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Why are rights offers in Hong Kong so different?

Chin-Chong Lee [a,*], Wai-Ching Poon [b], Jothee Sinnakkannu [b]

[a] *Faculty of Business, Communications and Law, INTI International University, Malaysia*
[b] *School of Business, Monash University Malaysia*

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ABSTRACT

Investors react adversely to the announcements of rights offers in Hong Kong and the abnormal return of rights offers on the announcement day is −12.10%. After taking price discounts, underwriting fees and abnormal returns into consideration, the total direct and indirect costs of the seasoned issuers of rights offers are tremendously high. The cross-sectional analysis shows that investors react more adversely to the issuers of rights offers with lower growth prospects, higher free cash flows, larger issue scales, lower pre-issuance stock run up and higher debt capacity. Our empirical result also indicates that cash-rich firms with few investment opportunities and firms with poor quality in terms of lower market-to-book ratio and larger price discounts choose rights offers over private equity placements. All this evidence supports that agency costs and private benefits of control matter in equity financing.

1. Introduction

In this paper we analyze the announcement effects and the choice between two types of seasoned equity offerings (SEOs) in Hong Kong, including underwritten rights offers (also known as standby or insured rights offerings) and private equity placements.[1] The existing shareholders in rights offers are given short-term preemptive rights to purchase new common stock of a firm on a pro rata basis. Alternatively, a firm may attempt to raise funds by a private placement which allows a firm to sell its own newly issued common stock directly to a private group of investors.

We find that the average abnormal return of rights offers on the announcement day is −12.10%. Although this result is similar to the previous research in Hong Kong for rights offers (e.g. Wu and Wang, 2005b; Ching

* Corresponding author. Tel.: +60 6 798 2000; fax: +60 6 799 7513.
E-mail address: chinchong.lee@newinti.edu.my (C.-C. Lee)

[1] In normal circumstances, a rights offer in Hong Kong must be fully underwritten. If not specifically mentioned, rights offers in Hong Kong are underwritten rights offers.

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et al., 2006), the magnitude of the negative price reaction is far larger than the effect of the corresponding rights offerings of −2.09% for industrial firms in the U.S. and in the U.K.[2] (e.g. Hansen, 1988; Eckbo and Masulis, 1992; Slovin et al., 2000). It is a puzzle why issuing firms will choose rights offers while the announcement returns of other SEOs such as public offers and private equity placements in Hong Kong are positive (see Wu et al., 2005). Our cross-sectional analysis indicates that there are more adverse price reactions to the issuers of rights offers with lower growth prospects, higher free cash flows, larger issue scales, and higher debt capacity, implying the support of the argument of both agency costs and private benefits of control in equity financing (Jung et al., 1996; Wu and Wang, 2005a). Currently there is limited research to empirically examine the rich predictions of the agency model by Jung et al. (1996) and the generalized Myers–Majluf model with private benefits of control by Wu and Wang (2005a). This paper contributes to the extant literature by providing empirical evidence which supports the rich predictions of these models.

In the agency model and the generalized Myers–Majluf model, issuing firms with valuable investment opportunities are compared and contrasted with issuing firms without valuable investment opportunities to develop the predictions of the models. In this paper we compare rights offers with private equity placements. Private placements are usually chosen by smaller and younger firms (see Wu, 2004; Cronqvist and Nilsson, 2005) and the asymmetric information about the valuation of these private issuers highly likely arises from growth opportunities rather than from assets in place (Wu et al., 2005). The direct comparison between rights offers and private placements helps sharpen the tests of the rich predictions of the models.

Wu et al. (2005) and an unpublished paper by Wu and Wang (2005b) examine private placements and rights offers in Hong Kong from 1989 to 1997, respectively. There are at least two differences between our sample and their samples. First, we only include the *earliest* rights offer or placement of an issuing firm over the entire period from 2003 to 2011. D'Mello et al. (2003) and Iqbal (2008) document that there is a positive relation between announcement period returns and the sequence of issues. D'Mello et al. (2003) further conclude that the lower negative announcement returns of later announcements of SEOs are because of the decrease of adverse selection costs in the subsequence equity offerings. This implies that the magnitudes of the announcement effects for rights offers and private placements in our study are larger than those in Wu et al. (2005) and Wu and Wang (2005b), which might include the later announcements of SEOs from the same issuing firm. Second, in contrast to Wu et al. (2005), the new shares in private placements in our sample are placed to new investors directly, not placed through investment banks or brokerage firms. Thus the underwriting fees of private placements in our sample are zero.

There are three motivations for undertaking research on the choice of rights offers versus private placements and the announcement effects of these two SEOs in Hong Kong. First, most industrial companies and regulated utilities in the U.S. had switched to firm commitment underwriting offerings since 1970s and the rights issues are in a minority now (e.g. Smith, 1977; Eckbo and Masulis, 1992; Eckbo, 2008). Wu et al. (2005) report that public equity placements (also known as firm commitment underwriting offerings) and private placements are the main forms of SEOs in Hong Kong. However, the recent statistical data in year 2009 and 2010 available from Fact Book published annually by Hong Kong Exchanges and Clearing Limited (HKEx) show that the total funds raised by issuers using underwritten rights offers exceed the total funds raised by issuers using both private and public equity placements (Fact Book, 2009, 2010). Therefore the revival of underwritten rights offers as a means of equity financing by public firms is worth examining closely.

Second, the adverse selection model proposed by Eckbo and Masulis (1992, 1995) predicts that the precommitments of major shareholders to subscribe the rights shares can reduce the adverse selection problems in SEOs and Slovin et al. (2000) provide evidence from the British firms to support this hypothesis. Subscription precommitments are rarely reported in some countries but large numbers of public firms in Hong Kong (i.e. 90% of issuing firms in our sample for rights offers) provide such precommitments in rights offers.[3] This unique characteristic of Hong Kong data provides an opportunity to examine how precommitments will affect the announcement effects of rights offers.

[2] Both Ching et al. (2006) and Wu and Wang (2005b) provide the average cumulative abnormal returns (*CAARs*) from day −1 to day 1 for rights offers in Hong Kong. Using 120 rights offers by 59 issuing firms from 1993 to 1998, Ching et al. (2006) find that the 3-day *CAAR* is −8.84%. Using 180 rights offers from 1989 to 1997, Wu and Wang (2005b) find that the 3-day *CAAR* is −7.65%. Our 3-day *CAAR* for rights offers is −11.90%.

[3] According to Bøhren et al. (1997), only 19 of the 200 insured and uninsured rights offers in Norway had subscription precommitments. Ursel (2006) also reports that underwritten rights offers in the U.S. rarely used precommitments.