SURVEY OF RIGHTS ISSUES

SYNOPSIS

The price movements of rights traded on the Sydney Stock Exchange for 1965-1968 are examined with a view to assessing the validity of the adage "stockholders should sell rights early" and of considering the relationship of the theoretical rights price to rights price movements. It is suggested that in all market conditions the price of rights tends to weaken in the middle third of the trading period, but it is the tone of the market which is the prime influence on whether the peak rights price occurs in the first or the final third of the trading period and the extent to which rights sell for more or less than their theoretical value.

AN ANALYSIS OF AUSTRALIAN RIGHTS ISSUES*

1965-1968

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I. *INTRODUCTION*

It is the purpose of this article to examine the price movements of rights traded on the Sydney Stock Exchange during the period 1965-68 with regard to:

(i) assessing whether the traditional view that rights attain their maximum price shortly after the start of trading and then decrease in price until the end of the application period, is accurate; and

(ii) considering the relationship of the theoretical rights price to the price movements during rights trading.

The Wall Street adage "stockholders should sell rights early" has been examined in two recent American studies. Professor Leffler, in a study reported in **Barron's,** September 16, 1957, analyzed the 75 rights offerings traded on the New York Stock Exchange for the 18 months ending June 30, 1957. Of the 33 of these for which rights were traded only during the subscription period(1), 13 reached their highest price in the first third of the rights trading period, 13 in the final third of the period, 2 in the middle third and 5 were considered inconclusive owing to occurrence of identical maximums in 2 or more of the 3 periods. Professor Leffler concluded that no advantage was apparent in selling rights in the first third of the period of rights trading.

Soldofsky and Johnson in a paper published in the **Financial Analysts Journal** for July-August 1967, considered the prices of rights sold on the New York Stock Exchange in 1966. They found that for the 25 cases traded only during the subscription period in 1966, the highest price occurred in 14 (i.e., 56% of) cases in the first third of the rights trading period and in 7 (i.e. 28% of) cases in the final third. Four cases were inconclusive and none had the peak price occurring in the middle third of the trading period. They concluded that "the maxim, 'sell rights early' should be taken with a 'grain of salt' because this study, as well as Leffler's, found that there is a considerable number of rights which reach their peak price in the final period(2)."

For the purpose of testing the applicability of the 'sell rights early' adage in Australian share markets the price movements of the rights issues traded on the Sydney Stock Exchange during the period 1965-68 were considered.

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II. *RIGHTS TRADING*

The rights trading period for each issue was divided into three periods. The prices used were the daily last sale prices as quoted in the **Australian Financial Review.** Table I sets out the average length of the rights trading period for each year considered. All rights issues considered were traded only during the subscription period.

Over the four years considered, a complete market cycle was experienced. With lower commodity prices, falling overseas reserves and higher interest rates, the share market suffered a sharp decline in prices in 1965. 1966 was a comparatively static year for the market but oil, gas and nickel discoveries and iron ore developments contributed to a booming share market for 1967-8.

TABLE I

AVERAGE LENGTH OF RIGHTS TRADING PERIOD

	No. of Days
1965	25
1966	32
1967	27
1968	27

It would be anticipated that in a falling market the peak price for rights would be reached in the first third of the trading period; in a static market that the peak price would also occur in the first third of the trading period as the selling pressure created by the issue could weaken the market for rights; and in a rising market the peak price for rights could be expected to occur in the final third of the trading period. Table II which presents the peak prices of rights traded over the period 1965 to 1968 inclusive, reflects these anticipations. In 1965, a falling year for the share market, 41.4% hit their peak price in the first third of the trading period; in 1966 when the market was static 54.2% of rights issues hit their peak rights price in the initial third of the trading period; and in 1967 and 1968 when the market boomed the emphasis shifts somewhat, although not entirely, to the final third of the trading period, with 28.5% and 31.0% of issues having their peak price in the final third in 1967 and 1968 respectively, as compared to 28.5% in the initial third of the trading period for both 1967 and 1968.

These results confirm the conclusion apparent from a comparison of the two American studies[3] that 'the prime reason for the difference is undoubtedly the tone of the stock market at the time of the two studies'.

TABLE II

PEAK PRICES OF RIGHTS

Year	No. of Issues	I	%	II	%	III	%	Inconclusive	%
		Period in which peak price reached							
1965	75	31	41.4	14	18.6	16	21.4	14	18.6
1966	48	26	54.2	3	6.2	14	29.2	5	10.4
1967	56	16	28.57	11	19.6	16	28.57	13	23.2
1968	42	12	28.5	5	12.0	13	31.0	12	28.5
	221	85	38.4	33	15.0	59	26.6	44	20.0

TABLE III

Year	No. of Issues*	No. for which Rights Exceeded Theoretical Value	%
1965	73	30	41
1966	45	22	49
1967	55	34	62
1968	36	26	72

* The number of issues listed here is not the same as that in Table II as complete information on a number of rights issues was not available.

It is clear that in all market conditions the prices of rights tend to weaken in the middle third of the trading period but apart from this, the tone of the market at the time of the issue appears to determine in which third of the trading period the majority of rights will have their peak prices.

III. THE THEORETICAL PRICE OF RIGHTS

Turning now to the second aspect of rights trading to be investigated, the relationship of the theoretical rights price to the price movements during rights trading, a definition of the theoretical rights price will first be necessary.

If we assume the current (pre-announcement) market price of shares in a company about to make a 2 for 5 rights issue is 1.38, then for the price of 5 shares, $6.90, an investor can obtain 2 new shares at the subscription price of 70 cents each. The average ex-issue price for these seven shares is $1.18 which, deducting the subscription price of 70 cents, yields the theoretical price of the right to subscribe 48 cents.

The question which prospective investors are interested in asking when an issue is announced is, should the company's shares be purchased cum-rights or does it pay to wait for the rights to be traded for the best bargains? It would be expected that in a strong bull market the cheapest buy is the old shares cum-rights, while in a bear market rights should weaken below their theoretical value and therefore be the beter bargain. In a comparatively static market, also, rights may sell below their theoretical value to the extent that the selling pressure for shares in the company increases with an issue.

One possible bias exists in the calculation of the theoretical rights prices. The market prices used for each issue were the closing sale prices for the month prior to the announcement of the issue. The only other price which normally would have been comparable for all issues, the ex-rights price of the old shares on the first day of trading ex-rights, could not be used as, for a number of the issues considered, a sale ex-rights was not made until well into the subscription period. To the extent that there is an 'announcement effect'[4] using a pre-announcement price may tend to over-estimate the market price of the shares concerned. However, there is little empirical evidence to support the view that there is a 'price depressive' effect on the market price of shares on the announcement of a rights issue, and the bias, if any, has only been considered of very minor importance.

As Table III reveals, an investor in 59% of the rights issues considered for 1965 would have been able to buy rights for less than their theoretical value, however, as the market situation improved between 1966 and 1968, correspondingly the number of issues for which rights failed to achieve at least their theoretical value decreased.

These results serve to reinforce the conclusion of the previous section, that investors in a falling market will be able to obtain rights cheaply, but in a rising market, buying in through rights will be more expensive than purchasing the shares cum-rights.

CONCLUSION

It may be concluded from this study that it is the tone of the share market which has been crucial to the decision in the Australian market for the period 1965-68 as to whether rights, or shares cum-rights are the cheapest way of investing in a company making a rights issue.

While the winning strategy for a prospective investor is that which adjusts to the changing winds of the market-place, one conclusion which

(Continued p. 15)

Rights Issues (from page 10)

also results from the studies of Leffler and of Soldofsky and Johnson as well as the present study, is that a shareholder seeking to dispose of his rights would, as a general rule, be foolish to dispose of them in the middle third of the trading period.

FOOTNOTES

(1) 42 of the 75 issues had rights traded on a "when issued" basis prior to the stated subscription period. "When issued" trading, which is only permitted after a new issue is certain of being offered, ends when the authorized subscription period begins.

(2) **Financial Analysts Journal,** July-August 1967, p. 104.

(3) **Ibid.** p. 103.

(4) John F. Childs in **Long-Term Finanenig** (Prentice-Hall, Englewood Cliffs, N.Y. 1962, pp. 249-60) put forward the view that on the announcement of a rights issue there is a tendency for the share price of the company concerned to fall, relative to the market as a whole, owing to potential investors in the company withholding from buying shares in anticipation of lower prices when the additional supply of shares reaches the market. A further influence in creating this "pre-offering pressure" (as Childs has termed it), is the dilution of the company's earnings as a result of the issue. Merrett, Howe and Newbould in **Equity Issues and the London Capital Market** (Longmans, 1967) concluded that for rights issues traded on the London Stock Exchange, the announcement effect was, at best, hard to discern, and the present writer's investigations of rights issues made between 1964 and 1967 for Australian rights issues supports the view of Merrett, Howe and Newbould rather than that of Childs.