Journal of Corporate Finance 24 (2014) 149–157

Contents lists available at ScienceDirect

Journal of Corporate Finance

journal homepage: www.elsevier.com/locate/jcorpfin

Why are conversion-forcing call announcements associated with negative wealth effects?

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ARTICLE INFO

Article history:
Received 3 October 2012
Received in revised form 13 October 2013
Accepted 21 October 2013
Available online 26 October 2013

JEL classification:
G30

Keywords:
Convertible call announcement effects
Signaling
Price pressure
Dividend protection
Hedge funds

ABSTRACT

We analyze call announcement returns taking into account two recent developments in the convertible bond market: the inclusion of dividend protection clauses in convertibles' terms, and the high fraction of convertible issues purchased by hedge funds. Calls of dividend-protected convertible bonds are predictable, yet we still observe a negative stock price reaction that cannot be explained by signaling. Greater hedge fund involvement prior to a call means less short selling in response to the call and we document a reduced price reaction. We conclude that price pressure and not signaling underlies the negative announcement effect of convertible bond calls.

1. Introduction

Companies that issue convertible bonds often include a call provision in the bond's terms and conditions. A call provision gives the issuing company the right to redeem the bond before its maturity date at a pre-specified call price. Survey evidence in Graham and Harvey (2001) suggests that the ability to call and force conversion is important, since the most important reason given for issuing convertibles is that they are seen as an inexpensive way to issue delayed common stock.

A number of empirical studies find that companies that call their convertible bonds experience a negative stock price reaction. A summary of previous studies in Table 1 shows that the estimated effect for in-the-money calls varies between −0.58% and −2.13% depending on the sample period, the methodology, and sub-sample investigated.[1]

The two principal rationales for the negative announcement effect are the signaling model of Harris and Raviv (1985) and the price pressure effect investigated in Mazzeo and Moore (1992) and traced to short-selling in Bechmann (2004). Harris and Raviv (1985) model an equilibrium in which managers truthfully signal by calling convertibles only when their private information is unfavorable.[2] A decision to call is then rationally perceived by investors as bad news and induces a negative stock price reaction, while forgoing an opportunity to force conversion is a signal of favorable inside information.

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[1] The studies in Table 1 all focus on a two or three day event window. Bechmann et al. (2014-in this issue) observe an abnormal return of +1.76% for a sample of out-of-the-money calls.

[2] The model is further developed in Nyborg (1995).

0929-1199/$ – see front matter.
http://dx.doi.org/10.1016/j.jcorpfin.2013.10.003

Table 1
Prior studies on announcement effects of convertible bond calls.

Study	Research period	Event window	Abnormal return defined relative to pre-event window		Abnormal return defined relative to post-event window	
			Abnormal return	Number of observations	Abnormal return	Number of observations
Mikkelson (1981)	1963–1978	(−1,0)	−2.13%***			
Ofer and Natarajan (1987)	1971–1980	(−1,1)	−1.3%[a]	111		
Campbell et al. (1991)	1962–1985	(−1,0)	−1.51%***	167	−0.58%***	167
Mazzeo and Moore (1992)	[b]	(−1,0)	−2.10%***	111	−1.20%***	111
Byrd and Moore (1996)	1975–1990	(−1,0)	−1.17%***	90		
Datta and Iskandar-Datta (1996)	1980–1992	(−1,1)			−1.54%***	50
Ederington and Goh (2001)	1985–1993	(0,1)			−0.70%***	271
Bechmann (2004)	1963–1995	(−1,0)			−1.75%***	309
Bricket al. (2007):						
Equally-weighted	1984–2002	(0,1)	−1.02%***	392	−0.91%***	389
Value-weighted	1984–2002	(0,1)	−0.88%***	392	−0.75%***	389
Bechmann et al. (in this issue)						
In-the-money calls	1993–2007	(0)	−1.53%***	364		
Out-of-the-money calls	1993–2007	(0)	1.66%***	190		

*** indicates statistical significance at the 1% level.
[a] the significance level is not reported by the authors.
[b] the research period is not defined by the authors.

Bechmann (2004) argues that price declines around convertible calls can be explained by short sellers entering the market at the time of a call. Convertible hedge desks try to lock in arbitrage profits by buying convertibles from long-only investors and shorting to hedge their equity risk. Underwriters also hedge their exposure by shorting stock. Bechmann (2004) concludes that the short sales triggered by call announcements create substantial price pressure.

In this paper we study two recent developments in the convertible bond market that a priori might be argued to have a mitigating effect on the negative abnormal returns accompanying call announcements. Both of these developments allow us to provide new evidence on the relevance of the signaling and the price pressure hypothesis. Additional evidence is important as the conclusions of prior studies have been mixed. For example, Datta et al. (2003) observe short-term price reversals after convertible bond calls, but still conclude that convertible bonds convey bad news implicit in their long-term stock price underperformance. On the other hand, Bechmann et al. (2014-in this issue) use high-frequency data to compare the announcement effects of in-the-money and out-of-the-money calls and find evidence for the price pressure hypothesis as the stock market reaction to in-the-money calls is associated with trade order imbalances.

The first development in the convertible bond market that we examine is that most convertible bonds issued today are dividend-protected. When a convertible is dividend-protected, the conversion ratio increases in the event of a dividend payment so as to hold constant the market value of the shares into which the bond is convertible. Grundy and Verwijmeren (2013) document that prior to 2003 convertible bonds were generally not protected against dividend payments while from 2003 on dividend protection of convertible bonds has become the norm. More than 95% of the convertible bonds issued since 2003 are dividend-protected. As a result, rationales for call delay that crucially depend on bondholders forgoing dividends if they do not convert are nullified when the bond is dividend-protected.[3] Grundy and Verwijmeren (2013) document the empirical absence of call delay for dividend-protected convertibles. The absence of call delay has made calls of protected bonds a near perfectly predictable function of the share price. Because of the predictability of these calls, the Harris–Raviv signaling model cannot be used to explain any negative price response that accompanies these calls since perfectly predictable announcements cannot provide signals.

The second potentially mitigating effect on the price reaction to call announcements comes about because a major part of the buy-side of the convertible bond market has changed from long-only investors to hedge fund investors.[4] Convertible bond funds hedge their equity exposure by shorting the underlying stock and, as a result, there is already substantial short selling before any call. The larger the fraction of the bond already held by convertible arbitrageurs at the time of the call, the smaller the additional short-selling in response to a call and the smaller any short-selling induced price pressure.

Comparing calls of dividend-protected and non-dividend-protected convertible bonds, we find that during the period 2000 through 2011 conversion-forcing call announcements are associated with similar negative stock price reactions for both groups. There is no significant difference between the price reaction to the predictable call of a dividend-protected convertible and the price reaction to the less predictable call of one of its unprotected cousins and we therefore conclude that signaling rationales

[3] Constantinides and Grundy (1986) and Asquith and Mullins (1991) argue that call delays occur when firms have an advantage of paying less in (after-tax) interest than they would pay in dividends if the bond were converted.
[4] See e.g. Brown et al. (2012) and Duca et al. (2012).