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PRIVATE PLACEMENTS AS SOURCES OF LONG TERM FUNDS FOR PUBLICLY QUOTED FIRMS IN THE NIGERIAN CAPITAL MARKET

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Abstract

Private placements are gradually becoming means of raising long-term funds in the Nigerian capital market by publicly quoted companies. These practices previously regarded as illegal gained renewed attention when the Securities and Exchange Commission (SEC) granted approval to some publicly quoted banks desirous of utilizing it in raising long term funds. This paper begins with a look at the Nigerian capital market. Thereafter, an overview of the concept of private placement is given to enable a better appreciation of its unique role in raising funds for organizations that are not publicly quoted in a registered stock exchange. It concludes with an exposition of the problems of allowing private placements for publicly quoted firms.

Introduction

In every society, there are always persons or institutions with funds in excess of needs as well as those who are in deficit positions. The deficit economic units resort to borrowing in order to cover their shortfalls. In an attempt to raise funds most organizations proceed to the capital market. Private placement is increasing becoming a means of raising long-term funds in the capital market of most developed and emerging economies. It is basically, used to refer to the sale of securities of a

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company that is not quoted on the floor of a regular stock exchange to a select group of investors. Private placements have long been considered illegal for publicly quoted companies in raising funds for growth in most developed and emerging markets (Nigeria inclusive). It was reserved primarily for private unquoted companies as well as small firms who are desirous or raising long term funds; but who are unable to bear the technicalities and cost of an initial public offer (IPO).

In recent times however, some emerging markets have relaxed their rules and regulations which barred publicly quoted firms from raising funds in the capital market through private placements. This trend has found its way into the Nigerian Capital Market as reflected in the leeway given some months ago by the Securities and Exchange Commission (SEC) to some publicly quoted banks desirous of utilizing private placements as a means of shoring up their capital base; in the light of the then Central Bank of Nigeria directive to all banks to increase their capital base to N25 billion within 18 months, such banks effectively utilized private placements without going through the stress of floating a seasoned new offer (IPOs as it is commonly referred to by the investing public).

Private placements from its very name is supposed to be private, and allowing firms that are publicly quoted in the Stock Exchange to engage in it could prove very dangerous as it could lead to a great deal of malfeasance in the capital market.

Against this background, the objective of this paper is to provide an overview of private placements as sources of long term funds for publicly quoted firms in the Nigerian Capital Market. It also looks at the legal/moral incorrectness of allowing private placements of publicly quoted firms as well as the dangers inherent in allowing such practices to continue in the capital market most especially as Nigeria still falls under the emerging markets status.

The Nigerian Capital Market

The Capital Market is a market for long term or longer term Funds and Securities whose tenor extends beyond one year. Typically however, long term funds are held for a minimum of five years to perpetuity; but corporate entities and government sometimes pool funds having a maturity of more than one year but less than five years usually referred to as "Medium Term Funds".

The Capital Market is a network of institutions and mechanisms existing for the mobilization and exchange of long and medium term funds in the form of shares, bonds and derivatives. It provides efficient access to opportunities for saving, long-term funds for industrial development, debts repayment and liquidity mechanism for investors (Osamwonyi and Anikamadu, 2002).

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Nwankwo (1980) noted that, the Capital Market exists to provide borrowing and lending opportunities, and enables the authorities to mobilize long-term capital for economic development of the country. It provides facilities for foreign firms to offer their shares and Nigerian investors to own foreign equities and opportunities for fresh capital to be raised in the market. It also facilitates the quotation and ready marketability of shares and stocks and maintaining code of conduct for the actors and their activities in the market. The market provides a healthy and mutually acceptable environment for participation, ownership and co-operation of local and expatriate capital in the joint effort to develop the Nigerian economy to the mutual benefit of all the parties involved.

The need for an efficient capital market in a developing economy like Nigeria cannot be overemphasized, as medium to long term financial intermediation process is important to allocative efficiency and operational efficiency in the utilization of scarce economic resources within the economy. Functions of the capital market include financial intermediation, offering enterprises opportunities for obtaining funds, acting as a means of ascertaining security prices, means of efficiently trading in securities, allocating and rationing funds. For the Nigerian capital market in particular, small to medium scale industries are encouraged through the second-tier market, bondification of domestic national debt, financing oil and gas industry, privatization and commercialization and internationalization of security exchanges (Osaze, 2002).

There are various sources of long term funds opened to organizations in the capital market. Basically sources of funds to organizations can be grouped into internal and external sources. Internal sources of funds are mainly from retained earning (proportion of profit that is not spent). External sources of funds include debt or equity financing or both. For instance, when firms need to raise capital they may choose to sell (or float) new securities. These new issues of stocks, bonds, or other hybrid securities typically, are marketed to the public by investment bankers on behalf of the issuing company in what is called the primary market. Purchase and sale of already issued securities among private investors takes place in the Secondary Market (Bodie et al, 1999).

There are two types of primary market issues of common stock; namely: Initial Public Offering (IPOS) and seasoned new issues. Initial public offerings are stocks issued by a formerly privately owned company selling stock to the public for the first time while seasoned new issues are offered by companies that already have floated equities. A Primary Market issue could also be either a public offering, which is an issue of stock or bonds sold to the general investing public and which also can be traded on the Secondary Market; or a private placement which is an issue that is sold

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to a few wealthy or institutional investors at most, and in the case of bonds, is generally held to maturity (Bodie et al, 1999).

Private Placements as Sources of Long Term Funds

Private placement is a sale of an issue of securities by the issuing company directly to a limited number of investors, often only one or two large institutional investors, such as a bank or an insurance company. It is basically a direct private offering of securities to a limited number of sophisticated investors. It is the opposite of a public offering. Olowe (1997) opined that private placement is an arrangement whereby an issuing house arranges for the company shares to be bought privately by small number of investors such as high networth individuals and institutional investors.

A private placement as the name indicates is a placing carried out privately rather than through the Stock Exchanges new issue market. A private placing of securities could be described as occurring on the primary finance market (Freear, 1985). In private placements, securities are placed by a Stockbroker with clients who have already agreed to subscribe, Advertising and underwriting costs are avoided, the security does not benefit from access to the Stock Exchange trading market. Also they tend to be smaller in size with low marketability which greatly reflects in its price.

Reasons for Private Placements

Private placements occupy a particular niche in the Capital Market of most economies where it serves as a veritable means of raising long term funds for small and medium size firms. Such firms are usually faced with the highest issue costs in public issues (Brealey and Myers, 1996). Such firms in dire need of funds who are faced with high floatation cost would find private placements very enticing. Private placement is best used when:

- A company needs cash to turn itself around and cannot spell out its hopes in a prospectus to raise funds by public subscription. Hence, sophisticated investors are invited privately "who can make a value judgment on the company's prospects and put up the money for investment purposes only;
- The company wants to raise money for special purposes, like a take-over or merger quickly;
- The privately owned company needs the financial muscle for going public;
- A privately owned company wants to remain private but desires to use the facilities provided by the capital market for funds raising (Osazc, 2002).

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Problems of Allowing Private Placements for Publicly Quoted Firms

Private placements are very much likely to have more restrictive covenants than public issues since it is easier to negotiate a private placement in the event of a default. The interest rates on private placements are usually higher than those on an equivalent public issue. This difference reflects the trade-off between a higher interest rate and more flexible arrangements in the event of financial distress, as well as the lower costs associated with private placements (Ross et al, 2003).

Furthermore, private placements lead to problems of undervaluing the shares of public investors in such a way that share prices do not reflect the true worth, value or market value of the firm. This, usually prevents price discovery which is the first value being sought in any developed capital market. It also does not encourage equal public access to the ownership of the shares of quoted companies; which leads to inequitable distribution of the wealth of the nation as a select group of individuals, corporate cabals, or institutions are usually targeted.

Full information disclosure is not as stringent as in the public offer, and as a result it does not guarantee the interest of the investing public as a public offer would. Corporate governance issues which are very fundamental in public offers are very much capable of being less emphasized in private placements. Private placements could lead to a great deal of market malfeasance as well as reduce the revenues of capital market participants if allowed for publicly quoted companies. It is bound to be quite secretive and does not usually increase the awareness of the general public in the activities of the capital market.

Conclusion

The use of private placements for publicly quoted firms in the Nigeria stock exchange is an unwelcome development quite capable of reducing the level of vibrancy that obtains in the capital market now. Furthermore, it could lead to a great degree of market malfeasance by market operators, reduce income of market participants as well as reduce the level of information which the investing public can have access to. This reduces emphasis on corporate governance as well as reduces the standard of the Nigerian Capital Market.

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