THE VALUATION EFFECT AND DETERMINANTS OF CORPORATE CONTRACTING

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Lijia Chen

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ABSTRACT

This study examined abnormal stock market returns to equity holders around corporate contract announcement that were obtained from Dow Jones & Company, Inc. between January 1, 1990 and December 31, 2000. Of the 7137 contract announcement found, 984 contract wining companies (contractee) and 575 contract giving companies (contractor) were not contaminated by other announcements and have sufficient CRSP data to enter the final sample that was analyzed for excess returns to the contractees. Excess returns were also analyzed for the contractors. The Asymmetric Information Hypothesis and Information Content Hypothesis were used to develop hypotheses that predict contract announcement abnormal returns. The Market Model was used to analyze abnormal returns for both the contractees and contractors. As expected, statistically significant cumulative average excess returns were found for contractee companies, but not for contractor companies. Contractee excess returns were also examined for different industry groups. Also, the international or domestic nature of the contractor is analyzed for differences in abnormal returns. Contrary to expectations, the market reacted with more significant abnormal return for domestic contracting than the international contracting. Finally, cross-sectional regression models are developed to test the statistical significance of variables relative to sample characteristic, firm size, profitability, and information asymmetries of firm. Contractee relative contract size was found to have significant impact on cumulative average abnormal returns. Dummy variables were included in the cross-section model to account for the sequence of the contract and nationality of the contractee and contractor, but they were statistically insignificant to the model. The variables for contractor's firm were also statistically insignificant in effecting abnormal returns for their equity.

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TABLE OF CONTENTS

LIST OF TABLES

LIST OF FIGURES

CHAPTER I

INTRODUCTION

This paper uses the event study methodology to empirically examine the effect of contract announcement on the market value of equity for both firms entering the contract. Capital Market Efficiency Theory suggests if the markets were efficient, prices would adjust quickly to all relevant information. In a semi-strong efficient capital market, financial markets react in direct proportion to relevant informational announcement and stock prices react to all publicly available information.

While economic and finance literature is replete empirically examined numerous types of corporate announcements, like merger and acquisitions, leverage buy-outs, joint-ventures, capital structures and dividend payout changes, there have been very few empirical studies examine market reaction to contract announcements. Many articles have sought to theoretically explain the contractual process from both the legal and the mathematical perspective. Most of the empirical studies were in the area of asymmetric information and agency theory, and only few are on the market reaction to contract announcements. Diltz (1990) empirically examined stock market reaction to large contracts between the U.S. Department of Defense and the award-winning firms.

This study examines the stock market's reaction to contract announcements between publicly traded U.S. corporations, international corporations as the contractee and publicly traded U.S. corporations, international corporations as the contractor. It was believed that because government contracts are so numerous, they might dominate non-government contracts in the analysis. Therefore, government contracts were exclude from this study.

The objective of this study is to examine market reaction to contract announcements between listed corporate, using the Market Model and Center for Research on Security Prices (CRSP) data (Brown and Warner 1985). Contract announcements are expected to convey relevant information to the market about management's expectations toward the future investment opportunities of their company. Therefore, contract winning companies (contractees) are expected to receive significant positive abnormal returns in the announcement period, especially when there were numerous bidders, should be seen as good news by the market. Conversely, contract-giving companies (contractors) are not expected to earn significant abnormal returns around the announcement period. The market is expected to see the giving of a contract as the normal course of business of the contractors.

This study will categorize international contracts from purely domestic ones. The market is expected to react positively to a USA corporation entering an international contract, which should be a sign of a company that is either starting to, or continuing to diversity internationally. It should be a good sign, hence excess returns are expected. From the contractor's point of view, international business is usually viewed as more risky than strictly domestic business. Therefore, if a contractor is willing to take on the additional risks of an international contract, the international contract announcement should convey important information about the contractors' expectations concerning the future investment opportunities of the contractee. Also, there could be information asymmetries and monopolies that caused the contractor to go international. In either case, the market is expected to react with greater excess returns for the international contract than those for the domestic one.

Market reaction to the contract announcement will depend on the nature of the industry group in which the firm is operating. Capital Market theory indicate that the existence of information asymmetry in different market segments, such as service vs non-service firm, will cause the market to react more strongly under certain circumstances. A firm in a high technology industry wining a contract is expected to receive greater abnormal return than that low technology one, because of information asymmetries and monopolies.

The Market Model will also be used to analyze the difference in excess returns for different relative contract sizes. Relative contract size will be the ratio of the dollar value of the contract, to the total assets of the firm one year prior to the contract announcement. The market is expected to be influenced by the relative contract size. The announcement of a large company winning a large contract should not convey the same information as a smaller company winning an equivalently large contract. When a small firm wining a large contract, abnormal returns are expected for a large relative contract size, which should be signifying that the contractor is confident that the smaller company can perform the large contract.

Finally, cross-sectional regression models will be developed to analyze which variables are good predictors of expected excess returns. As already mentioned, firm size and relative contract size are expected to be good predictors of cumulative excess returns in the stock market. Both contractee and contractor Cumulative Average Excess Returns (CAER) will be the dependent variable, and a cross-sectional regression will be done on both contractee and contractor samples. For both the contractee and contractor sample, the regression will include dummy variables indicative of the international aspects, and the announcement sequence of the contractee and contractor.