AN EMPIRICAL ANALYSIS OF MARKET REACTION AROUND BONUS ISSUE ANNOUNCEMENT IN NAIROBI SECURITY EXCHANGE

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Abstract

This research carried out an empirical analysis of market reaction around bonus issue announcement in the NSE. In most cases each and every Investor coming in to the security market faces a lot of uncertainty in an attempt to point out the cause of increase or decrease in the market price of securities and thus this research focused on the NSE as the sample in an attempt to know whether investors were adversely affected or not. The research used the event study approach where a sample of 12 firms which have had a bonus issue announcement larger than 25% for the period between 2005 to 2011 were selected and the researcher used a descriptive research where secondary data was used by analyzing security prices, NSE 20 share index, NASI Index and trading volume of firms which have been analysed and presented from which findings and recommendations were made.

The results obtained are consistent with previous studies conducted on emerging markets and not only, stating that there is significant non-zero cumulated abnormal return clustered closely
around the event day but also supports the signaling hypothesis, Liquidity hypothesis and Cash substitution hypothesis but refutes the attention getting hypothesis of bonus issue announcement.

**Key words;** Bonus, Scrip or Stock Dividend, Capital Markets, NSE 20-share index, Dividends, Market Index, Index, Blue Chip Stocks, Market Rationality, Stock Market

### Introduction

The impact of stock dividend announcements on the value of the firm remains a puzzle. According to Miller and Modigliani (1961) the value of a firm is not affected by the dividend policy of the firm. They argued that investors can undo any dividend policy effect without changing the value of the firm. However, contrary to their theoretical assumption, empirical studies of the impact of stock dividends on share prices show that significant price reactions occur on the announcement day (Mishra 2003, Chandrapala 2009).

Numerous suggestions have been offered to explain the nature of the share price reaction to stock dividend announcements, among which the signaling hypothesis is prominent. This hypothesis suggests that stock dividends are used by firms to reduce the information asymmetry between managers and investors about future earnings (Grinblatt *et. al.* 1984; McNichols and Dravid, 1990). Alternative explanations include the liquidity hypothesis which suggests that managers declare stock dividends to increase the liquidity of their shares (Lakonishok and Lev, 1987); the cash substitution hypothesis, which suggests that companies issue stock dividends as a substitute for cash dividends in order to conserve their cash reserves (Ghosh and Woolridge, 1989); the ‘attention-getting’ hypothesis, which suggests that managers declare stock dividends so as to attract the attention of financial analyst and investors (Grinblatt *et. al.*, 1984).

Otto Von Bismarck the great nineteenth century German statesman, once said; to assess the economic health of a Nation all one needs to do is visit its stock market, the movement of share prices expressed in changes in the stock market index can indicate the economic health of a Nation.

Eckbo *et al* (2002) Emerging markets are on the brink of becoming the losers from low interest rates initiated by the advanced economies’ central banks. Quantitative Easing lowered the
external value of currencies in advanced economies (US and UK), but caused stronger currencies in some of the more important emerging markets (Brazil and Mexico). This in turn led to weaker exports, slower growth, the introduction of capital controls and the threat of currency wars.

**Statement of the Problem**

Over the past few years interest rates on borrowed funds have been increasing and thus there has been an increasing trend of issuing stock dividends by firms listed in the NSE and thus reinvesting their earnings into other investments. In 2011 Centum Investment Limited embarked on cash retention to grow its asset base and therefore there is need to investigate the liquidity of such firms in order to ascertain the factors behind this trend and its effect on the market when such announcements are made.

Ariff and Lim (1990) argues that each and every Investor coming in to the security market faces a lot of uncertainty in an attempt to point out the cause of increase or decrease in the market price of securities and whether the market reaction around bonus issues gives strong positive or negative trigger in the security prices in the NSE. Therefore examining the market reaction to bonus issue announcements of such firms or its impact on shareholder’s value in an emerging market like Kenya can be a fruitful empirical work since a major problem facing investors in emerging markets is the return assurance on their stock market investment which in turn is affected by the liquidity of the announcing firms.

Several research studies have been made in the NSE but no research has been done to investigate the liquidity of the firms issuing stock dividends as judged by the market hence the present study will attempt carry out an empirical analysis of market reaction around bonus issue announcement in the NSE.

**General Objective of the study**

The general objective of the research study is to investigate the empirical analysis of market reaction around bonus issue announcement in the NSE.
Specific objectives

1. To test the bonus issue announcement and the signaling hypothesis in the NSE
2. To test the bonus issue announcement and the liquidity hypothesis in the NSE
3. To test the bonus issue announcement and the cash substitution hypothesis in the NSE
4. To test the bonus issue announcement and the attention getting hypothesis in the NSE
5. To test the capital market reaction to bonus issue announcement in the NSE

Justification of the Study

The NSE falls among the emerging stock markets which are probably the least researched in finance studies. Under the economic pillar of Vision 2030 efficient capital markets have been highlighted to be great importance in provision of capital to finance long-term investments in key infrastructure (such as roads, water and energy). Investigating the efficiency of stock market is very important. This is because stock market efficiency: Is important in boosting investor confidence, Is a necessary condition for the stock market to perform its developmental sense and it makes equity funding available for a long range of ventures.

By investigating the relationship of bonus issue announcements releases to security prices, this research study will bring out the possibilities of using the new information content releases to steer efficiency in the NSE, which will greatly be of benefit to the listed Companies, Government, researchers and Investors who are usually blindfolded by announcing firms which issue bonus issues for reasons of being illiquid. The NSE has the potential to be in the strong-form of EMH leave alone itself struggling to be efficient in the semi-strong form of EMH which can therefore be of great importance in achievement of Vision 2030

Literature Review

Bonus Issues and Informational Content

Bonus issues are simply distribution of additional stocks to the existing shareholders. It is a “free” issue of shares, without a subscription price, made to existing shareholders in proportion
to their current investment. A firm can distribute bonus shares by using retained earnings or accumulated capital reserves. Miller and Modigliani (1961) demonstrated theoretically that bonus issues, along with other types of dividends, do not alter shareholder wealth. If a company plans to finance a bonus issue from retained earnings, it makes a book entry to allocate retained earnings into paid-up capital in the shareholders’ equity section of the company balance sheet. Alternatively, a company that decides to realize a bonus issue by using accumulated capital reserves adjusts the accumulated capital reserves into paid-up capital. The company does not receive any cash and its financial position remains the same. The modification triggered by the bonus issue is that the number of outstanding shares is adjusted by the bonus issue ratio, therefore, the price of the shares declines according to the same bonus issue ratio.
Bonus Issues and signaling hypothesis

Several studies have shown abnormal returns around the announcement dates E.g., McNichols and Dravid (1990) provided further evidence to support the signaling hypothesis by examining the relationship between the size of a stock dividend (or split factor) and the degree of abnormal returns around the announcement dates. Their findings suggested a positive relationship between stock dividend size and abnormal return; that is, the larger the stock dividend, the greater the signaling benefits.

Balachandran et. al. (2004), examines share price reaction of the announcement of Bonus share issues for a sample of Australian companies over the period 1992-2000. They found that bonus issue announcement leads to a statistically significant positive price reaction. They provide evidence in support of signaling hypothesis consistent with the findings in the United States, Sweden, Canada and New Zealand.

Attention-getting hypothesis

Grinblatt, Masulis and Titman (1984) and Dhar and Chhaochharia (2008) were of the view that managers use bonus issue to attract attention from professional analysts so that valuation could be improved. Tang et al (2002) on the share price reaction to stock dividends in Greece did not find any evidence in support of a share price reaction. Instead, they found that stock dividends did not contain any information content as they mostly arise in Greece from a legal requirement to give effect to the capitalization of reserves form asset revaluations. They argue that the absence of the “surprise element” weakens the information content of stock dividend announcements and so share prices do not react due to the absence of new information (Papaionnou et al., 2000). However, despite this feature of the Greek market, a recent study by Leledakis, Papaioannou, Tang et al (2002) covering the period 1990-2000 did uncover a positive price reaction around stock dividend announcements in Greece, which they attribute to the ‘attention-getting’ and normal trading range hypotheses.
Conceptual Framework

Source (Study, 2013)

Balachandran (2005) examined share price reaction to announcement of bonus share issues of Australian companies (equivalent to stock dividends in the US and scrip issues in the UK). Price reaction to bonus issue announcements from the day of the announcements to the day after the announcements (day 0 to day 1) is statistically significant and positive of average 2.37% for uncontaminated events and 2.11% for contaminated events employing the market model.

Chandrapala Pathirawasam in the paper titled “The information content of stock dividend announcements: Evidence from Sloan (1987) studied the market reaction Sri Lankan stock dividends from 1998 to 2007 using the event analysis methodology. He reported positive abnormal returns in Sri Lanka (Colombo Stock Exchange) are much higher than any other international findings on the announcement day. Even after controlling the contaminated information, he found out that abnormal returns for pure stock dividends were positively significant on the announcement day. Further, announcement day abnormal returns were positively related with the size of the stock dividend announcement. Therefore these findings, based on Colombo Stock Exchange expand the empirical evidence on the signaling hypothesis of stock dividends.
Man Ana-Maria in the paper titled “Stock Dividend Impact on Stock Prices An Event Study on the Romanian Capital Market” (2009) states that at a first glance, it is usually asserted that stock dividends, just like stock splits are only cosmetic events. This paper examines the effects of stock dividend announcements on the Romanian stock market using evidence on listed companies on the RSE during 1998 – 2008 and the results obtained are consistent with previous studies conducted on emerging markets and not only, stating that there is significant non-zero cumulated abnormal return clustered closely around the event day.

Madhuri Malhotra, M. Thenmozhi, G Arun Kumar (2007), in their paper titled “Stock Market Reaction and Liquidity Changes around Bonus Issue Announcement: Evidence from India, examines share price reaction to the announcement of bonus issue for a sample of Indian companies. Standard event study methodology has been used for the purpose of studying the Bonus issue announcement reaction. Bonus issue announcement yields negative abnormal returns around the announcement date. There is a negative reaction after the bonus issue announcement conveying that the market underreacts after the announcement. It is also observed that there is no information leakage prior to the announcement.

Critical Review

The Briloff Phenomenon

Abraham Briloff argues that the assumptions typically made in expositions of the efficient markets model (zero transaction cost and all information is available cost free to all market participants) leave no economic rationale for information intermediaries. Given these assumptions there should be no reaction to releases made by intermediaries who restrict at no cost to releases made by intermediaries who restrict at no cost to all market participants. Therefore these results are inconsistent with a market that fully impounds the information in an information release at the time of its public release.

Nikolai Chuvakhin an economist argues that Investors are not identical. Even if they have precisely the same information available to them, they are likely to interpret it differently. More
importantly, they tend to act on it differently. One obvious example is tax status. Tax-exempt, tax-deferred, and taxable investors acting rationally will often choose different courses of action when presented with the same problem. Liquidity needs can also play a role.

Research Gap

Many researches’ have been made on testing the semi-strong form of EMH of NSE in the context of event announcement like dividend, stock split, seasonal effects etc, R. Olowe (1998) carried out a research on dividend announcement and firm value to test the semi-strong form efficiency of the NSE using the event study approach. A.M. Kuria (2010) carried out a research on the Seasonal Effects on the Stock Markets Trends Anomalies. Simbovo (2006) carried out a research on the effects of stock splits and large stock dividends in the Kenyan stock market. Musau (2007) carried out a research “Stock Splits: The Hidden Flaws”. J.O. Aduda and S.C. Chemarum (April 2010) Examined the effect of stock splits at the Nairobi Stock Exchange and found that there are indeed positive cumulative abnormal return across the different event windows. None of the study reviewed by the Researchers is in context to the Empirical Test of NSE Efficiency with Respect to Information Content of Bonus Issue Announcement.

Research Design and Methodology

This research problem was best studied by the use of a descriptive research due to the descriptive nature of bonus issue announcements designed to investigate the empirical analysis of market reaction around bonus issue announcement in the NSE. The population of interest comprised of the 59 listed companies in the NSE since these are companies that have met the listing requirements and as postulated by CMA and they can conclusively be used to represent the economy.
A purposive sample of 12 companies which have had a bonus issue of more than 25% in the period between years 2005 to 2011 drawn from 35 companies was used in the study. The study made use of the stock market data bought from the NSE data bank which was sorted and used to measure the impact of a bonus issue on the participating firms over the period of study.

Results of the findings and discussion
The research was designed to test whether there is significant difference in abnormal returns of stocks post-bonus announcement, when compared with pre-bonus announcement and thus how the market reacts to bonus issue announcement. On the bonus issue date there was a positive average abnormal return of 0.14% which was significant at 0.05% level.

The study found that generally the Kenyan market reacted negatively to bonus issue announcements. Thus the study was found to be in agreement with the signaling hypothesis which stated that firms issue bonus issues as a means of reducing the information asymmetry between managers and investors about future earnings. Madhuri et al (2007), found bonus issue announcement yields negative abnormal returns around the announcement date conveying that the market under reacts after the announcement.

Results indicated that generally there was an increase in the volumes of shares traded due to bonus issue announcement. This was especially so in the days around the bonus issue announcement. Trading activity was also seen to generally increase after the bonus issue announcement as compared to that before the bonus issue announcement. This was found to be in agreement with the study by Lakonishok and Lev (1987) whom investigated Liquidity Hypothesis, which suggests that stock dividend announcements are intended to improve liquidity, as the creation of additional stocks should lead to an increase in trading and greater ownership dispersion in a firm.

Results from the study also indicate that firms that issued bonus issue announcement without cash dividends like Barclays Bank of Kenya, National Industrial Corporation Bank and National Bank of Kenya had positive average abnormal returns of 0.03%, 0.448% and 0.01% respectively, after bonus issue announcement which is in agreement with the study by Chen, Firth and Gao.
(2002) which provided some evidence that stock dividends appear to be favoured over cash dividends in the Chinese market.

The study also found that the firms that issued bonus did not attract any attention from professional analysts to improve on their securities prices since the market reacted negatively to bonus issue announcements which does not support the attention getting hypothesis of the bonus issue announcements as supported by Leledakis, Papaioannou, Travlos, and Tsangarakis (2000) whom covering the period 1990-2000 did uncover a positive price reaction around stock dividend announcements in Greece, which they attribute to the ‘attention-getting’ and normal trading range hypotheses.

The study found that the capital market reaction of bonus issue larger than 25% is not instantaneous and thus the security prices react days before the announcement day and that also the larger the bonus issue ratio the larger the relative share price reaction which is consistent with Foster (1986).

**Conclusions**

Therefore the abnormal return of stocks post-bonus announcement, when compared with pre-bonus announcement identified is statistically different and we therefore reject the null hypothesis according to which the observed abnormal return is not event induced and we accept the alternative hypothesis that the abnormal return of stocks post-bonus announcement, when compared with pre-bonus announcement identified is statistically different and is influenced by the event of interest. To track the abnormal returns over a number of trading days, the CAAR was computed throughout the event period. The results indicate that there is a positive CAAR during the entire event window abnormal return.

**Recommendations**

This study made use of a simple methodology based on the market model to determine abnormal returns. There is need for further study in this area and a need to include more independent variables such as those relating to contaminated and uncontaminated firms so as to the determine whether and when other factors are considered the market would still react negatively to stock bonus issue announcements. There is also need for further study in stock splits relating to
contaminated and uncontaminated firms so as to the determine how the market would react with respect to such announcements.

Further the is need to carry out a research study on the reaction of bonus issue announcement with respect to firms in the financial and investment sector

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