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Rights issues and creeping acquisitions in India

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ABSTRACT

We analyze the extent to which promoters of firms listed on the Bombay Stock Exchange are using rights issues to circumvent regulatory provisions related to creeping acquisitions. We find that promoters use rights issues that do not have specific objectives for purposes of realizing an increase in their shareholdings. We find that a rights issue often follows a year in which the promoter has realized a loss of shareholdings. The results are especially true for firms belonging to a business group.

1. Introduction

Creeping acquisitions refer to the purchase of company shares by its investors (usually, promoters or shareholders with significant holdings) over a number of small transactions, so as to increase the investors' stake in the company by an economically significant amount without requiring any disclosure or other action by the investors. Thus, creeping acquisitions allow promoters (principal owners) to increase their stakes in firms by up to the maximum amount allowed under the prevailing securities regulations without triggering the need for any action mandated by the regulators.

In this paper, we analyze the extent to which promoters of firms listed on the Bombay Stock Exchange ("BSE") may be using rights issues to increase their stakes in firms, circumventing regulatory provisions regarding creeping acquisitions in the process. We find strong evidence that promoters of Indian firms could be using rights issues as a mechanism for increasing their stakes, and this is particularly true for firms belonging to Indian business groups, which are a collection of publicly traded firms spread across industries with

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significant common ownership and control, usually by a single family (Khanna and Palepu, 2000). Increases in stakes similar to the ones observed related to rights issues would otherwise have triggered disclosure and open offers per the regulatory norms.

The Indian securities markets are primarily regulated by the Securities and Exchange Board of India ("SEBI"), established in 1992 to "protect the interests of investors in securities and to promote the development of, and to regulate, the securities market" (SEBI, n.d.). Over the years, SEBI has taken several steps to improve disclosures by firms and corporate governance. Prominent among these are formation of: the Malegam Committee in 1995 to review disclosure requirements for public and rights issues that resulted in the SEBI Disclosure and Investor Protection Guidelines, 2000 ("DIP guidelines") (Malegam, 2004); the Bhagwati Committee in 1995 (and later, in 2001) to review regulations surrounding substantial acquisitions and takeovers that resulted in the Substantial Acquisitions of Shares and Takeovers Regulations ("Takeover Code") in 1997; and the Kumar Mangalam Birla Committee ("KMBC") in 1999 to identify steps to, among other aims, improve disclosures of financial and non-financial information to investors, and suggest a code of corporate governance practices that resulted in introduction of Clause 49 in the Listing Agreement of the Stock Exchanges in 2000.[2]

SEBI's primary motivations for enacting these regulations have been to improve protection of minority shareholders and improve corporate governance standards in the Indian financial market. For example, a key concern of the Takeover Code was to ensure that minority shareholders don't lose profitable exit opportunities in the event of a change in control through privately negotiated acquisitions, particularly in a business environment of mergers and acquisitions involving foreign companies. SEBI's focus on corporate governance is consistent with studies that have identified various benefits of improvement in corporate governance. For example, a cross-country study by La Porta et al. (2002) finds that firms in countries with better protection of minority shareholders and firms with higher cash-flow ownership by the controlling shareholder have relatively higher valuations. Further, better protection of outside shareholders is also associated with more valuable stock markets (La Porta et al., 1997), greater dividend payouts (La Porta et al., 2000), and higher correlation between investment opportunities and actual investments (Wurgler, 2000).

However, SEBI's regulations related to rights issues seem to undercut SEBI's regulations concerning creeping acquisitions. In particular, SEBI allows any change in promoters' holdings caused by a rights issue not to count towards the creeping acquisition limit when computing the maximum amount by which promoters can increase their stake in the company in a year without triggering public announcement and open offer requirements. Thus, it is likely that promoters may use rights issues to increase their stake and thus circumvent rules related to creeping acquisitions. Such attempts to increase promoter shareholding through rights issue could be motivated by, among others, a desire to recoup a reduction in promoter shareholding in years leading up to the rights issue. We investigate this possibility in the paper.

We also document that the rights issues are being offered at a substantial discount (relative to prevailing market prices) to shareholders. In theory, the discount should provide an incentive to minority shareholders to participate in a rights issue in order to realize profits by subscribing to the issue, acquiring shares at a discount, and subsequently selling shares at the market price. We posit that market frictions such as taxes and transaction costs may be limiting investors' ability to realize short-term gains associated with subscribing to a rights issue and then subsequently selling the rights shares.

We show that rights-issuing firms underperform similar non-rights-issuing companies. The underperformance is both statistically and economically significant. This is especially true for firms that undertake rights issues primarily to augment their working capital or retire debt (i.e., firms with non-specific objectives for the rights issues).

Our findings should concern policy makers like SEBI, because the ability of promoters to increase their stakes in firms, especially at prices below the market value of the stock of the rights-issuing company, is detrimental to the interests of minority shareholders, the very constituency that SEBI intends to protect. Increased promoter ownership concentrates more cash flow and voting rights in the hands of the promoters, potentially allowing them to make decisions that are disadvantageous to the minority shareholders. Increased promoter shareholding concentration through dilutive share issues has been defined as a form of tunneling by Johnson et al. (2000). In particular, Johnson et al. (2000) state that "the controlling shareholder can increase

[2] See http://www.sebi.gov.in/circulars/2003/cir2803.html for reference.