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Market timing of seasoned equity offerings with long regulative process

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ABSTRACT

A long regulative process exists between the initial announcement and execution of seasoned equity offerings (SEOs) in China. Although the initial announcement of an SEO is associated with a significant reduction in the stock price, the regulator (China Securities Regulatory Commission) finally approves it after a significant run up in the price of the stock. Chinese managers execute SEOs after additional stock price increases. As a result, the stock price at issuance is not significantly different from the price on announcement, and is significantly higher than the price three months before the announcement. We also find stock prices decline following the execution. These results suggest that regulative screenings for market stabilization are beneficial for SEO market timing, and that Chinese managers successfully time the market, even with a prolonged regulative process.

1. Introduction

This paper principally investigates how managers successfully time the market when the regulative process generates a long-term interval between the initial announcement and the actual issuance of new shares. Finance theory suggests that managers have incentives to time the market to sell overpriced shares (Myers and Majluf, 1984). A survey by Graham and Harvey (2001) reports that 66.94% of 392 US CFOs indicate that market valuation is one of the most important factors associated with seasoned equity offerings (SEOs). Empirical studies also support the market-timing hypothesis (Baker and Wurgler, 2000; Cohen et al., 2007; DeAngelo et al., 2010). Furthermore, Bo et al. (2011) show evidence that market timing is the most important motive of Chinese SEOs.

It is noteworthy that in the US and other developed countries, only a short interval exists between the initial announcement and actual issuance of the equities. For instance, Mikkelson and Partch (1986) report that the median (mean) length of the interval between the initial announcement and issuance is 18 (27) trading days for their sample of the US common stock issues.[1] The short interval implies that US managers can successfully issue overpriced shares if they can choose an appropriate time for the initial announcement. In contrast, there are regulatory procedures relating to Chinese SEOs that inevitably insert a long interval between the initial announcement and the execution of the SEO. Specifically, the China Securities Regulatory Commission (CSRC) monitors an SEO before it is executed (Glaeser et al., 2001; Zingales, 2009). Since firms need to follow a long regulatory process, the average firm in our research actually issued new shares about 316 business days after the initial announcement.

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[1] Mikkelson and Partch (1986) define the initial announcement day as the earlier of the date of the first report of the offering in the Wall Street Journal (WSJ) and the trading day following the registration at the SEC.

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Moreover, Huang et al. (2015) find a significant stock price reduction following SEO announcements. These facts raise a new question: How can managers issue overpriced shares after a long regulative process?

The following analyses pay particular attention to two post-announcement events. Firstly, we examine the CSRC's approval, since the timing of regulative approval may significantly affect the success of market timing, given that stock prices decline after the initial announcement. In terms of the objective of regulatory monitoring (protection of minority investors' wealth and improvement of market efficiency), the CSRC should prevent firms from issuing overvalued shares. In contrast, the CSRC may have an incentive to approve SEOs when the value of stock prices is ramped up to prevent a serious stock price slump after the stock is issued. Besides, the CSRC might have an incentive to pursue the interests of existing shareholders, of which the state comprises a significant portion. Another event of particular interest is SEO execution. Chinese firms are allowed to actually issue shares during the six-month period following regulatory approval. Managers should choose a day on which the stock price is near or at its highest level during the six-month interval, to the degree that they have market-timing ability. This institutional environment is advantageous, since it enables an investigation of whether SEOs are executed on a high stock price day during the executable period.

Using a sample of 101 SEOs in China between 2006 and 2014, we investigate stock returns between various events in the process of SEO: the initial announcement day, the subcommittee's decision day, the CSRC's formal approval day, the actual execution day, and the day of the execution deadline. Consistent with Huang et al. (2015) and previous US findings, firms experience a significantly positive excess return before the announcement, and stock prices decline significantly afterwards. However, the decline in stock prices stops about two months after the announcement, and we find that the CSRC formally approves the new stock issue after a significant stock price increase. In addition, we find a significant stock price increase between the CSRC's formal approval and the execution of SEOs. As a result, the stock price on the execution date is not significantly different from the price on announcement, and is significantly higher than the price three months before the initial announcement. Finally, stock prices decline significantly between the execution and deadline of the SEO. These results suggest that the choice of the CSRC's approval date is advantageous for SEO market timing, and Chinese managers successfully time the market even after the long-term regulative process.

We implement various additional analyses. We find that the probability of the CSRC's approval is positively related to the market-to-book ratio and negatively associated with the stock volatility, while state ownership is not significantly associated with the CSRC's approval. The result suggests that the CSRC allows firms with strong stock price records to conduct SEOs for market stabilization. To examine whether SEO firms' stocks are actually overvalued, we compute the overvaluation measure developed by Rhodes-Kropf et al. (2005), and find significant and persistent overvaluation during the period from initial announcement and execution. We also compute hypothetical returns during the main events by moving some events (announcement, CSRC's approval, and execution) earlier or later. Results suggest that firms experience significantly lower returns between the announcement and execution of SEOs and higher returns between the execution and deadline when the event dates are moved earlier or later. Although issuing firms offer significant discounts, the actual issue price is not significantly different from the market price on announcement, and is significantly higher than the price three months before the announcement. In addition, we find sample firms increase their cash holdings in the few years surrounding SEOs. Overall, the results suggest that Chinese managers successfully time the market, even within a long regulative process.

This study makes important contributions to the literature. First, we present new findings that the CSRC cares about market stability in the SEO approval process, and such concern is beneficial for SEO market timing. Chen et al. (2005) show evidence that the CSRC plays a disciplinary role for Chinese listed companies. Meanwhile, we present evidence of byproducts of the CSRC's monitoring. Recent Chinese studies have increasingly argued that political connections add value to firms (e.g., Liu et al., 2012). Our results suggest another mechanism through which the government supports private companies, although we do not argue that the Chinese regulative authority intentionally enhances market-timing behaviors. Finally, we offer additional evidence of managers' market-timing ability. Some previous studies present a skeptical view of the management ability of market timing (e.g., Brav et al., 2000; Butler et al., 2005; Eckbo et al., 2000). However, we present evidence of managerial market-timing ability by showing that managers are able to choose a high stock price day during the executable period. Taken all together, we present remarkable evidence that managers successfully time the market, even with a long regulative process.

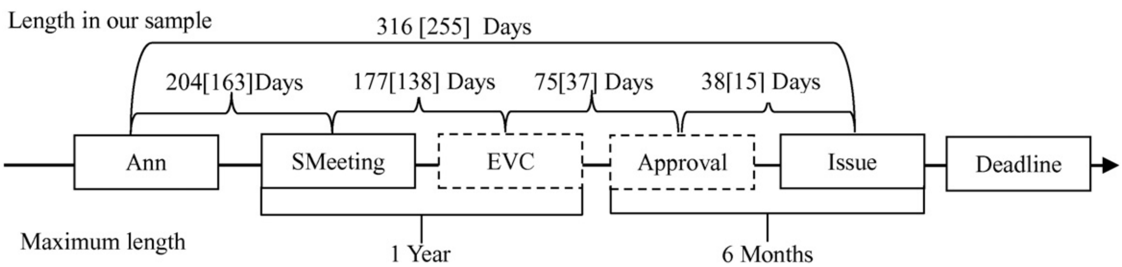

Fig. 1. Seasoned equity offerings process in China. This figure illustrates the main events in the process of Chinese SEOs. The figure also presents mean [median] intervals between events in our sample. Ann indicates the initial announcement. SMeeting is the shareholder meeting. EVC indicates the Examination and Verification Committee decision. Approval is the CSRC's final approval.