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Price reaction to rights issues in the Indian capital market

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Abstract

This study examines securities price reaction to announcements of rights issues by listed Indian firms during the period 1997–2005. We document a positive but statistically insignificant price reaction to such announcements. The price reaction is significantly more negative for firms with a family group affiliation compared to firms with no family group affiliation. The notable differential price reaction between firms with and without a family group affiliation can be explained by the "tunneling hypothesis." For firms affiliated with a family group, we surmise that investors perceive that the proceeds of the rights issue may be misused for the benefit of the controlling shareholder. We also find that higher levels of individual shareholding in the firm are associated with a more positive price reaction to the announcement.

JEL classification: D82; G14; K22
Keywords: Price reaction; Rights issues; Disclosure regulation; Informed trading; Event study

1. Introduction

This study examines share price reaction to the announcement of rights issues in India. Rights issues are commonly used by firms in many countries to raise new capital. This is documented, among others, in Australia (Balachandran et al., 2007), China (Wang et al., 2006), Greece (Tsangarakis, 1996), Hong Kong (Ching et al., 2006), Korea (Dhatt et al., 1996), Malaysia

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(Salamudin et al., 1999), New Zealand (Marsden, 2000; Anderson et al., 2006), Norway (Bφhren et al., 1997), Singapore (Tan et al., 2002), Turkey (Adaoglu, 2006) and UK (Slovin et al., 2000).

In the United States, most industrial firms rely solely on firm-commitment underwritten offers or seasoned equity offerings (SEOs) to obtain new equity finance. For US firms, the share price reaction to both firm-commitment underwritten offers and rights offers has almost invariably been negative (see, for example, Mikkelson and Partch, 1986; Barclay and Litzenberger, 1988; Hansen, 1989; Eckbo and Masulis, 1992). Several hypotheses have been advanced to explain the negative price reaction to new equity issues and the choice of flotation method for new equity in the US. This includes the signaling hypothesis of over-valuation of assets (Myers and Majluf, 1984), the tax advantage to debt (DeAngelo and Masulis, 1980), agency costs and wasteful investment (Jensen and Meckling, 1976; Stulz, 1990) and the price pressure hypothesis (Corwin, 2003). More recent evidence by Kim and Purnanandam (2006) suggests US investors react negatively to firm-commitment offers when they perceive managers will misuse the issue proceeds and engage in value-destroying corporate acquisitions or negative NPV investments. However, when investor and manager interests are well-aligned, Kim and Purnanandam (2006) find the price reaction insignificant around the announcement period of the offer.

US firms that raise equity through underwritten offers are typically large and share ownership is widely dispersed. For these firms, Eckbo and Masulis (1992) posit that the expected level of current shareholder take-up to any rights issue would be low and that a firm-commitment underwritten offer minimizes information asymmetry and adverse selection costs between the issuer and investors. Hansen (1989) argues that a firm-commitment offering enables underwriters to sell equity to new investors at the current market price and avoids the need to incur a price discount required to raise new equity under a rights issue. Kothare (1999) also presents evidence that rights issues in the US increase the bid-ask spread of the issuing firm's stock. These hypotheses and explanations of a negative price reaction to US equity issues do not, however, fully explain price reaction to the announcement of equity issues in other markets. For instance, Balachandran et al. (2007) report an insignificant price reaction, on average, to the announcement of a fully underwritten renounceable rights issue and a significantly negative price reaction for non-underwritten non-renounceable issues in an Australian setting. This contradicts Eckbo and Masulis (1992), who report significant negative price reactions for underwritten rights issues and insignificant price reactions for non-underwritten issues. Wang et al. (2006) reports a significant positive abnormal return of 4.8% on the ex-date for Chinese rights issues. They also document a significant and positive relationship between post-offering abnormal returns and changes in the operating performance of rights issuing firms. Empirical studies from Japan (Kang and Stulz, 1996), Norway (Bφhren et al., 1997), Switzerland (Loderer and Zimmermann, 1988) and Korea (Kang, 1990; Dhatt et al., 1996) document an increase in shareholder wealth around the announcement of rights issues.

In a similar vein, Tan et al. (2002) reports that firms that undertake larger rights issues have higher abnormal returns in Singapore. This evidence is not supportive of the wasteful investment or price pressure hypotheses that may partly explain the negative price reaction to US equity announcements. Tan et al. (2002) attributes a larger rights issue size to more favorable news about the earnings prospects of a firm and postulates that the issue provides a positive signal to investors of greater than anticipated new investment opportunities available to the firm. Similarly, Salamudin et al. (1999) reports a positive price reaction to a rights issue announcement in the Malaysian market when economic conditions are favorable. They attribute this finding to the signaling of profitable investment opportunities when growth prospects are strong in an emerging country. However for Hong Kong, Ching et al. (2006) reports negative abnormal returns to rights issue announcements. Many Hong Kong firms are dominated by insiders — individuals or family members that also take