

**Melbourne Centre for Financial Studies
Academic Research Grant**

A Study of Companies Listed on the Australian Securities Exchange based on the Commitments Test Entity Rule

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1. Background and aims of project

This project aims to examine the performance of all companies listed on the Australian Securities Exchange (ASX) on the basis of the ‘commitments test entity’ rule. Specifically, we aim to compare returns of ‘commitments test entities’ to those of companies listed according to the assets test or the profits test rules. We also expect to be able to shed some light on the delisting rates of ‘commitments test entities’.

As a result of the Commonwealth Law Economic Reforms Program (CLERP), entities that did not satisfy the listing requirements under the general admission criteria could list on the ASX as a Commitments Test Entity, if an agreement about the use of offer proceeds was reached with the Securities Exchange. Thus, CLERP and the amendments of ASX listing rules, implemented on 1 September 1999, resulted in a relaxation of listing rules and improved access for relatively small and recently established entities to public equity finance. These companies would otherwise struggle to obtain adequate amounts of finance and could have decided to relocate to markets where equity finance was more readily available. Costs of equity finance for early-stage businesses would also likely be higher if unable to raise capital through ASX.

The Commitments Test Entity listing standard is not very restrictive. A company that is not a going concern, does not have accounts’ history for the previous three years and is currently unprofitable, can list on the Australian Securities Exchange by raising \$10 million capital from investors conditional on making commitments to the ASX about the investment of proceeds. The Securities Exchange is enforcing the compliance of Commitments Test Entities through submission of a quarterly cash flow report to the ASX (Appendix 4C, ‘quarterly report for entities admitted on the basis of commitments’). The current institutional settings provide us with an opportunity to examine the effect of recent changes to ASX listing rules on returns to investors. We are also afforded an opportunity to examine the effects of the stock market cycle on equity funding and returns performance of recently listed companies (our sample would include post-April 2000 listings when equity funding was increasingly difficult to get for less established and recently listed entities). This research would also indicate that the academic disciplines of accounting and finance are continually examining and evaluating any developments in financial markets relevant to investors, to the regulators, and to companies listed on the Australian Securities Exchange.

We propose to examine returns performance of companies listed on the Australian Securities Exchange (ASX) since the introduction of the Commitments Test Entity listing rule by the Securities Exchange (in March 2000).¹ This rule provides an avenue for companies unable to satisfy the general admission criteria (the profits test or the assets test) to gain listing on the ASX based on commitments to use the offer proceeds according to agreements made with the Securities Exchange. We also intend to provide insights into any subsequent delistings (due to mergers and acquisitions, or bankruptcy). Thus, our aim is to provide a comprehensive examination of recent evidence on returns performance of recently listed initial public offerings on the Australian Securities Exchange. Implications of our research findings are likely to be relevant to investors seeking to diversify and include Commitments Test Entities into their investment portfolios. The

¹ Commencing 13 March 2000, the Australian Securities Exchange introduced changes to the regulation of company financing in Australia (see, Chapple, Clarkson, and Peters, 2005).

results would also be of relevance to regulators (the Australian Securities Exchange and the Australian Securities and Investments Commission) when considering amendments to current listing rules and equity financing regulation. Furthermore, the findings of the proposed research could be of assistance to companies making equity financing decisions. We estimate that this research could be completed within eight to ten months. We intend to submit the findings to Pacific Basin Finance Journal for consideration for publication.

2. Significance and Innovation

Commitments Test Entity listing rule provides an avenue for unprofitable (usually young) companies to gain listing on the ASX. Similar rules have been adopted by other stock exchanges (for example, the London Stock Exchange Alternative Listings Market - AIM in 1995). Thus, it is of great significance to evaluate the 'success' of these listings on the ASX as reflected in their share price performance subsequent to IPO as well as to systematically examine any delistings (due to bankruptcy or mergers and acquisitions). Insights about share returns on Commitments Test Entities may prove valuable to investors and the regulators, as well as research intensive young companies contemplating alternative sources of finance. Research methods used (presented in the 'Description of Approach' would be comparable to those commonly used in IPO research. This would enable the interested readers to compare our findings with historical evidence on IPOs or with any concurrent research on changes in listing rules in other financial markets.

3. Description of Approach

We require daily share price data for ASX listed companies between January 2000 and June 2005 (share prices to June 2008 are needed to examine long-term returns following listing for up to three-years or delisting). Share price data for this research is to be obtained from the Securities Industry Research Centre of Asia-Pacific (SIRCA). Additional information is to be extracted from offer prospectuses and company announcements. Subject to availability, the information would include (but are not limited to): market and book value of equity at listing, entity age at listing, and offer specific information (for example, offer subscription price, percent of retained ownership after listing, value of shares offered, offer underwriting and management fees).

Returns would be measured as cumulative excess returns, as well as buy-and-hold returns (returns would be adjusted for relevant industry index performance, or by using the matched-firm approach to benchmarking returns). We intend to use multiple regression models to examine returns performance of initial public offerings (both Commitments Test Entities and remaining IPOs) using data collected from offer documents and ASX company announcements. Moreover, we would use logit (or probit) regression models to examine the likelihood of delisting by recent ASX listed IPOs. For this purpose, explanatory variables constructed from public information collected from offer documents and company announcements would be used to explain the variability in the dependent variable (listing day returns, long-term returns, and incidence of delisting). Our proposed empirical model for listing day and long-term returns takes the following form:

$$R_i = \beta_0 + \beta_1 \text{CTE} + \beta_2 \text{EPS} + \beta_3 \text{LN_AGE} + \beta_4 \text{B/M} + \beta_5 \text{OFR_PR} + \beta_6 \text{RETAIN} + \beta_7 \text{UW_FEE} + \beta_8 \text{LN_VALUE} + \epsilon_i$$

where:

- CTE – dichotomous variable with unity representing IPOs listed as Commitments Test Entities;
- EPS – is a dichotomous variable with unity representing positive earnings forecast in the offer prospectus;
- LN_AGE – denotes a natural logarithm of the number of days between the incorporation and ASX listing date;
- B/M – is the book to market value of equity ratio (estimated market value at IPO subscription price);
- OFR_PR – is the reciprocal of the IPO subscription price;
- RETAIN – is the percent retained shares as a proportion of total shares after the IPO;

UW_FEE – represents the underwriting fee as proportion of offer value;
LN_VALUE – is the natural logarithm of the offer value (at IPO subscription price)

Our proposed empirical model for the probability of delisting within three years after going public takes the following form:

$$\text{Prob}(y=1) = \Phi(\beta_0 + \beta_1 \text{CTE} + \beta_2 \text{EPS} + \beta_3 \text{LN_AGE} + \beta_4 \text{B/M} + \beta_5 \text{OFR_PR} + \beta_6 \text{RETAIN} + \beta_7 \text{UW_FEE} + \beta_8 \text{LN_VALUE})$$

where variables are defined as above.

References

ASX Listing Rules. Available at: <http://www.asx.com.au/supervision/rules/listing/index.htm>

Chapple, L., P. M. Clarkson, and C. J. Peters, 2005, Impact of the Corporate Law Economics Reform Program Act 1999 on initial public offering prospectus earnings forecasts, *Accounting and Finance* 45, 67-94.