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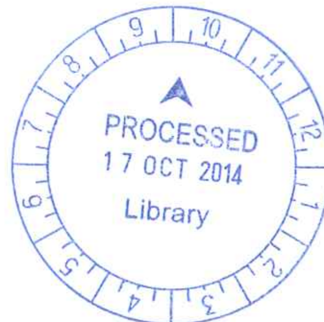
MASTER OF BUSINESS ADMINISTRATION

Underwriter Certification and the Roles of New Investors in Seasoned Equity Offerings in Hong Kong



Author: Yang Lina

Student No: I13002900

Supervisor: Ken Lee Chin Chong

Submission Date: 27 August 2014

Ethics Number: Null

Final Word Count: 13837

Acknowledgement

Foremost, I would like to express my sincere gratitude to my supervisor Mr. Ken Lee Chin Chong for the continuous support of my master study and research, for his patience, motivation, enthusiasm, and immense knowledge. He led me into the world of finance and enlightens me the first glance of research. His guidance helped me in all the time of research and writing of this thesis. I could not have imagined having a better supervisor and mentor for my master study.

I would also like to thank the rest of my thesis committee: Mr. Chin Yin Fou and Ms. Rebecca, for their encouragement, insightful comments, and hard questions.

My sincere thanks also goes to my fellows for the sleepless nights we were working together before deadlines, and for all the fun we have had in the last year.

At least, I am grateful to my parents Yang Hongfang and Han Xuelian, for giving birth to me at the first place. And thank for all of the spiritual and material supporting throughout my life from my parents, my young sister Yang Liyuan, and my best friend Jin Ru.

Yang Lina

August, 2014

Declaration

"I hereby declare that this research project is of mu own effort except for the information that has been used from various authors that have been cited accordingly and ethically."

Yang Lina

27 August 2014

Table of Contents

Acknowledgement I
Declaration II
List of Tables VI
List of Equations VII
List of Hypotheses VIII
Abstract IX
Chapter One: Introduction 1
1.1 Private Equity Placement 1
1.2 Open Offer 2
1.3 Stock Market in Hong Kong 3
1.4 Problem Statement 5
1.5 Research Objectives 6
1.6 Scope of the Study 7
Chapter Two: Literature Review 8
2.1 The Market Reaction to Announcements of Private Placements and Open Offer 8
2.2 The Hypothesis for the Market Reaction of Seasoned Equity Offerings 10
2.2.1 Asymmetric Information Hypothesis 11
2.2.2 Information Hypothesis 12
2.2.3 Managerial Entrenchment Hypothesis 13
2.2.4 Monitoring Hypothesis 14
2.3 The Certification Role of Underwriter 15
Chapter Three: Methodology 20
3.1 Data Sources 20
3.2 Research Sample Size 21

3.3 Research Techniques 25

3.3.1 Market Model 25

3.3.2 Event Study Test Statistics 28

3.3.3 Multiple Linear Regression Model 32

3.4 Hypotheses 33

Chapter Four: Findings and Discussion 35

4.1 Event Window Analysis 35

4.2 Regression Analysis of Private Equity Placement 38

4.3 Regression in Open Offer 43

Chapter Five: Conclusion, Recommendation, Limitation and Self-Reflection 50

5.1 Conclusion 50

5.2 Recommendations 51

5.3 Limitations 53

5.4 Self- reflections 53

Bibliography 55

Appendices 60

Appendix 1: Descriptive Statistics of Private Equity Placement 60

Appendix 2: Descriptive Statistics of Open Offer 60

Appendix 3: Multiple Regression of Equation 16 61

Appendix 4: Correlations of Each Regression Models 62

Appendix 5: Regression Model 1a 64

Appendix 6: Regression Model 1b 65

Appendix 7: Regression Model 2a 66

Appendix 8: Regression Model 2b 68

Appendix 9: Regression Model 3a 69

Appendix 10: Regression Model 3b 70

Appendix 11: Regression Model 4a 72

Appendix 12: Regression Model 4b 73

Appendix 13: Correlations in Open Offer 74

Appendix 14: Regression in Open Offer 76

Appendix 15: Regression of Model 2 77

Appendix 16: Regression of Model 3 78

Appendix 17: Regression of Model 4 80

Appendix 18: Regression of Model 5 81

Appendix 19: Regression of Model 6 83

Appendix 20: Regression Model 5 (Type = 0) 84

Appendix 21: Regression Model 5 (Type = 1) 86

List of Tables

Table 1: Distribution of Sample by Year 22
Table 2: Characteristics of Sample 23
Table 3: Event Window Analysis 36
Table 4: Correlations of Variables in Equation 16 39
Table 5: Regression Models Analysis of Private Equity Placement..... 40
Table 6: Correlations of Variables in Equation 17 44
Table 7: Regression Models Analysis of Open Offer..... 45
Table 8: Regression Model 5 in Open Offer 48

List of Equations

Equation 1 26
Equation 2 26
Equation 3 26
Equation 4 27
Equation 5 27
Equation 6 28
Equation 7 28
Equation 8 29
Equation 9 29
Equation 10 29
Equation 11 30
Equation 12 30
Equation 13 30
Equation 14 30
Equation 15 30
Equation 16 32
Equation 17 32

List of Hypotheses

Hypothesis 1 33
Hypothesis 2 33
Hypothesis 3 33
Hypothesis 4 33

Abstract

Private equity placement and open offer are two methods of issuing new shares in seasoned equity offering. Even though open offer is believed similar to private equity placement, it was predicted that the announcement effects of this two types of offerings are opposite. This thesis explores the impact of announcement of two types of offerings in Hong Kong during 2010 to 2013. Market model and multiple linear regression analysis are used to figure out the announcement effects of two types of offerings and the factors that influence the announcement effect. It is proved that the stock react to private equity placement positively and response to the open offer negatively. In addition, the new investors who purchased the new shares of issuing firms in private equity placement are proved play an important role in monitoring the management of companies. In addition, certification effects of underwriter in open offer are not observed based on the results of this thesis, even though they are believed could mitigate the negative announcement effect of open offer by certifying firm value of issuing firms. However, the stock prices of companies whose new shares are underwritten by investment bank are indicated perform better than those companies underwritten by the largest shareholder of issuing firm.

Key Words: Seasoned Equity Offerings, Private Equity Placement, Open Offer, Announcement Effect, New Investors, Underwriting Effect.

Chapter One: Introduction

This research is going to study two types of seasoned equity offerings in Hong Kong including private equity placement and open offer. In private equity placement, shares are generally issued to new investors outside of the issuing company. While in open offer, the pre-emptive rights of existing shareholders are preserved, which allows them to claw back new shares from placee. However, the stock reaction to these two methods are supposed to be opposite (Myers & Majluf, 1984). Therefore, the Average Abnormal Return, Cumulative Average Abnormal Return, and Cumulative Average Abnormal Return referred in market model are used to measure the announcement effects to figure out how stock price react to two types of equity offering in Hong Kong.

In this research, the announcements of private equity placement are proved lead to an increase in stock price. On the contrary, the stock price react negatively to the announcement of open offer. By analyzing fraction which refers to the proportion of new shares issued on the total shares after placing, the new investors involved in private equity placement are found play monitoring role in the management of issuing firm, which urges managers to take more care of prospects of issuing firm. Through the analysis of underwriting effects in open offer, both two types of underwriters are believed have no significant effects on the announcement effect of open offer.

1.1 Private Equity Placement

Private placement is widely used in Seasoned Equity Offerings (SEOs) around the world which is issued to non-existing shareholders. It was believed that the participation of new investors make contribution to improve the stock

performance of issuing firm (Wruck, 1989; Wu, 2003; Lee, et al., 2014). It can be seen frequently in New York (NYSE) and American Stock Exchange (ASE) for a firm to issue new shares. During the period from mid-1979 to 1985, the average proceeds generated from a private sell of issuing company listed on NYSE and ASE is up to $31.5 million. It was only $5 million lower than that in public equity offerings (Asquith & Mullins, 1986).

In a private placing or subscription agreement, only a small group of new investors are allowed to participate in buying the new shares of issuers. The existing shareholders are not allowed to purchase new shares offered by private equity placement. In general, the number of new investors involved in the private placing agreement is usually less than six. In a private equity sale, existing shareholders cannot claw back shares from placee since they must display their pre-emption rights in advance.

1.2 Open Offer

Open offer was dined as a special private placement with pre-emptive rights preserved (Armitage, 2002). Due to existing shareholders could take their pre-emptive rights on or after the announcement day, they can claw back a pro rata of the new shares even if the shares have been promised by placee to purchase them. However, this pre-emptive right in open offer is just entitlements and not allowed to sell. It has no value if they were not taken up by existing shareholders. Otherwise, it is called that existing shareholders claw back new shares from placee.

In open offer, underwriter is widely used to underwrite the new shares. The contractual role of underwriter is an arranger who purchases unsold shares that issuing firm is going to offer at the offer price, up to the limited number presented

in underwriting commitment. By doing this, arrangers take the underwriting risk. In order to transfer this risk, arrangers (investment banks or broker) need to negotiate with individuals or institutions privately in advance prior to the public announcement of new shares. Therefore, on announcement day, the arranger has a list of investors' name who has promised to purchase partial or all of the new shares verbally. They are the potential placee. When the potential placee purchase the new shares they promised to buy, the underwriting risk of underwriter and part of the underwriting fee will be transferred. Actually, when investors agree to purchase the shares, the shares are said to have been placed with claw back in an open offer (Armitage, 2002).

The legally binding contracts are going to be signed on or after the announcement day. The potential placee will become insiders if they buy the shares as promised. Alternatively, it can also be occurred that some of them obliged not to purchase the share on and after the announcement. If amount of new shares have been committed to purchase by existing shareholders or any other interested party, it is not necessary to underwrite those shares for looking for placee (Armitage, 2002).

1.3 Stock Market in Hong Kong

Hong Kong Stock Exchange (HKEx), built in 1891, is the oldest stock market in Asia. The total market capitalization of HKEx is up to HK$16.985 trillion with 1,500 listed firms. It is ranked as the third largest stock market in Asia, and the fifth largest one around the world (Woori Korindo Securities, 2012).

The shares of companies traded in HKEx are named "H" shares. However, companies listed as "A" share in Shanghai Stock Exchange are also allowed to list in Hong Kong. This behavior is called dual listing in which the shares are

subdivided into two types called "H" Share and Red Chip Share. Red Chip Share refers to those stocks listed in Hong Kong but incorporated outside China. Dude to the strong restriction of Chinese government on Chinese people to invest abroad and on foreigners to invest on "A" shares, many companies choose to dual listing in Hong Kong. Chinese government pulls foreign investors to HKEx and let them pull capitals through Hong Kong indirectly. Thus, "H" share and Red Chip Share account for the large part of total market capitalization in HKEx. They are also the major route for investing the growing Chinese firms (Woori Korindo Securities, 2012).

In HKEx, there are two markets: Main board and Growth Enterprise Market (GEM).

- Main Board

Main Board is believed as a major stock market in HKEx where many well-known Hong Kong and Chinese companies such as HSBC, Petro China, Cathay Pacific, and any others are traded. In terms of market size, total market capitalization, and trading volume, it is much more popular than GEM.

- Growth Enterprise Market (GEM)

GEM, developed for growth companies, is another stock market in HKEx. Companies whose profitability or track record do not up to par with the requirement of Main Board are allowed to trade in GEM. It makes GEM quite similar to NASDAQ. Considering that the growth enterprise stocks traded in GEM are higher risk compare to those stocks traded in Main Board together with more chances due to larger volatility, a strong disclosure principle is required in GEM. Detail information related to financial condition of issuers are required to provide frequently to disclosure to the market. Most of the companies issuing shares through private equity placement and open offer in Hong Kong as well as

the research sample are traded in GEM.

1.4 Problem Statement

In Hong Kong, many companies are owned by families, therefore, there is a high ownership concentration with an average 40 percent of controlling ownership (Wu, et al., 2005). Average of the new equity offerings issued in Hong Kong take more than 10% of existing share outstanding (Wu, et al., 2005). Therefore, an equity issue to new investors definitely results in a decrease in ownership concentration in private placements. It is a significant change in ownership structure, which might influence the investors' responses to issuers' share price.

According to the researches, it was proved that there is a positive effect of private placement (Wruck, 1989; Michael, et al., 1993; Eckbo & Norli, 2005; Wu, 2003; Lee, et al., 2014). These researches were conducted in different countries. Research conducted by Wruck (1989) as well as Hertzel and Smith (1993) are in US; Eckbo and Norli (2005) focused on Norway; Wu, et al. (2005) and Lee, et al. (2014) kept an eye on Hong Kong.

However, the explanations for this positive announcement effect of private equity placement are found mixed. Research conducted by Wruck (1989) in USA suggested that 4.5% average abnormal return generated due to the announcement of a private placement. She put forward that the positive announcement effect of private equity placement is a result of the monitoring effects of new investors. Wu, et al. (2005) also approved the positive announcement effects with a little lower figure, but didn't support the monitoring effects of new investors. Barclay, et al. (2007) also proposed that new investors play no current and subsequent monitoring role in issuing firms. These mixed explanations on the announcement effect of private equity placement provide an