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Impact of Rights Issue on Share Returns of Firms Listed on The Nairobi Securities Exchange, Kenya

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Abstract: *The study establish the impact of rights issue on share returns of firms listed on the Nairobi Securities Exchange. The study adopted an event study methodology which attempted to establish the information content of rights issue on share returns. The population of this study was 18 companies listed in the NSE. Secondary data collected spans 7 years from 2005-2012; share prices for 30 days before the announcement of rights issue and 30 days after the announcement date was used to generate actual returns, expected returns and abnormal returns. T test analysis was used to test whether there was significant difference on returns between the two periods before and after announcement date. Following the study findings, it was possible to conclude that the market return is a good predictor of stock returns hence the market model was validated. Finally, results led to the conclusion that the expected returns as well as the market returns were significantly higher after rights issue than before rights issue. However, abnormal returns were not significantly different implying that the information content of rights issues do not affect stock return and this may be an indicator of market efficiency. The unique contribution of the paper is that it will reduce the inconclusiveness that has been observed in empirical studies focusing on impacts of rights issue on stock returns.*

Keywords: *Rights Issue, Nairobi Securities Exchange, Share Returns, Listed Firms*

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I. Introduction

Companies need adequate capital base to enable them operate efficiently. Companies use either equity or debt financing but equity is preferred since it forms a permanent source of funding that cannot be redeemed easily. Listed corporations around the world typically raise external equity capital either from existing shareholders under rights issues or from new investors through initial public offer (IPO). In most cases, a rights issue is offered by closed-end companies; those that redistribute all their earnings failure to which, they face backlash from shareholders who may sell en mass and lower company's value (Gowthorpe and Amat, 2005). Legally a rights issue must be made before a new issue to the public. This is because existing shareholders have the "right of first refusal" otherwise known as a "preemptive rights on the new shares (Hillier, Ross, Westerfield & Jordan, 2013). By taking these preemptive rights up, existing shareholders can maintain their existing percentage holding in the company. However, shareholders can, and often do, waive these rights, by selling them to others.

It has been noted that prior to the announcements of rights issue the market forces come into play and share prices change based on this information. The general feeling is that the prices will change because the price will now be cum rights. But the rights issue announcements are often accompanied by corporate news over why the capital is being sought. The market will therefore take this information into account and react to it. If the money is to be put to really good use, then the share price may rise, even though the prospect of extra shares has a dilutive effect. So the question is; what is the impact of rights issues on share returns of the issuing company?

Rights issues provide a useful mechanism for raising equity for such companies and according to Lambrechts and Mostert (1980), rights issues give the existing shareholders the option of purchasing new shares, normally issued at a discount to the prevailing market price to encourage participation. It is noteworthy that the type and source of finance to be raised by the firm depends on a variety of factors one being the cost. Coffee (2002) analyzed the transaction costs involved in a rights issue and issue of common stock at the stock exchange and found out that both offerings incur many legal and filing charges. For a firm issuing common stock, the costs include preparing and publishing a prospectus and lining up buyers for the issue. In contrast to a rights issue, the company is required to contact all the shareholders and set up mechanism for the selling of rights.

I.I Nairobi Securities Exchange

The Nairobi Securities Exchange was constituted as a voluntary association of stock brokers registered under the societies Act in 1954. In 1991 the Nairobi Security Exchange was incorporated under the companies Act cap 486; laws of Kenya as a company limited by guarantee and without a share capital (NSE, 2013). Subsequent developments of the market has seen an increase in the number of stockbrokers, introduction of investment banks, establishment of custodial institutions, credit rating agencies and the number of listed companies have also increased over time. Securities traded include equities and bonds (NSE, 2013). 1996 witnessed the largest share issue in the history of NSE; the privatization of Kenya Airways. In May 2006, NSE formed a demutualization committee to spearhead the process of demutualization and in September 2006 live trading on the automated trading systems of the Nairobi Securities Exchange was implemented. In July 2007 NSE reviewed the Index and announced the companies that would constitute the NSE Share Index. The review of the NSE 20-share index was aimed at ensuring that it is a true barometer of the market.

In 2008, the NSE All Share Index (NASI) was introduced as an alternative index to measure the overall market performance. The Index incorporates all the traded shares of the day. Its attention is therefore on the overall market capitalization rather than the price movements of select counters. The Nairobi Securities Exchange marked the first day of automated trading in government bonds through the Automated Trading System (ATS) in November 2009. The automated trading in government bonds marked a significant step in the efforts by the NSE and Central Bank of Kenya (CBK) towards creating depth in the capital markets by providing the necessary liquidity (NSE, 2013). In July 2011, the Nairobi Stocks Exchange Limited changed its name to the Nairobi Securities Exchange Limited. The change of name reflected the strategic plan of the Nairobi Stocks Exchange to evolve into a full service securities exchange which supports trading, clearing and settlement of equities, debt, derivatives and other associated instruments. In September 2011 the Nairobi Securities Exchange converted from a company limited by guarantee to a company limited by shares and adopted a new Memorandum and Articles of Association reflecting the change. In October 2011, the Broker Back Office commenced operations; thus the system has the capability to facilitate internet trading which improved the integrity of the exchange trading systems and facilitates greater access to the securities market (ibid, 2013).

I.II Statement of the Problem

Most companies in Kenya often issue rights but it has not been established how this impacts these companies' stock returns. Loughran and Ritter (2004) found out that American companies that offer rights issues tend to underperform in the long run, as compared to their counterparts that do not. A number of studies have been undertaken about right issues and its impact on stock prices. For example Karanja (2006) conducted a study on an evaluation of post rights issue effects on firms' share price and traded volumes. He noted that most firms that announce rights issue usually experience a decrease in the share price after the issue at least in the very short run. Kakiya (2007) conducted a study on the effects of announcements on stock returns. The findings from the study were that trends in stock returns are dependent on event announcement. Olesaaya (2010) conducted a research on the effects of rights issue on stock returns and he investigated companies listed at the NSE. The study found negative abnormal returns prior to announcement of rights issue, positive abnormal returns during the announcement and negative results thereafter. Munene (2006) studied the relationship between profitability and sources of financing of quoted companies at the NSE. Some studies done previously in Kenya focused on the influence of macro-economic indicators on stock market returns. Irungu (2012) did a study on the informational content of general election results announcement at the Nairobi Securities Exchange and established that general election results carried a lot of information which affected the performance of shares trading at the NSE.

From the above discussion, it can be seen that limited studies if any have been conducted on the impact of right issue on stock returns. The existing studies are inconclusive; while some researchers find significant positive effects; others find significant negative effects while still others don't find any significant effects. This area is therefore riddled with inconclusiveness. This study therefore sought to investigate the impact of rights issue on stock returns at the Nairobi Securities Exchange. It compared the stock returns of firms before and after issuance of rights issues.

The objective of the study was to establish the impact of rights issue on stock returns at Nairobi Securities Exchange.

II. Literature and Empirical Review

The theoretical foundations that have discussed and explained right issue on stock returns expectation gap are the Modern Portfolio Theory (Markowitz, 1952. Tobin, 1958), Efficient Market Hypothesis and The Random Walk Hypothesis (Fama, 1970, 1965)

Njoroge (2003) conducted a study on the impacts of right issue announcements on share prices of companies listed at the Nairobi Stock Exchange. The study was based on a sample of six rights issues between 1996 and 2002. The study examined whether the average abnormal returns surrounding the rights issue announcement was statistically different from zero. The market model was used to derive the expected returns and a t-test statistic was used to test the hypothesis. Data analyzed for six companies showed negative price adjustment for companies, which issued rights. The results document a negative abnormal return prior to the announcement day of the rights issue and a moderate setback thereafter.

Suresha and Gajendra (2012) conducted a study on the market reaction to rights issue announcement news, using an event study methodology for fifty stocks from 1995 to 2011 and also examined neglected firm and price pressure hypothesis. They found that in previous studies, it is evident that stock returns are significantly affected negatively or positively around rights issue announcement dates. The event has reported negative ARR and it was statistically insignificant. There was no significant change in trade volume for the observations stocks during event window. The study concluded that the Indian market reacts negatively to rights issue announcement.

Sakwa (2013) conducted a study on the effect of rights issue announcement on stock returns of companies listed at the Nairobi securities exchange. The study covered a period of ten years from 2003 to 2012. A traditional event study approach was adopted for this study. The mean adjusted returns model as specified in Brown and Warner (1985) was used in this study. This model uses the mean return over the estimation period as the normal return for the security had the event not taken place. A study of 13 out of the 61 companies listed on the NSE that had rights issued during this period was done. A two tailed t-statistic at 95% confidence level was done to test for statistical significance of the mean abnormal returns. The results of the study show that stock returns react positively to rights issue announcements. A positive mean abnormal return was recorded over the event period with the highest abnormal returns being on day t+2. There was a statistical difference between mean abnormal returns observed during the event period and estimation period for eighteen events and no statistical significance for one event. It was recommended that the Capital market intensifies supervision of market participants to enforce compliance with market regulations and also implement education programs to raise awareness among market participants and reduce information asymmetry.

Bashir (2013) investigated the market reaction to rights issue announcement news by employing an event study methodology. This study focuses on the performance of thirty one rights issues in Karachi Stock Exchange (KSE) from 2008 to 2011. They tested whether the investor can gain or lose an above normal return by relying on public information impounded in a rights issue announcement. Using event study methodology, the study tested whether excessive abnormal return exists during event window. Abnormal returns were calculated by use of the market model and t-tests were conducted to test the significance. The study found evidence of existence of positive abnormal returns on event date. However this gain in shareholders wealth was statistically insignificant. The study concluded that the reaction of Karachi Stock Market is an indication of no rights issue announcement affects i.e. no wealth maximization for investors.

Miglani (2011) conducted a study on the impact of rights shares issued by Indian companies that took place during 2005 and 2010. The samples of 32 rights issues were used to study the announcement effect. The study examined the stock price reaction to information content of rights issues with a view to finding out whether Indian stock market is semi-strong efficient or not. The standard event study methodology was used for the purpose of examining the rights issue announcement reaction. The study revealed statistically significant abnormal returns on the announcement & surrounding dates.

Madhuri, Thenmozhi, and Kumar (2003) found negative reaction to the bonus issue announcement. They were of the opinion that market under reacted after the announcement of bonus issue. Kabir & Roosenboom (2003) observed that statistically significant negative abnormal return associated with announcement effect of rights issues in Netherlands. Mishra, (2005), examined the stock price reaction to information content of bonus issue. The results indicated significant positive abnormal returns for a five day period prior to bonus announcement. The results indicated the semi strong market efficiency of the Indian stock market. Chen and Chen (2007) examined 205 right issues in China and found market reacts negatively around such announcement date, but positively during the post announcement period (in +10 to +20 days expiration period). Vergos et. al (2008) investigated the effects of political, economic, investment and analysts report announcement on share prices of Hellenic telecommunication organization. The study found that stock prices do not react to public announcement and continue to increase or decrease until 10 days after the event. Owen & Suchard (2008) reported significant abnormal return associated with announcement of right issue of equity in Australia.

Kithinji (2014) conducted a study on the effect of rights issue on firms share performance in the Nairobi Securities Exchange, Kenya. The study found that Rights issues give existing shareholders the option of purchasing new shares, normally issued at a discount to the prevailing market price in order to encourage participation in the capital raised over purchasing shares in the market. The research was to evaluate the effects

of rights issue on firms' subsequent trading prior to and after the issue. All the firms listed at the Nairobi Securities Exchange were part of the NSE 20 share index which was considered. In addition to this, all the firms that performed rights issue between 2007 and 2012 were included in the target population whether or not they were part of the NSE 20 share index.

Karanja (2006) did a study on an evaluation of post rights issue effect on firms' share price and traded volumes. The study evaluated 9 out of the 14 firms that had announced rights issue by analyzing 90 days after the rights issue and noted that most firms that announce rights issue usually experience a decrease in the share price after the issue at least in the very short run. The study recommended that firms that announce rights issue must consider information asymmetry as this highly determines the firms share prices after successful rights issue. Olesaaya (2010) did a research on the effects of rights issue on stock returns and he investigated companies listed at the NSE. The study used market model which is a statistical model that relates the returns of any given security to the return of the market portfolio to measure and analyze the abnormal returns. The study assumed that the abnormal returns reflect the stock market's reaction to the announcement of rights issue. The study found negative abnormal returns prior to announcement of rights issue, positive abnormal returns during the announcement and negative results thereafter.

Wabwire et.al (2013) conducted a study on issues that may impact the market returns. In addition, the study assessed the effects of the turnover and volume traded on the market return. The study incorporated all the seven recently floated IPOs at the NSE between January 2006 and March 2009. The main results from the fitted linear regression model showed that all IPOs had a significant effect on the market return. This study employed logistic regression to evaluate the effect of the IPO announcement within the 60-day window period on the market index. The study found that all IPOs had positive significant influence on the market return except for Eveready and KenGen.

III. Methodology

The study adopted an event study methodology which attempt to establish the information content of right Issue on share returns. The population of this study was 18 companies listed in the NSE. The secondary data was collected for 7years from 2005-2012. Share prices for 30 days before the announcement of right issue and 30 days after the announcement of the right issue was used to generate actual returns, expected returns and abnormal returns. T test analysis was used to test whether there was significant difference on returns between the two periods before and after announcement date. The collected secondary data was coded and entered into Statistical Package for Social Sciences (SPSS, Version 20.0) for analysis. The study collected data on NSE 20 share index for the identified right issue dates.

MacKinlay (1997) outlined an event study methodology involving the following steps: (i) identification of the event of interest; (ii) definition of the event window; (iii) selection of the sample set of firms to be included in the analysis; (iv) prediction of a "normal" return during the event window in the absence of the event; (v) estimation of the "abnormal" return within the event window, where the abnormal return is defined as the difference between the actual and predicted returns, without the event occurring; and (vi) testing whether the abnormal return is statistically different from zero. The study computed the changes recorded in share prices as measured by the NSE 20 Share index. To arrive at conclusive results, the study compared the performance of the NSE 20 share index before, during and after right issue for the seven years 2005 to 2012.

The market model that was applied was;

Y=a+b1x1+error term
Where
Y= actual returns
X1=market return
B1=market risk

The research applied a mean adjusted return model below to measure abnormal returns on securities in the period of study.

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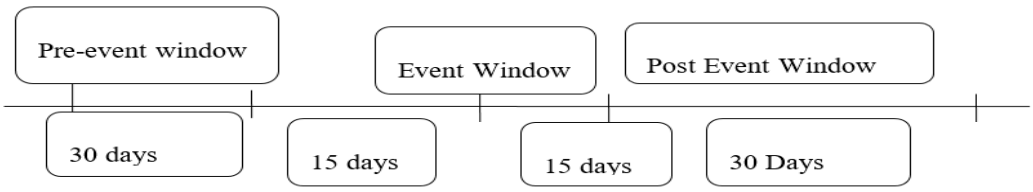

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$$AR_{it}=R_{it}-(\alpha_i+\beta R_{mt})$$

Where:

AR_{it}= abnormal return of stock i at date t

R_{it}= actual return of stock i at time t

R_{mt}= market return

α and β=firm specific constants or parameters from the estimation period.

In event studies abnormal returns were aggregated over both observation of events and investigation windows. Individual securities' abnormal returns were aggregated AR_{it} for each period for any given number of N events. Cumulative average abnormal returns

$$CAAR_{(T1,t2)}=\sum_{t1}^{t2}\frac{1}{N}\sum_{T-1}^{n}AR_{IT}$$

Test statistics were used to measure the statistical significance the $CAAR_S$ reported before and after the event window of a significant level of 95%. To test for the strength of the model the study tested at 95% confidence level and 5% significant levels. If the significance number found is less than the critical value (α) set 0.05, then the conclusion would be that the model is significant in explaining the relationship. Else the model would be regarded as non - significant.

IV. Findings Conclusion

A conclusion section must be included and should indicate clearly the advantages, limitations, and possible applications of the paper.

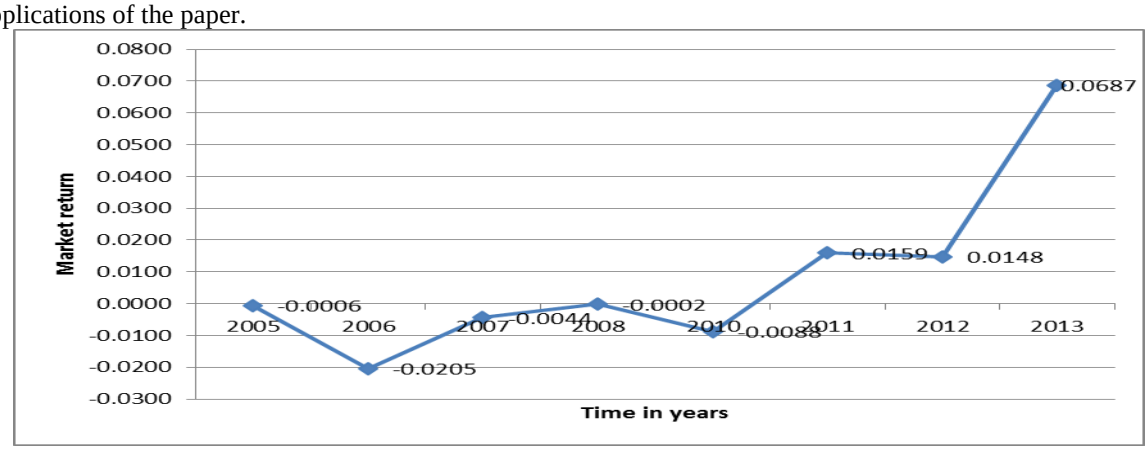

Figure 4.1: Trend Analysis of Market Returns

Although a conclusion may review the main points of the paper, do not replicate the abstract as the conclusion. A conclusion might elaborate on the importance of the work or suggest applications and extentions. This section presents the trend analysis of the dependent and independent variables of the study. The trend analysis of the market return represented in figure 4.1 shows that there was a drastic decline from year 2005 to year 2006 followed by a slight increase in the year 2007 to 2008 and drastic increase in the market returns in 2010 to 2013 to attain a mean of 0.00687.

Trend analysis in stock returns presented in figure 4.2 indicates a slight decline in stock return in year 2005 and a slight increase in 2007. The mean stock return of year 2008 to 2010 drastically increase to the mean of 0.0391 which indicates that there were many companies that made their right issues that year hence high stock returns.

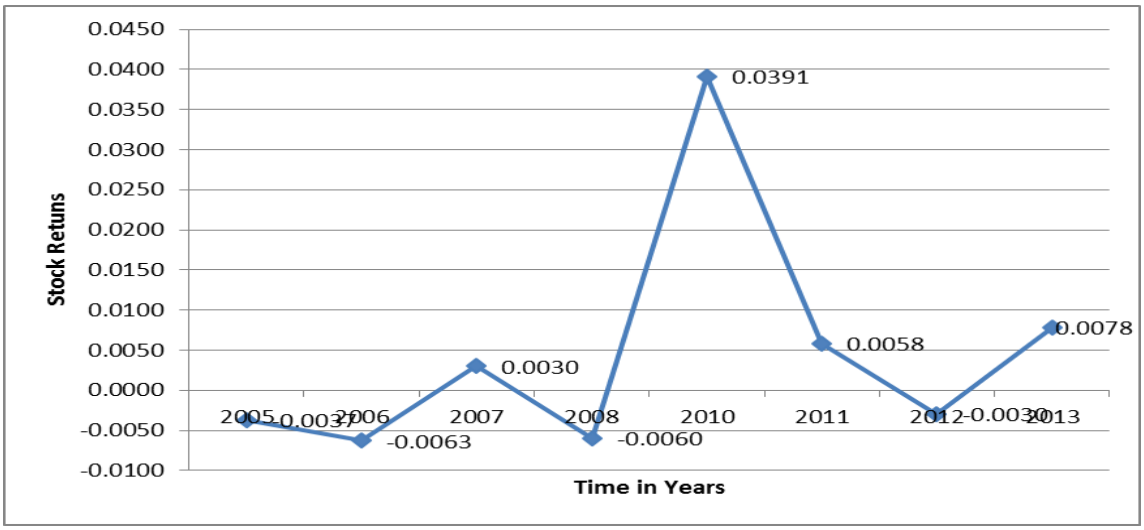

Figure 4.2: Trend Analysis in Stock Returns

Although a conclusion may review the main points of the paper, do not replicate the abstract as the conclusion. A conclusion might elaborate on the importance of the work or suggest applications and extentions. This section presents the trend analysis of the dependent and independent variables of the study. The trend analysis of the market return represented in figure 4.1 shows that there was a drastic decline from year 2005 to year 2006 followed by a slight increase in the year 2007 to 2008 and drastic increase in the market returns in 2010 to 2013 to attain a mean of 0.00687

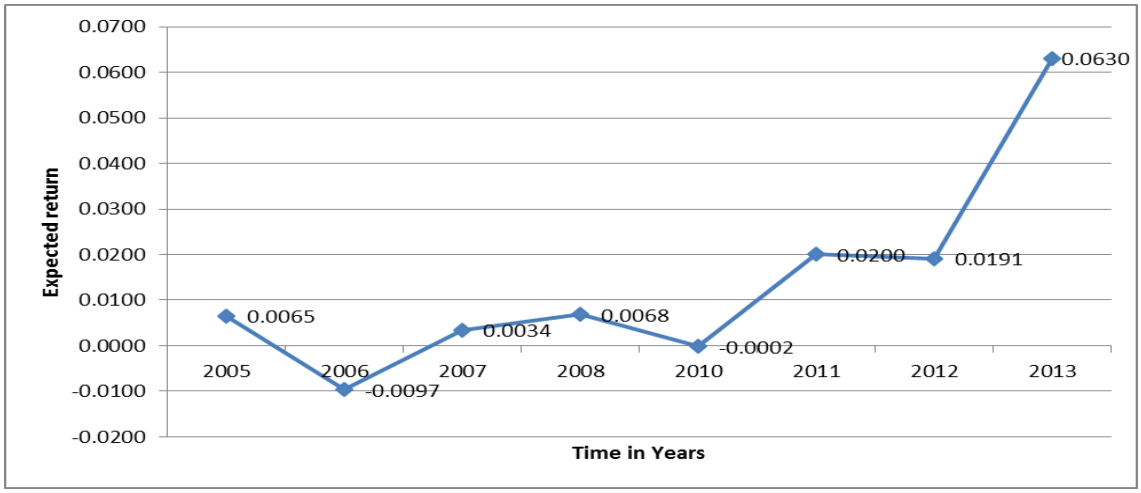

Figure 4.3: Trend Analysis of Expected Returns

Trend analysis in expected returns presented in figure 4.3 indicates a decline in expected return in year 2005 to 2008 and a drastic increase in the year 2010 to 2013. The mean expected return of year 2006 was the lowest at -0.0097 which indicates that there were few companies that made their right issue that year hence low market returns. This indicates that there was also low activity in individual stock returns and market returns in that year hence the low expected returns.

The trend analysis of the abnormal return represented in figure 4.4 shows that there was a slight incline from year 2005 to year 2007 followed by a slight decrease in abnormal returns in the following years. Abnormal returns present the difference between the actual returns and the expected returns over a certain period of time. This changes that caused the drift in abnormal returns as represented by the graph can be explained by the changes in market returns and the right issue. In 2010 the abnormal returns shoot to 0.0392 and were the highest

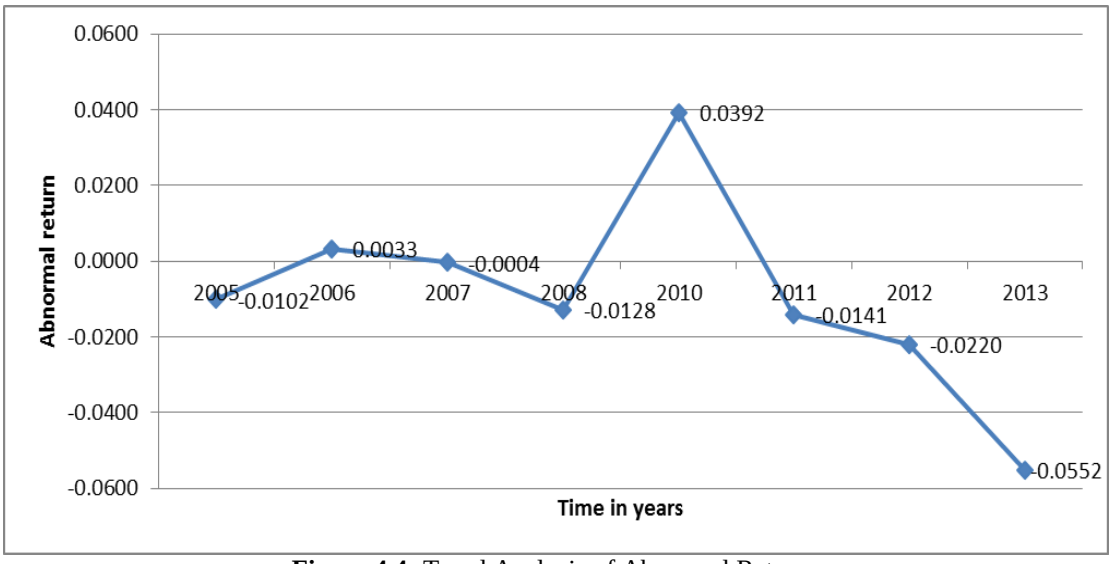

Figure 4.4: Trend Analysis of Abnormal Returns

This was because to the issuance of the right issue thus the individual stock returns for the companies increased due to the market activities. This further is because abnormal returns are sometimes triggered by events. In finance events can typically be classified as occurrences or information that has not already been priced by the market. The decline in 2012 and 2013 may be as a result of a decline in the firms' market value which exceeded the expected amount, this therefore is a loss.

This section illustrates the fitness of the model used in the study as well as the calculation that derived the alpha and beta coefficients for generation of the abnormal returns. Table 4.1 shows fitness of the regression model in determining the abnormal returns. The variables that are used to determine abnormal returns were actual stock returns and market returns. From the results presented below, an R square of 0.014 indicates that the independent variable; market return explains 1.4% of the variations of actual stock return. This shows that the goodness of fit of model is not satisfactory.

Table 4.1 Regression Fitness Model

Indicator	**Coefficient**
R	0.118
R Square	0.014
Adjusted R Square	0.013
Std. Error of the Estimate	0.339725

ANOVA statistics presented on Table 4.2 indicate that the overall model was statistically significant. This was supported by an F statistic of 12.206 and probability (p) value of 0.001. Probability value (p) is usually given the value of 0.05; therefore any value below the same is statistically significant while any value above 0.05 is not significant. Therefore from the results the reported p value 0.001 was less than the conventional probability of 0.05 significance level thus its significance. The ANOVA results imply that the overall model is significant.

Table 4.2: Analysis of Variance (ANOVA)

Indicator	**Sum of Squares**	**df**	**Mean Square**	**F**	**Sig.**
Regression	1.409	1	1.409	12.206	0.001
Residual	100.178	868	0.115		
Total	**101.587**	**869**			

Table 4.3 presents results of the alpha and beta constants that were used to derive the abnormal return. The model presented below shows how the abnormal return was calculated. The regression of coefficients results further indicate that the variable market return had a positive and significant relationship with the actual

stock return, which is evident from the value 0.001. The conventional value of 0.05 is the scale that determines the significance of an independent variable, thus any value below 0.05 is significant and a value above the same is not significant. Therefore in the results, 0.001 is lower than the conventional value 0.05 thus making the market return variable significant in explaining actual stock return and determining the beta and alpha coefficients.

Table 4.3: Regression of Coefficients

Variable	Beta	Std. Error	t	Sig.
Constant	0.007	0.012	0.614	0.539
Market returns	0.815	0.233	3.494	0.001

Y=0.007+0.815X

Y =Expected Return

X= Actual Returns

The table below provides descriptive statistics for the returns, market, expected and abnormal returns before and after right issue. The results indicate a high score in the mean of market return after right issue than before the right issue. This is presented by a negative mean of 0.002 before the right issue and a mean of 0.000 after right issue. The stock returns had a mean of 0.018 before the rights issue and a mean of 0.001 after the rights issue. The same case is also presented in the expected returns mean where the returns before the rights issue is 0.006 and after the rights issue is 0.007. The mean of the abnormal return before the right issue is 0.013 and the mean after the right issue is -0.006. These results show that Abnormal returns show insignificant differences before and after right issue.

	Period	Mean	Std. Deviation	T	Sig.
Market return	before	0.002	0.063	8.409	.000
	After	0.000	0.031		
Stock return	before	0.018	0.510	0.35	.931
	After	0.001	0.028		
Expected	before	0.006	0.051	8.409	.000
	After	0.007	0.026		
Abnormal	Before	0.013	0.506	0.598	.758
	After	0.006	0.030		

V. Conclusion

Following the study findings, it was possible to conclude that the market return is a good predictor of stock returns. Finally, results led to the conclusion that the expected returns as well as the market returns were significantly higher after right issuance than before right issue. However, abnormal returns were not significantly different implying that the informational content of right issues do not affect stock return and this may be an indicator of market efficiency. The unique contribution of the paper is that it will reduce the inconclusiveness that has been observed in empirical studies focusing on impact of right issue.

VI. Recommendations for further studies

This study recommends that further studies to be done on the impact on stock return of the companies listed at the NSE; could include bonus issues, IPOs, elections, post-election violence, and global economic crisis. This is because this study focused on the impact of rights issue on share return thus, a yearly overview could be an interesting study to identify the effects on company's financial and share performance. Also, other studies on other rights issue on stock return should be done to show clearly the effect of events announcement on right issue.

The study recommends that NSE to establish and enhance policies for investing so as to attract and encourage large institutional and foreign investors to participate at the NSE. The study also recommends that policy makers and regulators at the NSE should encourage more research on the NSE form of efficiency; this will provide a forum for investors to get the information on the form of efficiency of the market and boost their confidence in the operations of NSE.

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