MOTIVATIONS BEHIND STOCK SPLIT AND ITS SEVERAL ASPECTS

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ABSTRACT
Nowadays, the corporate action of stock split is a frequent phenomenon undertaken by many companies in India and abroad. In fact, investors get very excited to hear that the stocks in which they have invested are going to be split. There are many reasons why the management of a company is motivated to do a stock split. Based on the review of many earlier studies, the present study focuses on specifying the motivations behind stock split and its various aspects. The study describes many aspects regarding stock split, such as the aspect of liquidity and optimal trading range, signalling aspect, the aspect of getting more recognition by the neglected firm, the aspect of getting more benefits by organising multiple events just after the stock split, tax-option, and volatility aspect, etc. Before making an investment decision, an investor should analyse these aspects of stock split and the motive of the company behind it.

Keywords: Stock split, Motivations, Liquidity hypothesis, Signalling hypothesis, Neglected firm hypothesis

1. INTRODUCTION

U.S. Securities and Exchange Commission defines stock split as "a declaration that has no effect on the value of what shareholders own. When a company declares a stock split, the share price will shrink, but the number of shares will increase proportionately".

Accordingly, a stock split is a decision by the company's board of directors to multiply the number of outstanding shares by dividing them into numerous shares. Although the number of outstanding shares rises by a certain multiple, the total money value of shares stays the same compared to pre-split amounts because the split did not add any book value. By stock split, every stockholder gets additional stock without paying the issuer company (Fama et al., 1969). For example, in a 2-for-1 split, a new share is issued against every share held. This means that if there were 10 lakh outstanding shares before the split, there would now be 20 lakh shares. There has been no increase in the market capitalization of the company. Hence, post-split, the stock price decreases in the reverse split ratio. Split can occur at any ratio. The most usual ratios are 2:1, 3:2, 5:4, 4:3, etc. (Dhar & Chhaochharia, 2008). The number of additional shares issued per old share is called the split factor (Lin et al., 2009). Due to stock splits, investors now have more shares than before. However, the proportion of holding the shares after the split remains the same as before the split, i.e., there is no impact on the ownership interest of the existing shareholders.

Thus, as per earlier studies, a stock split is often argued as a purely cosmetic event or is just like an event of cutting a pie into small pieces that should neither create nor destroy any value. Rather, the process incurs real costs. Indeed, a substantial number of companies continue to do this financial manipulation, and investors get very excited to hear that the stocks in which they have invested are going to be split. It reveals that the investors' behaviour and the companies' actions do not necessarily agree with the concepts of Finance Theory. Instead, it comes under the purview of a new study area called Behavioural Finance, which precisely describes the motivations behind stock splits.

2. REVIEW OF LITERATURE

The survey of Baker and Gallagher (1980) and Baker and Powel (1993) reveal that corporate managers undertake stock split decisions mainly to bring the stock prices into a better trading range and enhance liquidity. Many research studies like Muscarella and Vetsupens(1996), Angel (1997), Mishra(2006), Mohanty and Moon (2007), Das and Gouda (2007), Rajesh (2013), Thirunellai(2014), Mistri (2016), etc., have found the evidence of enhancement in liquidity and marketability of stocks due to the stock split.

Further, some studies such as Desai and Jain(1997), Conroy and Harris (1999), NINI (2001), Ariff, Khan, and Baker (2004), Dhar and Chhaochharia(2008), Chavali and Zahid (2011), Nguyen and Nguyen (2012), Chakrabarti et al. (2017), etc., have found positive market reaction and wealth creation around the stock split announcement and/or effective dates and therefore supported the signaling hypothesis.

Research studies like Conroy, Harris, and Benet (1990), Koski (1998), Wulff(2002), Das and Gouda (2007), etc., have evidenced increment in the volatility of returns surrounding the stock split. Whereas, according to Sen (2018), stock split causes an increment in volatility for cheap stocks but not for costly stocks.

ISSN 2394 - 7780

On the other hand, Mistri (2016) has observed an improvement in the financial performance of stock-splitting companies in India. However, Bajaj and Arora (2017) have found no change in financial performance after the stock split.

Moreover, D'Mello, Tawatnuntachai, and Yaman(2003) found stock splits to reveal positive information before the Seasoned Equity Offering (SEO) obtained larger proceeds at the equity offering than other equity issuing firms. Whereas, Guo, Liu, and Song (2008) examined whether some firms use stock split as another tool to manipulate their stock prices before an acquisition to lower the acquisition announcement cost.

Further, studies like Gupta and Gupta (2007) and Choudhary and Choudhary (2009) opined on splitting stocks by the companies with low market prices that they announced stock split just with the aim of getting more recognition in the market.

By reviewing many earlier studies on the stock split, it is observed that there is a mixed finding about different aspects of stock split.

3. OBJECTIVE OF THE STUDY

The main objective of the study is to understand a company's motives for undertaking a stock split and to determine several aspects that an investor should know before making any investment decision regarding the stock-splitting company.

4. METHODOLOGY

The study is fully based on the review of the results and observations of earlier studies relating to the corporate action of stock split. This study attempts to derive the several aspects of stock split based on the thorough review of earlier literatures on this field.

5. FINDINGS OF THE STUDY

It is observed that the management of a company undertakes the decision of stock split mainly to bring the share prices into the optimum price range so that the marketability and liquidity of shares enhance and the ownership base of the company becomes wider. Simultaneously, the main motivation behind the stock split is also to provide positive signals regarding the pronounced performance of the company and its dazzling prospects.

Therefore, it can be said that the management of a company is motivated to do a stock split for many reasons, which may create confusion in the minds of investors. There should be a clear understanding of the different aspects of stock split.

Based on earlier studies, several aspects of stock splits can be discussed as follows:

i. **Optimal price range hypothesis:** There is an optimal price range for securities. Stocks traded in this range are supposed to have less brokerage fees as a percent of the value traded and, therefore, seem to be more liquid. This optimal range is said to represent a compromise between the wants of wealthy investors and institutions that will reduce brokerage costs if securities are high-priced and the desires of small investors who will lessen odd-lot brokerage costs if securities are low-priced. Implicitly, there is a trade-off between diversification benefits and the lower transaction costs of round lot trading (Copeland, 1979). Angel (1997) defined optimal share price as a price that represents a trade-off between the incentives that a lower price creates for intermediaries through commissions and wider spreads and the cost imposed by a lower price through higher bid-ask spreads. The stock split is mainly carried on by a company when its share price rises to a very high level and becomes out of the popular trading range. Stock split leads to a reduction in price and places the share in a more popular trading range.

ii. **Liquidity hypothesis and defused ownership:** Regarding liquidity, management generally announced a stock split to reverse stock illiquidity because of higher stock price than other companies in the same sector. The stock price is high; hence, there are fewer participants due to affordability issues leading to illiquidity. After the split, the stock price reduces to a certain extent, and the number of shares increases based on the split factor. This low price of stock attracts small and wealth-constrained investors and leads to a greater number of transactions. Due to this, the spread between the bid and ask prices of the stock reduces, and for that, the investors who are involved in frequently opening and closing their position in the stock can also be benefitted. In this way, a stock split increases the ownership base of the companies and provides better liquidity and a 'wider' market. An increase in ownership base or defused ownership also helps the management to retain control over the affairs of the companies in its own hands without any interference. Small investors have an insignificant shareholding in the company and cannot exercise much control. A company's management can also use a stock split as a defensive measure against a potential hostile takeover, as it results in a greater number of shares in circulation.

 ISSN 2394 - 7780

iii. **Signalling hypothesis:** Stock split is often used by the management of a company as a means to provide favourable signals for future prospects and to reduce the information asymmetry between the managers and the shareholders. There is a psychological feeling that the stock is good now as the split is generally announced by the companies that are exceptional performers. The excellent performance is expected to continue post-split, too.

iv. **Neglected firm hypothesis:** It states that a company's shares trade at a discount if there is little information available about it. Thus, firms use the stock split to draw attention to ensure that information about the company is more widely recognized than before.

v. **Multiple event hypothesis:** Firms split their stock to reveal information and then issue stocks after a split, hoping the share price will be higher. Such firms intend to use the positive impact of the higher prices to raise more funds by issuing stock after the split.

vi. **Tax-option hypothesis:** The expression "tax option" merely expresses the notion that the investors have more possible tax alternatives, the more volatile the stock price, ceteris paribus (Lamoureux & Poon, 1987). Constantinides (1984) argued that security volatility is desirable, given the number of the US tax code. In particular, preferential treatment is given to long-term capital gains. Short-term capital losses may be used to counterbalance short-term gains. A security with a price that fluctuates wildly presents its holders with the opportunity to realise losses short terms or gains long term to re-establish short-term status. He argued that investors are willing to pay for a "tax-option" component of security. Thus, securities with higher volatility will have higher values, ceteris paribus.

Thus, from the above-specified aspects it is clear that the motive of stock split is not just to bring liquidity and widening ownership base, but there are several aspects of stock split that an investor should understand before making investment decision for any stock splitting company.

6. CONCLUSION

Companies are motivated to do stock splits for several reasons, as investigated in earlier studies. Those may be to enhance liquidity and ownership base, to bring the share into a better trading range, to minimise the information asymmetry between the management and investors, to provide favourable information regarding the prospect of the company, to get more recognition in the market, to make the share price more volatile, to undertake multiple events after stock split by using its positive impact, etc. There should be a critical and in-depth evaluation of all these aspects of stock splits before making any investment decision so that small and retail investors can go on the right path and save their hard-earned money.

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