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A Study On “Implications Of Stock Splits In India”

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Abstract

Stock split means division of the face value of the stock. Stocks are basically split to increase the supply of stocks in the market. Stock splits do not change the capital structure and capitalization but they only readjust them and thereby increase or decrease number of outstanding shares of the company. Stock splits are different from other corporate actions like buyback of shares, bonus issues and right issues. This research article concentrates on the concept of stock splits – a theoretical framework including guidelines for stock splits in India. The present research article does not employ any specific tool for organizing the existing literature on the stock splits. The research article concludes that the companies in India like the companies in advanced countries should split their stocks only when they are sure that their stock splits will ensure abnormal returns, increase in the volume of trading and signal the better prospectus for the company in the future. The companies in India should not frequently split their stocks to manipulate the share price and confuse the market.

Keywords: Stock Market, Indian Stocks, Stock Splits, Share Market

1. Introduction

The United States of America introduced stock splits in the financial market for the first time. Since then, they have been prevalent in the many developed and emerging financial markets as one of the widely adopted financial strategies to readjust the capital structure and capitalization of the company. However, the stock splits became a reality in India only when the Government of India introduced the stock splits in the capital market in 1999.

2. Methodology of Study

This research article concentrates on the concept of stock splits - a theoretical framework including guidelines for stock splits in India. It also underlines whether stock splits ensure abnormal returns, increase the volume of trading and signal the better prospects for the company in the future. The information required for the article have been collected from the various secondary sources viz., books, Journals articles and websites. This study does not employ any specific tool but it makes an attempt to organize the existing literature to understand the concept of stock splits properly.

3. Concept of Stock Splits

Stock Split is corporate action. It refers to the splitting of the face value of a share of a larger denomination into a number of shares of a smaller denomination. Stock splits increase the number of outstanding shares but the share capital of the company remains the same. There is no outflow of funds. The basic purpose of stock splits is to increase the volume of trading. The popular stock splits ratios are 2 for 1, 3 for 2 and 5 for 4. When a company splits its stock, the market price of stock is reduced by the split ratio. As a result, the stock becomes cheaper and affordable to the new investors.

4. Stock Splits: Classification

Stock splits may be general stock splits or reverse stock splits. The difference between regular stock splits and reverse stock splits is that the regular stock splits increase the volume of trading and signal the better prospects for the company in the future but the reverse stock splits do not aim at signaling the company's value but moving the share prices to a more attractive trading range. The general stock splits and reverse stock splits are as below:

1) **General Stock Splits** General stock splits mean splitting the stock of a higher value in to a number of shares of a smaller in value. In other words, they imply splitting the stock of a larger denomination into a number of shares of a smaller denomination. The regular stock splits increase the number of outstanding shares, volume of trading and stock price and signal the better prospects for the company in the future. However, they reduce the stock price by the split factor and decrease the earnings per share but the reduction in the stock price and decrease in the earnings per share do not affect the value of the shareholders. The general stock splits are very common and popular in the corporate world. The popular general stock splits ratios are 2 for 1, 3 for 2 and 5 for 4.

2) **Reverse Stock Splits** Reverse stock splits literally mean splitting the stock of a smaller denomination into fewer stocks of a larger denomination. They decrease the number of outstanding shares and increase the earnings per share. Moreover, they do not signal the value of the company but they move the share price to a more attractive trading zone. The reverse stock splits are not common and popular as compared to the general stock splits. The reverse stock splits ratios, for instance, may be 1 for 2, 2 for 3 or 4 for 5.

5. Discussion and Analysis

- **Reasons for Stock Splits**

The reasons for stock splits are as follows;

1) To reduce the face value of a stock to readjust the capital structure without inflow or outflow of funds.
2) To increase the number of outstanding shares i. e., free float in the market.
3) To increase the liquidity and market capitalization of a stock.
4) To bring down the market price of a stock to a reasonable level to make it cheaper and affordable to the newer class of investors.
5) To rest the fear of hostile takeover and stock accumulation by raiders.
6) To signal the undervaluation of stock.
7) To signal the financial strength and better prospects for the company in the future.

- **Stages of Stock Splits**

The life cycle of stock splits involves the following six major stages;

1) Pre-announcement

Stocks normally enter the pre-announcement stage quietly after a long period of healthy growth. However, in some stocks, it occurs quickly due to the unexpected rise in the stock price. This stage of stock splits is often associated with significant rise in the stock price.

2) Announcement

The announcement stage of stock splits pulls in a large number of new buyers. As a result of the unexpected demand for stock, the stock price normally goes higher by giving a chance for abnormal returns for those who positioned in the stock prior to the stock splits announcement.

3) Dormancy

In this stage, the price returns to the normal as the initial interest subsides in the days following stock splits announcement. The shorter the time between the announcement of stock splits and the stock splits date, the lesser the duration of a dormancy stage.

4) Pre - split Run

The investors who missed the chance of accumulating the shares at pre announcement and announcement stage, now, in pre – split

run, bid up the price for the limited supply of shares. This stage is just before the split date.

5) Stock Splits

In the stock splits stage, (stock split date), the investors buy shares to accumulate them at the lower stock splits price. These final buyers who did not buy shares at the announcement and during the pre – splits run can push the price even higher during the stock splits period.

6) Post Splits

The stock price, in the post splits phase, reacts to the increased supply and retreat for a while. However, the strong performers often quickly dip and then continue to fly higher.

- **Stock Splits and Buybacks, Bonus Issues and Rights Issues**

Stock splits, buyback of shares, bonus issues and right issues are major corporate actions rather strategies which create value for the shareholders in one or the other way. However, they are different from each other. The following table depicts the comparison between these corporate actions;

Table 1: Stock Splits and Buybacks, Bonus Issues and Rights Issue

Sr. No.	Stock Splits	Buybacks	Bonus Issue	Right Issue
1	Division of the face value of shares	Buying its own equity shares	Issue of equity shares at free of cost to the share-holders	Issue of equity shares at a conc-essional rate to the shareholders.
2	Neither inflow Nor outflow of funds	Outflow of funds	Neither inflow Nor outflow of funds	Inflow of funds
3	Readjusts capital structure and capitalization of the company	Bought from the market or share-holders	Issued to the shareholders	Issued to the shareholders
4	Increases the supply of stock	Decreases the supply of stock	Increases the supply of stock	Increases the supply of stock
5	Protects the interest of the shareholders	Rise in the interest of the shareholders	Dilutes the interest of the shareholders	Dilutes the interest of the shareholders
6	Signals under-valuation of stock	Signals under-valuation of stock	Signals financial strength of the company(free reserves)	Signals financial strength of the company(free reserves)
7	No additional liability of servi-cing the capital	Decrease in the liability of servi-cing the capital	Increase in the liability of servic-ing the capital	Increase in the liability of servi-cing the capital

- **SEBI Guidelines for Stock Splits in India**

The Ministry of Finance vide circular no. 1/7/SE/81 dated January 22, 1983 had restricted to change the face value at a denomination lower than Rs. 10 keeping them fixed at Rs. 10 or Rs. 100. However, the Companies Act, 1956 empowered a limited company to alter its share capital by using stock splits but the stock splits were not very common in the Indian stock market as the listed shares had a fixed face value of Rs.10 or Rs.100. The usage of stock splits increased after the approval for the stock splits from the SEBI vide circular no. SMDRP/POLICY/CIR-16/99 dated June 14, 1999. This circular from the SEBI on stock splits allowed the companies to choose any face value for their equity shares provided it is not issued in a decimal of a rupee.

After the introduction of stock splits in India in 1999, it was observed that the several companies were resorting to frequent splitting of their stocks within a short period of time. The Securities and Exchange Board of India set up the Secondary Market Advisory Committee (SMAC) as a standing committee to advice on the matters related to the Secondary Market including the existing loop holes in splitting a stock by the company.

However, the committee was reconstituted under the chairmanship of Dr. R. H. Patil. The SMAC deliberated on the aforesaid issue and recommended that the provisions of the SEBI circular no. SMDRP/POLICY/CIR-16/99 dated June 14, 1999 may be modified to include the following;

1) The existing companies which have issued Rs.10 or Rs.100 may change the standard denomination in to any denomination other than decimal of a rupee by splitting the existing shares after amending their memorandum of association and articles of association.
2) No listed company whose market price in the previous six months is less than Rs. 500 per share can split the face value of its equity share.
3) If the company had gone in for splits, it would not be permitted to do it again for a period of three years from the date of the last splits.
4) A change in the par value will have to be disseminated through the websites of the stock exchanges and through EDIFAR for a continuous period of one year from the date of the last splits

- **Stock Splits in India**

Stock split is a natural and constructive strategy. It should be used in time to produce the desired result. When a company splits its stock, the market price of the stock is reduced by its split ratio. The stock then becomes cheaper and affordable to the new investors. As a result, the stock becomes active and the volume of trading normally increases if everything is going well in the market. If not means something is wrong with the stock split. However, practically, in India, the stocks are split on the basis of the requirement of the companies. They split their stocks very frequently within a short period of time. One of the reasons for frequently splitting the stocks may be poor volume of trading. This undesirable practice of frequently splitting the stocks was observed by the regulatory authority. The regulatory body, Securities and Exchange Board of India, then set up the secondary market Advisory Committee (SMAC) as a standing committee to advice on the matters related to the Secondary Market including the existing loop holes in splitting a stock by the company. The recommendations of the committee under the chairmanship of Dr. R. H. Patil which are produced earlier in this article brought some discipline in the stock

splits in India. Moreover, the stock splits in India has to go a long way to be like in the advanced countries of the world.

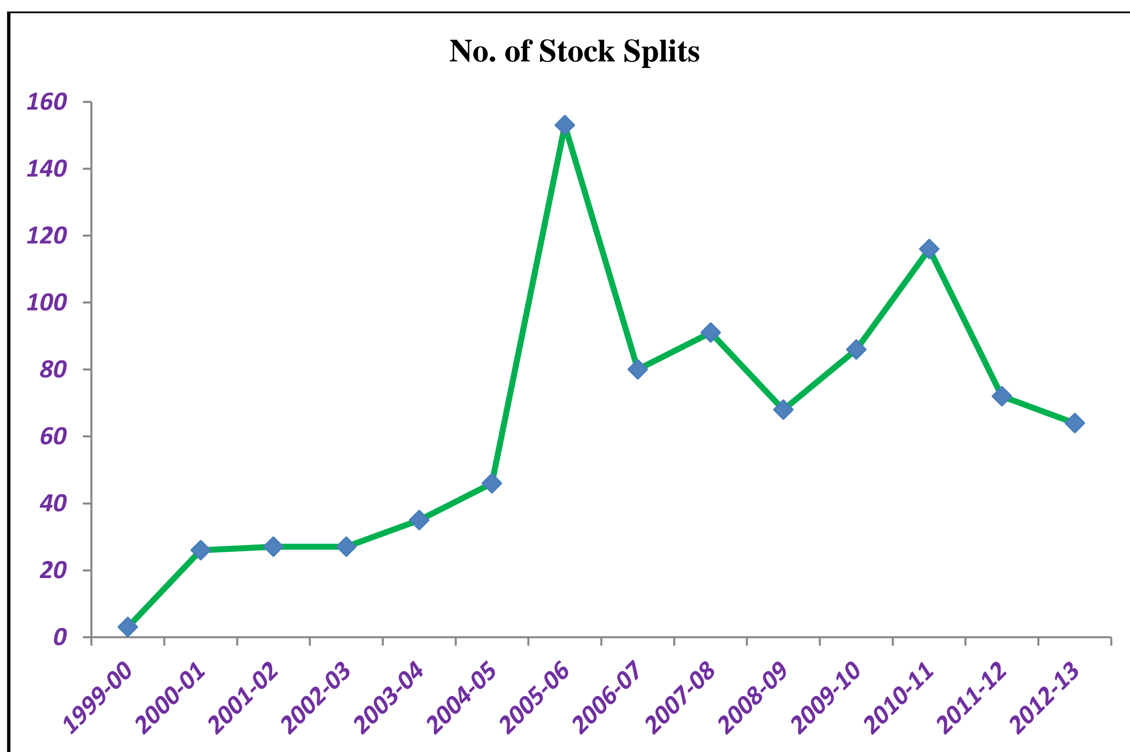
- **Trend in Stock Splits in India for a Period of 15 Years**

The following table and the graph depict the trend in stock splits in India from 1999 to 2013 for a period of 15 years to elucidate and justify the previously mentioned undesirable practice of splitting the stocks frequently by companies in India:

Table 2: Initial Stock Splits Announcements by Listed Companies from 1998-99 to 2012-13

Year	No. of Stock Splits
1998-99	---
1999-00	3
2000-01	26
2001-02	27
2002-03	27
2003-04	35
2004-05	46
2005-06	153
2006-07	80
2007-08	91
2008-09	68
2009-10	86
2010-11	116
2011-12	72
2012-13	64
TOTAL	894

(Source: Motilal Oswal Data Base)



The above table and chart indicate that the number of stock splits increased from 03 announcements in1999- 2000 to 153 announcements in 2005- 06. It increased consecutively year by year since the announcement of stock splits till 2005- 06.

However, the number of stock splits announcements from 2006-07 to 2012-13 was within a range of above 60 announcements and below 120 announcements. Thus, the stock splits announcements by the companies rose from 3 announcements in 1999-2000 to 894 announcements in 2012-13 for a period of 15 years.

- **Research on stock splits in India**

The research on stock splits in India is very limited. A very few research scholars have worked on the concept of stock splits in India. It might be because of splitting the stocks frequently. On the contrary, in the advanced countries, the research on the topic of stock split is not as much as expected but much better than in India. However, one of the reasons for the quality research on stock splits in the developed countries might be the scope for empirical research to establish evidences to make deliberations on genuine stock splits that signal the financial strength of the company rather than to manipulate the stock price in the market.

Some of the research studies undertaken on stock splits in India include 1) Chhavi Mehta (2007) surveyed 539 stock splits from 517 companies. He concluded that the motive of stock splits in India is to improve the liquidity(volume of trading), 2) Koustub Kanti Ray(2011) studied 351 stock splits and observed that the stock splits improve the volume trading and 3) Dr. Prabhakar Rane(2016) studied 86 initial stock splits from the companies listed on Bombay Stock Exchange and National stock Exchange. He found that the share price of the stock falls after the stock split announcement, hence, stock split does not ensure any abnormal returns and the increase in the volume trading after stock splits is temporary. However, so far, nobody has worked on whether stock split improves the earnings per share and signals the better prospects for the company in the future.

6. Conclusion

The stock splits finally in India increase the volume of trading for a short period of time They do not ensure abnormal returns as the stock price falls after the announcement. If the stock splits to produce what is expected from them, the ceiling on the stock price for the stock split should be raised to Rs. 1,000 per share in the previous six months. No problem, if the companies do not split the stocks but if they split the stocks, the stock splits should deliver what is expected from them.

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