

Impact of business groups on the pricing of IPO's on the Tel Aviv Stock Exchange, 2004-2007¹

Aharon Cohen Mohilever²; Gitit Gur Gershgoren

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Summary

The phenomenon of business groups that are incorporated in a pyramid-shaped structure is widespread in the Israeli economy. In recent years, public discussion has turned on the impact of this phenomenon on the level of business concentration in the economy, and on activity within the non-financial and financial Israeli markets. A committee has been appointed to deal with the problem of increasing competitiveness in the market (the "Concentration Committee"). This paper examines a particular aspect of the concentration issue: the ownership by business groups of financial brokers who manage other people's money. This research presented in this paper focuses on the period between 2004 and 2007. The paper's findings were presented to the Concentration Committee and constituted the basis for changes made by the Israel Securities Authority in order to deal with the issues that were raised within the framework of the committee.³ These changes include, *inter alia*: the definition of the purchase of securities in related offerings as conflict of interest transactions; requiring fund managers to conduct analysis to support investing decisions; and requiring fund managers to provide monthly reports which include information regarding purchases in related offerings, and the board of directors' position regarding such. Additionally, in the years 2008-2009, a number of fund managers were subjected financial penalties because they violated statutory provisions regarding the approval of coordinated and OTC transactions (including purchases through issues) and/or with regard to the manner of their reporting. After the Concentration Law and the above-mentioned regulatory changes are assimilated, there will be a need to re-examine these aspects in order to see whether the expected societal, value-related and regulatory changes had actually occurred. These subjects will be examined when the data needed for such a review will accumulate.

An examination of all the IPO's in the Israeli economy between January 2004 and December 2007 shows that ownership by business groups of financial brokers leads to overpricing of the group's initial offerings and a significantly lower return on the investment in issues by companies that belong to business groups

¹ **The views expressed in this paper do not necessarily reflect the position of the Israel Securities Authority.**

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² London Business School

³ We have reviewed the steps taken by the ISA here, but other regulators have also taken various actions with a similar objective.

owned by mutual funds who participated in the offering. These findings indicate that the groups may be using the financial brokers in order to support the offering price for companies belonging to the group. The findings show that there is a higher probability that funds participate in the issues of companies belonging to their business group and that they will sell the shares purchased in the issue very quickly. These findings are an expansion of the finding in research literature regarding the transfer of wealth from minority shareholders to the controlling shareholders in business groups (tunneling).

These phenomena can point to a deficiency in the allocation of resources, because companies belonging to business groups are offered at a higher price. These findings do not negate the possibility that notwithstanding this, there is a benefit for savers as a result of a broker belonging to a business group - a benefit which can be set off against (or possibly even exceed) these possible disadvantages. (An example would be the advantages obtained as a result of preferential access to information about the issuing companies.)