



Minimum Profitability Ruling a Boon or Bane? Some Lessons from China

China's Securities Regulatory Commission (CSRC) stands out in its approach to tightening restrictions for listed companies wanting to initiate rights issues or seasoned equity offerings (SEOs). The country's experience, relevant to other emerging markets, prompted a research paper co-authored by Kevin C.W. Chen, accounting chair professor at the Hong Kong University of Science and Technology, and Singapore Management University accounting professor Jiwei Wang, published recently in the International Journal of Accounting.

According to the authors, since the 1990s the commission had been fine-tuning various measures towards this end, culminating in the July 2002 regulation of a minimum 10% return-on-equity (ROE) for a period of three years. Before the 2002 regulation, also referred to as the "landmark ruling," listed companies took advantage of a lack of consistency in the regulations leading to a situation where rights offerings far exceeded the shares raised through initial public offerings.

Says Wang, "In the early 1990s, listed companies were able to issue additional shares only through pre-emptive rights offered to existing shareholders. This kind of offering is known as a rights offering in the US. A study by K Chen and H Yuan in a 2004 paper entitled, 'Earnings management and capital resource allocation: Evidence from China's accounting-based regulation of rights issues' found that due to the lack of other means for listed companies to raise capital, and insatiable demand for stocks from the Chinese investing public, offerings were excessively abused by listed companies. To curb this activity, the CSRC issued a series of regulations to restrict rights issues after November 1993."

The regulatory commission's position on SEOs differs from many other countries where, after the initial public offering, regulators typically adopt a "disclosure-based" approach. According to the authors, the practice elsewhere, other than in China, is that no official approval is needed for the issuance of additional shares as long as companies provide adequate disclosure. There is no profitability threshold that a company has to meet before making an application to seek fresh funds in other stock markets.

In their paper, the authors assess market reaction to the 2002 regulation, and provide a background briefing to help shed light on the characteristics of China's stock market. The study shows that the landmark ruling did achieve some useful objectives in China's particular investment environment. Says Wang, "Firms not measuring up to the profitability threshold cannot raise additional shares which protects the investing public. The ruling appears to have had a positive influence in terms of market reactions, whilst yielding interesting statistics about firms below the profitability threshold and their SEO conduct."

Chinese Context

According to the authors, the situation in China differs in at least three aspects. Firstly, the government believes



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that local investors lack the sophistication to weed out firms with poor prospects. This is supported by one school of thought which proposes that governments should intervene to correct market failures and maximise social welfare.

Secondly, firms can sell additional shares at a discount from the ongoing price. This is typical in other markets too. In the case of the US, the SEO discount averaged 2.92% in the 1990s. In China, the average discount is much higher at 21.6%, based on data from 119 SEOs initiated between June 1998 and June 2005. This high discount in effect forces current holders of tradeable shares to buy the additional shares to avoid dilution of the value of their shareholdings. The majority shareholders, who typically own non-tradeable shares, do not suffer from this dilution.

Third, research in many equity markets worldwide has documented an “adverse-selection” problem in equity offerings. It implies that managers know more than the market about the true value of their firm and have incentives to issue SEOs when the prices of their stocks are over-valued. As a result, investors typically react negatively to SEO announcements and the stocks of SEO firms significantly under-perform the market after the offering. Says Chen, “This problem is more severe in China, again, because most of the majority shareholders' shares are not tradeable and they do not suffer from negative market reactions or from poor post-SEO performance. Thus, Chinese regulators consider it beneficial to have a hurdle that limits the number of firms which can undertake SEOs.”

Pros and Cons

The regulatory authority is convinced of the benefits of its 2002 regulation even though earlier experience did reveal what is known as an earnings manipulation phenomenon, whereby the minimum profitability figure, duly announced, became a sought-after target to achieve in the annual reports of listed companies eager to qualify for SEOs.

This phenomenon is observed by Chen and Yuan in their 2004 paper which shows that a similar minimum qualification of 10% ROE during 1996–1998 induced a clear earnings-management pattern in which firms used non-operating items to boost earnings to achieve the rights-issue qualification. Many firms were able to obtain governmental approval to conduct rights issues but their subsequent performance was generally below industry norms.

According to the paper, the second consequence of the 2002 regulation was that it excluded firms with good future performance, referred to as a type 1 error, whilst allowing firms with poor future performance to conduct SEOs, known as a type 2 error. For example, among all firms with ROEs of less than 10% in 2002, only 13.4% had a turnaround in 2003 showing ROEs above 10%. On the other hand, among all firms with ROEs above 10% in 2002, 35.5% had their ROEs fall below 10% in 2003. Thus, using 10% as a benchmark for performance can lead to both types of error, resulting in some resource misallocation.

Benefits

The authors conducted an initial study of 250 firms initiating SEOs of which 187 were announced before July 2002, and the rest after implementation of the minimum profitability threshold. Since many firms did not complete the SEO proposals that were initially announced, the sample was reduced from 187 to 65 firms, covering 48 firms above the threshold and 17 below the threshold. Performance was measured using market-adjusted returns, that is, the cumulative monthly stock returns minus cumulative monthly market index returns.

For the 187 firms with SEO announcements between May 2000 and July 2002, nearly 90 companies, or 48%, did

not meet the 10% ROE requirement. Following the landmark CSRC announcement, there were only 63 SEO proposals over a 30-month period, from July 2002 to December 2004, and only seven firms did not meet the 10% ROE threshold. The seven firms were eligible according to a separate regulation issued in 2001 which allowed firms that were re-organised, due to mergers, acquisitions, and major restructuring, to issue additional shares with a minimum ROE of 6%.

Comments Wang, "China's 2002 regulation did bring about benefits. By restricting SEO opportunities to firms meeting the 10% minimum profitability threshold, the control imposed limits on the potential supply of additional shares to the market. This regulation was, therefore, successful in substantially reducing the number of firms announcing SEO proposals." Another benefit of the regulation is that it precludes firms with relatively poor financial performance from issuing additional shares. Since their stock prices are more likely to under-perform in the future, the regulation can reduce the "adverse-selection" problem.

The authors conducted an analysis of market and company performances following the 2002 landmark ruling by employing an augmented market model used in previous studies. Specifically, they developed a value-weighted portfolio of all 1126 listed firms using available data, and analysed the cumulative abnormal returns around the announcement dates of the 2001 and 2002 rulings. Market reactions within a three-day window were examined, starting from one trading day before to one trading day after the CSRC announcement.

Findings

Comments Chen, "Our research yields three conclusions. The landmark ruling has an impact on the overall market valuation due to its effect in limiting the additional supplies of shares to the market. Also, the ruling seems conducive to a less negative reaction by the market to SEO announcements. The third finding is that firms below the threshold are more likely than firms above the threshold to conduct SEOs at the peak of their stock prices."

The first finding was that market reaction to the 2002 regulation is stronger for firms with ROE below 10% than for firms with ROE above 10%. Overall, the Chinese stock market reacted positively to the landmark ruling. Moreover, for firms with above 10% ROE, the reaction to their SEO announcement was less negative after the 2002 regulation. The research also found that firms recording below 10% ROE under-performed the market after their SEO placement, similar to what had been observed in other markets, while those above the threshold out-performed the market.

The second observation was that investors should react less negatively to individual firms' SEO announcements after the 2002 regulation. In other markets worldwide, investors typically react negatively to SEO announcements owing to the problem of "adverse-selection" highlighted earlier. Thus, an SEO announcement is seen as over-valuation of the firm's stock in established markets. Similarly, the Chinese stock market is expected to react negatively to such announcements. It should be noted that no accounting-profit threshold existed in China prior to July 2002. Previously, every company with a "healthy financial condition" qualified to apply to initiate SEO contributing to a much larger pool of such companies, but the figure was greatly reduced after the 2002 regulation.

Thirdly, the authors found that the 2002 regulation reduced the "adverse-selection" problem because companies tended to conduct SEOs when their stocks were over-valued. Firms conducting SEOs substantially out-performed their non-issuing peers in both stock returns and accounting profitability prior to the SEO, but they significantly under-performed their peers after the offerings. Under the 2002 regulation, firms are required to have an average three-year ROE of 10% in order to propose an SEO. Due to their superior performance, such firms are less likely to under-perform their non-issuing peers after the SEO.

China can share its stocks and shares regulation experience which is merit-based and differs from the disclosure-based approach used in many other countries. It offers lessons to other emerging markets in requiring performance-oriented results as a pre-condition to rights issues. Emerging markets are also likely to have an investing public lacking sophistication and an environment where companies are likely to exploit any regulatory weaknesses.

According to Wang, the research paper extends earlier studies “by showing that the regulations seem to achieve some useful objectives in China's particular investment environment. Our study also explains why accounting-based regulations still exist given the manipulative behaviour they cause.”

He adds, “Finally, one important limitation should be pointed out. That is, our objective was to examine whether the adverse-selection problem is reduced by using an ROE cut-off relative to the regulatory regime in which no cut-off was imposed. It could be argued, however, that a measure such as market-to-book ratio might be a better measure for regulators to reduce the adverse-selection problem; but this is beyond the scope of this study.”

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