THE ANNOUNCEMENT EFFECTS OF RIGHTS AND BONUS ISSUES ON MALAYSIAN STOCK PRICES

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ABSTRACT

This study examines stock price behaviour during announcements of share distribution in the form of rights and bonus issues in the Malaysian stock market over the period 1983-91. The study reveals that there is a positive price reaction prior to rights issue announcement, but a significant portion is immediately lost after the announcement. Analysis on the value of rights further reveals that market reacts not to the rights issue per se, but to the information content of the rights announcement. As for bonus issue, the results show that the market reacts strongly and positively to bonus announcement. This behaviour is contrary to a rational behaviour in an efficient stock market. Liquidity motive and expected future dividend could be argued as possible explanations for the price run-ups. These however, are quite unlikely due to already low price of some of the stocks, and the very low dividend yield of Malaysian stocks.

1. INTRODUCTION

According to the pecking order theory of capital structure, a company will first use internal resources to finance investment projects. If external financing is required, then a choice will have to be made between a new share issue or debt issue. In this instance, for reasons that have been explored elsewhere (Kester and Isa, 1994), Malaysian companies in general prefer equity issues via rights offerings to debt issues for their additional requirements. Rights issue is a form of raising additional equity by first offering to existing shareholders subscription in new issues at a predetermined subscription price for the amount of shares in proportion to their ownership so that shareholders can maintain their proportionate interest in the company. In order to entice shareholders to subscribe to the right issue, the subscription price is normally set at substantially below the existing market price.

Bonus issues (or stock dividends as these are normally referred to in finance texts), are additional shares distributed to existing shareholders for free. In other countries, stock dividends normally refer to small percentage distribution of shares, but in Malaysia, a bonus issue can be as large as 100 percent

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of issued shares, or a distribution in the ratio of 1 for 1. This will double the number of shares outstanding. When bonus shares are issued, part or the whole of the capital reserve account will be capitalized.

Somewhat similar to a bonus issue is the "stock split", which occurs when the par value of the share is changed. For example, a change of the par value from RM1.00 to RM0.50 is equivalent to a share distribution of 2 for 1. It has the effect of doubling the number of shares outstanding. For splits, capital reserves are not capitalized, only the par value and the number of shares are changed. Both bonus issues and share split have the effect of increasing the number of shares outstanding, but maintaining the proportionate ownership of existing shareholders. No additional fund is raised in either of these exercises.

Theoretically, a bonus issue or a stock split is not a thing of value to investors, and should have no effect on shareholders' wealth. Shareholders receive additional shares only to maintain their proportionate ownership of the company. The market price of the share should decline proportionately, such that the value of their holdings remains the same. One most commonly cited reason for companies to issue bonus shares or to split shares is the desire to reduce market prices to a more popular trading range. Companies may also issue bonus to compensate for nonpayment of cash dividends.[2]

The objective of this study is to examine the stock price behaviour during the announcement of rights and bonus issues in the Malaysian stock market. This study also serves to provide the much needed empirical evidence on the price efficiency of the market.

2. LITERATURE REVIEW

A considerable number of studies have been conducted on the effects of additional share distribution on stock prices. Asquith and Mullins (1985) discussed three possible hypotheses of price effects: no price effect, negative price effect and positive price effect.

The No-Price Effect Hypothesis assumes that the demand curve for a firm's share is essentially horizontal. Securities are said to be close substitution for one another, they face similar risk and return

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[2]*Beginning from 2nd November 1993, the Securities Commission no longer allows listed companies to split shares, interested companies are instead encouraged to reduce the board lot of their shares.*

characteristics, are either directly available in the market or can be constructed through combination of existing securities. One study that can be considered to be in support of this hypothesis is that by Fama, Fisher, Jensen and Roll (1969). They concluded that price adjustment caused by a split was not associated with the split per se but rather with the expectations of future dividends.

The Negative Price Effect Hypothesis asserts that investors are typically facing a downward sloping demand curve, and therefore more shares supplied to the market means a permanent reduction in prices. One of the earlier studies of rights issue is by Nelson (1965), who found that there was a significant drop in the market price associated with the rights announcement. Another study which support this hypothesis is that of Asquith and Mullins (1985), which showed that seasoned equity offering is associated with price decline around the announcement date. The study by Lakonishok and Lev (1987) on stock splits and stock dividends also finds that prices decline on the announcement date. They conclude that stock splits were mainly aimed at bringing stock prices to a "normal trading range". In addition, Lamoreux and Poon (1987) find that stock splits also lead to a wider stock ownership.

The Positive Price Effect Hypothesis predicts that rights and bonus issues are associated with favorable information about planned investments of the issuing corporations. Empirical evidence consistent with this hypothesis is found in many studies on developing markets such as Singapore and Malaysia. Tang (1976) in his study of bonus issue on the Stock Exchange of Singapore over the period 1970-75 finds that prices increase on the announcement date. He explains that this may be due to new information, which often accompanies bonus announcements. Ariff and Johnson (1990) also report price increases beginning from about four months before bonus announcements, but prices immediately stabilize after the announcement, reflecting an efficient market situation. But for rights issues, they find that prices continue to rise into the first month after the announcement, which is inconsistent with an efficient market situation.

As for the Malaysian market, a study by Ng (1984) on bonus issues indicated an existence of price run-ups prior to and until the announcement day, after which, average residuals are randomly distributed about zero. As for rights issue, Ng finds that average residuals also increase in the months preceding the announcement. A later study by Neoh (1989) reveals a peculiar result. Neoh examines price movements of 78 stocks which issued bonus over the period 1968-83. He finds that there was a strong upward movement of market model residuals from 15 weeks before the announcement until

about 3-4 weeks after the announcement. He attributes the price run-ups after the announcement to the ignorance of local investors chasing the prices up. However, a steady decline after week 4 up to week 50 wipes out all previous gains. Neoh also analyses his sample along the lines laid out by Fama et. al. (1969), and finds that the price behaviour is about the same regardless of whether there was a dividend increase or not after the bonus issue. Ku-Ismail's study (1990) on the Malaysian market, utilizing more recent data, on bonus announcements over the period 1985-87 also reveals similar behaviour.

3. DATA AND METHODOLOGY

This study uses data collected from several sources. Daily prices and the Kuala Lumpur Stock Exchage (KLSE) Composite Index were obtained from the Computer Center, University Malaya, while the rights and bonus information was obtained from the Investors Digest, a monthly publication of the KLSE. The information bonus and rights issues are cross-checked against the company announcements and prospectuses filed with the KLSE.

The sample includes all companies that made either rights, or bonus, or both, during the period from January 1983 to Dcember 1991. Information on stock splits is also collected, but normally splits are done together with bonus issues. Over the period only two companies undertook share split, hence the sample is too small for analysis. For each stock, data ranging from 30 trading days before and 30 trading days after the announcement date are collected. This period forms the study window. To be included in the sample, the stock must be reasonably actively traded. A sample will be excluded if there is no transaction for a total of ten trading days within the study window. Returns are calculated based on the daily closing prices of the stocks. Cash dividends are excluded from the return computation, but capital changes are taken into account. The performance of rights and bonus issues are evaluated using the market adjusted cumulative abnormal returns (CAR). In this method, the KLSE Composite Index returns are deducted from the actual returns of the stocks. This model is chosen for return analysis because of the difficulty in obtaining data and in applying alternative models such as the market model or the CAPM, due to the thinness of the market. The market-adjusted return is obtained as follows:

$$ar_{it} = r_{it} - r_{mtl}$$

where, ar_{it} is the market adjusted return for stock i in event day t, r_{it} is the actual return on stock i in event day t, and r_{mt} is the market return in event day t. The KLSE Composite Index is used in computing the market return.

The average market return on a portfolio of n stocks for event day t is the equally weighted arithmetic average of the market adjusted returns.

$$AR_t = (1/n)ar_{it}$$

where, AR_t is the average market adjusted return in event day t, and n is the number of stocks in the portfolio in event day t.

The cumulative market adjusted returns from event day r to event day s is the summation of the average market-adjusted returns:

$$CAR_{r,s} = \sum AR$$

4. RESULTS AND INTERPRETATIONS

Table 1 shows the total number of announcements used in this study. The study analyzed 58 rights announcements over the period 1983-91, 43 bonus announcements, 36 bonus and rights announcements and 7 bonus and split announcements. The table also quite clearly shows that rights issues tend to be associated with the business cycle, which, to some extent is indicated by the movements of the KLSE Composite Index. Funds are raised from the rights issues and it can be seen that the majority of the rights issues are made during the years 1989-90. These are actually recovery years

TABLE 1

NUMBER OF ANNOUNCEMENTS BY TYPE AND BY YEAR

Year	Rights Only	Bonus Only	Rights-plus Bonus	Bonus plus Splits	Market Index Return (%)
1983	8	7	4	2	37.79
1984	4	5	9	4	-24.41
1985	1	2	1	-	-23.09
1986	-	3	-	-	8.13
1987	4	4	2	-	3.46
1988	9	4	1	-	36.84
1989	19	9	10	-	57.33
1990	12	8	7	1	-10.92
1991	1	1	2	-	11.05
Total	58	43	36	7	-

from the economic downturn of the mid-eighties. This period is also associated with the long run bullish trend in the stock market. The bonus issues, tend to be well distributed over the years, but is also seen to be more frequently announced during the bullish periods.

Table 2 presents the abnormal returns and cumulative abnormal returns (CAR) for all the four sample categories around the announcement date. Figure 1 shows the CARs for all the four sample categories. The first two columns of the table show the abnormal returns and the CAR for rights issue announcement. Figure 1 indicates that, for the rights issue announcement, there exist positive abnormal returns right from the beginning of the event windows This leads to a gradually increasing CAR, which reaches a peak of 6.92 percent on the announcement date. The largest single day abnormal return occurs on day -3, at 1.17 percent. After the announcement, stock prices suffer a drop for five consecutive days, losing about 2.61 percent abnormal return, which is about 38 percent of the pre-announcement gains. The CAR then stabilizes at around 4.0 percent.

The overall results on rights issue announcement indicates that there is a positive reaction from the market for companies making cash calls via rights issue. These companies on the whole gain more than 4.0 percent abnormal return around the announcement period. Since it is normally the case that rights announcements are also accompanied by explanations of the purposes of raising the fund, the market may well be reacting to the use of funds as opposed to the rights announcement per se. The results also tend to indicate that the market correctly anticipates the announcement as evidenced by the gradually rising CAR prior to the announcement. However, a sharp increase in abnormal return three days before the announcement could be due to information leakage. The drop in the CAR after the announcement tends to indicate market over reaction to the announcement. The drop in the CAR immediately after announcement is quite different from results of earlier studies on the Malaysian market, notably Neoh (1989), which find that prices continue to increase for a brief period after announcement.

The third and fourth columns of Table 2 show abnormal return and cumulative abnormal return for bonus issue announcement. The CAR is also graphed in Figure 1. The behaviour of the CAR for bonus issue announcement is somewhat similar to that of the rights issue announcement. It shows a gradually increasing trend right from the beginning of the event window, up to day-1. Thereafter, it shows large daily increases for two consecutive days, that is for day 0 and 1. The peak of the CAR is at day 2, at 6.98 percent. The CAR experiences a slight drop after the announcement, and

levels off at about 5.5 percent.

The behaviour of the CAR for bonus issue announcement is quite consistent with earlier studies on the Malaysian market. However, as discussed earlier, a bonus issue is just a distribution of free shares to existing shareholders. There should be a proportionate drop in share prices on the ex-bonus day, such that total shareholders' wealth is unchanged. Therfore, in an efficient market, a bonus issue should not result in any price reaction. What is shown by our results is therefore quite disturbing because it clearly indicates that the market attaches a positive value to bonus issues. In fact, the value added for a bonus issue is higher than for a rights issue. One plausible explanation is that the market expects higher cash dividends in the future. However, considering the very low dividend yield of Malaysian companies (Isa, 1993), the information content hypothesis is quite unlikely. Empirical evidence that price reaction to bonus announcement is not due to subsequent dividend changes is also documented by Neoh (1989). Another possible reason for the price increase is enhanced liquidity in stock trading. This however, is also doubtful because some of the shares are already lowly priced.

The fifth and sixth columns of Table 2 show abnormal return analyses for announcement of bonus together with rights issues. Normally bonus is distributed first, followed by rights distribution, and the newly issued shares are entitled to the rights issue as well. The CAR in Figure 1 shows that it closely follows the behaviour of both the rights issue announcement and the bonus issue announcement discussed above. However, the price increase prior to the announcement is more pronounced, with the CAR reaching a maximum of 8.72 percent on day 1. The CAR quickly drops thereafter, losing more than half of the preannouncement gains in three weeks. It then stabilizes at less than but close to 4.0 percent. The rapid decline in the CAR after the announcement tends to indicate market over-reaction similar to that observed for the rights issue announcement.

The last two columns of Table 2 show the abnormal returns for the bonus together with splits announcement. The general behaviour of the CAR as shown in Figure 1 is quite similar to the other three that have been discussed, but price impact is more pronounced. The CAR takes an increasing trend from the beginning of the event window, reaching its peak at 18.99 percent on day 1, with the largest gain recorded in the last 5 days when it gains 6.20 percent. Although the CAR drops continuously for about two weeks after the announcement, it stabilizes at about 15.0 percent, far above the other three CARs analyzed here.

The behaviour of the CAR depicted by the bonus-with-split announcement is indeed very puzzling. Both bonus and splits per se, in theory, should not bring about any additional value to the firm because these are just accounting manipulations that result in additional shares. There is neither funds raised, nor new programs announced. But the market reacts very strongly to such announcement. This tends to reflect that the market is irrational or ignorant, or both. This may also be the reason behind the ruling of the Securities Commission not to allow companies to split shares, as of November 1993.

TABLE 2

ABNORMAL RETURNS AND CUMULATIVE ABNORMAL RETURNS AROUND SHARE DISTRIBUTION ANNOUNCEMENT ON THE KLSE, 1983-91

	RIGHTS		BONUS		RIGHTS + BONUS		BONUS + SPLIT	
DAY	AR	CAR	AR	CAR	AR	CAR	AR	CAR
-29	1.02	1.02	-0.18	-0.18	0.51	0.51	0.16	0.16
-25	0.53	1.86	0.14	0.13	0.38	1.61	0.79	1.37
-20	0.28	2.46	0.24	1.12	-0.19	2.32	0.70	3.69
-15	0.02	3.05	-0.08	1.81	-0.14	3.45	0.54	6.21
-14	0.13	3.18	0.21	2.02	-0.44	3.01	0.90	7.11
-13	0.15	3.33	0.06	2.08	-0.34	2.67	2.05	9.16
-12	0.10	3.43	0.07	2.15	0.40	3.07	0.87	10.03
-11	0.25	3.68	-0.03	2.12	-0.30	2.77	1.28	11.31
-10	0.22	3.90	-0.07	2.05	0.22	2.99	0.49	11.80
-9	0.05	3.95	0.35	2.40	-0.08	2.91	0.95	12.75
-8	0.31	4.26	-0.24	2.16	0.24	3.15	-0.01	12.74
-7	0.15	4.41	-0.14	2.02	0.43	3.58	0.11	12.85
-6	0.26	4.67	-0.08	1.94	0.11	3.69	0.25	13.10
-5	-0.05	4.62	-0.05	1.89	-0.22	3.47	-0.31	12.79
-4	0.23	4.85	0.27	2.16	0.52	3.99	0.51	13.30
-3	1.17*	6.02	0.75	2.91	0.23	4.22	1.72	15.02
-2	0.39	6.41	0.46*	3.37	0.88	5.10	0.89	15.91
-1	0.48	6.89	0.15	3.52	1.19*	6.29	1.38	17.29
0	0.03	6.92	1.30*	4.82	1.02	7.31	1.24	18.53
1	-0.74	6.18	1.98*	6.80	1.41	8.72	0.46	18.99
2	-0.38	5.80	0.18	6.98	-0.50	8.22	-1.57*	17.42
3	-0.53	5.27	-0.62*	6.36	-0.05	8.17	-1.12*	16.30
4	-0.23	5.04	-0.25	6.11	-0.29	7.88	0.15	16.45
5	-0.73*	4.31	-0.26	5.85	-1.14	6.74	-0.21	16.24
6	0.02	4.33	0.00	5.85	-0.16	6.58	-0.77	15.47
7	0.11	4.44	-0.22	5.63	-0.88	6.70	-0.17	15.30
8	-0.16	4.28	0.11	5.74	-0.27	6.43	-0.14	15.16
9	-0.21	4.07	0.07	5.81	-0.57*	4.86	-0.79*	14.37
10	0.03	4.10	-0.36	5.45	-0.11	4.75	-0.14	14.23
11	0.56	4.66	-0.15	5.30	0.19	4.94	0.76	14.99
12	-0.07	4.59	-0.11	5.19	-0.37	4.57	-0.18	14.81
13	-0.51*	4.08	-0.10	5.09	0.40	4.97	-0.54	14.27
14	0.00	4.08	0.34	5.43	-0.25	4.72	-0.41	13.86
15	-0.02	4.06	0.04	5.47	-0.58	4.14	0.05	13.91
20	-0.05	4.19	-0.07	5.14	0.18	3.94	-0.40	14.58
25	-0.09	4.40	0.07	4.99	-0.24	3.67	-0.01	14.72
30	0.14	3.85	-0.11	4.92	-0.31	4.00	0.24	14.65

*Significant at 5 percent level.

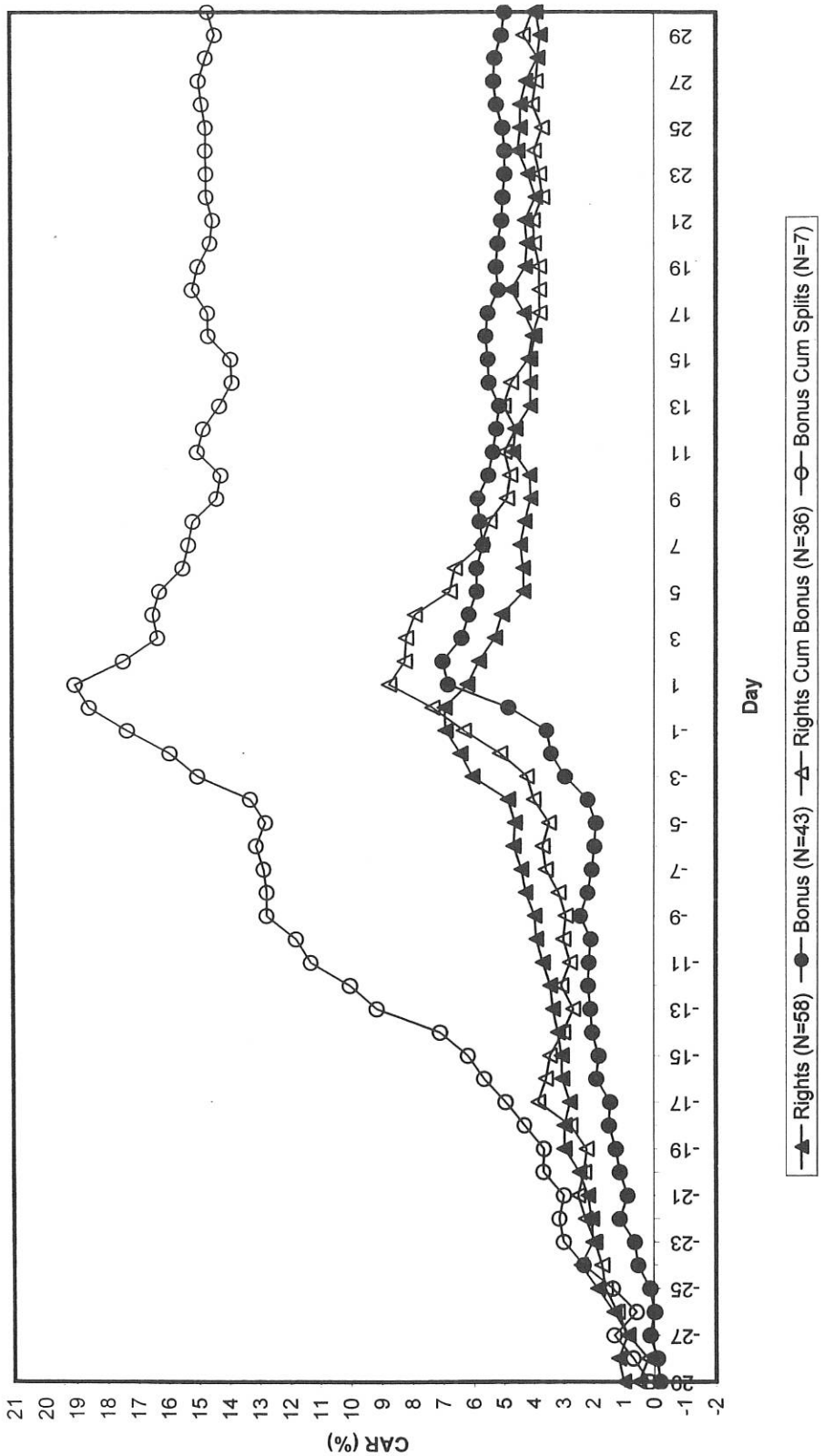


Figure 1: CARs Around Share Distribution Announcement on the KLSE, 1983-1991

4.1 VALUE OF RIGHTS

When a company makes a rights issue, the rights are mailed to its shareholders, one right for each share held. The rights give the shareholders the right but does not impose the obligation to buy additional shares in proportion to their holdings, at a certain price before a certain expiration date. The shareholders actually have the option of either to exercise the rights and subscribe to the new shares, or sell the rights to a third party, or do nothing and let the rights expire.

The main factor determining the success or otherwise of a rights issue is the subscription price, normally set at a discount from prevailing market price. The larger the discount, the greater is the probability of success. However, due to market movements and the time taken by the approving authority, what would have been originally an attractive discount when the subscription price was set, may turn out to be no longer attractive when approval is accorded. In practice, almost all rights issues are fully underwritten by merchant bankers, and hence the success or failure of an issue does not affect the amount of funds raised.

For empirical investigation, we calculate the value of rights at the time of the announcement for each company. These are then ranked and two sub-samples are formed, one having value of rights greater than RM1.00 and the other having negative values. Negative value of rights occurs when the subscription price is greater than the market price. The value of rights is calculated using the following formula, which is explained in most standard financial management texts.

$$R = (P-S)/(N+1)$$

where, R = market value of right when share is traded cum rights,
P = market value of stock selling rights-on,
S = subscription price for the new shares, and
N = number of rights required to purchase one new share.

The price behaviour of the two sub-samples is shown in Table 3 in terms of abnormal returns and CARs. The CARs are also graphed in Figure 2. The CARs clearly indicate that the market correctly differentiates a successful rights issue and the less successful issue. For companies with value of rights greater than RM1.00 at the time of the announcement, the CAR shows an increasing trend from the beginning of the event window up to the announcement day; thereafter, it stabilizes. Assuming there exist early signals of firms planning for a rights issue, this behaviour is consistent with the notion of market efficiency.

On the other hand, the CAR for companies with negative value of rights does not depict any particular trend prior to the announcement. However, the CAR experiences large drops for the two consecutive announcement days. The CAR then continues to decline over the following three weeks, until it reaches a low of -18.05 percent on day 17, before leveling off. It gives the impression that the market is taken by surprise when a bad performing company announces a rights issue. In other words the market is not fooled by the announcement, but interprets the events correctly, regardless of whatever reasons provided by the company for raising the funds. However, the evidence that prices continue to decline after the event is inconsistent with an efficient market situation.

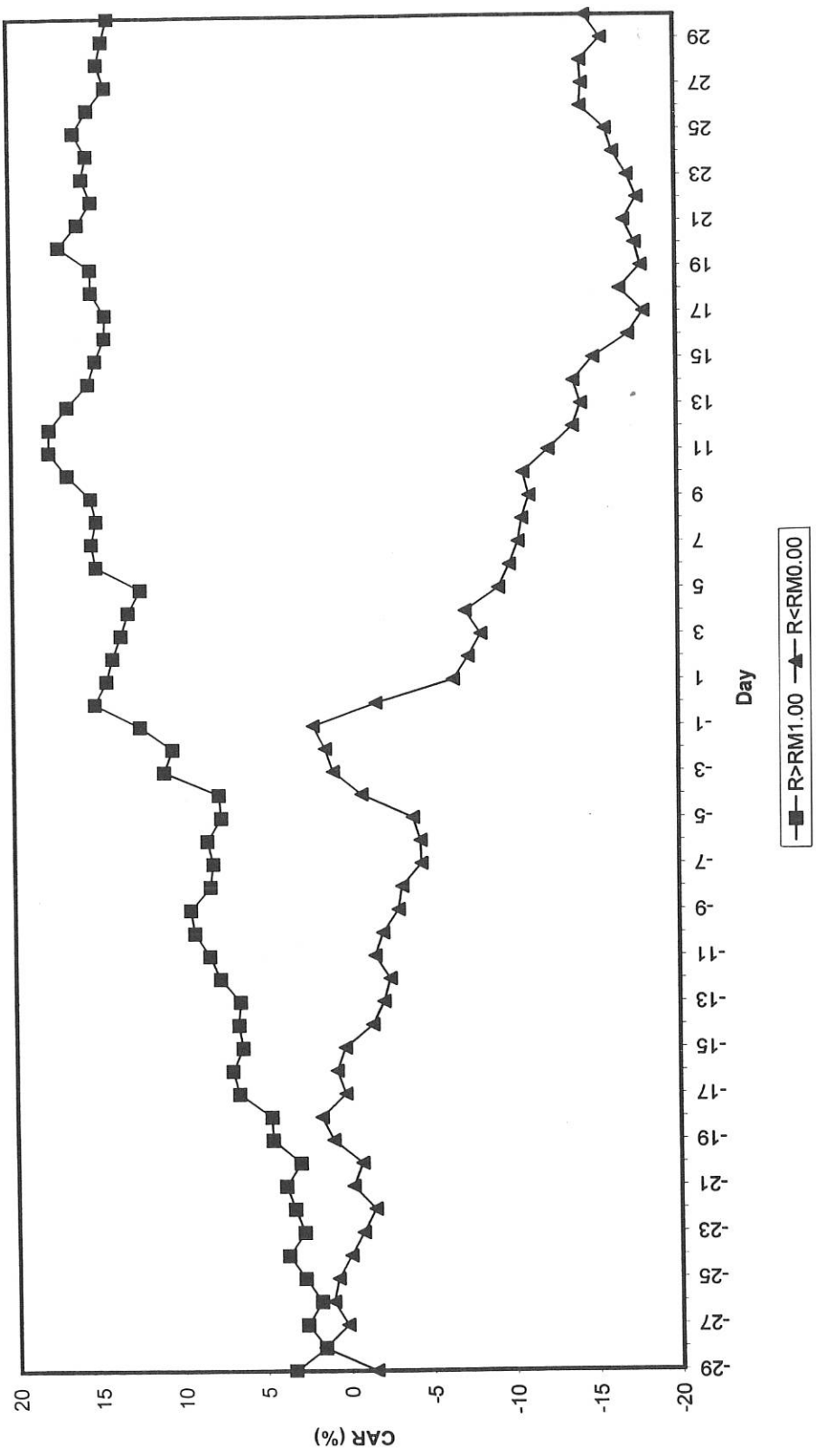
TABLE 3

ABNORMAL RETURNS AND CUMULATIVE ABNORMAL RETURNS AROUND RIGHTS ISSUE ANNOUNCEMENT, FOR DIFFERENT VALUES OF RIFHTS.

	R > RM1.00		R < RM0.00	
DAY	AR	CAR	AR	CAR
-29	3.37	3.37	-1.47	-1.47
-25	0.95	2.71	-0.29	0.75
-20	-0.88	2.91	-0.56	-0.78
-15	-0.62	6.31	-0.51	0.16
-14	0.23	6.54	-1.66	-1.50
-13	-0.10	6.44	-0.69	-2.19
-12	1.19	7.63	-0.38	-2.57
-11	0.64	8.27	0.93	-1.64
-10	0.90	9.17	-0.51	-2.15
-9	0.25	9.42	-0.93	-3.08
-8	-1.21	8.21	-0.23	-3.31
-7	-0.18	8.03	-1.18	-4.49
-6	0.35	8.38	0.04	-4.45
-5	-0.84	7.54	0.45	-4.00
-4	0.13	7.67	3.06	-0.94
-3	3.28	10.95	1.70	0.76
-2	-0.51	10.44	0.45	1.21
-1	1.96*	12.40	0.71	1.92
0	2.70	15.10	-3.75	-1.83
1	-0.73	14.37	-4.66	-6.49
2	-0.36	14.01	-0.91	-7.40
3	-0.52	13.49	-0.79	-8.19
4	-0.44	13.05	0.95	-7.24
5	-0.72	12.33	-2.04*	-9.28
6	2.66	14.99	0.66	-8.62
7	0.27	15.26	-0.53	-9.15
8	-0.28	14.98	-0.22*	-9.37
9	0.29	15.27	-0.45	-9.82
10	1.40	16.67	-0.34	-10.16
11	1.10	17.77	-1.52	-11.68
12	-0.04	17.73	-1.48*	-13.16
13	-1.08	16.65	-0.49	-13.65
14	-1.28	15.37	0.44	-13.21
15	-0.45	14.92	-1.20	-14.41
20	1.90	17.07	-0.36	-17.69
25	0.77	16.13	0.43	-15.98
30	-0.37	13.97	1.57	-14.17

*Significant at 5 percent level.

Figure 2: CARs Around Rights Issue Announcement for Different Values of Rights



A word of caution in reading and interpreting the results of this study, however, seems to be in order. Tests of significance, using the standard t-statistics are performed only on the average daily abnormal returns (AR), and not on the cumulative abnormal returns (CAR). Although some of the daily abnormal returns are quite large, especially during the announcement period, many are not significant at the five percent significant level, presumably caused by the erratic behaviour of the individual stocks that lead to large standard deviations.

5. CONCLUSION

The objective of this study is to examine stock price behaviour during announcements of share distribution in the form of rights and bonus issues in the Malaysian stock market. The study uses daily price data for companies making such announcements over the period 1983-91. Stock returns are adjusted against the KLSE Composite Index returns to obtain the abnormal returns.

The study reveals that there is a positive price reaction prior to rights issue announcement. However, a significant portion of the pre-announcement gains is immediately lost after the announcement. Nevertheless, the overall result is a net gain to shareholders. Analysis on the value of rights further reveals that the market reacts not to the rights issue per se, but to the information content of the announcement.

As for bonus issue, the results show a puzzling phenomenon. The market reacts strongly and positively to bonus announcement. This behaviour is contrary to a rational behaviour in an efficient stock market. Liquidity motive and expected future dividend could be argued as possible explanations for price run-ups. These however, are quite unlikely due to the already low price of some of the stocks, and the very low dividend yield of Malaysian stocks.

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