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MARKET REACTIONS TOWARDS CAPITAL EXPENDITURE ANNOUNCEMENTS**DR. SHANTANU MEHTA****DIRECTOR****ST. KABIR INSTITUTE OF PROFESSIONAL STUDIES****AHMEDABAD****RAJALAKSHMI VEL****ASST. PROFESSOR****ST. KABIR INSTITUTE OF PROFESSIONAL STUDIES****AHMEDABAD****ABSTRACT**

This study attempts to examine share price reactions to a firm's capital expenditure announcements in the Indian stock market. While previous studies make important contributions to furthering our understanding of the valuation effects of corporate investment decisions, they do not suggest why capital allocation decisions of some companies are favorably received by the market, whereas similar decisions of other companies are discouraged by the market. Therefore the pertinent research question is to examine the key determinants of positive/negative abnormal returns. In this study we postulate investment opportunities by focused firms are assessed positively (increase) by market and those by diversified firms are assessed negatively by the market (decrease) irrespective of their industry background. Our empirical results are consistent with these predictions. The results of our study support our conjecture that focused firms tend to have better investment opportunities than highly diversified firms.

KEYWORDS

Investment opportunities, Event study, Capital Expenditure, Abnormal returns.

JEL CLASSIFICATION

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INTRODUCTION

Corporate managers are regularly faced with three major policy decisions: Investment decisions, dividend (payout) decisions, and financing decisions. A number of studies have rigorously examined the impact of announcements of corporate financing and dividend decisions on the market value of firms (Masulis, 1980, 1983; Eades et al., 1985; Kalay and Lowenstein, 1985; Ofer and Siegel, 1987; Barclay and Litzenberger, 1988; Lang and Litzenberger, 1989; Loderer and Mauer, 1992; Denis, 1994; Jung et al., 1996). However, empirical evidence on the valuation effects of announcements of corporate capital expenditure decisions is relatively sparse. This study aims to provide evidence on the impact of capital expenditure decisions on share prices in the Indian stock market.

LITERATURE REVIEW

McConnell and Muscarella (1985) examine the market reaction to capital expenditure decisions by industrial and public utility firms. They find that announcements of increases (decreases) in capital expenditures lead to significant positive (negative) stock returns for industrial firms. For public utility firms, however, they find that announcements of capital expenditure decisions do not have any material effect on stock returns. Chan et al. (1990) examine the market response to announcements of R&D spending by firms in both high and low-technology industries. They find that those firms in high-technology industries which announce increases in R&D spending, on average, experience positive abnormal returns, but those in low-technology industries experience negative returns. Chan et al. (1994) find that the stock market reacts positively to business relocation decisions that are motivated by business expansion or cost savings, but negatively to decisions that are motivated by capacity reduction or facilities consolidation.

IMPORTANCE OF THE STUDY

In a competitive market, funds for capital expenditure will be allocated to projects that enhance the firm's long-term prospects. Based on the premise, markets should react positively to corporate announcements of capital expenditure decisions to the extent it maximizes firm value. While previous studies make important contributions to furthering our understanding of the valuation effects of corporate investment decisions, they do not suggest why capital allocation decisions of some companies are favorably received by the market, whereas similar decisions of other companies are discouraged by the market. Therefore the pertinent research question is to examine the key determinants of positive/negative abnormal returns. For this, it is important to understand investment opportunities by both focused and diversified firms.

STATEMENT OF THE PROBLEM

As suggested by Wernfelt and Montgomery (1988) and Lang and Stulz (1994), focused firms tend to have better investment opportunities than highly diversified firms. Therefore investment opportunities by focused firms are assessed positively (increase) by market and those by diversified firms are assessed negatively by the market (decrease) irrespective of their industry background. This rests on the premise that since firms with better investment opportunities are more likely to invest in positive net present value projects, capital investments by focused firms will be more worthwhile than those by diversified companies.

OBJECTIVES OF THE STUDY

The objectives of the study are stated as follows:

1. To conduct an event study of capital expenditure announcements.
2. To examine if market reactions vary with the characteristics of the company making the announcement.

HYPOTHESIS

Hypothesis1: Announcements of increase in capital expenditures by focused are viewed favourably by the market

Hypothesis2: Announcements of increase in capital expenditures by diversified firms are received negatively by market.

FRAMEWORK FOR RESEARCH

The standard event study methodology and regression analysis are employed to empirically test the hypothesis.

CHARACTERISTICS OF INVESTMENT DECISIONS

Kester provided classification for capital expenditure decisions for project appraisal. The following investment categories emerge out of the classification provided.

- Cost reduction projects
- Asset expenditure projects
- Product/market diversification projects
- Research and development projects

All the above classifications of investment decisions are covered for the study.

SAMPLE SELECTION PROCEDURE

Data on capital expenditure announcements are collected from NSE India and Capitaline database for the period starting 1st April 2013 to 31st December 2013. For each capital expenditure news, an announcement date is identified. Initially 12 companies were identified with capital expenditure announcements. However, only companies meeting the following criteria were finalized as samples.

- i. Announcements pertinent to capital spending decisions are selected in the sample. Thus announcements of acquisitions, tender offers, strategic alliances are excluded from the sample.
- ii. Announcements must contain information about the approximate size and the general use of funds.
- iii. Announcements must be made in isolation of other announcements (i.e. earnings, dividend, split, bonus etc). This reduces the effect of extraneous information on stock prices.
- iv. Finally companies whose daily return data for the period of the study must be available from nseindia.com.

These restrictions eliminate 7 samples from the initial database.

METHODOLOGY**MEASURING ABNORMAL RETURNS**

The study employs the standard event study methodology to measure abnormal returns around capital expenditure announcements. The estimation period is from -7 to +7 days prior to announcement. Daily stock return data during the study period of 30 days are obtained from nesindia.com. Let R_{it} designate the stock return of firm i on day t . Then the abnormal return of firm i (AR_{it}) during the event period is measured using the following formula:

$$AR_{it} = R_{it} - (\alpha + \beta_i R_{mt})$$

CAPITAL EXPENDITURE ANNOUNCEMENTS**MAHINDRA AND MAHINDRA**

Announcement Date: 4/9/2013

Announcement Details: M&M announced 10000 Crore in next three year with the purpose of launching new products. A new plant would be set up Maharashtra for this purpose. Of the 10,000 crore capex, Rs 7,500 crore are for automotive and farm equipment and another Rs 2,500 crore investment will be on group companies.

CAIRN INDIA

Announcement Date: 13/7/2013

Announcement Details: Cairn India has announced a capex of Rs 16,000 crore or \$3 billion for finding and producing more oil over the next three years through the end of FY 2016. In Rajasthan alone, the company will be investing over Rs 13,000 crore and drilling over 450 wells comprising 100 exploration wells and over 350 development wells.

RELIANCE INDUSTRIES

Announcement Date: 6/06/2013

Announcement Details: Reliance industries announced a planned capital outlay of Rs1,50,000 crore over the next three years, spread over its core business of petrochemicals and oil as well as the retail and telecom sectors. The investments span oil and gas exploration and production, refining and marketing, petrochemicals, retail and broadband and digital services.

NTPC

Announcement Date: 17/09/2013

Announcement Details: NTPC has planned capital expenditure of over Rs.20,000 crore during the current fiscal till March 31, 2014. This would take its installed power generation capacity to over 41,000 MW.

POWER GRID CORPORATION

Announcement Date: 19/09/2013

Announcement Details: State-run Power Grid Corp has announced its capital expenditure for 2012-17 by Rs 10,000 crore in view of additional projects and adding transmission capacity undertaken by the firm. A company is also taking additional projects are being taken up including the smart grid projects, joint ventures with other firms.

ANALYSIS

TABLE 1

Days	Cairn		MM		Power Grid		NTPC		Reliance	
	Exp Return	Abnormal Return	Exp Return	Abnormal Return	Exp Return	Abnormal Return	Exp Return	Abnormal Return	Exp Return	Abnormal Return
7	1.67	2.33	0.66	6.34	-0.48	-2.37	0.94	-2.49	0.17	1.45
6	1.25	-0.85	-0.39	6.39	0.64	-1.15	1.08	1.59	0.31	0.57
5	0.57	-2.12	-0.80	5.80	-0.44	1.71	1.64	1.03	0.55	-1.52
4	2.06	0.63	0.10	3.90	0.74	2.07	0.85	-2.21	-0.48	-2.86
3	-0.24	0.71	0.13	2.87	-0.48	-0.01	0.24	1.40	-0.59	-1.37
2	1.17	-1.59	-0.63	2.63	-0.49	0.39	0.83	1.12	0.85	-2.17
1	0.92	-0.39	-0.23	1.23	-0.94	-1.40	0.19	-0.08	0.08	2.68
D-Day	-0.63	3.46	1.03	0.61	0.74	0.10	0.85	1.19	0.24	-1.24
1	-1.25	0.25	-0.02	1.02	0.39	-1.23	0.86	2.35	-0.03	-1.30
2	-0.94	0.10	-0.07	2.07	-0.60	1.21	1.10	-1.78	-0.26	0.30
3	-0.56	-1.69	-0.66	3.66	0.09	1.42	0.19	0.70	-0.45	0.72
4	-1.81	-0.31	-0.21	4.21	-0.30	-0.40	0.38	-2.57	0.11	0.88
5	0.65	1.12	0.26	4.74	0.56	-0.91	0.92	2.20	-0.46	1.33
6	-0.90	-4.05	-1.44	7.44	0.50	-0.66	0.54	1.90	1.21	1.10
7	-1.59	2.37	0.67	6.33	-0.46	1.22	0.76	0.05	-0.21	1.44

EMPIRICAL RESULTS

The above table reports abnormal returns surrounding the capital expenditure announcements made by Indian firms during the six month period. The sample is a mix of firms to enable market reaction of focused and diversified companies to be analysed. The investigation period is one week before and one week after the announcement date. For four samples of focused firms the market reaction is positive and significant for the day of the announcement. There is post announcement drift in one sample. For diversified company positive returns are observed in the pre-announcement period (-1,-3,-4 & -5 days). This is consistent with the previous literature given by Wernfelt and Montgomery (1988) and Lang and Stulz (1994) that focused firms tend to have better investment opportunities than highly diversified firms

CONCLUSION

Abnormal returns around announcement date of capital expenditures

TABLE 2

Days	Both		Focused Companies		Diversified Companies	
	AR (%)	t-Value	AR (%)	t-Value	AR (%)	t-Value
-5	4.90	0.74	6.42	1.12	-1.52	0.61
-4	1.53	1.7	4.39	2.13	-2.86	1.07
-3	3.60	3.13	4.97	3.59	-1.37	2.35
-2	0.38	2.4	2.55	3.07	-2.17	1.72
-1	2.04	1.79	-0.64	2.98	2.68	1.43
0	-0.26	1.51	0.96	1.98	-1.24	1.48
1	1.09	1.69	0.21	1.94	-1.30	1.64
	13.28	2.46**	18.86	3.53***	-7.78	1.94*

* Significant at the 10% level

** Significant at the 5% level

*** Significant at the 1% level

The mean difference test of focused companies and diversified companies portfolios is statistically significant at the 5% level (t-statistic of 1.72)

Table 2 shows that the CAR value for focused company is 18.86 and is statistically significant at the 1% level. The corresponding CAR value for diversified companies is -7.78 and is statistically significant at the 10% level. The mean difference test of CAR between the two portfolios is statistically significant at the 5% level (with a t-statistic of 1.72). We observe that the wealth effects of capital expenditure decisions by focused companies are more favourably rated than those by diversified companies. The finding of this study also supports hypotheses which assert that focused companies are perceived to be more likely to emphasize the maximization of shareholder wealth than diversified companies. The findings of this investigation are also consistent with a recent study by Ferris, Kim and Kitsabunnarat (2003) who found that diversified companies experience loss of shareholder wealth because of the tendency of managers to over-invest and deviate from the wealth maximization principle.

SCOPE FOR FURTHER RESEARCH

Further research can be extended to consider other characteristics that may reveal the quality of the firms' investment opportunities which determines positive/negative reactions.

ANNEXURE**TABLE 3**

Cairn India Ltd			Y variable		X variable		
Days	Dates	Closing Price	Stock Return	Index Closing	Index Return	Expected Return	Abnormal Returns
7	15-Jul-13	302.65	4.0034	6030.8	0.6609	1.67	2.33
6	16-Jul-13	303.2	0.3973	5955.25	0.4122	1.25	-0.85
5	17-Jul-13	295.7	-1.5481	5973.3	0.0175	0.57	-2.12
4	18-Jul-13	303.65	2.6885	6038.05	0.8914	2.06	0.63
3	19-Jul-13	308.05	0.4729	6029.2	-0.4622	-0.24	0.71
2	22-Jul-13	306.7	-0.422	6031.8	0.3669	1.17	-1.59
1	23-Jul-13	310	0.5351	6077.8	0.2226	0.92	-0.39
D-Day	24-Jul-13	308.6	2.8323	5990.5	-0.6912	-0.63	3.46
1	25-Jul-13	304.25	-0.9925	5907.5	-1.0535	-1.25	0.25
2	26-Jul-13	303.45	-0.8333	5886.2	-0.8715	-0.94	0.10
3	29-Jul-13	297.55	-2.2503	5831.65	-0.6524	-0.56	-1.69
4	30-Jul-13	292.15	-2.1273	5755.05	-1.3879	-1.81	-0.31
5	31-Jul-13	295.15	1.7758	5742	0.0636	0.65	1.12
6	1-Aug-13	289.9	-4.9508	5727.85	-0.849	-0.90	-4.05
7	2-Aug-13	296.3	0.7823	5677.9	-1.2547	-1.59	2.37

TABLE 4

Mahindra & Mahindra			Y variable		X variable		
Days	Dates	Closing Price	Stock Return	Index Closing	Index Return	Expected Return	Abnormal Returns
7	30-Apr-13	924.1	2.4104	5930.2	-0.0405	-0.1194	2.5298
6	2-May-13	953.6	4.3440	5999.35	1.4878	0.3832	3.9608
5	3-May-13	961	0.8924	5944	-0.8259	-0.3777	1.2701
4	6-May-13	966.45	1.1884	5971.05	0.4399	0.0386	1.1498
3	7-May-13	959.1	-0.2133	6043.55	1.0044	0.2243	-0.4375
2	8-May-13	946.4	-1.7493	6069.3	0.0849	-0.0782	-1.6711
1	9-May-13	947.9	0.3547	6050.15	-0.4639	-0.2587	0.6134
D-Day	10-May-13	970.2	2.5310	6094.75	0.8022	0.1577	2.3733
1	11-May-13	967.6	0.2435	6107.25	0.3129	-0.0032	0.2466
2	13-May-13	956.35	-0.7936	5980.45	-1.9309	-0.7412	-0.0524
3	14-May-13	950.8	-0.4658	5995.4	0.0952	-0.0748	-0.3910
4	15-May-13	983.75	3.1996	6146.75	2.1250	0.5928	2.6068
5	16-May-13	985.4	0.5510	6169.9	0.6796	0.1174	0.4336
6	17-May-13	987.3	0.7346	6187.3	0.2325	-0.0296	0.7643
7	20-May-13	1,002.00	1.7672	6156.9	-0.6631	-0.3242	2.0914

TABLE 5

Power Grid			Y variable		X variable		
Days	Dates	Closing Price	Stock Return	Index Closing	Index Return	Expected Return	Abnormal Returns
7	11-Sep-13	99	-2.85	5913.15	0.44	-0.4764	-2.37
6	12-Sep-13	99	-0.50	5850.7	-1.36	0.6437	-1.15
5	13-Sep-13	99.75	1.27	5850.6	0.39	-0.4439	1.71
4	16-Sep-13	102.55	2.81	5840.55	-1.51	0.7417	2.07
3	17-Sep-13	101.55	-0.49	5850.2	0.45	-0.4805	-0.01
2	18-Sep-13	100.4	-0.10	5899.45	0.45	-0.4856	0.39
1	19-Sep-13	100.4	-2.33	6115.55	1.18	-0.9388	-1.40
D-Day	20-Sep-13	101.6	0.84	6012.1	-1.51	0.7423	0.10
1	23-Sep-13	99.25	-0.85	5889.75	-0.94	0.3858	-1.23
2	24-Sep-13	99.15	0.61	5892.45	0.64	-0.6010	1.21
3	25-Sep-13	100.5	1.52	5873.85	-0.47	0.0906	1.42
4	26-Sep-13	99.3	-0.70	5882.25	0.16	-0.3024	-0.40
5	27-Sep-13	98.95	-0.35	5833.2	-1.23	0.5619	-0.91
6	30-Sep-13	98.05	-0.15	5735.3	-1.13	0.5047	-0.66
7	1-Oct-13	99	0.76	5780.05	0.42	-0.4616	1.22

TABLE 6

NTPC			Y variable		X variable		
Days	Dates	Closing Price	Stock Return	Index Closing	Index Return	Expected Return	Abnormal Returns
7	5-Sep-13	130.45	-1.55	5592.95	0.71	0.9418	-2.49
6	6-Sep-13	134.3	2.68	5680.4	1.12	1.0825	1.59
5	10-Sep-13	138.6	2.67	5896.75	2.76	1.6376	1.03
4	11-Sep-13	137.6	-1.36	5913.15	0.44	0.8517	-2.21
3	12-Sep-13	139.45	1.64	5850.7	-1.36	0.2425	1.40
2	13-Sep-13	141.1	1.95	5850.6	0.39	0.8340	1.12
1	16-Sep-13	142.95	0.11	5840.55	-1.51	0.1893	-0.08
D-Day	17-Sep-13	143.15	0.13	5850.2	0.00	0.8539	-0.72
1	18-Sep-13	144.9	3.21	5899.45	0.45	0.8567	2.35
2	19-Sep-13	147.1	-0.68	6115.55	1.18	1.1031	-1.78
3	20-Sep-13	148.3	0.88	6012.1	-1.51	0.1890	0.70
4	23-Sep-13	142.8	-2.19	5889.75	-0.94	0.3828	-2.57
5	24-Sep-13	145.45	3.12	5892.45	0.64	0.9194	2.20
6	25-Sep-13	149	2.44	5873.85	-0.47	0.5433	1.90
7	26-Sep-13	149.7	0.81	5882.25	0.16	0.7571	0.05

TABLE 7

Reliance			Y variable		X variable		
Days	Dates	Closing Price	Stock Return	Index Closing	Index Return	Expected Return	Abnormal Returns
7	28-May-13	843.4	1.61	112.5	0.13	0.1679	1.45
6	29-May-13	847.9	0.88	113.5	0.49	0.3128	0.57
5	30-May-13	836.8	-0.97	114.4	1.06	0.5477	-1.52
4	31-May-13	806.3	-3.33	113.3	-1.44	-0.4752	-2.86
3	3-Jun-13	787.9	-1.97	111.4	-1.72	-0.5920	-1.37
2	4-Jun-13	780.2	-1.32	113.2	1.80	0.8504	-2.17
1	5-Jun-13	802	2.75	112.45	-0.09	0.0768	2.68
D-Day	6-Jun-13	792	-1.00	112.05	0.31	0.2416	-1.24
1	7-Jun-13	783.6	-1.33	110.65	-0.36	-0.0344	-1.30
2	10-Jun-13	789.35	0.04	110	-0.90	-0.2561	0.30
3	11-Jun-13	785.6	0.27	107.85	-1.37	-0.4491	0.72
4	12-Jun-13	790.8	0.99	108	0.00	0.1132	0.88
5	13-Jun-13	789.8	0.87	105.75	-1.40	-0.4601	1.33
6	14-Jun-13	814.65	2.32	109.1	2.68	1.2127	1.10
7	17-Jun-13	825.55	1.23	108.2	-0.78	-0.2063	1.44

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