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Market reaction to "unsweetened" and "sweetened" rights offerings in an emerging European stock market

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Abstract

This research investigates the market reaction to both "unsweetened" (plain) and "sweetened" (with simultaneous distribution of bonus issues) rights offerings in the Istanbul Stock Exchange. Consistent with previous U.K. and U.S. evidence, although with larger magnitude, the announcement day abnormal returns for "unsweetened" rights offerings are negative and significant, suggesting that such issues convey unfavorable information about the future operating performance, investment opportunities, liquidity and dividend policy. In contrast, for "sweetened" rights offerings, the abnormal returns are positive. The empirical results do not provide evidence for the enhanced trading liquidity effect (the "sweetener" split effect) and for the overvaluation signaling effect.

JEL classification: G3; G32

Keywords: Rights offerings; Signaling; Liquidity

1. Introduction

The market reaction to seasoned equity offerings has been the focus of a significant number of empirical investigations in developed capital markets, especially in the U.S. where corporations predominately use firm commitment public offerings in issuing seasoned equity. Empirical studies in these capital markets show significant negative announcement returns conveying negative

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signals about the firm value. Even though rights offerings are rarely used in the U.S., an average negative announcement effect of −2% is observed.[1] In the U.K., continental Europe and in many emerging markets, rights offering is the primary flotation method. Slovin et al.'s (2000) study on "insured" and "uninsured" rights offerings in the U.K. reports negative announcement returns of −2.9% and −5% respectively. Similarly, Gajewski and Ginglinger (2002), and Marsden (2000) find negative announcement effects for the French and New Zealand corporations respectively. However, in other markets such as Switzerland, Japan, Malaysia, Korea, Greece, Germany and Norway, several studies report positive announcement effects (e.g., Loderer and Zimmermann, 1988; Kang and Stulz, 1996; Salamudin et al., 1999; Kang, 1990; Tsangarakis, 1996; Gebhardt and Heiden, 1998; Bohren et al., 1997).

Several hypotheses have been put forward to explain the market reaction to seasoned equity issues, including adverse selection and signaling effects associated with information asymmetries, agency costs of free cash flow, wealth transfers between classes of security holders, and moral hazard problems in lowering managerial stock ownership. The signaling hypothesis appears to be the most developed theoretically and supported empirically (e.g., Myers and Majluf, 1984). However, this hypothesis and others do not completely explain the unfavorable/favorable market reaction evidence to equity issues in different institutional settings. Investigation of market reaction and underlying motivations in different institutional and geographical settings makes this research potentially enlightening, especially for the managers of multinational corporations.

There is only a limited amount of research on market reaction to rights offerings in emerging markets that have the following typical institutional settings: (1) Corporations can only use rights offerings in their seasoned equity issues; (2) there is a lack of organized secondary market for the rights; (3) there is a low diffusion of ownership; (4) there is a weak commercial paper market; and (5) there are limited financing alternatives for corporations. The Istanbul Stock Exchange (ISE) is an emerging European capital market with these institutional characteristics.

Seasoned equity issues are called "paid-in capital increase" issues in the Turkish capital market. Like in the rest of Europe, rights offerings are the norm in the ISE. Plain rights offerings are called "unsweetened" rights offerings and rights offerings with simultaneous distribution of bonus issues are called "sweetened" rights offerings in the ISE. Bonus issues are similar to stock dividends in the U.S., but they are not financed from retained earnings and/or distributable profit. Bonus issues in Turkey are mainly financed by using the "revaluation reserve", an equity account in which the fixed assets are adjusted for inflation by a constant ratio announced by the Ministry of Finance periodically.[2] To a certain extent, the balance sheets are adjusted for the persistent inflation in Turkey by using the revaluation reserve.

This research investigates the price behavior of "unsweetened" and "sweetened" rights offerings during the announcement period and tries to shed light on the motivations and characteristics of corporations using these two types of rights offerings. The market reaction to clean samples of "unsweetened" and "sweetened" rights offerings is investigated for the period 1994–1999. The results show large negative abnormal returns of −7.1% during the announcement period of "unsweetened" rights offerings. These results are similar to the U.S. and the U.K. where the

[1] White and Lusztig (1980), Hansen (1988), and Eckbo and Masulis (1992) detect negative announcement effects of −1.03%, −2.61%, and −1.39% respectively.

[2] Bonus issues are common corporate practice in several emerging markets such as China, Australia, Greece and India, and especially in countries with inflation problem. In addition to the revaluation reserve, other equity reserves used occasionally are the share premium account, the cost revaluation account, the capital gain from the sale of corporation's real estate and the capital gain from the sale of the corporation's portfolio of participatory shares.