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## Franking credits and market reactions: Evidence from the Australian convertible security market



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### ABSTRACT

This study investigates whether convertible preference share issues affect firm value in Australia. The literature suggests that the announcement of straight equity issues has a negative impact. However, the outcome for convertible preference share issues (CPS) remains unknown. We selected those CPS deemed to be equity-like under the 2001 tax classification framework for this study, as only such convertibles may attach franking credits to their dividends. In line with the straight equity studies, we found significant and abnormal negative returns during the announcement periods. We initially report no statistical significance between the issuing firm's available franking credit levels and market reaction. When we controlled for ownership concentration, however, we found a positive and statistical association. This is the first study to report such an association within the CPS market, suggesting that equity-like CPS resident investors may seek franking credits and so react positively to an issuing firm's level of available franking credits.

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## 1. Introduction

The effect of announcements of straight equity issues on firm value within a full imputation tax system such as Australia has been investigated by [Beggs and Skeels \(2006\)](#). However, their study

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excluded convertible preference shares (CPSs). Given the unique Australian regulatory regime and its tax environment, the size and sign of the market reaction to CPS issues remain unknown. [Linn and Pinegar \(1988\)](#) and [Davidson et al. \(1993\)](#) in the US and [Abhyankar and Dunning \(1999\)](#) in the UK found significant negative abnormal returns for announcements of CPS issues. [Suchard \(2001\)](#), [Ng \(2004\)](#) and [Tan \(2004\)](#), however, have reported inconsistencies in the magnitude, direction and significance for Australian CPSs.

To date, most market reaction studies have been conducted in the US under a classical tax regime. Australia, Canada, Chile, Mexico and New Zealand are all regulated by a full imputation tax system, where investors receive a tax credit on dividends paid from earnings on local corporate tax. Shareholders can then use these franking credits to offset their own tax liability. As dividends and their ability to attach franking credits impacts firm value differently to a classical tax system, the price reaction to CPSs under an imputation system remains unclear. This gap within the literature motivated us to ask the following research question: what is the market reaction to a firm's announcement of a CPS issue under an imputation system?

Of all the full imputation jurisdictions, Australia is the ideal environment to address this question. It has an active convertible market, and since 2001, its tax laws clearly distinguish between debt- and equity-like issues, with only the latter convertibles being allowed to attach franking credits to their dividends. Before 2001, no framework existed to classify such securities and consequently firms misclassified them. This prompted the Treasury to work with industry to differentiate debt-like from equity-like convertibles. This is a critical issue within the convertible market, as the current literature often struggles to separate a debt- from an equity-like security. While a convertible security's legal form is recorded at issuance, its true tax classification is generally determined by its economic substance. The substance over form debate has caused uncertainty and concerns for issuers and investors. Australia's Debt and Equity Tax Act 2001 addressed this issue by listing the following characteristics determining whether a convertible security is equity-like<sup>1</sup>: (i) the interest carries a right to a return that is effectively contingent on the firm's economic performance; (ii) conversion to equity is at the discretion of the company; and (iii) it is issued in perpetuity or has a maturity greater than 10 years.

Furthermore, franking credits attached to dividends have important implications for investors in Australia. The demand by resident taxpayers for such credits plays a crucial role within the Australian capital market ([Suchard and Singh, 2006](#)). The 2001 Simplified Tax System Act allows resident taxpayers with low tax rates, such as pension funds, not-for-profit organizations and low-income earners to cash any unutilized credits on receipt of franked dividends. Previously, any unutilized credits were forfeited. This development has not been addressed in prior studies ([Suchard, 2001](#); [Ng, 2004](#); [Tan, 2004](#)).

In addition, [Truong and Partington, 2008](#) report a positive market reaction to straight-equity issues from firms with higher levels of franking credits. Conversely, [Feuerherdt et al. \(2010\)](#) note that as the marginal investor is a non-resident and barred from utilizing such credits, no statistical relevance is expected. These mixed results motivated us initially to calculate the market reaction over our entire sample, and then replicate the analysis on a subset controlled for investor type (i.e., resident vs. non-resident). We also employed the 2001 Debt and Equity Tax Act to select only equity-like convertible preference issues, i.e., the securities allowed to attach franking credits. Then, we extended our research further by investigating the market reaction to CPSs on issues deemed to pertain to resident investors only. We subsequently expected a more positive market reaction by firms with higher levels of available franking credits. Hence, a firm's propensity to dispense franking credits may be an important characteristic to investors within a dividend policy perspective in a full imputation tax system like Australia.

We employed an event study methodology to measure share price changes before and after the announcement of 85 new convertible preference share issues deemed to be equity-like issues under the 2001 Act. The announcements were made over the period 2001–2010. Overall, we found significantly negative abnormal returns during a firm's announcement period, indicating that the Australian

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<sup>1</sup> This study includes only convertible preference securities meeting these characteristics, as we are interested in their ability to attach franking credits to dividends.

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