



Research Paper-Commerce/Mkt. Management

Stock Split –An Instrument to Effect Share Prices

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Abstract:

A stock split proportionately increases the number of shares outstanding by corresponding decrease in face value of shares. It is said to be a complicated happening for researchers where in theory and practice are contrary to each other. On one hand, in theory, a stock split is a cosmetic change while on other hand, empirically, several studies have observed that stock splits results in significant impact on ARs and liquidity around announcement and ex-split day of stock splits. The present discussion offers different arguments to explain the unprecedented consequences of stock splits.

Keywords: *Stock split, Share prices*

1. Introduction

The financial markets in India especially stock markets have witnessed a number of changes in terms of trading environment, regulatory framework, increased competition, increase in range of instruments traded and presence of better informed market players.

In a financial market investors are exposed to a variety of information on daily basis like updated corporate earnings, revised macroeconomic indices, policy maker's statements and political news. A public company initiates a number of actions, termed as corporate actions, which affect prices of securities issued by company.

The corporate actions are - dividend announcements, rights issues, mergers and acquisitions, stock splits, bankruptcy, delisting, de-merger, initial public offer, liquidation, takeover, partial or final redemption, conversion of convertible bonds, warrants issue etc. These corporate actions may have direct or indirect impact on prices, volume, face value etc. of securities when information about the actions is disclosed through any channel of communication.

A corporate announcement is information about the corporate action. It is important to understand which news is good or positive and which news is bad or negative for a company. Researchers are interested in understanding effect of different corporate announcements. Studies have been done in past to analyse impact of these corporate announcements on share prices. Stock split is a corporate announcement which has been subject of interest for academicians as well as practitioners and topic of interest in the current study. There is ample scope for academic contributions in this research area, both in terms of appropriately analysing the impact of stock splits and in terms of extending literature by investigating new aspects of the theme.

The present article starts by introducing concept of stock splits along with brief discussion of different hypotheses relating to it formulated and tested in different empirical studies done in past covering various aspects of stock splits.

Stock Splits-Definition

Stock split is a corporate decision in which company divides face value of the equity share into more than one unit. Stock splits add no value but increases number of shares. A stock split is a decision by company's board of directors to increase number of outstanding shares of the company without changing shareholders equity but by changing face value of equity shares.

Main hypotheses about Stock splits

Stock split is a numeric change in face value of shares and it does not affect equity ownership of the investors. In theory, stock splits should not have any effect on share prices and there should not be any value creation as a result of it. In spite of theoretical simplicity, this corporate event has induced different reactions in variety of capital markets all over the world. Empirical studies in past have tried to analyse this significant reaction around stock splits. The empirical studies have tested different hypotheses and suggested them as possible explanations for significant impact on share prices around stock splits. The same are discussed below:

Optimal trading range hypothesis

This hypothesis was proposed by Copeland (1979) and states that there is a price range in which trading of shares of a company is most favourable for that company. There is maximum liquidity in this range. If share prices are higher than this price range, managers decide to split shares to bring down share prices. Thus stock splits is done in order to maintain share prices in a favourable trading range and improve liquidity by facilitating trading of shares. According to Conroy, Harris, and Bennet (1999) when shares become quite costly, stock splits is undertaken to move share prices to a suitable price range. The optimal trading range is considered as a compromise between desires of wealthy investors and institutions who desire a high price (to minimize brokerage costs) and desires of small investors who desire a low-price.

Signaling hypothesis

The hypothesis is based on assumption that there is information asymmetry between managers and investors of the company. This hypothesis assumes that managers convey their confidence in company's future favourable performance and cash flows through announcement of stock splits. Fama, Fisher, Jensen, and Roll (1969) stated that companies decide to split if management believes that future dividend of the company will be higher. The studies by Lakonishok and Lev (1987), Brennan and Copeland (1988) and; Asquith, Healy, and Palepu (1989) reported evidences that support this hypothesis.

Dividend hypothesis is a variation of signaling hypothesis. According to it stock splits can be interpreted as news about possible dividend increases in future. According to this hypothesis positive abnormal returns and increase in share prices around announcement day are not result of split per se, but result of possible dividend increases or decreases that is expected to follow or precede splits (Desai and Jain, 1997).

Optimal tick size hypothesis

Angel (1997) introduced the optimal¹ tick size hypothesis. According to Easley, O'Hara and

¹ An optimal tick size is considered to be the tick size that matches cost of extended bid-ask spreads along with advantages of higher liquidity. In equity markets there is an institutionally mandated minimum absolute tick size, which is optimal relative to share price. It is an optimal point where companies want to be.

Saar (2001) stock splits are used to move share prices into optimal range of tick size. It also results in lower share prices and relative higher tick size.

A large or higher tick size encourages investors to place limit orders. It reduces transaction costs and increases liquidity. It also increases incentive for market makers to promote such shares because of higher commission related to bid ask spreads and share based commission (Schultz, 2001).

Majority of equity markets around the world have policies on tick size. The main distinction is whether the equity market utilizes a single absolute tick size which applies to majority of shares, or a set of tick sizes which is function of share prices. In India tick size is very small and in majority of stock exchanges it is five paise only. Thus like other markets one of the primary reasons to go for stock splits in India cannot be to attain optimum tick size.

A variation of this hypothesis is the target-price habit hypothesis proposed by Raymond and Yiuman (2000). It considers sociological aspects of maintaining a stable target-price habit established by mutual reinforcement among financial analysts, managers and investors. This hypothesis holds that models based on economic reasons alone do not fully explain reasons of stock splits.

Tax timing hypothesis

The hypothesis was introduced by Lamoureux and Poon (1987). According to it stock returns are comparatively more volatile after a stock split and shares after a split, attain higher importance for tax-purposes. This is because stock splits results in an increase in number of shares traded and trading volume, due to lower share prices. The nature of clients for shares changes whenever there is a stock split. After a split, investors who are tax exempted do not gain from such split, as expected increase in potential earnings is diverted to tax saving options and these potential earnings are useless for them. The high tax paying individuals seem to favour such shares because split results in wide fluctuations in share prices. It gives an opportunity to investors to realize short-term losses which are compensated with long term gains later on. Thus tax-option value of such shares which are split increases (Lamoureux and Poon, 1987).

Liquidity hypothesis

This hypothesis is a variation of optimal trading range hypothesis. It is based on assumption that corporate liquidity is affected by share prices (Maloney and Mulherin, 1992; Muscarella and Vetsuypens, 1996). If share price is too high. Then liquidity may decline. A low share price attracts more individual investors (especially small investors), enhances trading liquidity and reduces trading costs. There are mixed reactions in support of this hypothesis. Lakonishok and Lev (1987) and Baker and Powell (1993) supports this hypothesis.

Neglected-firm hypothesis

Arbel and Swanson (1993) in relation to stock splits proposed neglected-firm hypothesis. It states that stock splits are used to draw attention of investors to company and gain recognition. According to this hypothesis little information in the market about a company which is not drawing interest of investors may attract attention of investors and result in an increase in number of shares traded of the company. This hypothesis is also termed as small-firm hypothesis or attention-getting hypothesis.

Self- selection hypothesis

This hypothesis was suggested by Ikenberry, Rankin, and Slice (1996). This hypothesis is synthesis of signalling and trading range hypothesis. According to it managers use stock splits to move share prices in a desired trading range. But they condition their decision to split based upon expectations about future performance of the company.

Manipulation hypothesis

According to this hypothesis stock splits is regarded as a tool to manipulate share prices prior to events like mergers, acquisitions public offers etc. D'Mello, Tawatnuntachai and Yaman (2003)² examined equity issues and noted that 14.38% of the issues were announced after stock splits in a year. They suggested that due to stock splits seasonal equity offering tended to become more marketable for individual investors. Guo, Liu and Sory (2008)³ reported that companies use stock splits to increase share prices and decrease cost of acquisition before acquisition announcement.

Dispersion of control energy or enlarge clientele hypothesis

This hypothesis was put forward by Demsetz and Lehn (1985) and supported by Morck, Shleifer and Vishny(1988); McConnell and Servaes (1990); and Kole (1995). According to this hypothesis company reduces share prices in order to disperse their ownership among larger investors and attract small investors that are not in a position to control the company. Thus stock splits are used to discourage possible takeovers (Lakonishik and Lev, 1987) because as a result of it shareholder base is expanded and diversified.

Price illusion hypothesis

The hypothesis was suggested by Chan (2003). According to it objective of a company is to enhance its market value. To achieve this objective there must be price illusion in relation to the shares among investors. This illusion can be created using stock splits because investors have limited abilities to assess value of shares for which they usually analyze fundamentals of the company, consider relative share prices of overall market and company's history. New investors consider absolute share value and like to buy low-priced shares. Considering these factors in mind companies use stock splits to enhance their market value by trying to affect investor's judgment without changing fundamentals of the company like manipulate share prices, offer additional equity etc.

Conclusion

The existing empirical researches have prompted a series of debates regarding significance and role of stock splits. There has been no consensus on how markets and share prices generally react to stock splits. It is not possible to generalize market reaction elicited by stock splits around announcement and ex-day. It is quite captivating to find behaviour of share prices around stock splits though in theory splits have no effect on value creation.

² D'Mello, Tawatnuntachai and Yaman (2003) were of view that stock splits is used to increase share prices to a higher level before company sells new shares to raise more funds.

³ Guo, Liu and Sory (2008) studied mergers and acquisitions along with stock splits and were of view that acquiring companies are likely to use stock splits to manipulate share prices of target companies before merger and acquisitions. This tendency of manipulation was found truer for acquirers with low earning quality as compared to acquirer with higher earning quality.

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