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# Shareholder nonparticipation in valuable rights offerings: New findings for an old puzzle☆

Clifford G. Holderness, Jeffrey Pontiff*

*Boston College, Carroll School of Management, 140 Commonwealth Avenue, Chestnut Hill, MA 02467 United States*

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ABSTRACT

Shareholder participation in valuable domestic rights offerings averages only 64%, which is considerably lower than previously asserted. This causes wealth transfers from nonparticipating to participating shareholders that average 7% of the offering. Wealth transfers are larger in nontransferable and bigger offerings. The stock market reacts more negatively to larger wealth transfers. Offerings with lower shareholder participation also fall short in raising publicly stated capital goals. Rights offerings are far more common in countries with institutional practices that limit nonparticipating shareholders' wealth losses. These findings suggest that agency conflicts influence the use of rights offers.

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## 1. Introduction

A rights offering is one of three major ways for a public corporation to issue securities, with the other ways being a public sale or a private placement. In a rights offering, shareholders are given the right, but not the obligation, to purchase newly issued securities that are proportional to their fractional ownership in the firm. To provide incentives for shareholders to participate, a rights offering is typically priced at a substantial discount to the exchange price.

Rights offerings are a frequent method for raising capital although there is substantial variation across countries. For example, they are rarely used in the United States, Israel, and Canada. On the other hand, in Italy, 85% of all seasoned equity issuances by value and 63% by numbers are via rights offerings, whereas seasoned public equity offerings account for only 5% and 16%, respectively.[1] In Sweden, rights offerings account for 85% of seasoned issuances by value and 53% by numbers, while public offerings constitute less than 1% by both measures.[2] In many other countries, including such diverse markets as Singapore and the United Kingdom, seasoned equity is far more likely to be raised via a rights offering than a public offering.

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* Corresponding author. Tel.: +1 617 552 6786; fax: +1 617 552 0431.
*E-mail addresses:* clifford.holderness@bc.edu (C.G. Holderness), pontiff@bc.edu (J. Pontiff).

[1] Italian Stock Exchange Website for 2005–2011; http://Table5.borsaitaliana.it/borsaitaliana/statistiche/mediaitaliano/statistiche/mercatoprimario/2011/aumentipagamento.en_pdf.htm.

[2] Cronqvist and Nilsson (2005). We thank Professors Cronqvist and Nilsson for confirming that although legal, public offerings of seasoned equity in Sweden are rare.

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Financial economists have long argued that rights offerings are an attractive way to raise equity capital. Because both public offerings and private placements are typically sold to outside investors at a discount to the exchange price, this discount is a cost to the current shareholders. As Brealey, Myers, and Allen (2014, p. 390) explain, "this cost can be avoided completely by using a rights issue." This conclusion is echoed by Berk, DeMarzo, and Harford (2012, p. 430) who write, "rights offerings protect existing shareholders from underpricing." In addition, Smith (1977) documents that the direct costs of rights offerings are lower than either public offerings or private placements. The term "the rights puzzle" refers to the difficulty financial economists have reconciling these benefits to shareholders with the infrequent use of rights offerings in some countries, notably, the United States.

The conventional wisdom is that virtually all shareholders exercise their rights and purchase stock in a rights offering. For instance, Ross, Westerfield, and Jaffe (2010, p. 637) report that only "a small percentage of shareholders (less than 10%) fail to exercise valuable rights." To the extent researchers contemplate the possibility of significant nonparticipation, it is seen as not mattering for the firm undertaking the rights offer. As Smith (1977, p. 281) writes, shareholder nonparticipation "affects the distribution of wealth among the owners, but it does not impose costs on owners as a whole."

Although it is assumed that the vast majority of shareholders participate in valuable rights offerings, the basis for this belief is unclear. Firms are under no legal obligation to report the participation of shareholders in rights offerings, and many firms do not voluntarily reveal this information. We are aware of no existing reliable data on shareholder participation in rights offerings. In this paper we present such data.

To obtain reliable data on shareholder participation, we contacted domestic companies that had conducted rights offerings. Using hand-collected data from 179 rights offerings from 1988 to 2009, we find that on average only 64% of all rights are exercised. Only 22% of our offerings have participation rates that are consistent with the conventional wisdom of 90% or greater participation. By design, all of the rights offerings we study are in-the-money, so the nonparticipating shareholders are, by definition, leaving money on the table.

We find that shareholder participation tends to be lower for nontransferable offerings, non-pure-stock offerings, and flexible-price offerings that sell stock at a price that is mechanically guaranteed to be at a discount to the exchange price. Shareholder nonparticipation leads to wealth transfers that average almost 7% (median 2.7%) of the capital raised by the rights offering. We also document that the fractional ownership of institutions increases between the announcement and expiration of an offering, suggesting that institutional shareholders fully participate and perhaps even oversubscribe. This mirrors Kothare's (1997) finding that blockholder and insider ownership increase around rights offerings. It appears that rights offerings tend to transfer wealth to blockholders, insiders, and institutions at the expense of other, typically smaller, individual shareholders.[3]

We also find that shareholder nonparticipation has implications beyond the wealth transfers among shareholders. Offerings with low shareholder participation are less successful in raising the stated funds sought than are offerings with high shareholder participation. We also find, as others have found, that the stock-price reaction to the announcement of a rights offering is mildly negative. What we report for the first time is that larger expected wealth transfers among shareholders are associated with a more negative stock-price reaction. We explore several avenues for the apparent connection between the wealth transfers and stock-price reaction.

Finally, we investigate whether shareholder wealth losses might help explain the widely varying frequency of rights offers around the world. Ideally, we would do so by replicating our study for other countries, but this is not practical. Instead, we survey the practice of rights offerings around the world to see if there are protections for nonparticipating shareholders. We find this to be the case, but primarily only in those countries where rights offerings are common. In some instances following the major offering an investment bank sells any unexercised rights through a rump offering. In other instances, brokers automatically sell rights that shareholders do not exercise. In both cases the proceeds are credited to the nonparticipating shareholders. The United States and other countries that have few rights offerings typically offer neither protection. Furthermore, in most countries by law rights offerings must be transferable. This is telling because our findings show that wealth transfers among shareholders are lower in transferable offerings. Yet in the United States only half of all rights offerings are transferable, and many of these rights do not trade on exchanges. Thus, in countries where rights offerings occur more frequently, the expected wealth transfers among shareholders—and the related conflicts among shareholders and with management—are likely to be lower than in the United States. Although we are unable to say whether the popularity of rights offerings is a response to these investor protections or whether the investor protections are a response to the frequency of rights offerings, it is clear that they occur hand-in-hand and that these protections reduce the heretofore under-appreciated conflicts created by shareholder nonparticipation in valuable rights offerings.

## 2. Overview of rights offerings

An overview of key dates and institutional details is helpful for understanding our evidence on shareholder nonparticipation. Table 1 is a timetable and discussion of important dates in a representative domestic rights

[3] If equity is mispriced, underwritten public equity issuance can cause wealth transfer between current shareholders and future shareholders. Kim and Weisbach (2008) present international evidence that is consistent with this type of wealth transfer. This differs from rights offerings where wealth transfers are purely among current shareholders.

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