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The choice between rights and underwritten equity offerings: Evidence from Chinese stock markets[☆]



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ABSTRACT

We study the choice and valuation effects of alternative flotation methods using a sample of Chinese firms that must meet the return on equity (ROE) thresholds set by the government to raise equity capital. The ROE requirement, although changed over time, seems to play an important role on the valuation and performance of seasoned equity offerings. The analysis of 219 rights and 75 underwritten offerings between 2000 and 2004 shows that Chinese firms that are not qualified for the flotation method with a higher ROE requirement suffer the most at announcement and experience significantly lower buy-and-hold abnormal returns than those that are qualified. Our results suggest that the freedom to choose their preferred flotation method may be valuable to firms that meet the higher ROE requirement. Finally, our probit models identify several determinants of the choice of flotation methods.

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1. Introduction

The choice between rights and underwritten equity offerings has been a topic of interest to financial economists since the publication of Smith (1977). Most studies have centered on the ‘rights offering

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paradox' issue¹ as Smith (1977) and Eckbo and Masulis (1992) show that the direct flotation costs of rights offerings are lower than those of public underwritten offerings, but fewer than 10% of U.S. firms issue seasoned equity directly to existing shareholders through rights offerings. In those studies, firms are free to choose flotation methods. However, what if firms do not have the luxury of selecting rights or underwritten offerings? In China, due to unique regulatory requirements, firms may not have the freedom to choose their preferred flotation methods, providing a great opportunity to study the choice as well as the valuation effects of alternative methods.

In the Chinese stock markets, a rights issue used to be the only source to raise seasoned equity capital, but underwritten public offerings have emerged since 1998. The number of underwritten issues has increased significantly and surpassed that of rights offerings for the first time in 2002, consistent with the international trend. According to the Chinese security regulation, before March 28, 2001, a listed firm may issue rights only if its ROE is above ten percent in each of the three most recent years, whereas no such requirement exists for underwritten offerings. By identifying and studying the three groups of firms – firms that issued rights, firms that were qualified for rights but issued underwritten offerings, and firms that were not qualified for rights offerings so issued underwritten offerings – we provide insights to the choice of flotation methods and the corresponding market responses.

From March 28, 2001 to June 20, 2002, the ROE requirement was six percent for both rights and underwritten offerings. During this particular period, qualified issuing firms had the opportunity to choose their preferred flotation method. However, starting on June 21, 2002, the ROE requirement was raised to ten percent for underwritten offerings whereas the requirement for rights issues remained at six percent. Because of this regulation, in this period, three groups of firms – firms that issued underwritten offerings, firms that were qualified for underwritten offerings but issued rights, and firms that were not qualified for underwritten offerings so issued rights – can be identified and examined. The results from this analysis along with the evidence obtained from groups during earlier periods provide us with a better understanding of the choice of flotation methods and the valuation effects.

Although a trend toward a greater use of underwritten offers is evident in a number of countries, the valuation effects of announcements of seasoned equity issuances do not seem to be internationally consistent. International comparisons of flotation methods are interesting because the relative frequencies of rights and underwritten offerings differ substantially across countries. Existing theories do not provide a convincing story to explain the cross-country variation on the choice of flotation methods. In addition, empirical evidence on valuation effects of seasoned equity issues is mixed. For example, Slovin et al. (2000) study the flotation methods in the United Kingdom and find that placings (a form of public securities issuance comparable to the U.S. firm commitment offering) generate a significantly positive two-day excess return of 3.3%, contrary to the negative returns observed in the U.S. markets. Bøhren et al. (1997) also find that the two-day abnormal announcement return is significantly positive for uninsured rights issues on the Oslo Stock Exchange, again contrary to the U.S. evidence.

Using a sample of 219 rights offerings and 75 public underwritten offerings in Chinese stock markets during 2000–2004,² we find negative announcement-day returns, consistent with information-based

¹ Existing explanations for the paradox include capital gains taxes (Smith, 1977), the selection bias argument (Hansen and Pinkerton, 1982), the transaction costs hypothesis (Hansen, 1988), the adverse selection model (Eckbo and Masulis, 1992), and the liquidity reduction argument (Kothare, 1997). However, there is currently insufficient evidence to suggest that any of these alternative explanations can resolve the paradox. Miles and Peterson (2002) use a different approach and find support for the selling cost explanation of the paradox. In a related study, Khorana et al. (2002) find significant conflicts of interest in rights offerings by closed-end funds. Although our study may have some implications on the paradox, we have no intention to provide a solution to the paradox.

² The sample period starts in 2000, the year when underwritten public offerings became widely available to Chinese firms, and ends in 2004 because no SEOs were allowed between September 2004 and January 2005 due to regulatory debates and reviews of the SEO regulation. As a result of the regulatory scrutiny, no rights offerings were issued in 2005 and 2006. Although three and seven underwritten public offerings were issued in 2005 and 2006, respectively, we do not include these issues in our sample due to the lack of a comparable group of rights offerings. New SEO regulations have become effective since April 2006.

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