcement effects. It produces a non-monotonic pattern of announcement returns in relation to the expected NPV of new projects, or growth. More precisely, when expected growth is negative, the announcement returns are more likely to be negative, consistent with the argument of overinvestment-driven agency problem by Jung, Kim, and Stulz (1996). On the other hand, when asymmetric information about assets-in-place is a major concern, negative announcement returns also occur and become worse with an increase in this asymmetric information, consistent with the adverse-selection argument of Myers and Majluf (1984). In general, we find that announcement returns increase with expected growth. When uncertainties cloud expected growth rather than assets-in-place, announcement returns are likely to be positive, consistent with the insights from Ambarish, John and Williams (1987) and Cooney and Kalay (1993). When expected growth is highly positive but less fraught with uncertainties, the announcement returns descend to zero, much like the extreme case (the best announcement return) in Myers and Majluf (1984) where the new issues have no information content. The theoretical finding of a non-linear relationship between announcement returns and growth prospects seems to be consistent with some unexplained evidence in the empirical literature. Previous studies on the U.S. market find a strong positive relationship between the announcement effects and investment opportunities but fail to uncover significantly positive announcement effects for issuing firms with obviously high investment opportunities (see, e.g., Pilotte, 1992; Denis, 1994; Jung, Kim and Stulz, 1996, among others).

In Myers and Majluf (1984), the adverse selection effect always dominates. In our generalized model due to the possible acceptance of bad projects by the managers, the pre-announcement stock prices are lower than in the case of Myers and Majluf (1984). This is the main reason for possibly positive announcement effects, which occur when asymmetric information about growth opportunities

overwhelms asymmetric information about assets-in-place—the source of adverse selection effect. This insight provides a resolution to the puzzle that less levered small growth firms favor new equity issues, documented recently by Fama and French (2002). Small growth firms have little collateral value and can hardly take debt if monitored (inside) debt is not available. Such firms should face serious asymmetric information problems in issuing new equity and hence have high equity issuance costs according to Myers and Majluf (1984). Fama and French conclude that this perplexing phenomenon is not consistent with the pecking order model of Myers (1984). Our model suggests that asymmetric information about firm value that comes mainly from growth rather than assets-in-place may not necessarily be a disadvantage in new issues.

The remainder of the paper is organized as follows. Section 2 reviews the related literature. Section 3 develops our new model and discusses the model's various theoretical predictions. Section 4 implements numerical experiments to examine how firm characteristics jointly affect under- and overinvestment. Simulations produce the expected firm value which helps address not only some corporate governance issues in terms of private benefits and insider ownership but also the determinants of the announcement effects. Section 5 concludes the paper.

## **2. Related Literature**

In this section, we review previous studies that either attempt to extend the Myers and Majluf model or take a different approach to addressing related issues. This review helps clarify the contributions of this paper.

Dybvig and Zender (1991) argue that optimal managerial compensation can be chosen such that managers maximize both the old and new shareholders' wealth in new equity financing. As a result, there will be no agency conflicts and the Myers-Majluf investment inefficiency (underinvestment) will disappear. Our managerial objective function is free from this criticism because the analysis in Dybvig

and Zender (1991) explicitly requires that "financial claims and control rights be assigned equally well to different claimants".<sup>2</sup>

Early studies tend to emphasize either overinvestment (Jensen and Meckling, 1976; Jensen, 1986), or underinvestment (Myers, 1977; Myers and Majluf, 1984). Few have discussed about the investors' concern on both under- and overinvestment at the same time. Stulz (1990) is a marked exception. Stulz (1990) assumes that managers prefer expanding firm assets to maximizing firm value, but with strings attached. If managers maximize investment only to undertake negative NPV projects after exhausting good projects, shareholders can curtail this by either refusing to provide more fund or forcing managers to pay out free cash flows (using outstanding debt that is due at the time of the investment decision making). But due to asymmetric information, shareholders are not able to know precisely when free cash flows and overinvestment occur. Consequently, when internal cash flows (unobservable to outside investors) are high, managers are likely to overinvest, and when the cash flows are low, managers are likely to underinvest because they cannot truthfully convince the market that they need necessary new equity for good projects.

Stulz (1990) concludes that managerial discretion brings about two kinds of costs, one from underinvestment, and the other from overinvestment, and suggests that financing policies can affect firm value. For example, debt has a disciplinary effect to force managers to disgorge cash flows and hence to mitigate the overinvestment problem recognized by Jensen (1986) but at the same time to aggravate the underinvestment problem. The tradeoff between the positive and negative effects of debt financing, which is later empirically supported by McConnell and Servaes (1995), gives rise to an optimal capital structure.

Our joint analysis of under- and overinvestment is close to that in Stulz (1990). But there are at least two remarkable differences. First, the reason to give up positive NPV projects (causing the underinvestment problem) in Stulz (1990) is the shortage of internal fund because equity investors are

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<sup>2</sup> Rights issues, a special form of new equity financing, do not cause investment inefficiency and announcement effects in the Myers-Majluf framework. Nevertheless, when private benefits of control exist, rights issues can have significant announcement effects (see Wu and Wang, 2003).



always suspicious about the use of fund and make outside funding costly, whereas in our analysis it is the Myers-Majluf type of managers' concern on the adverse-selection effect of the new issue/investment decision. Second, Stulz (1990) assumes away managers' incentive for self-discipline. Our analysis includes managers/controllers' equity ownership. Insider ownership in our model affects both under- and overinvestment. Thus, our model is able to address some corporate governance issues even using insider ownership alone.

Previous research has also shown that the value effects of insider ownership are not straightforward. Morck, Shleifer and Vishny (1988) find that an increase in insider ownership of U.S. firms up to some point (less than 5 percent) increases firm value; but for a higher level of insider ownership (from 5 to 25 percent), which means more managerial voting power but by far insufficient in alignment with the interests of outside shareholders, an increase erodes firm value. They interpret that managerial entrenchment cemented with sufficient voting power is an important counter factor to the incentive-alignment effect of insider ownership. These two opposing effects may produce an optimal ownership structure. As managerial entrenchment is related to the difficulty of corporate takeover, the view in Morck, Shleifer and Vishny (1988) is supported by the model of Stulz (1988). The incentive-enhancing role of insider ownership suggested by Jensen and Meckling (1976) is absent, however, in Stulz (1988). In other words, it is not clear to what extent the incentive-alignment effect may counter the managerial entrenchment. Unlike the previous research, our analysis in the generalized Myers and Majluf framework considers two corporate governance variables, private benefits and insider ownership at the same time; each of the two variables has opposing effects on under- and overinvestment. Thus, our analysis is able to show how an optimal ownership structure is achieved through these variables' effects on under- and overinvestment and hence firm value.

While the adverse selection effect of Myers and Majluf (1984) is well received in the literature about the announcement effects of SEOs, there are other compelling theories. Based on the insight from Stulz (1990), Jung, Kim and Stulz (1996) suggest an agency model for new equity financing. They argue that the stock price drop at the announcement of a new issue is largely because of the overinvestment-

related agency problem rather than the Myers-Majluf adverse selection effect.<sup>3</sup> On the other hand, the multiple-signal model of Ambarish, John and Williams (1987) supports the possibility of positive announcement effects of new equity issues.<sup>4</sup> Empirically, positive announcement effects, completely absent in the prediction of Myers and Majluf (1984), are indeed evident.<sup>5</sup> Cooney and Kalay (1993) point out that the prediction of non-positive announcement effects by the model of Myers and Majluf (1984) is a direct result from the key assumption that managers only take positive NPV projects.<sup>6</sup> Consistent with the intuition of Cooney and Kalay (1993), our extension of the Myers-Majluf model also predicts positive as well as negative announcement effects of SEOs. Different from Cooney and Kalay, our model imposes a well-defined agency cost structure and is able to show how corporate finance variables explicitly affect both under- and overinvestment and hence firm value, and how to decompose the sources of announcement effects of SEOs. Unlike Ambarish, John and Williams (1987), our model does not simply attribute the negative announcement effects to underinvestment and positive effects to overinvestment.

### **3. The Model**

In this section, we develop our new model that extends Myers and Majluf (1984). We begin the setup with the assumptions (Section 3.1), build the model (Section 3.2), and highlight the potential ability of the model to tackle the intricacy of some corporate governance issues (Section 3.3).

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<sup>3</sup> SEOs in the U.S. market usually show negative announcement effects (e.g., Asquith and Mullins, 1986; Masulis and Korwar, 1986, among others). In survey papers, both Smith (1986) and Eckbo and Masulis (1995) document an average abnormal return of about –3.0 percent for U.S. industrial firms.

<sup>4</sup> The Myers and Majluf (1984) model is also a signaling model (see Daniel and Titman, 1995). The model focuses only on the new issue as a signal to the market. In contrast, Ambarish, John and Williams (1987) allow dividends as an additional signal (for firm type) prior to the new issue. See also related work of Miller and Rock (1984) and John and Williams (1986).

<sup>5</sup> The literature has documented positive announcement effects for SEOs in international markets like in Japan, the UK and Hong Kong, as well as for private placement everywhere (see a review in Wu and Wang, 2002).

<sup>6</sup> Myers and Majluf (1984) also acknowledge this restriction in their footnote 12.

### 3.1. Assumptions

*Assumption 1:* Managers maximize the controlling shareholders' wealth, which includes both the entitled cash flow rights according to insider ownership,  $w$ , the fraction of existing shares outstanding, and private benefits,  $c$ , which arise in new investments.  $c$  is the dollar amount of the project's present value that is obtained by the insiders. Unlike outside investors, managers/controllers shareholders or insiders are able to pursue their self-interested goals (at the expense of outside shareholders). Note that insiders are treated in this paper as a single party that exclusively obtains the value of  $c$ ; how insiders share in private benefits is not a concern in our model. The assumption we introduce at the beginning is fundamentally different from the original assumption in Myers and Majluf (1984), where the managers maximize the existing (passive) shareholders' wealth. The remaining assumptions are either the same as in Myers and Majluf (1984) or slightly revised to keep compatible with Assumption 1.

*Assumption 2:* It is public knowledge that the firm has both assets-in-place and an investment opportunity that requires investment,  $I$ . In general, the firm has financial slack,  $S$ . Thus, the firm needs to issue equity,  $E = I - S$ , to finance the new investment when  $S < I$ . The new issue targets only new investors. The firm is entirely equity financed. Debt financing is not considered.

*Assumption 3:* There are three dates:  $t = -1$ ,  $0$ , and  $+1$ . At time  $t = -1$ , both the insiders and the market know the joint distribution of the assets-in-place,  $A$ , and the NPV of the investment opportunity,  $B$  (characterized by their means,  $\bar{A}$  and  $\bar{B}$ , and standard deviations,  $\sigma_A$  and  $\sigma_B$ ). At time  $t = 0$ , the insiders receive private information about the realizations of  $A$  and  $B$ ,  $a$  and  $b$ , respectively, while the market does not receive this information until  $t = +1$ . At time  $t = 0$ , the firm makes and discloses the decision: either issue new equity to invest or do nothing. But the information asymmetries about  $A$  and  $B$  still take effect.

*Assumption 4:* Negative values for  $A$  are ruled out. The market anticipates that the insiders may accept a negative NPV project because the new project gives rise to an opportunity for private benefits. As a result,  $B$  may take on negative values. There is no correlation between  $A$  and  $B$ .

*Assumption 5:* There are no taxes and transaction costs. But explicit agency costs in the form of private benefits of control are allowed as mentioned in Assumption 1. Both the insiders and the market know the size of private benefits of control.

*Assumption 6:* The risk-free rate of return is equal to zero. All agents are risk-neutral. The firm's stock price is efficiently determined (conditional on all public information available).

### 3.2. The Model

At time  $t = 0$ , if managers/control shareholders tell the market that the firm will issue to invest, the expected value to the insiders is  $\frac{wP_{is}}{P_{is} + E}(a + b + E + S - c) + c$ , where  $P_{is}$  is the market value of the firm at the time of the announcement. The first part of the expected value is the insiders' entitled fraction of the firm's value conditional on the equity issue and the second part is their private benefits. Note that the private benefits appear in the first part as costs to the firm, which are borne by all shareholders but outside (minority) shareholders will have no part in the private benefits whatsoever. This is a direct result from Assumption 1.

The managers/controlling shareholders may pass up the new investment. In this case, their wealth is  $w(a+S)$ . The managers/controlling shareholders will prefer to issue and invest if

$$w(a+S) \leq \frac{wP_{is}}{P_{is} + E}(a + b + E + S - c) + c. \quad (1)$$

The decision to issue/invest or not depends on the insiders' private information  $(a, b)$ . Condition (1) has the borderline (indifference line),

$$b = \frac{E}{P_{is}}a + E\left(\frac{S}{P_{is}} - 1\right) + c\left(1 - \frac{1}{w} - \frac{E}{wP_{is}}\right). \quad (2)$$

Figure 1 depicts all the decision-making scenarios for the managers/controlling shareholders. When  $(a, b)$  lies in region  $M'$ , condition (1) is met and the firm issues to invest. Note that, in our model, even for some negative NPV projects (i.e., negative values for  $b$ ), the firm may still issue to invest. This is

more likely to happen when  $a$  is lower. On the other hand, when  $(a, b)$  falls in region  $M$ , the firm will do nothing. Note that region  $M$  is truncated somewhere at the bottom. Because  $A$  is truncated at zero, the minimal value for a non-trivial value for  $B$ , according to the indifference line (2), is  $B_{min}$   $[= E(\frac{S}{P_{is}} - I) + c(I - \frac{I}{w} - \frac{E}{wP_{is}})]$ , below which it can be treated as unlikely because the firm is definitely not interested in such a project and it does not help disclose any new information at time  $t=0$ .

Unlike the original underinvestment model of Myers and Majluf (1984), our model predicts that the firm will overinvest as well as underinvest.<sup>7</sup> As shown in Figure 2, when  $(a, b)$  lies in region  $M2$ , the firm underinvests. In contrast, when  $(a, b)$  falls in region  $M3$ , the firm overinvests. Thus, due to asymmetric information, the expected loss of firm value comes from both under- and overinvestment at the same time, not just from one or the other. Note that our model can still generate rich predictions when either asymmetric information about growth or asymmetric information about assets-in-place is assumed away (see the Appendix).

Another interesting implication of allowing the acceptable NPV of the new investment,  $B$ , to be negative is that the stock price will not always drop at the announcement of the new issue, as pointed out by Myers and Majluf (1984) in their 12<sup>th</sup> footnote and emphasized by Cooney and Kalay (1993). To understand this, we have to show (backwards) the equilibrium prices at  $t = -1$  and 0.

At time  $t = 0$ , the market will update its estimate of the firm's value conditional on new information. If the firm issues to invest, the equilibrium firm value is

$$P_{is} = \bar{A}(M') + \bar{B}(M') + S - c, \quad (3)$$

where  $\bar{A}(M')$  and  $\bar{B}(M')$  are the expected values of  $A$  and  $B$  conditional on region  $M'$ , respectively, as shown in Figure 1. In contrast, if the firm does nothing, the firm value becomes

$$P_{no} = \bar{A}(M) + S, \quad (4)$$

where  $\bar{A}(M)$  is the expected value of  $A$  conditional on region  $M$ . Note that the new investment is skipped in this case.

At time  $t = -1$ , the market will evaluate all the scenarios for time  $t = 0$  and reach the equilibrium firm value

$$P_b = \bar{A}(M' + M) + [\bar{B}(M') - c]\pi + S, \quad (5)$$

where  $\bar{A}(M' + M)$  is the expected value of  $A$  conditional on both regions  $M'$  and  $M$ , and  $\pi$  is the probability that  $(a, b)$  is in region  $M'$  (issue and invest). In effect, we have  $P_b = \pi P_{is} + (1 - \pi)P_{no}$  and  $\bar{A}(M' + M) = \pi \bar{A}(M') + (1 - \pi) \bar{A}(M)$ .

As  $P_b$  is the weighted average between  $P_{is}$  and  $P_{no}$  with a positive weight of  $\pi$ , it is obvious that  $P_{is} > P_b$  if and only if  $P_{is} > P_{no}$ . Thus, from equation (3) and (4), the firm value jumps upon the announcement of the firm's decision to issue and invest, when

$$P_{is} - S > \bar{A}(M), \quad (6)$$

and drops when

$$P_{is} - S < \bar{A}(M). \quad (7)$$

Note that, in Myers and Majluf (1984), condition (6) is ruled out because any  $(a, b)$  that falls in region  $M$  (do nothing) has an assets-in-place value,  $a$ , that is higher than  $P_{is} - S$  due to the limitation that  $b$  cannot be negative. In our setting, condition (6) holds if the joint distribution of  $(A, B)$  conditional on  $M$  (do nothing) concentrates sufficiently in the subregion as indicated by the shaded right triangle below the indifference line in Figure 2. This suggests that issuers that have a low, less noisy assets-in-place value

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<sup>7</sup> Cooney and Kalay (1993) have also modified the Myers and Majluf (1984) framework to consider overinvestment. Lack of a clear agency cost structure in their analysis, the region of issuing to invest when  $b < 0$  (the case of overinvestment) is not clearly defined there. See a more detailed discussion in the Appendix.

but have a big standard deviation of the new project's NPV are necessary to produce positive announcement effects.

Why issuing firms' stock prices can jump as well as drop at the time of the announcement of new issues can be further understood as follows. Let  $P_{is}-P_b$  be the announcement effect, which can be viewed as consisting of the information effect from existing assets and the information effect from new projects (net private benefits), that is,

$$\begin{aligned} P_{is} - P_b = & \{ \bar{A}(M') - \bar{A}(M' + M) \} && \text{(Information About } A) \\ & + \{ [\bar{B}(M') - c] - [\bar{B}(M') - c] \pi \} && \text{(Information About } B-c). \end{aligned} \quad (8)$$

Upon the announcement of new issues, the information about the assets-in-place is the revision of the market's estimate of the assets-in-place from  $\bar{A}(M'+M)$  to  $\bar{A}(M')$  while the information about investment opportunities is the revision of the market's estimate of the NPV of new projects subtracting private benefits from  $[\bar{B}(M') - c]\pi$  to  $[\bar{B}(M') - c]$ . Note that the joint probability distribution of  $A$  and  $B$  (even if  $A$  and  $B$  are not correlated) influences both the estimates of assets-in-place and investment opportunities so that these estimates are not really independent.

In Myers and Majluf (1984), because  $B$  is assumed to be truncated at zero, we have the conditions  $\bar{A}(M') \leq \bar{A}(M'+M) \leq \bar{A}(M)$ , meaning that the expected value of assets-in-place conditional on a decision to issue cannot be higher than the expected value of assets-in-place conditional on a decision to do nothing. In other words, the issuers are expected to be firms with lower rather than higher values of assets-in-place. Thus, given this unique separation, the information effect from the assets-in-place cannot be positive. Further more, although the information effect from investment opportunities (where  $c=0$ ) is always positive, the negative information about assets-in-place always overwhelms the positive information about the new investment, because condition (7) is always satisfied in Myers and Majluf (1984).

Our generalized model, however, produces richer predictions. The model accommodates also negative values of  $b$ . Thus,  $\bar{B}(M')$  can be negative. Even if  $\bar{B}(M') > 0$ ,  $\bar{B}(M') - c$  can be negative since

$c > 0$ . Also,  $\bar{A}(M') \leq \bar{A}(M' + M) \leq \bar{A}(M)$  may not always hold. Thus, the announcement effect is open to all scenarios, as shown in Table 1. We could even observe positive information about assets-in-place and negative information about new projects (subtracting private benefits). For an issuing firm's stock price to jump, one positive information effect must outweigh the other negative information effect, or both information effects must be positive. These are cases that satisfy condition (6), where the expected value of the assets-in-place conditional on doing nothing,  $\bar{A}(M)$ , is lower. Thus, a positive announcement effect reflects either an undervaluation of existing assets, good news about investment opportunities, or both.<sup>8</sup>

All in all, the two information effects jointly produce an announcement effect. In our model, if both information effects are positive or if the positive one overwhelms the other negative one, an issuing firm's stock price jumps. Otherwise the stock price drops as the original Myers and Majluf model predicts. In the next subsection, we discuss the ability of our model to address some corporate governance issues.

### 3.3. Corporate Governance in Terms of Private Benefits and Insider Ownership

Private benefits of control give rise to the concern regarding corporate governance. In our model, because of share dilution in SEOs, the misalignment of interests of insiders versus outside investors always occurs in the presence of private benefits of control.

Even when the fraction of the exiting shares held by the managers/controlling shareholders,  $w$ , goes to unity, there is still a possibility of overinvestment and our model does not converge to the original Myers and Majluf model. Graphically, our indifference line shifts from the original one by  $c$  (i.e., setting  $w=1$  in equation (2)) and region  $M3$  will not disappear. The expected loss of value here due to overinvestment comes from the fact that the private benefits are the costs to the firm that have to be borne

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<sup>8</sup> A positive announcement effect reflects an undervaluation of existing assets only when  $A$  and  $B$  are highly positively correlated (with a high volatility of  $B$  at the same time). Otherwise, a pair of, say, big  $a$  and not very big  $b$  is likely to occur and falls in region  $M$ . This makes  $\bar{A}(M)$  become bigger, easily violating condition (6).



by all shareholders but outside shareholders take no part of the private benefits obtained by the insiders. The market rationally incorporates this inauspicious situation into the firm value.

On the other hand, when  $w$  becomes small enough, condition (1) may always hold. This means that the firm may always issue to invest, unable to disclose any new information at  $t=0$ . Likewise, if  $c$  is very large, condition (1) may always hold as well. Of course, each of the two extreme scenarios may be unlikely, because too small  $w$  is hardly compatible with the controlling power and too large  $c$  is not easy for managers to conceal without facing a legal challenge. Perhaps, non-extreme cases are more realistic. In order to address in depth related corporate governance issues, we can explicitly show, using the model we developed above, how private benefits and insider ownership affect both under- and overinvestment and hence firm value.

In the next section, we turn to simulations for various equilibrium predictions that cannot be explained easily in terms of Figures 1 and 2.

#### **4. Numerical Experiments for Equilibrium Predictions**

In this section, we discuss the expected loss of firm value due to under- and overinvestment (Section 4.1), the firm valuation effects of the two corporate governance variables: private benefits and insider ownership (Section 4.2), and the determinants of announcement returns of new equity issues (Section 4.3). To these ends, we start with describing how to implement the simulation procedure.

The firm value,  $P_{is}$ , which is conditional on the firm's decision to issue and invest at  $t=0$ , is determined in equilibrium.  $P_{is}$  depends on the joint probability distribution of  $(A, B)$  and is a crucial variable of the indifference line in (2). Although no analytical solution is available, we can resort to a simulation procedure as suggested by Myers and Majluf (1984) as follows:<sup>9</sup>

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<sup>9</sup> In our simulations that follow in this section we hardly encounter multiple solutions or any convergence problem in iterations. The Myers-Majluf simulation procedure turns out to be very effective. The number of runs in each simulation we implement is 10,000.

Given  $E$ ,  $S$ ,  $c$ ,  $w$ , and a joint probability distribution of  $(A, B)$ , set the initial value to be  $P_{is} = \bar{A} + \bar{B} + S - c$ ;

- (1) solve for regions  $M'$  and  $M$  using the indifference line of (2);
- (2) calculate a new trial value according to equation (3),  $P_{is} = \bar{A}(M') + \bar{B}(M') + S - c$ ;
- (3) continue steps (2) and (3) until  $P_{is}$  converges. Note that regions  $M2$  (underinvestment) and  $M3$  (overinvestment) in Figure 2 are also jointly determined in equilibrium.

#### 4.1. Expected Loss of Firm Value due to Under- and Overinvestment

The Myers-Majluf adverse-selection model predicts that the firm may pass up good investment opportunities by doing nothing. This happens with probability  $F(M2)$ . Thus, the *ex ante* loss of firm value is  $LU = F(M2)\bar{B}(M2)$ . Our model predicts not only underinvestment but also overinvestment. In our model, overinvestment occurs with probability  $F(M3)$ . Thus, the ensuing *ex ante* loss of firm value is  $LO = F(M3)\bar{B}(M3)$ , which is negative.

Table 2 illustrates, under various scenarios, the magnitudes and probabilities (*Prob.*) of the *ex ante* losses of firm value,  $LU$  and  $LO$  due to the firm's under- and overinvestment, respectively. For ease of comparison,  $LU$  and  $LO$  are scaled by  $F(M1+M2)\bar{B}(M1+M2)$ , which is the expected value added when the firm is to issue and invest whenever good investment opportunities come by. Thus,  $LU$  and  $LO$  are expressed as percentages. We keep parameter values to be the same in each panel, unless a particular parameter is under investigation. In the simulations, we assume  $E=50$ ,  $\bar{A} = 100$ ,  $\bar{B} = 10$ ,  $\sigma_A=50$ ,  $\sigma_B=10$  (standard deviations of  $A$  and  $B$ , respectively, truncated accordingly as indicated in Figure 1),  $c=5$  (half the unconditionally expected NPV of the new project as given), and insider ownership,  $w=0.51$  (a majority voting power), and  $S=0$  (so  $I=50$ ) except in Panel D.

As a Myers-Majluf framework emphasizes information asymmetries, Panel A of Table 2 reports how the uncertainties about assets-in-place influence under- and overinvestment. We let  $\sigma_A$  vary from 10 to 100 while keeping other parameter values constant. It turns out that increasing  $\sigma_A$  aggravates the underinvestment problem but alleviates the overinvestment problem. As the experiment shows, when

$\sigma_A=10$ , we have  $LU=0.00$  and  $LO = -5.35$  percent; when  $\sigma_A=100$ ,  $LU$  reaches 74.0 percent but  $LO$  drops (in absolute size) to  $-1.2$  percent. Thus, more uncertainties about assets-in-place deter the firm from undertaking even a good project because the adverse information effect of overvaluation is too costly for the not very overvalued firm. This is one of the main insights in Myers and Majluf (1984). Conversely, smaller information asymmetry about assets-in-place mitigates the Myers-Majluf underinvestment problem but invites a new adverse effect, overinvestment.

In Panel B of Table 2, we examine how the expected NPV of investment opportunities influences under- and overinvestment. Though we leave out the details here in interest of space, we find that high (low) NPV of investment opportunities in terms of high (low)  $\bar{B}$  tends to mitigate (aggravate) both under- and overinvestment. This means that if there are two opposing agency costs from under- and overinvestment, such as the two costs of managerial discretion in Stulz (1990), the counter effects will be very much pronounced for low growth firms but weak for high growth firms. Our theoretical analysis here lends direct support to the view by McConnell and Servaes (1995).

In Panel C, we let the issue/investment size,  $E$  or  $I$  (since  $S=0$  here), vary from 5 to 100. The results show that the underinvestment problem significantly worsens when  $E$  increases. For example,  $LU$  and the corresponding probability remain very small when  $E=5$  but, respectively, reach 73.04 and 63.01 percent when  $E=100$ . On the other hand, there seems to be a small hump in the pattern for  $LO$  despite the monotonic decrease in the probability from 9.40 to 2.67 when  $E$  increases from 5 to 100 (the negative sign for the value of  $LO$  means that overinvestment destroys value).

The hump means that the overinvestment problem is alleviated only when  $E$  is either small or large. When  $E$  is small, the expected profitability (or  $\bar{B}/E$ ) of the new project is high so that both under- and overinvestment problems remain small. When  $E$  is large, the expected profitability becomes so low that the firm is most likely to forego the new project—a situation in which the overinvestment problem seems to be contained due to the outweighing dilution effect on the equity interest of the insiders. The main message here is that the issue/investment size affects overinvestment in a non-linear way.

Another insight from the Myers-Majluf model is that financial slack,  $S$ , is valuable because it can help alleviate the underinvestment problem. Panel D of Table 2 shows that this is just one phenomenon. When  $S$  increases from 1 to 45 (or equivalently with  $E$  decreasing from 49 to 5, given  $I=50$ ),  $LU$  reduces from 26.17 percent to zero, as does the probability from 27.06 percent to zero. At the same time, with the increasing probability,  $LO$  becomes more negative from  $-3.01$  to  $-3.40$  percent when  $LU$  drastically reduces from 26.17 to 6.94 percent. Thus, more financial slack can aggravate overinvestment, leading to a negative effect. The pattern of  $LO$  with an increase in  $S$ , however, has a hump in the middle of the  $S$  range. When financial slack is very large, increasing toward 45,  $LO$  in absolute terms actually decreases to  $-2.02$ . Nevertheless, while  $S$  is very large, over- rather than underinvestment is the factor that reduces firm value. The message here is that while more financial slack alleviates underinvestment, it invites overinvestment.

Table 3 shows that the opposing effects of financial slack on under- and overinvestment can produce an optimal firm value for an interior amount of financial slack. For example, as shown in Panel A of Table 3 ( $c=5$ ), with insider ownership of 25 percent, a moderate amount of financial slack equal to 15 (or 25) gives the optimal firm value of 107.79, a bordered number. Likewise, as shown in Panel B ( $c=10$ ), an interior optimality occurs for  $S=5$  and  $w=0.5$ . Note that the corresponding firm values with smaller private benefits (Panel A) are always higher than those with larger private benefits (Panel B), reflecting that the value effects of private benefits are more direct and drastic. Nevertheless, controlling for  $c$  and  $w$ , our analytical results about  $S$  are consistent with the static tradeoff views on cash holdings in Kim, Mauer and Sherman (1998) and Opler, *et al.* (1999). Our results are also consistent with the prediction by Stulz (1990), who argues that when cash flows are high, managers tend to overinvest, and when cash flows are low, managers tend to underinvest. Unlike Stulz (1990), however, our model is able to accommodate Myers and Majluf's (1984) insight of the positive effect of financial slack, and Jensen's (1986) adverse effect of free cash flow on investment in an explicit asymmetric information framework (see the literature review in Section 2).

Taken together, the results of this section show how exactly under- and overinvestment jointly affect firm value under the influence of a range of corporate finance variables. Factors such as the uncertainties about assets-in-place, investment/issue size, and financial slack each have opposing effects on under- and overinvestment, whereas corporate growth opportunities help alleviate and solve both the under- and overinvestment problems at the same time.<sup>10</sup>

#### **4.2. The Valuation Effects of Corporate Governance in Terms of $c$ and $w$**

Private benefits of control and insider ownership are two important variables considered in the corporate governance research. In this section, we examine how private benefits of control,  $c$ , and the fraction of existing shares held by the insiders,  $w$ , affect corporate investment decisions as characterized by under- and overinvestment, and hence the expected firm value. First, we look at the effects of one variable given the other. Then, we analyze the overall firm valuation optimality with respect to various sets of  $(c, w)$  combinations.

Table 4 reports the results of numerical experiments. To keep consistence, parameter values in each panel of Table 4, unless varying under investigation, are the same as in Table 2. Panel A shows the results for various levels of  $c$  given  $w=0.51$ . Private benefits, deemed as a control variable to the insiders, remain largely unverifiable. But this uncertainty about private benefits is less important in our analyses as long as one accepts that the market anticipates private benefits but outside shareholders cannot do anything about them. On the other hand, private benefits should be subject to some exogenous restrictions due to managerial reputations as well as the degree of law enforcement. For one thing, big losses of firm value due to the adverse effects of large private benefits inevitably tarnish insiders' reputations. As a result, insiders may restrain from taking large private benefits. In this sense, private benefits have endogenous consequences. Interestingly, as our experiments in Panel A show, increasing  $c$  from 0.1 to 25 reduces  $LU$  from 54.59 to 2.20 percent but worsens  $LO$  from  $-1.45$  to  $-6.78$  percent. While it is

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<sup>10</sup> We also considered positive (0.25) and negative ( $-0.25$ ) correlations of A and B in the simulations for this section as well as Sections 4.2-4.3 below. The results (available on request) have not qualitatively changed.

understandable that the overinvestment problem is worsened with an increase in private benefits, the favorable impact of the increase in private benefits on underinvestment is rather striking.

The fact that this positive effect on underinvestment counters at the same time the deteriorating overinvestment problem may lead to an optimal firm value by the managers/controllers' choice of a particular amount of private benefits. Indeed, Panel A also unveils the existence of such an interior optimum. When  $c=1$ , which is a non-extreme (or interior) number, the expected firm value reaches the highest value at 108.22.

The other popular corporate governance variable we examine, insider ownership,  $w$ , like  $c$ , also shows the opposing effects on under- and overinvestment. In Panel B of Table 4, given  $c=5$  as we set, when  $w$  increases from 0.05 to 0.75 (or 75 percent),  $LU$  increases from nil to 50.39 percent, but  $LO$  improves from  $-7.79$  to  $-1.59$  percent. Thus, a closer incentive-alignment between insiders and outside shareholders aggravates the underinvestment problem but does ameliorate the overinvestment problem. The two opposing effects can give rise to an optimal ownership structure. As shown in Panel B, when  $w=0.25$ , the expected firm value peaks at 108.39 in our example.

Panel C of Table 4 reports results from a whole set of  $(c, w)$  combinations. To start, the results show that given  $w$ , an optimal firm value, as indicated by a bordered number in row Max, occurs for an interior amount of private benefits at almost all levels of  $w$ . This reconfirms one of the main insights of our model: some amounts of private benefits are better than no private benefits because private benefits help alleviate underinvestment. In contrast, while an optimal firm value of 108.27 does occur for an interior level of insider ownership  $w=0.35$  with  $c=5$ , optimal firm values given  $c$  are in many cases reached at the two extreme levels of insider ownership we show—reflecting either its incentive-alignment effect or its adverse effect on underinvestment dominates.

It is interestingly that the firm value effects of  $w$  demonstrate a clear reversal for small versus large private benefits, as shown in Panel C. When  $c$  is small, a lower level of insider ownership tends to produce higher firm value. But when  $c$  is large, the reverse is observed (for example, for  $c=0.1$ , 108.48 at  $w=0.05$ , versus 107.00 at  $w=0.75$ , whereas for  $c=15$ , 98.14 at  $w=0.05$  versus 101.73 at  $w=0.75$ ). The

reason is that when  $c$  is small, the private benefits induced overinvestment becomes contained. As a result, a lower level of insider ownership tends to substantially alleviate underinvestment, as the adverse effect of  $w$  on underinvestment, which tends to overwhelm its alignment effect when  $w$  is higher, is a major concern in this situation. In contrast, when private benefits become larger, the market's concern over underinvestment tends to diminish. As a result, the incentive-alignment effect of insider ownership is more likely to dominate.

The analyses above focus on a partial optimality of firm value (conditional on  $c$  or  $w$ ). How about an overall optimality? In all  $(c, w)$  combinations shown in Panel C, the overall optimal firm value, as indicated by one of the dash-line bordered numbers, is reached at  $c=1$  and  $w=0.05$ . This means that if firm-value-conscious insiders can freely choose  $c$  and  $w$ , they should choose a relatively small amount of private benefits and a lower level of insider ownership in order to maximize the firm value. This seems to be a corner solution in terms of insider ownership.

In reality, however, the insiders may not be able to choose  $c$  and  $w$  freely. In many countries around the world, weak law enforcement allows insiders to expropriate outside investors greatly but controlling shareholders have to keep a lock on control by keeping large share holdings, as suggested by the rent-protection theory of Bebchuk (1999). On the other hand, strong law enforcement with reputable legal infrastructure, such as in the Anglo-American economies, prevents insiders from expropriating outside investors to the extent widely possible in an economy under weak law (Bebchuk, 1999; and La Porta, *et al.*, 1999).

With these constraints considered, our results can shed further light. As shown in Panel C of Table 4, assuming that strong law caps  $c$  at 5, the finding that the optimal firm value is reached at the low end of insider ownership (i.e., 112.08 at  $w=0.05$ ) is in line with the observation that a typical listed U.S. firm has dispersed ownership structures. Yet this does not invalidate the alignment effect of insider ownership in principle. The finding that a higher level of insider ownership given capped  $c$  leads to a lower firm value simply reflects the primary concern by the market over the deteriorating underinvestment problem with an increase in insider ownership, as already explicitly shown in Panel B. In other words, with expropriation

constrained (or  $c$  capped), while the self-interest of insiders has a limited impact on firm value, a decrease in insider ownership can substantially alleviate the underinvestment problem, as we also argued above. The resulting value improvement, as shown in column *Max-Min*, occurs by 5.29 at maximum (from  $w=0.75$  to  $w=0.05$ ) for  $c$ 's capped at 5. The main point here is that the adverse effect of insider ownership on underinvestment is so pronounced as to confound the incentive-alignment effect when private benefits are small.

Of course, when private benefits are large, the concern by the market over both the direct erosion of firm value and the induced-overinvestment tends to dominate. As shown in the bottom half of Panel C, under weak law (i.e.,  $c$  reaching 10 and above), an increase in  $c$  always reduces firm value but an increase in  $w$  improves firm value. As a result, in contrast to the strong law scenario, we observe the opposite corner solution—namely, the optimal firm value of 104.14, dash-line bordered, is reached at  $w=0.75$ , the highest level of insider ownership we show. This is consistent with the view in the literature that in countries with weak law enforcement where controlling shareholders are able to obtain large private benefits, firms usually have concentrated ownership structures. Our results, however, emphasize that expropriation may not be rampant because insider ownership does have a strong alignment effect here.

One would argue that even under weak law, the firm-value-conscious insiders who keep large share holdings can maximize firm value by taking as small private benefits as possible, as shown in Panel C (for example at  $w=0.75$ , 107.00 for  $c=0.1$  instead of 104.14 for  $c=10$ ). We have two lines of defense against this argument. First, as suggested by the rent-protection theory, the more private-benefits oriented controlling shareholders are willing to pay a premium to takeover the firm, crowding out the more firm-value-conscious controlling shareholders.

Second, it is difficult to know how firm-value-conscious the insiders can be, or how much firm value the insiders are willing to trade with private benefits for their reputations. We take  $c$  as given in the model because  $c$  is a complicated function of insiders' reputation and conscience which vary widely across individuals and hence is less tractable in modeling.



Yet  $c$  has endogenous implications in our model. Denote the  $c$ -induced variation in firm value (controlling for  $w$ ) to be the max-min difference in firm value given  $w$ . As shown in Panel C, the  $c$ -induced value variation is the largest at the lowest insider ownership and the smallest at the highest level of insider ownership (i.e. 23.94 at  $w=0.05$ , and 12.02 at  $w=0.75$ , as shown in row *Max-Min*). This suggests that firm value at a high level of insider ownership is less sensitive to considerable variations in private benefits due to the strong alignment effect for self discipline. Given that a lower level of insider ownership is not sustainable under weak law, it seems that controlling shareholders in concentrated ownership structures can reap considerable private benefits with a relatively muted adverse effect on firm value. This means that insiders tend to choose considerable private benefits anyway in concentrated ownership structures.

One may notice that the above analyses ignore the correlation of  $c$  and  $w$ . Private benefits in different firms that have the same level of insider ownership are deemed to vary due to various insiders' reputations and conscience as well as complex contracting environments. But it is generally true that a higher level of insider ownership tends to correspond to a smaller amount of private benefits because the incentive for the insiders to obtain private benefits reduces when gaps between the cash flow and control rights become smaller. As shown in Panel C of Table 4, this negative correlation between  $c$  and  $w$  can be considered as limiting the feasibility of  $(c, w)$  combinations as represented by the shaded numbers (from the bottom left corner to the top right corner). As a result, the optimal firm value of 108.05, dash-line bordered, is reached at  $c=5$  and  $w=0.35$ —an interior solution.<sup>11</sup>

The results in this section provide clear evidence that both private benefits and ownership structures matter in corporate governance. Albeit constrained in various scenarios, they are deemed to be decision variables, as expected by the market, for insiders in determining the optimal value of the firm. The existing literature about the effects of corporate ownership structure on firm value especially

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<sup>11</sup> Some well-known companies in markets popular with concentrated ownership structures happen to have controlling ownership around 35 percent. For example, the Hong Kong tycoon, Mr Li Ka Shing, has 37 percent ownership of Cheung Kong Limited, the parent holding company of Li's empire.

emphasizes the tradeoff between the good and bad elements of corporate governance practices. For example, Morck, Shleifer and Vishny (1988), Stulz (1988), and McConnell and Servaes (1990) distinguish between positive incentive effects and negative control (entrenchment) effects of higher managerial ownership; La Porta, Lopez-de-Silanes, Shleifer and Vishny (2000) model the direct tradeoff between private benefits and costs (penalties for obtaining private benefits). Our analysis, however, shows that the good elements of corporate governance alone, such as higher incentives or lower private benefits, can even aggravate the underinvestment problem, an important adverse effect under asymmetric information.

In our model, the insight about the effects of these corporate governance variables on valuation stems from the fundamental tradeoff between the under- and overinvestment problems caused by market imperfections. Aggarwal and Samwick (1999) also consider such a tradeoff but they have to assume private benefits for overinvestment and private costs for underinvestment. In contrast, we only need to introduce positive private benefits in a Myers-Majluf framework to tell the two stories. More important, our prediction is unambiguous: as long as expected private benefits exist, corporate governance in terms of private benefits and insider ownership has valuation effects and can lead to an optimal ownership structure.

Our results also shed new light on the recent debate regarding the optimal managerial ownership structure. A recent paper by Demsetz and Villalonga (2001), among others, emphasizes an endogenous variable approach to insider ownership that predicts no systematic relationship between managerial ownership structure and firm value. As a result, the once well received literature in support of a non-linear relationship between insider ownership and firm performance such as in Morck, Shleifer and Vishny (1988) has become controversial. This very relationship has also been challenged by Himmelberg, Hubbard and Palia (1999), who argue that the unobservable heterogeneity in the firms' contracting environments must plague the finding of an optimal ownership structure. Unlike previous studies in the literature, our analytical results are directly based on corporate governance effects on investment

inefficiencies to reveal the outcomes of corporate governance in relation to firm value, and hence are largely free from this line of criticism.

Another unsolved issue in the literature is about the different conclusions based on empirical evidence on the alignment effects of insider ownership in dispersed versus concentrated ownership structures. In a recent survey paper on international corporate governance by Denis and McConnell (2003), one of their main findings is that while existing studies on the alignment effects of insider ownership in concentrated ownership structures are largely in agreement, a larger body of research in the context of dispersed ownership structures, typically in the U.S., is inconclusive about this simple alignment effect due to the endogeneity problem (see Demsetz and Villalonga, 2001). Although previous studies in the context of concentrated ownership structures may also be subject to the endogeneity problem, our analyses are ready to provide an explanation: The incentive-alignment effect of insider ownership is largely confounded by the adverse effect of insider ownership on underinvestment in dispersed ownership structures, but it becomes pronounced in concentrated ownership structures where large private benefits substantially diminish the market's concern over underinvestment so that the overinvestment becomes a major problem.

#### **4.3. Determinants of Announcement Returns of Equity Financing**

In the original Myers-Majluf logic, a firm's decision to issue will predominately convey an overvaluation of the firm's assets-in-place because the NPV of new projects is assumed to be non-negative. If rational managers are expected to accept bad projects as well, it becomes possible that the decision to issue and invest may signal good news as well as bad news. The predominant good news, as shown in Table 1, is either an undervaluation of assets-in-place, positive information about new investments, or both. As a result, issuing firms' stock prices may jump in some cases, in contrast to the classic prediction by Myers and Majluf (1984).

What are the factors that influence the announcement returns, which can be decomposed into the information effect from assets-in-place and the information effect from new projects (subtracting private benefits)? Similar to what is suggested by Ambarish, John and Williams (1987), Cooney and Kalay find

in their simulations that positive announcement returns are more likely when the inside information of managers is derived more from investment opportunities than from assets-in-place. In this section, we provide a further investigation into the underlying effects on the announcement returns.

Table 5 reports the results for firms with a lower expected assets-in-place value,  $\bar{A} = 5$  (left half of the table), and with a higher such value,  $\bar{A} = 10$  (right half), respectively. Throughout the table, we set constant the controlling shareholder's ownership,  $w=0.51$  (or 51 percent), financial slack,  $S=0$ , but we allow the issue/investment scale,  $E$ , and private benefits,  $c=E/10$  (which is tied with  $E$ ), to vary to some extent. In Panel A, we set constant the expected NPV of investment opportunities or growth,  $\bar{B} = 1$ , the standard deviations of  $B$ ,  $\sigma_B=1$ , and allow standard deviations of  $A$ ,  $\sigma_A$ , to vary. The relative uncertainties about growth opportunities are measured by  $\sigma_B/\sigma_A = 1/\sigma_A$  (not explicitly shown in the table.)<sup>12</sup> As the evidence shows, when  $\sigma_A$  increases from 0.50 to 2.25 (so  $1/\sigma_A$  decreases), the stock return for  $t = -1$  to 0 decreases from 1.41 to  $-0.73$  percent (for  $\bar{A} = 5$  and  $E=1$ ); when  $E$  increases from 1 to 3, the announcement returns decrease but the cross- $\sigma_A$  return patterns are always preserved. Thus, our numerical experiments confirm the prediction of Cooney and Kalay (1993) that the announcement returns can be positive and in positive relation to  $\sigma_B/\sigma_A$ , within reasonable ranges of issue/investment scales and assets-in-place values.

As shown in our theoretical analysis earlier, according to condition (6), given  $P_{is}$ , a small value of  $\bar{A}(M)$  is likely to produce a positive announcement return. What is the empirical implication? Imagine the following simple case. If the expected value of assets-in-place, or both conditioning on issuing and on doing nothing (i.e.,  $M'$  or  $M$ ), remains low, a positive announcement return is likely to occur when the standard variation of  $B$  tends to be high. Note that, as shown in equation (3),  $P_{is}$  increases with  $\bar{B}(M')$  which is positively related to the standard deviation of  $B$  when  $a$  is likely to fall in the low value range—a

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<sup>12</sup> For ease of comparison, we follow Cooney and Kalay (1993) to represent the various relative uncertainties about growth by varying only the uncertainties about assets-in-place.

scenario where the Myers and Majluf adverse-selection effect remains minimal. This suggests that positive announcement effects are likely to occur to issuers with a small firm size.

The smaller a firm, the asymmetric information about the firm is more likely to arise from its investment opportunities than from its assets-in-place. Thus, firm size should be a good proxy for  $\sigma_B/\sigma_A$ . Yet small firm size is only a necessary condition for positive announcement returns. Small firms' growth prospects with a lot of uncertainty are the key. Indeed small growth firms are more likely to issue new equity than are value firms. Thus, it may not be strange at all that small issuers are more likely to have positive announcement returns. Kang and Stulz (1996) in Japan and Wu and Wang (2002) in Hong Kong, respectively, document that the average announcement returns of new non-private equity issues are significantly positive and the announcement returns are significantly *negatively* related to firm size.

Since smaller issuers are seemingly fraught with more asymmetric information and hence their stock prices should drop more at the announcement of new issues according to the Myers-Majluf model, Kang and Stulz (1996) view their evidence as puzzling in this regard. Similarly, Fama and French (2002) document that less levered small growth firms favor new equity and conclude that this perplexing phenomenon is not consistent with the pecking order model of Myers (1984). Our generalized Myers-Majluf framework, however, provides a resolution to this puzzle. Small growth firms can anticipate and enjoy positive announcement effects of new issues, as severely asymmetric information about these firms is likely to arise from investment opportunities rather than from assets-in-place. Thus, asymmetric information may not necessarily be a disadvantage in issuing new equity.

There are also other widely used proxies, such as market value over book value, commonly measured by the level of expected NPV of investment opportunities or growth (relative to book value). In Panel B of Table 5, to measure the expected growth relative to the value of assets-in-place by  $\bar{B} / \bar{A}$  (not explicitly shown in the table), we let the expected growth,  $\bar{B}$ , vary from  $-2$  to  $5$ , while keeping constant the standard deviations of  $B$ ,  $\sigma_B=1$ , and the parameters of assets-in-place as in Panel A. It turns out that when the expected growth is negative (i.e., expected overinvestment), the announcement returns are most likely to be negative and worse for lower assets-in-place value (left half) and for larger issue/investment

scales ( $E=1$  to 3). For example, when  $\bar{B} = -2$ , the announcement returns with  $E=1$  and 2, respectively, are  $-7.24$  and  $-27.82$  percent for  $\bar{A} = 5$  but are  $-1.05$  and  $-5.65$  percent for  $\bar{A} = 10$ . Obviously, the new issues convey bad news predominately from the bad investment (its probability,  $\pi$ , changes from less than one at  $t = -1$  to unity at  $t=0$ ). In contrast, when the expected growth turns out positive, we do observe announcement returns increasing and becoming even positive. The reason is that, when the expected growth is higher, the good news about the new investment tends to overwhelm the adverse information effect from the assets-in-place, if any. Interestingly, when the expected growth becomes highly positive, for example, when  $\bar{B}$  reaches 4 and 5, the announcement returns descend to zero. In our example, the information content of the new issue approaches zero because the market has already expected that the new investment's NPV is so high that no firm is likely to pass up such a good investment. As a result, the positive information about the very good investment becomes much weaker and hence can be easily offset by any adverse information effect from the assets-in-place.<sup>13</sup>

The pattern of announcement returns is not in monotonic relation to the expected growth as shown in Panel B of Table 5. This non-monotonic pattern is the manifestation of all possible scenarios. First, the negative returns can reflect the confirmation of an agency problem that managers/controlling shareholders may make a decision that can destroy the firm value for the sake of their own private benefits. Jung, Kim and Stulz (1996) find evidence in support of the overinvestment-driven agency problem argument. They show that firms with poor investment opportunities that otherwise should issue debt experience an extremely significant drop of stock prices in response to their new equity issues. But this does not necessarily contradict the adverse selection argument of Myers and Majluf (1984). As we have shown, when asymmetric information about assets-in-place predominates, negative announcement returns also occur and become worse with an increase in this asymmetric information. Second, the zero announcement returns coincide with the extreme case in Myers and Majluf (1984) where the positive information effect

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<sup>13</sup> In the corner solution case of no asymmetric information about assets-in-place as discussed in the Appendix, even if the expected growth is very high, the condition in (9) may not be satisfied, or the decision to issue and invest remains slightly uncertain. But the positive announcement effect diminishes if the information effect from growth becomes weaker, which is a situation with very high expected growth.

about good investments disappears along with the adverse information effect from assets-in-place. The mechanism to reach the possibly zero announcement returns in our setting is different, though. Here both adverse information from assets-in-place and the positive information effect from good investments tend to remain, but one is offset by the other. Finally, our model can accommodate positive announcement returns depending on how the two information effects about assets-in-place and investment opportunities jointly influence the announcement returns of the new issues.

One would argue that fixing the growth uncertainties in Panel B of Table 5 might not be practical. In practice, great growth opportunities tend to go with high growth uncertainties. To capture this, we impose the restriction:  $\bar{B} = \sigma_B$ , while measuring the expected growth relative to that of the assets-in-place by  $\bar{B} / \bar{A}$  (not explicitly shown in the table). In Panel C of Table 5, when both the growth opportunities and uncertainties increase in tandem, the announcement returns increase until they start to decrease. Thus, the non-monotonic pattern of the announcement returns in relation to the expected growth is still evident. Compared with the results in Panel B, however, the announcement returns here become higher. The marginal positive effects on announcement returns stem from the increasing growth uncertainties as we have seen in Panel A. Strikingly, the marginal positive effects of the growth uncertainties are so powerful that the information content of the new investment in the new issue can still be substantial for the issuing firms with very high expected growths.

In a nutshell, our model in an explicit asymmetric information framework with an agency cost structure reconciles major SEO models about announcement effects.<sup>14</sup> We demonstrate that there is a non-monotonic pattern of the announcement returns in relation to expected growth, and that small growth

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<sup>14</sup> Our results here are based on  $w=0.51$  as an example for firms with concentrated ownership structures. A lower insider ownership, however, is common in firms with dispersed ownership structures such as in the U.S. We hence recomputed all the results in this section using  $w=0.10$  instead of  $w=0.51$ . It turns out that there is no qualitative change in the new results (available on request).

firms are likely to enjoy positive announcement effects of new equity issues.<sup>15</sup> The new insight from our model helps rationally explain a puzzle regarding the pecking order in financing for small growth firms in the literature.

## **5. Conclusions**

We have introduced an agency cost structure based on private benefits of control to extend the original asymmetric information framework of Myers-Majluf (1984). The managers/controlling shareholders in our generalized model maximize their own wealth that includes the value of insider equity ownership and private benefits of control. The model generates many interesting new predictions. We review the major results as follows.

(1) Under information asymmetries and agency conflicts as we specify in this paper, the model shows how some important firm characteristics each affect under- and overinvestment at the same time. A decrease in uncertainties about assets-in-place (the source of adverse selection) ameliorates the underinvestment problem but aggravates the overinvestment problem; an increase in firm growth opportunities tends to mitigate both the under- and overinvestment problems; an increase in issue/investment size (given profitability) makes the issuing decision less likely and aggravates underinvestment while alleviates overinvestment initially, but afterwards tends also to aggravate overinvestment; more financial slack helps overcome the underinvestment problem but gives rise to the market concern over overinvestment, producing possibly an optimal firm value for an interior amount of financial slack.

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<sup>15</sup> There is a concern about cheating in the market when small growth firms have an advantage in issuing new equity. We argue that this advantage cannot come by repeatedly for a particular growth firm. When the firm initially issues new equity, both its assets-in-place value and the uncertainties about it increase—a situation that makes the adverse selection effect stronger and hence positive announcement returns less likely. As a result, it will endogenously diminish the firm's new issue advantage in subsequent new issues. Thus, growth firms can anticipate and enjoy the new issue advantage mainly in the early stage of their life cycle. The model of Ambarish, John and Williams (1987) can also produce positive announcement returns. For a viable market to accommodate firms with the new issue advantage in equilibrium, they rule out cheating based on issuers' reputations using a repeated game argument.



(2) Like most corporate finance variables, both private benefits and insider ownership each have opposing effects on under- and overinvestment. An increase in private benefits is more likely to prod managers to undertake negative NPV projects but tends to dispel the market concern over underinvestment. Likewise, an increase in insider ownership mitigates overinvestment—the incentive-alignment effect, but aggravates underinvestment—the Myers-Majluf adverse-selection effect. These opposing effects may produce an interior optimal firm value.

(3) If one accepts that strong law caps private benefits, the incentive-alignment effect of insider ownership tends to be overwhelmed by the adverse effect of insider ownership on underinvestment, producing an optimal firm value at a low level of insider ownership. If one accepts that weak law allows large private benefits, the alignment effect of insider ownership becomes pronounced because large private benefits alone diminish the concern over underinvestment. As a result, a high level of insider ownership unambiguously leads to an optimal firm value. The value effect reversal of insider ownership under small versus large private benefits is consistent with the empirically documented relationships between firm value and insider ownership in dispersed versus concentrated ownership structures around the world (Denis and McConnell, 2003).

(4) Our model predicts positive as well as negative announcement effects of seasoned equity issues. If assets-in-place are likely to have a low value—diminishing the adverse selection effect, and if the market expects growth prospects but with a lot of uncertainties, new equity issues are likely to convey good news. This prediction, however, is ruled out in the original Myers and Majluf (1984) framework, because their pre-announcement stock price is too high due to their truncation of negative NPV's of new investment in the expectation. While this prediction is similar to Cooney and Kalay (1993), our analysis not only resolves the incentive compatibility problem but also explicitly decomposes the sources of announcement returns, producing a non-monotonic relationship between announcement returns and expected growth.

(5) The justification for positive announcement effects of some equity issues produces a generalized version of the Myers' (1984) pecking order in financing. When the uncertainties about the firm value

comes primarily from assets-in-place—the source of adverse selection as reaffirmed by Myers (2002), the adverse selection effect dominates and the classic Myers pecking order rules; conversely, when asymmetric information comes mainly from growth rather than assets-in-place, the adverse selection discount in equity issues tends to disappear and even to be reversed. This suggests that stock price volatilities may not necessarily discourage new equity issues. Recent corporate finance literature has drawn a lot of attention to the popular argument of managerial timing in response to the market mispricing in new equity issues (Baker and Wurgler, 2002). This paper points out some rationality behind those new equity issues that are well received by the market, and this rationality makes investors difficult to evaluate whether there is mispricing.

In conclusion, the work of this paper has substantially enriched the Myers-Majluf asymmetric information framework in explaining many important issues of corporate finance and governance.

## **Appendix: Some Peripheral Issues about the model**

In this appendix, we discuss some corner solutions (section A.1) and show how an agent cost based on private benefits of control makes more economic sense than transactions costs in enriching the original Myers and Majluf framework (section A.2).

### **A.1 No asymmetric information about assets-in-place or about growth opportunities.**

In general, asymmetric information arises from assets-in-place as well as from investment opportunities. If there is no asymmetric information about the assets-in-place, the equilibrium firm value at  $t=0$  becomes  $P_{is} = S + a + \bar{B}(M') - c$ , and condition (1) accordingly becomes

$$E \frac{a + S - \frac{c}{w}}{a + \bar{B}(M') + S - c} \leq E + b + c \left( \frac{I}{w} - 1 \right). \quad (9)$$

Note that when  $b$  as well as  $\bar{B}(M')$  are non-negative and  $c=0$ , condition (9) is always satisfied. This is exactly the situation in Myers and Majluf (1984) where firms always issue to invest. In our setting, however, since  $b$  and hence  $\bar{B}(M')$  may take negative values, the decision to issue is not a sure thing. Thus, the announcement effect in this extreme case is driven purely by the information about investment opportunities and whether the effect is positive or negative depends on condition (6) or (7).

On the other hand, if there is no asymmetric information about investment opportunities, the equilibrium firm value becomes  $P_{is} = S + \bar{A}(M') + b - c$ , and condition (1) takes the form

$$E \frac{a + S - \frac{c}{w}}{\bar{A}(M') + b + S - c} \leq E + b + c \left( \frac{I}{w} - 1 \right). \quad (10)$$

When  $b + c(I/w - 1) = 0$ , condition (10) is reduced to  $a \leq \bar{A}(M')$ . This is a typical situation of Akerlof's (1970) market breakdown, as discussed by Myers and Majluf (1984), that firms will not issue except when  $a = a_{\min}$ , which is the minimum value of  $A$  (known to the market). Otherwise, the decision to issue always has information content. Thus, if there is no asymmetric information about either assets-in-place or investment opportunities, new issues in our setting do not as easily degenerate into the no-information-content situation as those in Myers and Majluf (1984).

## A.2 Private benefits versus transaction costs.

In Myers and Majluf (1984), and in Cooney and Kalay (1993) as well, the indifference line that separate the region to issue and invest from the region to do nothing intercepts at  $P_{is} - S$  on the  $a$ -axis. In contrast, our indifference line shifts to the right by  $\frac{c}{w} + \frac{cP_{is}}{E} \left( \frac{I}{w} - 1 \right)$ , which is positive, due to positive private benefits,  $c$ , as shown in Figures 1 and 2. If  $c$  goes down to zero, our indifference line converges to theirs as a special case of equation (2). Note that because managers/controllers have no incentives to take any negative NPV projects when  $c=0$ , the distribution of  $B$  should be truncated at zero as shown by Myers and Majluf.

Myers and Majluf (1984) suggest that issuing costs can, indeed, turn a slightly positive NPV project into an acceptable negative one. Cooney and Kalay (1993) recapture this idea as one of their arguments to produce the prediction of possible positive announcement effects. Myers and Majluf show that the indifference line in this case takes the form

$$b + E = \frac{E + T}{P_{is}}(S + a), \quad (11)$$

where  $T$  is the issuing costs. Note that the issuing costs cannot be easily assumed away by treating  $b$  as an after-cost NPV (as in the case of ordinary project expenses) because there is an additional dilution effect so that more shares have to be issued to build up enough before-cost proceeds. But the after-cost NPV of the new investment is  $b - T$ , which can be negative and is truncated at  $-T$ , because  $b$  always remains non-negative in Myers and Majluf (1984).

What does the region of overinvestment look like in this case? Without loss of our insight, let us ignore the effects of  $T$  on the slope and the intercept of equation (11), and consider the after-cost  $b$ . It turns out that the region is not the whole region of  $M3$  like in Figure 2, but it is limited to the top part of region  $M3$  truncated at a horizontal line parallel to the  $a$ -axis at  $-T$  on the after-cost  $b$ -axis. Obviously, this region of overinvestment depends very much on the magnitude of the transaction costs. Fundamentally different in our model, however, we just need to assume a small value for  $c$  to make valid the whole region of overinvestment as shown by region  $M3$  in Figure 2 (by considering even the original  $b$ ). Thus, private benefits rather than transaction costs are more appealing in explaining overinvestment.

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**Table 1:**

**The Announcement Effect, (A)+(B), of Equity Financing Decomposed into Two Underlying Information Effects, from Assets-in-place (A) and from New Investment (B)**

Scenario	(A) Information Effect About <i>A</i>	(B) Information Effect About <i>B-c</i>	(A)+(B)	Announcement Effect
(1)	+	+	+	+
(2)	+	-	+	+
(3)	+	-	-	-
(4)	-	+	-	-
(5)	-	+	+	+
(6)	-	-	-	-



**Table 2: Expected Loss of Firm Value Due to Under- and Overinvestment**

This table reports simulated expected losses of firm value at  $t = -1$  due to under- ( $LU$ ) and overinvestment ( $LO$ ), along with their occurring probabilities (Prob.). Underinvestment happens with probability  $F(M2)$ . The ensuing *ex ante* loss of firm value is  $LU = F(M2)\bar{B}(M2)$ . Overinvestment occurs with probability  $F(M3)$ . The *ex ante* loss of firm value is  $LO = F(M3)\bar{B}(M3)$ , which is shown being negative (see Figure 2). For ease of comparison,  $LU$  and  $LO$  are scaled by  $F(M1+M2)\bar{B}(M1+M2)$ , which is the expected value added as if the firm were to issue and invest whenever there are good investments, and hence are given as percentages. The value of assets-in-place,  $A$ , and the NPV of investment opportunities,  $B$ , are jointly normally distributed with zero correlation. Parameters when fixed are shown right below the title of each panel.  $\bar{A}$ ,  $\bar{B}$ ,  $\sigma_A$  and  $\sigma_B$  are means and standard deviations of assets-in-place and the NPV of investment opportunities, respectively. Other parameter values include new issue size,  $E$  ( $=I-S$ ), investment scale,  $I$ , financial slack,  $S$ , private benefit,  $c$ , and insider ownership,  $w$  (in percentage). We let  $\sigma_A$ ,  $\bar{B}$ ,  $E$  (or  $I$ ), and  $S$  vary, respectively, in Panel A, B, C, and D to examine their effects on under- and overinvestment. The number of simulation runs is 10,000. And the simulated probability distributions are truncated at  $A > 0$ , and  $B > B_{\min}$  (i.e., the critical value of NPV, less than which the firm will never launch any new project). This information is available to the market before the firm reveals whether or not it will issue to invest at  $t=0$ .

	LU	Prob.	LO	Prob.
<b>Panel A: Under/overinvestment and Uncertainty about Assets-in-place</b>				
$\bar{A}=100, E=50, \bar{B}=10, \sigma_B=10, c=5, w=0.51, S=0$				
$\sigma_A$				
10	0.00	0.02	-5.35	14.01
25	2.40	4.14	-4.30	11.00
50	32.09	31.47	-2.70	6.31
75	65.91	57.30	-1.64	3.54
100	74.01	63.30	-1.17	2.69
<b>Panel B: Under/overinvestment and Expected NPV of New Project</b>				
$\bar{A}=100, \sigma_A=50, E=50, \sigma_B=10, c=5, w=0.51, S=0$				
$\bar{B}$				
5	73.83	53.31	-3.27	4.31
10	29.50	30.11	-2.56	6.39
25	2.31	3.52	-0.05	0.38
50	0.01	0.01	0.00	0.00
75	0.00	0.00	0.00	0.00
<b>Panel C: Under/overinvestment and New Issue/investment Scale</b>				
$\bar{A}=100, \sigma_A=50, \bar{B}=10, \sigma_B=10, c=5, w=0.51, S=0$				
$E=I$				
5	0.01	0.01	-2.29	9.40
10	0.10	0.53	-2.72	9.34
25	4.83	7.81	-3.10	8.48
50	31.12	31.03	-2.53	6.12
75	63.15	55.50	-1.55	3.61
100	73.04	63.01	-1.17	2.67
<b>Panel D: Under/overinvestment and Financial Slack</b>				
$\bar{A}=100, \sigma_A=50, I=50, \bar{B}=10, \sigma_B=10, c=5, w=0.51$				
$S$				
1	26.17	27.06	-3.01	6.77
5	19.18	21.17	-3.17	7.34
15	6.94	9.99	-3.40	8.23
25	1.83	3.91	-3.22	8.82
35	0.22	0.87	-2.77	9.11
45	0.00	0.00	-2.02	9.47

**Table 3: Effects of Financial Slack on Under- and Overinvestment, and Firm Value**

This table reports simulated expected losses of firm value due to under- (LU) and overinvestment (LO) as well as firm value ( $P_b$ ) at  $t = -1$  in relation to financial slack ( $S$ ). To adjust for initial endowments of financial slack, we use  $P_b - S$  for comparable firm valuations. Constant parameter values are  $\bar{A}=100$ ,  $\bar{B}=10$ ,  $\sigma_A=50$ ,  $\sigma_B=10$ ,  $I=50$ . Others vary as shown in the table, with  $c=5$  in Panel A and with  $c=10$  in Panel B. Also  $w$  takes a value of 0.1, 0.25, 0.50 and 0.75 respectively. The bordered numbers highlight the highest firm values for a range of  $S$  in various scenarios. The simulations are run in the same way as in Table 2. See also the notes there for the description of probability distributions and the definitions of parameters.

$S$	$w=0.1$			$w=0.25$			$w=0.5$			$w=0.75$		
	$LU$	$LO$	$P_b - S$	$LU$	$LO$	$P_b - S$	$LU$	$LO$	$P_b - S$	$LU$	$LO$	$P_b - S$
<b>Panel A: Under/overinvestment and Firm Value (<math>c=5</math>)</b>												
1	0.00	-7.75	107.52	5.35	-5.66	107.66	27.69	-2.85	106.92	48.51	-1.70	105.80
5	0.00	-7.77	107.51	3.26	-5.79	107.75	21.04	-3.04	107.31	37.00	-1.94	106.55
10	0.00	-7.77	107.51	1.67	-5.98	107.79	13.99	-3.20	107.73	25.37	-2.15	107.29
15	0.00	-7.77	107.51	0.69	-6.17	107.79	8.25	-3.28	108.05	17.25	-2.22	107.79
25	0.00	-7.77	107.51	0.05	-6.46	107.74	2.02	-3.36	108.32	5.39	-2.17	108.49
45	0.00	-7.77	107.51	0.00	-6.78	107.67	0.00	-2.40	108.43	0.01	-0.53	109.25
<b>Panel B: Under/overinvestment and Firm Value (<math>c=10</math>)</b>												
1	0.00	-7.60	102.06	0.38	-7.25	102.16	13.99	-4.42	102.97	44.18	-2.23	103.13
5	0.00	-7.60	102.06	0.21	-7.34	102.13	9.76	-4.57	102.99	34.05	-2.44	103.33
10	0.00	-7.60	102.06	0.06	-7.40	102.11	5.73	-4.77	102.95	22.38	-2.70	103.55
15	0.00	-7.60	102.06	0.01	-7.45	102.09	2.83	-4.94	102.88	13.63	-2.86	103.63
25	0.00	-7.60	102.06	0.00	-7.57	102.07	0.54	-5.21	102.70	3.70	-2.80	103.63
45	0.00	-7.60	102.06	0.00	-7.60	102.06	0.00	-5.25	102.48	0.00	-1.37	103.60

**Table 4: Effects of  $c$  and  $w$  on Under- and Overinvestment, and Firm Value**

This table reports effects of private benefits,  $c$ , (Panel A), and insider ownership,  $w$ , (Panel B), on simulated expected losses of firm value due to under- and overinvestment, and the firm value at  $t = -1$ , as well as the firm valuation under various  $c$  and  $w$  combinations (Panel C). Financial slack,  $S$ , is set zero. Other constant parameter values are shown below individual panel titles. The bordered numbers highlight the highest firm values for a range of  $c$  or  $w$  shown in the table. In Panel C, smaller  $c$  values (0.1, 1, and 5) correspond to strong law reinforcement while larger  $c$  values (10, 15, and 25) reflect weak law reinforcement. The dash-line bordered numbers highlight the value optimality for various  $c$  and  $w$  combinations: all, under strong law enforcement, under weak law enforcement, and under the assumption that  $c$  and  $w$  are highly negatively correlated (the group of shaded numbers). The simulations are run in the same way as in Table 2. See also the notes there for the description of probability distributions and the definitions of parameters.

Panel A: Under/overinvestment and Firm Value in Relation to Private Benefits					
$\bar{A}=100, \sigma_A=50, \bar{B}=10, \sigma_B=10, E=50, w=0.51$					
$c$	$LU$	Prob.	$LO$	Prob.	Firm Value
0.1	54.59	51.15	-1.45	3.31	108.10
1	49.78	47.17	-1.70	3.82	108.22
5	31.72	31.88	-2.85	6.32	107.53
10	15.82	16.91	-4.10	9.17	104.39
15	8.16	9.13	-5.33	11.52	99.73
25	2.20	2.65	-6.78	14.08	89.27

Panel B: Under/overinvestment and Firm Value in Relation to Insider Ownership					
$\bar{A}=100, \sigma_A=50, \bar{B}=10, \sigma_B=10, E=50, c=5$					
$w$	$LU$	Prob.	$LO$	Prob.	Firm Value
0.05	0.00	0.00	-7.79	15.92	108.20
0.1	0.00	0.02	-7.77	15.86	108.21
0.25	5.19	6.67	-5.64	12.37	108.39
0.35	14.57	15.94	-3.96	9.14	108.18
0.51	33.90	33.23	-2.44	5.78	107.31
0.75	50.39	46.90	-1.59	3.76	106.41

Panel C: Firm Valuation Optimality under Various $c$ and $w$ Combinations									
$\bar{A}=100, \sigma_A=50, \bar{B}=10, \sigma_B=10, E=50$									
$c$	$w=0.05$	$w=0.1$	$w=0.25$	$w=0.35$	$w=0.50$	$w=0.75$	Max	Min	Max-Min
Strong 0.1	108.48	107.61	107.11	107.08	107.00	107.00	108.48	107.00	1.49
Law 1	112.08	111.26	108.66	108.00	107.26	106.79	112.08	106.79	5.29
5	108.14	108.15	108.27	108.05	107.34	105.86	108.27	105.86	2.41
10	103.14	103.14	103.27	103.57	104.10	104.14	104.14	103.14	1.00
Weak 15	98.14	98.14	98.16	98.41	99.44	101.73	101.73	98.14	3.58
Law 25	88.14	88.14	88.14	88.17	89.03	94.98	94.98	88.14	6.84
Max	112.08	111.26	108.66	108.05	107.34	107.00	112.08	107.00	
Min	88.14	88.14	88.14	88.17	89.03	94.98	94.98	88.14	
Max-Min	23.94	23.12	20.52	19.87	18.30	12.02			

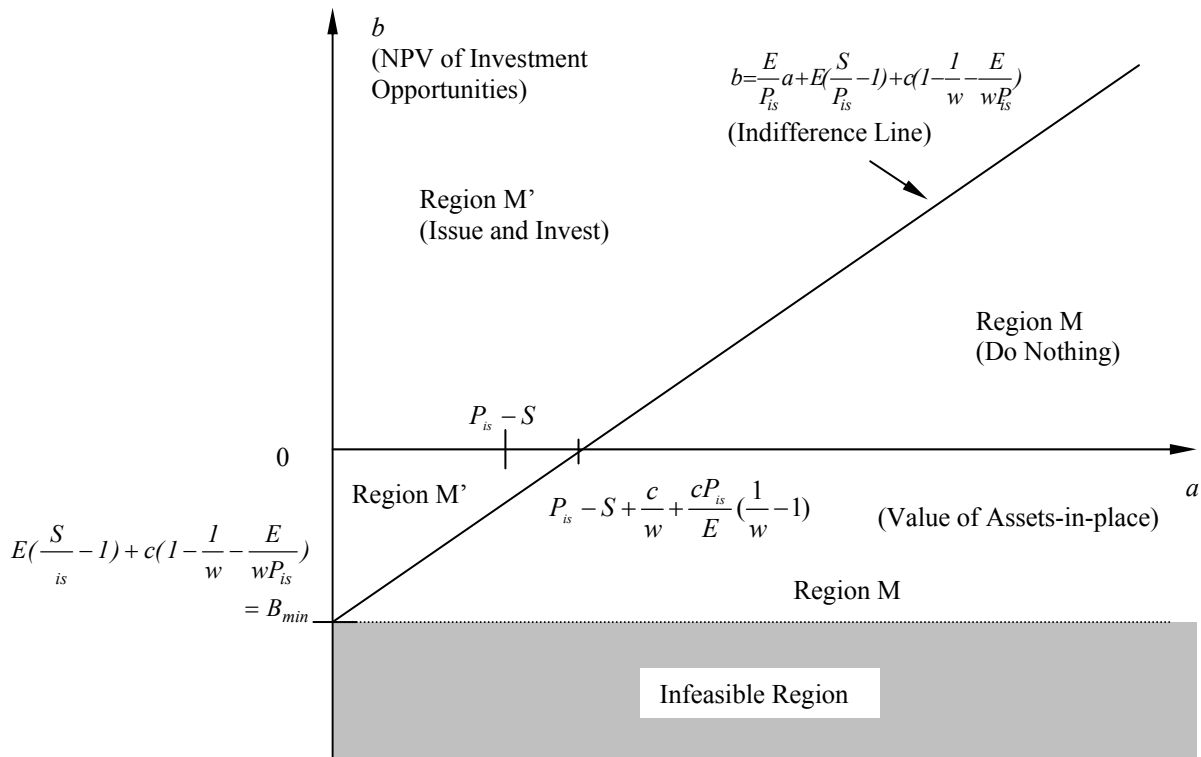
**Table 5: Underlying Effects on Announcement Returns**

This table reports simulated SEO announcement returns in relation to relative uncertainty about the expected NPV of new investment or growth (Panel A), to the expected growth (Panel B), and to the expected growth opportunities and uncertainties varying in tandem (Panel C). Throughout the table, we also use two different expected assets-in-place values,  $\bar{A} = 5$ , (in the left half of the table), or  $\bar{A} = 10$ , (right half), each under various issue/investment scales. We also keep insider ownership,  $w=0.51$  (or 51 percent), constant but allow the private benefits,  $c=E/10$  (which is tied with  $E$ ), to vary. The announcement return is measured as the percentage change in firm values from  $t=-1$  to 0. In Panel A, with the expected growth,  $\bar{B} = 1$ , growth uncertainties,  $\sigma_B=1$ , we let the standard deviations of  $A$ ,  $\sigma_A$  to vary. The relative uncertainty about growth opportunities is actually  $\sigma_B/\sigma_A = 1/\sigma_A$  (not explicitly shown). In Panel B, we let the expected growth vary. In Panel C, we impose the restriction of  $\bar{B} = \sigma_B$  so as to allow the expected growth and uncertainty to vary in tandem. The relative expected growth is actually  $\bar{B}/\bar{A}$  (not explicitly shown, with the growth uncertainty being constant in Panel B and with the uncertainty changing in tandem in Panel C). Financial slack,  $S$ , is set zero. Simulation is run exactly the same way as in Table 2.

$\bar{A} = 5$				$\bar{A} = 10$		
$E=1.00$		$E=2.00$	$E=3.00$	$E=1.00$	$E=2.00$	$E=3.00$
<b>Panel A: Announcement Return and Relative Uncertainty about Growth</b>						
$\bar{B}=1.00, \sigma_B=1.00, c=E/10, w=0.51$						
$\sigma_A$						
0.50	1.41	0.73	0.23	0.96	0.64	0.33
0.75	1.26	0.54	0.07	0.92	0.58	0.26
1.00	1.06	0.29	-0.21	0.83	0.48	0.17
1.25	0.83	-0.08	-0.66	0.74	0.35	0.00
1.50	0.49	-0.59	-1.33	0.62	0.16	-0.22
1.75	0.15	-1.15	-2.23	0.49	-0.07	-0.45
2.00	-0.28	-1.93	-3.38	0.31	-0.35	-0.78
2.25	-0.73	-2.80	-4.57	0.15	-0.63	-1.19
<b>Panel B: Announcement Return and Expected Growth</b>						
$\sigma_A=1.00, \sigma_B=1.00, c=E/10, w=0.51$						
$\bar{B}$						
-2.00	-7.24	-27.82	-45.25	-1.05	-5.65	-10.10
-1.00	-1.37	-10.08	-19.63	0.60	-1.84	-4.85
0.00	1.22	-1.59	-4.60	1.42	0.27	-0.86
1.00	1.10	0.24	-0.19	0.93	0.41	0.12
2.00	0.16	0.05	0.00	0.17	0.06	0.02
3.00	0.00	0.00	0.00	0.01	0.01	0.00
4.00	0.00	0.00	0.00	0.00	0.00	0.00
5.00	0.00	0.00	0.00	0.00	0.00	0.00
<b>Panel C: Announcement Return and Expected Growth with Uncertainty in Tandem</b>						
$\sigma_A=1.00, c=E/10, w=0.51$						
$\bar{B} = \sigma_B$						
0.50	-0.28	-1.17	-1.33	0.12	-0.20	-0.34
1.25	1.41	0.73	0.21	1.02	0.79	0.37
2.00	1.63	1.59	0.99	1.28	1.34	1.02
2.75	1.51	1.97	1.44	1.24	1.58	1.45
3.50	1.21	1.96	1.62	1.18	1.66	1.68
4.25	1.67	1.82	1.73	1.15	1.72	1.74
5.00	0.97	1.73	1.77	1.06	1.65	1.80
5.75	0.92	1.63	1.69	0.92	1.63	1.76

**Figure 1:**

**A Firm's Issue-invest Decisions under Asymmetric Information between the Market and the Firm's Informed Insiders who Have Insider Ownership,  $w$ , and Obtain Private Benefits ( $c > 0$ ) from New Investments**



**Figure 2:**

**Expected Under- and Overinvestment for a Firm's Issue-invest Decisions under Asymmetric Information between the Market and the Firm's Informed Insiders who Have Insider Ownership,  $w$ , and Obtain Private Benefits ( $c > 0$ ) from New Investments**

