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The long run performance of UK firms making multiple rights issues

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ABSTRACT

This study examines the long run performance of firms offering multiple rights issues in the UK and differentiates between one-time and multiple issuers. By analysing a sample of 1146 rights issues offered by 788 London Stock Exchange listed industrial companies between 1988 and 2008, this study reports that firms making multiple rights issues do not experience significant long run underperformance following the third or subsequent issues. However, the one-time rights issuers do experience underperformance during the sample period. The findings of this study thus imply that those firms which are making multiple rights issues are of better quality and investors could avoid loses by investing in firms which had made more than one rights issue in the past. The results also suggest that researchers which are intending to examine the long run post-event performance of firms should control the incidence of similar events that had happened in previous years.

1. Introduction

Prior research shows that investors respond adversely to rights issues announcements and that rights issuers underperform alternative benchmarks in the long run for up to five years after a rights issue (Abhyankar & Ho, 2007; Andrikopoulos, 2009; Iqbal, Espenlaub, & Strong, 2006; Levis, 1995; and Slovin, Sushka, & Lai, 2000). In addition, these firms also outperform these benchmarks during the one year period prior to the issue. Similar results have been observed for the seasoned equity offerings (SEOs) in the US market (Loughran & Ritter, 1997; Spiess & Affleck-Graves, 1995; and Teoh, Welch, & Wong, 1998) and in other countries (see for example, Pastro-Llorca & Martin-Ugedo, 2004, for Spain and Stehle, Ehrhardt, & Przyborowsky, 2000 for Germany). In this regard, D'Mello, Tawatnuntachai, and Yaman (2003) show that those US firms which raise equity more frequently must be distinguished from infrequent equity issuers. Their study finds that the US market responds favourably to frequent and adversely to infrequent equity issuers at the time of equity announcements. It also shows that firms which raise equity more frequently enjoy an improved level of information availability at subsequent equity issues which may be, due to their long term existence, larger size or the press and analysts following. Iqbal (2008), while examining the market reaction to frequent and infrequent UK rights issuers, finds similar results. However, his study does not relate the frequency of equity issue or the incidence of multiple equity offerings to the long run return and operating performance.

Some other recent studies report that the UK rights issuers underperform different benchmarks 'on average' in the long run, however, these too do not distinguish among equity issuers based on whether they are frequent or infrequent issuers (for example, Capstaff & Fletcher, 2011; Andrikopoulos, 2009; Ngatuni, Capstaff, & Marshall, 2007; and Abhyankar & Ho, 2007). Other studies also argue that only good quality firms tend to raise equity more frequently whereas poor quality firms raise equity less frequently (Hovakimian & Hutton, 2010). This finding describes that market participants would expect that good quality equity issuers may experience less or no underperformance whereas poor quality overpriced issuers may observe significant underperformance in the long run.

Keeping in view the uncertainty in findings and limited research on this issue in the UK, this study uses 1146 UK industrial rights issues made over the period January 1988 to June 2008 and examines their long run stock return and operating performance from one year before to three years after the issue. This study is different from previous UK studies and makes a number of contributions. First, we use a larger sample size and expanded time period spanning over 20 years period as compared to other recently published UK studies, which have employed relatively smaller time periods. For example, Capstaff and Fletcher (2011) examine equity/rights issues data over the period

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1996 to 2007, Andrikopoulos (2009) uses data over the years 1988 to 1998, Abhyankar and Ho (2007) use data from 1989 to 1997, and Ngatuni et al. (2007) use data from 1986 to1995 as their sample period. Thus we argue that due to a larger sample size and expanded time period our results are not period specific. Second, this study employs different methods to estimate long run return (BHAR, CAR, Fama–French three and four factor return both in event-time and calendar-time) and operating performance (such as, EBITDA/TA, ROA, ROS) which is also adding new insights to this investigation.

An in-depth investigation of the sample indicates that 603 issues are made by 245 firms (with two or more issues during the sample period) and the remaining 543 issues are offered by single issuers. The results further highlight that, on average, firms making multiple rights issues do not experience significantly negative abnormal operating or stock return performance at or after the third issue whereas one-timers experience statistically negative and significant abnormal performance following their single rights issue. These results are consistent with the market feedback hypothesis on equity issuance which is tested by some recent research findings (see for example, Hovakimian & Hutton, 2010). Thirdly, our findings imply that firms which are making multiple rights issues are of better quality as compared to those which are one-time issuers. We could also relate our results to Billet, Flannery, and Garfinkle (2011) who observe that firms do not experience any underperformance if the incidence of multiple security issuance of a specific type (for example SEOs) is controlled. We may thus argue that investors could study the performance of firms that had made equity issues in the past and avoid investing in firms that are first-time or infrequent issuers. Finally, the results also suggest that studies which examine the long run performance of equity issuers should control the incidence of multiple equity issues made by the same firm. However, existing UK studies in this area such as, Capstaff and Fletcher (2011), Ngatuni et al. (2007), Abhyankar and Ho (2007), and Andrikopoulos (2009) do not control the incidence of multiple equity issues which are limiting the generalisability of their findings and provide grounds for the pursuance of this study.

The rest of this paper is organised as follows. Section 2 describes institutional set up for equity issuance in the UK and reviews prior literature before outlining the testable research hypotheses. Section 3 is detailing the research methodology and data. This section helps in testing the proposed research hypothesis. The section also provides details of the sample selection criteria and data description. Section 4 discusses the results on long run return and operating performance of multiple and single rights issues/issuers. Finally, Section 5 concludes the study by highlighting the main findings, identifying the limitations of the study, and specifying some avenues for future research.

2. Institutional set-up, prior literature and hypothesis development

In order to perform their operations, firms need funds all over their life time. Historically, most of the publicly listed firms in the UK have used a rights issue as their preferred method of generating equity capital. A rights issue gives the existing owners the right to participate in the issue in proportion to their ownership stake in the firm. If this option is not exercised by the owners then they also have the privilege to sell those rights (a call option) in the open market. However, following the deregulation of the UK stock market in the mid-80s, firms have been raising equity through open offers or placings or a mixture of these two. Open offers also give a first right to the existing owners to participate in the new equity issue in proportion to their stake in the firm, however, the open offer letter is not a negotiable instrument. Hence, existing owners have to either purchase the new shares at the stated price (usually at a discount of up to 10%) or just forgo that option.

It is generally agreed that announcement of equity issuance sends a signal (good or bad) to the stock market. The stock market evaluates that signal and re-values those firms upward or downward. Given the markets are efficient, issuing firms' post-issue performance should be similar to other firms in their industries. However, empirical studies show that issuing firms underperform different benchmarks (market or matched firms) in the long run indicating market under-reaction or inefficiency, which is an issue of great concern. In accordance with the tests of the market feedback hypothesis on equity issuance, Hovakimian and Hutton (2010) highlight that firms which experience higher post-issue returns would tend to offer equity again for financial growth.

The adverse market response to rights issue announcements in the UK and to SEOs in the US have been well documented in various studies (see for example, Eckbo & Masulis, 1995; Iqbal, 2008; Levis, 1995; and Slovin et al., 2000) and explained by the adverse selection model of Myers and Majluf (1984). Markets, on average, respond negatively to equity announcements as they perceive such announcements to be a signal of issuing firms' overvaluation, however, they do not fully adjust this overvaluation at the time of announcement. Consequently, due to initial under-reaction, issuing firms continue to underperform in the long run as shown in the US and the UK studies (for example, Abhyankar & Ho, 2007; Andrikopoulos, 2009; Loughran & Ritter, 1995; Ngatuni et al., 2007; and Spiess & Affleck-Graves, 1995). Again, it may be the asymmetric information that causes this prolonged under-reaction (Andrikopoulos, 2009, p-193).

While investigating this issue, Iqbal (2008) finds that the availability of information improves at each subsequent rights issue, made by a frequent UK rights issuer. This study also reports that such firms experience negative but insignificant market reaction at the third and subsequent issues. Given that the information asymmetry diminishes at each subsequent issue and the market reacts less negatively to such issues, it would be worthwhile to study the long run performance of multiple rights issuers, as well. To the best of the authors' knowledge, there is hardly any study that differentiates between the long run performance of frequent and infrequent equity issuers in the UK. In this regard, D'Mello et al. (2003) examine the long run performance of multiple equity issuers in the US and did not find any relation between three year post-issue long run return performance and their sequence, however, the authors observed that operating performance of multiple equity issuers (for their industrial subsample) improve (become less negative) following each subsequent issue.

This study is thus an attempt to examine this relationship in the UK. Recently, Billet et al. (2011) examine the long run performance of firms making multiple-type security issuances (IPOs, SEOs, public debt issues, bank loans, and private equity issues) in the US. They note that multiple security issuances are not very uncommon and point out that previous studies have overlooked this important aspect (that is, multiple security issuance by the same firm) while examining the long run performance. Although they report significant long run underperformance following multiple-type security issues, however, they do not find any significant underperformance following the issuance of any single/specific security type (such as SEOs) after controlling for its multiple issuances.

In addition, Fama (1998), in support of the market efficiency, argues that markets over-react or under-react to different events with similar probabilities in the long run in response to the announcement and expected performance of SEOs. Here the point is that if the markets are efficient then they should not over-/under-react, or it is possible that their reaction is based on the quality of the issuing firm. Hence, it is important to differentiate between the performance of frequent and infrequent equity issuing firms to see if the market reactions are influenced by the issuing frequency and quality, that is, their performance following a previous issue. Fama (1998) also contends that the average underperformance of SEOs may be due to the bad model problem (for example, use of BHARs in cross-section). Recent studies (for example, Barber & Lyon, 1997; Jegadeesh, 2000; and Loughran & Ritter, 2000) suggest alternative methodologies to estimate long run returns to address the bad model problem.