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Rights Offerings, Renounceability Underwritten Status, Ownership Structure and Liquidity

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1. Abstract

Kothare (1997) argues that increased spreads represents a significant cost to issuing firms shareholders, making rights offerings costlier than firm commitment offerings and finds evidence consistent with this argument in US. However, Balachandran et al (2007) show that high quality firms choose fully underwritten rights issues, intermediate quality firms choose non-underwritten issues and lower quality firms choose partially underwritten rights in Australia. Thus, this study examines the impact of rights offerings on bid-ask spreads between underwritten and non-underwritten rights offerings in Australia to shed some light on the impact of equity issuance on liquidity.

2. Background and aims of project

Heinkel and Schwartz (1986) argue that there is information content in the choice of financing method made by the firm and the choice reveals, either partially or totally, the quality of the firm. Specifically, their "rational expectations, partially revealing information equilibrium" model predicts that (a) high quality firms signal through rights issues with standby agreements (known as underwritten rights issues in Australia) – i.e. such firms are willing to pay the fixed investigation costs associated with standby agreements; (b) intermediate quality firms signal through the subscription price of an uninsured rights issue; and (c) lower quality firms choose firm commitment offers. Balachandran et al. (2007) argue that high quality firms will select fully underwritten rights issues, intermediate quality firms will select non-underwritten rights issues while lower quality firms will choose partially underwritten rights issues, and they find results consistent with their arguments in Australia.

Kothare (1997) shows that rights offerings are followed by a significant increase in proportionate bid-ask spreads after the ex-date for US firms, whereas firm commitment offerings are followed by a significant decrease in proportionate bid-ask spreads, and these changes in spreads are correlated with changes in ownership structure of the issuing firms. She argues that this finding explains why managers prefer firm commitment offers in the US, particularly larger firms with more diffuse ownership structures and frequently traded stocks. However, her sample focuses on non-underwritten rights offerings (82 are non-underwritten and 3 are underwritten rights issues). Our calculations reveal an average price reaction in the US, from the day before the announcement date to day of the offer expiration, of -12.34% for non-underwritten rights issues of industrial firms compared to -3.52% for underwritten rights issues of industrial firms and -2.67% for the firm commitment offers of industrial firms (see table 8 in Eckbo and Masulis, 1992 in pages 320-321). Ursel (2006) finds that rights issues are used by firms in financial distress with difficulty accessing underwriting services in US. She argues that these firms have little to lose from the costs of adverse selection that accompany the lack of underwriter certification of non underwritten rights issues. Moreover, subscription price (usually much lower than the market price prevailing at the subscription price release date) for rights offerings are released on the ex-date in the US instead of at the initial announcement date. In Australia, the subscription price is announced with the initial announcement of the rights offering. Synthesising all of these considerations, we argue that changes in bid-ask spread after the ex-date will vary between underwritten rights offerings and non-underwritten rights offerings. If high quality issuers use fully underwritten rights issues as documented by Balachandran et al (2007), then there should not be any increase in bid-ask spread after the ex-date for underwritten rights offerings.

2. Significance and innovation

This will be the first study to examine the differential impact of rights offerings on liquidity between underwritten rights and non-underwritten rights offerings. The US is typified by wide dispersion in share ownership whereas Australia has high ownership concentration. Slovin et al (2000) argue that the paucity and vintage of samples of US rights offerings make it difficult to obtain a definitive assessment of the relative effects of alternative flotation methods. Unlike in US, rights offerings are popular in Australia. Given the similarity of American and Australian corporate finance, differences in the practices used in each country to price and market seasoned equity and differences in ownership structure (diffused versus concentrated), provide a setting that facilitates an examination of the effects of rights offering on liquidity using a large sample of rights offerings in Australian market. Thus, this will shed further light on the impact of equity issuance on liquidity.

3. Description of Approach

We will use two proxies for liquidity: average trading turnover and percentage bid-ask spread. The former is calculated as the average of daily trading turnover (volume divided by the total issued shares) for a year (we will also examine for 100 working days) prior to the announcement of rights offering, as well as the corresponding period after the ex-date. The latter is computed as the average daily percentage bid-ask spread (the difference in closing bid and ask quotes, divided by their mid-point) for the same period. We will compare the average bid-spread and average daily turnover between the periods prior to the announcement date and the corresponding period after the ex-date to identify whether there are liquidity changes after the ex-date for fully underwritten, non-underwritten, and partially underwritten rights offerings. We will also compute a ratio of pre announcement period average bid-ask spread to post ex-date average bid-ask spread; and pre announcement period average trading volume to post ex-date trading volume and examine whether they differ between fully underwritten, non-underwritten and partially underwritten rights offerings using parametric ANOVA test statistics and non-parametric Kruskal Wallis test statistics. We will also examine the changes in liquidity against pre announcement ownership variables (directors' holdings and substantial holdings) as well as post takeup ownership variables (directors' holdings and substantial holdings) using regression analysis.

Robustness Check: We will also identify control firms for each rights issue announcement that meet the following criteria: (a) similar industry; (b) 70% to 130 of the market value of the announcer on the announcement date; (c) closest BM ratio of the announcer prior to the announcement date of sample firm; and (d) did not announce rights offerings one year prior to one year after the sample firm's announcement date. We will examine whether the average daily turnover and average spread varies between the announcers and control firms for a year after the ex-date as well as pre announcement period.

Outcome of this project will lead to an ARC grant application examining the impact of underwritten versus non-underwritten rights offering on liquidity around the world.

References

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