



UNIVERSITI PUTRA MALAYSIA

**EQUITY CAPITAL RAISING AND DETERMINANTS OF ITS PRICE
BEHAVIOUR IN MALAYSIA**

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**EQUITY CAPITAL RAISING AND DETERMINANTS OF ITS PRICE
BEHAVIOUR IN MALAYSIA**

by

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LIST OF ABBREVIATIONS

ASEAN	Association of South East Asian Nations
CIC	Capital Issues Committee
D-W	Durbin Watson
EPF	Employees Provident Fund
FIC	Foreign Investment Committee
GDP	Gross Domestic Product
GNP	Gross National Product
IPOs	Initial Public Offerings
KLSE	Kuala Lumpur Stock Exchange
MGS	Malaysian Government securities
MTI	Ministry of Trade and Industry
NBER	National Bureau of Economic Research
NEP	New Economic Policy
NYSE	New York Stock Exchange
OECD	Organisation of Economic Cooperation and Development
OLS	Ordinary Least Squares
PDS	Private Debt Securities
RAM	Rating Agency of Malaysia
SC	Securities Commission
SCAN	Securities Clearing Automated Network
SEOs	Subsequent Equity Offerings
SPEEDS	<i>Sistem Pemindahan Elektronik untuk Dana dan Sekuriti</i> or Scripless Security Trading System (SSTS)
TBs	Treasury Bills



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Capital investment is an important economic activity that contributes to economic growth. Aggressive capital formation leading to high economic growth can be the result of either public expenditure policies for welfare betterment or private initiatives, which enable the market mechanism to operate effectively and efficiently. In Malaysia, the private sector plays an active role in economic development, so its ability to raise external funding must not be encumbered by restrictive policies that increases costs of financing. Thus, the first objective of this study is to search for a link between the amount of capital raised by the private sector and changes in macroeconomic factors. Time constraints limit the study to external capital funding in the form of equity only, both seasoned and unseasoned ones. Apart from relating the volume of equity raised to a certain macroeconomic variable, the research is extended to identifying



factors in explaining the price behaviour of rights issue announcements and listing of IPOs.

This study is based on findings in the U.S. that volume and price behaviour of equity issues (particularly seasoned equity) are influenced by movement of the business cycle as measured by the National Bureau of Economic Research (NBER). Since similar index is not available in Malaysia, a proxy closely related to variations in the business cycle was used. This proxy is the term premium, which is the excess of the average 20-year Malaysian Government Securities (MGS) yield over the 3-month Treasury bill (TB) yield. Evidence of a significant association between term premiums and movements of the business cycle in the U.S. is the basis, which led to the adoption of this variable in the study.

The research design used in this study is the event study methodology to measure price behaviour of rights issues and IPOs, and the ordinary least square regression method to determine the variables explaining the price behaviour. The market-adjusted return was used to derive abnormal returns of rights issues.

Regressing the term premium against volume of equity raised showed a significant negative relationship with coefficient of -0.88 billion and t-value of -2.17 . This became more pronounced with the incorporation of a time trend, the coefficient being -1.1 billion with t-value of -4.89 . Similar relationship exists when volume of equity raised was analysed in terms of IPOs and rights issues, the coefficients were -0.48 billion ($t=-2.32$) and -0.4 billion ($t=-1.94$) respectively. Adding a

time trend improved the results to -0.60 billion ($t=-4.73$) for rights and -0.53 billion ($t=-4.49$) for IPOs. The significant relationship enabled the time period over 1965 to 1995 to be classified according to favourable and unfavourable economic conditions. These periods were then used to segregate the sample of IPOs and rights issues according to the two identified conditions.

Factors attempting to explain the excessive return on initial trading day of IPOs were of three different levels, namely firm, market and economic conditions. The demand pressure hypothesis was tested since investors in the IPO market are assumed to be speculative and prone to overreaction. Results indicate the importance of timing variables (market and economic conditions) and two firm-specific variables being significantly related to underpricing. These are net tangible assets and current ratio. Significant negative coefficients of these variables, -0.753 ($t=-3.07$) for net tangible assets and -0.088 ($t=-6.02$) for current ratio, gave a strong indication of investors' preference for highly risky securities since these are the ones with high returns. Furthermore, the significant positive coefficient for cumulative market return prior to listing showed that demand by aftermarket traders are greatly influenced by the condition of the stock market. In *bullish* market, demand is greater causing higher underpricing. Economic condition also affects underpricing significantly. When the economy is favourable, average underpricing was 125 percent, 46 percent higher than in unfavourable conditions.



Regression of rights issue announcement return against the three levels of variables mentioned above revealed the importance of term premium and Tobin's q ratio. Periods of falling term premiums coincide with the prosperity phase of the business cycle during which abundant investment opportunities were available. When firms decide to raise equity during these periods, they signal to investors of the presence of positive net present value projects, and investors respond favourably causing announcement day return (over -8 to +1 days) to be positive. The coefficient for Tobin's q ratio as a measure of investment opportunities, was marginally positively significant at 0.01 ($t=1.70$) indicating that firms with high Tobin's q tend to have high announcement day return. To further strengthen the results, coefficients corrected for heteroscedasticity were also reported. The positive announcement effect was also tested for possibility of high future earnings as an explanation. Results of parametric and non-parametric tests were ambiguous, where the former indicated declines in earnings and the latter showed a larger proportion with earnings increases.



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**PEROLEHAN MODAL EKUITI DAN PENENTU KELAKUAN HARGA
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Pelaburan modal adalah sangat penting untuk pertumbuhan ekonomi. Pembentukan modal bagi pertumbuhan ekonomi yang pesat boleh disebabkan oleh polisi belanjawan awam untuk peningkatan kebajikan atau melalui inisiatif swasta untuk membolehkan mekanisme pasaran berfungsi dengan cekap. Di Malaysia, sektor swasta memainkan peranan aktif di dalam pembangunan ekonomi. Keupayaannya untuk mendapatkan modal luaran tidak boleh dibebani oleh polisi-polisi terhad yang akan menaikkan kos kewangan. Objektif utama tesis ini adalah untuk mencari kaitan antara modal luaran dengan faktor-faktor makroekonomi. Kajian ini terhad kepada modal luaran di dalam bentuk ekuiti sahaja ekoran kesuntukan masa. Selain daripada mendapatkan hubung-kait antara jumlah ekuiti luaran dan faktor makroekonomi, kajian ini diperluaskan dengan menggunakan faktor tersebut dalam menerangkan kelakuan harga semasa pengumuman terbitan hak dan penyenaian terbitan awam dilakukan.



Kajian ini dijalankan berdasarkan hasil penemuan di Amerika Syarikat yang menunjukkan bahawa jumlah dan kelakuan harga terbitan ekuiti dipengaruhi oleh kitaran perniagaan yang diukur oleh “National Bureau of Economic Research (NBER)”. Memandangkan indeks yang serupa tidak terdapat di Malaysia, proksi yang mempunyai hubungan rapat dengan kitaran perniagaan telah digunakan. Proksi tersebut ialah premium jangka masa iaitu perbezaan antara kadar purata Sekuriti Kerajaan 20-tahun dengan Bil Perbendaharaan 3-bulan. Hubungan bererti antara premium jangka masa dan fasa-fasa kitaran perniagaan di Amerika Syarikat menjadi asas penggunaan faktor tersebut di dalam kajian ini.

Lakaran penyelidikan yang digunakan ialah metodologi peristiwa kajian untuk mengukur kelakuan harga terbitan hak dan awam. Kaedah ganda dua terkecil biasa digunakan bagi menentukan faktor-faktor yang mempengaruhi kelakuan harga. Kaedah pulangan pasaran terlaras pula digunakan untuk memperolehi pulangan residual bagi terbitan hak.

Melalui kaedah regresi, premium jangka masa menunjukkan perhubungan negatif bererti dengan jumlah ekuiti luaran, mempunyai koefisien -0.88 bilion dan statistik t -2.17 . Penambahan arah aliran masa menyatarakan lagi koefisien kepada -1.1 bilion dengan statistik t sebanyak -4.89 . Hubungan yang serupa didapati apabila jumlah ekuiti luaran dibahagikan kepada terbitan hak dan terbitan awam dengan koefisien masing-masing -0.48 bilion ($t=-2.32$) dan -0.4 bilion ($t=-1.94$). Penggunaan tren masa membaikkan keputusan kepada -0.6 bilion ($t=-4.73$) untuk terbitan hak dan -0.53 bilion ($t=-4.49$) untuk terbitan awam. Kaedah

ini membolehkan jangkamasa daripada 1965 hingga 1995 dibahagikan kepada keadaan ekonomi makmur atau meleset. Apabila premium jangka masa menurun keadaan ekonomi ditakrifkan sebagai makmur, dan sebaliknya. Ini membolehkan sampel terbitan awam dan terbitan hak diklasifikasikan berdasarkan kriteria berkenaan.

Faktor-faktor yang menjelaskan pulangan yang tinggi pada hari pertama terbitan awam diniagakan dipilih daripada tiga tahap yang berbeza, iaitu di peringkat firma, pasaran saham dan ekonomi. Hipotesis tekanan permintaan diuji berdasarkan fakta bahawa pelabur terbitan awam adalah spekulatif dan menunjukkan tindak balas melampau. Hasil kajian mendapati bahawa pembolehubah masa dan dua pembolehubah firma mempunyai hubungan bererti dengan pulangan permulaan. Pembolehubah firma yang dimaksudkan adalah aset ketara bersih dan nisbah semasa. Koefisien negatif bererti sebanyak -0.753 ($t=-3.07$) untuk aset ketara bersih dan -0.088 ($t=-6.02$) untuk nisbah semasa menunjukkan bahawa kecenderungan pelabur kepada sekuriti berisiko tinggi kerana pulangan yang juga tinggi. Pulangan kumulatif pasaran pula menghasilkan koefisien positif bererti yang menunjukkan bahawa permintaan pelabur ke atas syer-syer yang telah disenaraikan bergantung kepada keadaan pasaran saham. Permintaan berlebihan semasa pasaran saham meningkat menyebabkan pulangan permulaan yang tinggi. Keadaan ekonomi juga mempengaruhi pulangan permulaan di mana dalam situasi kemakmuran, terbitan awam mencatat pulangan sebanyak 125 peratus, lebih 46 peratus daripada situasi sebaliknya.

Pulangan pengumuman terbitan hak apabila diregresi dengan pembolehubah-pembolehubah daripada tiga tahap yang telah dinyatakan di atas menunjukkan kepentingan premium jangka masa dan nisbah Tobin q. Premium jangka masa yang menurun bertepatan dengan fasa kemakmuran di mana pada fasa ini terdapat banyak peluang perniagaan. Apabila firma membuat keputusan untuk menambah ekuiti luaran, keputusan itu dianggap sebagai isyarat kepada pelabur bahawa firma mempunyai peluang-peluang pelaburan bernilai bersih positif dan tindakbalas pelabur yang menyebabkan pulangan pada hari pengumuman (diukur daripada hari -8 hingga +1) menjadi positif. Nisbah Tobin q sebagai pengukur peluang perniagaan menunjukkan koefisien positif bererti t bernilai 0.01 ($t=1.70$) di mana firma yang mempunyai nisbah yang tinggi akan mendapat pulangan pengumuman yang tinggi. Bagi mengukuhkan lagi hasil penemuan, koefisien yang telah diperbaiki dari segi heteroskedastisiti juga dilaporkan. Kemungkinan kesan pengumuman yang positif disebabkan oleh keuntungan masa depan yang tinggi juga diterokai. Ujian-ujian berparameter dan tak berparameter menunjukkan hasil yang kabur. Di dalam ujian berparameter keuntungan masa depan berkurangan manakala dalam ujian tak berparameter, sebahagian besar firma-firma mengalami perolehan masa depan yang meningkat.



CHAPTER I

WHAT DETERMINES EQUITY CAPITAL DEMAND?

Introduction

The first part of this chapter discusses the importance of capital to economic development, followed by a description of the scenario in Malaysia leading to the change from public to private sector financing. Next, the research objectives are outlined as well as the significance of the study. Finally, the chapter concludes with a description of the research process and plan as well as the structure of the thesis.

The Process of Capital Formation

Capital formation or investment is an economic activity crucial to a country's development. It is widely documented in development economics literature that high investment rates are associated with greater economic growth (Harrod 1939, Domar 1947, Lewis 1955, Rostow 1971). For example, Rostow suggested that an investment rate of 10 percent is necessary for a country to initiate economic growth, whereas Lewis proposed a figure of 12-15 percent. In fact, a recent study by Levine and Renelt (1992) over a cross-section of countries reports a significant relationship between growth and capital formation.



The accumulation of capital requires the mobilisation of an economic surplus that can be channelled into productive investment. The essential steps involved in the process of capital formation are:

- i) an increase in the amount of real savings,
- ii) the channelling of savings through financial intermediaries to productive investors,
- iii) the process of investment which involves conversion of savings into capital stocks, and
- iv) the creation of economic openness to induce resource flows from outside.

Funds for capital formation are sourced from internal savings and foreign capital inflows. Real domestic saving is the limiting factor influencing the rate of investment and its importance should not be neglected, while foreign capital inflows, although beneficial, carry the burden of debt servicing and repayment (Sey 1979 and Guth 1979).

The capital market is an important element in the capital acquisition process through the interaction of providers and users of funds. It enables successful mobilisation and efficient allocation of private savings to entrepreneurs to generate optimum benefits. This leads to the creation of more goods and jobs, which strengthens the economy and improve standards of living. Without the capital market, savers and users tend to be identical and private investment depends heavily on prior self-saving. Such a mechanism is inefficient and stagnates economic growth. Thus, to

achieve development, the internal financing constraints need to be removed and mechanisms to facilitate capital acquisition be developed (McKinnon 1973).

In the early stages of economic development, direct intersectoral lending used to be the norm. Surplus resources from one sector were being directly channelled to users in another sector based on close contacts and familiarity. The credit market was not organised then, causing inefficient allocation of resources: defeating the purpose of profit optimisation. In this type of environment, financial assets were scarce and illiquid. Furthermore, many potentially high-yielding investment projects had to be shelved due to lack of funds. This led to the development of financial institutions to perform crucial financial intermediation services and facilitate efficient transfer of funds from providers to users.

An efficient capital market has the necessary mechanism to ensure capital allocation to investments yielding the highest return. It encourages healthy competition within the financial system. Financial claims on investing units by surplus units led to accumulation of financial assets. To further stimulate savings, attractive financial assets need to be supplied to investors to enable collection of a larger pool of financial resources. Besides the function of mobilisation and allocation of scarce resources, the capital market creates liquidity of financial assets through its pricing mechanism. By ensuring liquidity, it instils investors' confidence in the saving-investment process that forms the basis for successful capital accumulation.

Public and Private Sector Financing in Malaysia

In Malaysia, economic development has been achieved through a series of five-year economic plans which emphasised heavy public sector spending on infrastructure and the development of conditions favourable to commercial agriculture and manufacturing activities. For an economy dominated by exports of primary commodities, the global reduction in prices coupled with unfavourable foreign exchange situation during the early 1980s caused massive deficits in the balance of payment accounts: the deficit was 14 percent of GNP in 1982. At the same time, excessive public expenditure to develop appropriate heavy industrial base resulted in huge fiscal deficits which was 18 percent of GNP in 1982. This twin deficit situation necessitated the introduction of structural adjustment programmes to reduce government expenditure and encouraged greater involvement of the private sector.

This shift in emphasis from public sector-led development to active involvement by the private sector is a natural phenomenon of a progressive nation (Huq 1994). Eventually this caused a demarcation of the roles played by the public and private sectors respectively. The public sector reduced its activities to providing supportive services, maintenance of law and order, internal and external security and administrative justice, whereas the private sector was encouraged to provide the economic decisions involving production and consumption to exchange. This, it was realised, would enable the market mechanism to operate effectively and efficiently to propel the economy towards more growth.

Greater private sector investment can be achieved with availability of funds at competitive rates. Rather than being dependent on borrowed funds from financial institutions, firms have the alternative of procuring funds from the capital market. In fact, in the Seventh Malaysia Plan (over 1996 and 2000), it is estimated that private investment will increase by 86 percent from a base of RM207 billion over the Sixth Malaysia Plan to RM385 billion (Seventh Malaysia Plan (1996-2000), p.492). The capital market is expected to provide the bulk of financing to the private sector. However, Kharas (1991) notes that, even though Malaysia has one of the highest domestic savings rate in the world, there is a need to address the problem of allocational inefficiency. A high proportion of household savings is channelled into provident and pensions funds, life insurance and other non-financial institutions. These institutions prefer to invest, due to either regulations or capital safety predilections, in government securities. Mechanisms and policies are needed to re-channel public sector excess funds to the private sector. Thus, this thesis addresses the question of whether economic conditions influence the amount of capital raised by the private sector and how the instruments (in this case rights issues and IPOs) used for such purpose would behave under varying conditions.

Research Objectives

The main concern of this study is the issue of primary equity securities by corporations in Malaysia. Initially a search will be made for appropriate macroeconomic variable(s) likely to be correlated with primary equity issues. This relates to the observation that clustering of equity issues occurs at certain periods. One explanation for this is that, because of time-varying asymmetric information, managers take the opportunity to issue equity when asymmetric information is low to reduce the costs of adverse selection (Myers and Majluf 1984). If time-varying asymmetric information is present, then larger (smaller) volume of issues will be made when asymmetric information is low (high).

According to Choe, Masulis and Nanda (1993) and Ariff and Khan (1997), variations in information asymmetry are caused by changes in macroeconomic conditions. In particular they demonstrated that equity issues made during business cycle expansions experienced less adverse price reaction. Thus, the first part of this study is to look for appropriate macroeconomic factor(s), which explains volume of equity raised by corporations.

The major instruments of the primary equity issue market include initial public offerings (IPOs), for firms wishing to be listed on the Kuala Lumpur Stock Exchange; and rights, private placements and special issues for already listed companies. The intention here is to fill gaps in the literature on price behaviour of IPOs and rights issues in Malaysia.