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ROLE OF BONUS RATIO IN ADJUSTMENT OF STOCK PRICES: STUDY OF LARGE CAP COMPANIES LISTED ON BOMBAY STOCK EXCHANGE

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ABSTRACT
Corporate actions are events that affect each and every shareholder whether individual or institutional. Bonus issue is, a corporate event, very popular across the globe. The present study is an attempt to examine the role of bonus ratio in adjustment of stock prices during the bonus issue announcement. The sample consists the 55 bonus issue announcements made by Indian large cap companies listed on S&P BSESENSEX100 index. Event study methodology has used to find out the impact of bonus announcement on stock return. It is found that large bonus ratio is related to higher stock returns. The study has documented highly positive returns for 1:1 bonus ratio. Moreover, bonus ratio contains the significant information about the earnings of the company. It is a measure of information content of bonus announcements. Hence, bonus ratio plays a significant role in adjustment of stock prices in Indian stock market.

KEYWORDS
(BSE) Bombay Stock Exchange, stock prices, bonus ratio, bonus issue.

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INTRODUCTION
Bonus issue is the distribution of additional stocks to the existing shareholders in proportion of their current investment. A bonus issue increases the number of outstanding shares but has no effect on shareholders proportional ownership of shares. A company can distribute bonus shares by using retained earnings or accumulated capital reserves. If a company distribute a bonus issue by using retained earnings, it makes a book entry to allocate retained earnings into paid-up capital in the stockholder's equity section of the company's balance sheet. On the other hand, if a company distribute bonus shares by utilizing accumulated capital reserves, it adjusts the reserves into paid-up capital. In both cases there is no inflow of cash. It results increase in number of shares in the hands of each shareholder, but their relative claim on assets of the company will reduces to that portion (Mishra, 2005). Sometime, bonus issue can be seen as an alternative of cash dividend but in India a company cannot issue bonus shares in lieu with cash dividend. There is no value addition of investment due to issue of bonus shares. The reserves of the company contracts and the share capital expands post a bonus issue. The absolute book value of the company remains same, but due to increase in number of outstanding shares, the book value per share falls. Also, there is a decrease in earnings per share to the adjustment of bonus ratio.

The bonus issue entails all the existing shareholders to get additional shares in proportion to the shares held by them, without changing the basic capital structure of the company. Analysts at times overvalue the advantages of more liquidity provided by the bonus shares and higher dividends in long term this is because the bonus issue increases the confidence and expectations about the company. The management that issue bonus shares implies an insight that revenues and profits are likely to increase in near future and the extended capital base will be benefited through higher dividend. It is generally perceived that the manner in which the investors interpret the bonus issue information can be understood by knowing the share prices around the information release. Market value of a share after the bonus issue depends on the dividend decisions, if a company increase dividend in near future as a result stock value will improve and if company do not increase the dividends then stock prices may fall rather than increase.

Modigliani and Miller (1961) explained theoretically that bonus issue along with other types of dividends does not alter shareholders wealth. There is no effect on stockholder's ownership of stocks, financial position and capital structure of the company. Hence, there should be no effect on stock price of a company but empirical studies (Grinblatt et al., (1984), McNichols & Dravid (1989), Obaidullah (1992), Dhar & Chhaochharia (2008) and Joshipura (2009) with others) have observed a significant positive abnormal return around the bonus issue announcements across the globe. There have been various hypotheses have developed to explain the effect of bonus issue on stock return and liquidity. But so far, few studies have been reported impact of bonus ratio on stock return.

Bonus shares are issued in a particular ratio (e.g. 1:1, 1:2 etc.) and it means that the company will issue one bonus share for every one share held by the existing shareholders and one bonus share for every two-share held by the existing stockholders respectively. Lukose & Rao (2002) defined the bonus ratio as the number of outstanding stocks after the bonus issue divided by the number of stocks before the issue. On the basis of the bonus ratio, re-adjustment takes place in capital and reserves position of the company. A few studies (McNichols & Dravid (1990), Obaidullah (1992), Tanner & Balachandran (2002), Lukose & Rao (2002), Dhar & Chhaochharia (2008) with others) have reported the significant relationship between the announcement period abnormal returns and size of the bonus issue or bonus ratio.

In a classical study Grinblatt et al., (1984) have explained that in case of stock dividends (bonus shares) 'the reduction in retained earnings will restrict the firm's ability to pay cash dividends if the firm does not anticipate increased earnings.' Furthermore, they have documented that firms signal information about their future earnings or equity values through their split decisions. Brennan & Copeland (1988) also argued that size of the split factor signals information to the market and a 'firms do not split by a factor larger than is warranted by their stock prices and private information'. McNichols and Dravid (1989) have extended the study of Grinblatt et al., (1984) and have analyzed whether the split factor itself has the signal. They explained that 'managers use their private information about the firm to set the split factor (bonus ratio), and this allows investors to make inferences about managers' private information from the observed split factor (bonus ratio).' Furthermore, they have documented that more favorable the managers' information about the value of the firm, the greater the split factor. They provided further evidence in the relationship between the size of a stock dividend and the degree of abnormal return around the announcement dates. Their findings suggested a positive relationship between stock dividend size and abnormal return. The study found difference of 6.6% of t-value, of three-day return prediction error, between the small stock dividend subsample (less than 10% split factor) and the large stock subsample.

Does the market reaction differ according to bonus size? The question was raised by Obaidullah (1992) in his study. The study has included the sample of 75 bonus announcements for Indian stock market. Based on different bonus ratios the study evident no any role of bonus ratios in adjustment of stock return. They documented that market reaction is not necessarily higher for higher bonus ratios or vice versa. The study also found that very small ratios (less than 1:2) have failed to any significant impact on the stock prices.

For Australian stock market, Balachandran & Tanner (2002**)** hypothesized that announcement period abnormal return will be positively related to bonus size. For the hypothesis they gave an explanation that large size bonus issues have more information content than small size issue and expects more abnormal returns. Moreover, the study found the magnitude of price reactions to bonus issues announcement to be significantly related to the size of the bonus issue. Moreover, Lukose and Rao (2002) considered bonus ratio as a variable to analyses the announcement effect of bonus issue.

In a study based on Sri Lankan stock market Fernando and Gunaratne (2009) have analyzed the 139 bonus issue announcements over the period of 1991 to 2007. To analyses the effect of bonus ratio they have studied 59 large bonus issue announcements (ratio more than 30%) from the selected sample. Study has clearly documented that high abnormal returns have earned for high ratio samples. The positive drift resulted with the sample of high bonus issue ratio confirms the positive correlation between the size of the bonus issue and the performance on and around the bonus issue announcement. Furthermore, they found 6 to 8% more CAAR for high bonus ratio samples. They have suggested to investors that if they hold the high bonus ratio stocks during the event window, they can earn around 20% abnormal return. Moreover, they have described this phenomenon 'may be due to the signaling impact associated with bonus issue announcements.' They documented that investors expect higher cash flow from bonus issue companies as future dividends because the number of shares in hands goes up with bonus issue.

Moreover, Malhotra et al., (2012) expressed that the change in abnormal returns due to bonus issue announcement is significantly influenced by size of bonus issue and the pre-cumulative abnormal return.

OBJECTIVES OF THE STUDY

Most of the previous studies have reported that announcement period abnormal return is significantly correlated with the size of bonus issue. But we have lack of studies based on large cap companies whether bonus ratio play any role in the price adjustment, over-reaction/ under-reaction of the stock prices of these companies.

Hence, the present study is an attempt to investigate the role of bonus ratio in adjustment of stock prices during the bonus issue announcement. The main objective of the study is to investigate whether bonus ratio has any impact on stock valuations of large cap companies during the selected study period.

DATA AND METHODOLOGY

The nature of the study is quantitative. The study is purely based on secondary data. Event study methodology has used for the research work. The approach is established by Fama et al. (1969). It has been used in a variety of researches for examining the effect of new information on the stock valuation. We have used seven days event window for the present study.

The study has included the sample of 55 bonus issue announcements announced by large cap Indian companies listed on S&P BSESENSEX 100 index for the period of 1st April 2011 to 31st December 2018. Stock price and market index related data has collected from Bombay Stock Exchange website. For analysis purpose, we have retrieved daily closing stock price and market index value for eight days i.e., 4 days before the announcement, 0th day (event day) and 3 days after the announcement in post event window. Furthermore, announcements related data has been retrieved from different sources like newspapers, companies own websites and other related websites.

TOOLS FOR ANALYSIS

Daily return: The daily return on security and market index is calculated by using the following formulas;

Rit = (P1 - P0 / P0) *100

Where,

P1 stands for closing stock prices on successive day.

P0 stands for closing stock price on previous day.

Rmt = (M1 - M0 / M0) *100

Where,

M1 stands for index closing price on successive day.

M0 stands for index closing price on previous day.

Abnormal return: The abnormal return is calculated by simply deducting the return on selected market index from the raw return. Symbolically,

ARit = Rit – Rmt

Where,

ARit represents the abnormal return for the security i in time period t.

Rit represents the realised return of security i for period t.

Rmt represents the realised return for market index in time t.

Cumulative Average Abnormal Return (CAAR): It is simply adding the AAR on each successive day. When there is no impact of an event it should be zero (Obaidullah, 1992). Symbolically;

$$CAARit = \sum_{t}^{i} AARt$$

where,

AARt stands for average abnormal return for stock i for period t.

AAR is simply calculated by adding all sample's abnormal return and divided by the total number of samples.

The study has used the cross-sectional t-test to examine the statistical significance of CAARs at the 5% significance level for the event window.

FINDINGS

Table 1 is representing the total number of bonus announcements selected for the study. As it is clear from the table 1 the highest number of announcements have come under the 1:1 bonus ratio. This bonus ratio is very common in Indian stock market (Mehta et. al., 2014). Lukose and Rao (2002) also found nearly 50% of the sample of their study having bonus ratio 1:1. For the present study almost 51% of bonus issue announcements are included in the ratio 1:1. According to selected samples, another popular ratio is 1:2 which has included 29.09% bonus issue announcements. While other ratios (say, 1:3, 1:4, 1:10, 2:1 and 3:2) are included in rest 30% selected sample announcements.

Table 2 is representing the CAARs of selected sample companies for the study period. Sample companies starting from serial number 1 to 28 belongs to 1:1 bonus ratio. Next, announcements from serial number 29 to 44 are representing 1:2 bonus ratio and remaining 10 samples (from 45 to 55) belongs to ratios 2:1, 3:2, 1:10 and 1:4 respectively as due to a smaller number of announcements we have collectively taken together these ratios and classified them fourth category named as other ratios. The CAAR has experienced an overall increase around the announcement period. Analysis based on bonus ratios, collectively for all bonus ratios (all announcements), 67.27% bonus announcements have recorded positive abnormal return on announcement day (T0). While at the end of window period, on day 3, 61.81% announcements are found to be positive. For bonus ratio 1:1, study has found 67.85% announcements are positive on event day and 71.42% announcements have documented positive abnormal return at the end of event window (day 3). Furthermore, Bajaj finance has earned highest abnormal return around 17% followed by HCL and Divis Laboratories respectively. For category of bonus ratio 1:2, we have found 68.75% announcements have recorded positive return for both announcement day as well as at the end of window period. HPCL2 has recorded highest return for the particular bonus ratio. For category other ratios, we have observed that 60% announcements have documented positive return on event day and only 50% announcements found to be positive at the end of window period. In this category, ICICI has earned highest abnormal return during the event window.

Table 3 and figure 1 are representing CAARs for different bonus ratios during the study period. In graph, horizontal line is representing window days starting from day -3 to day -1 in pre-announcement window and from day 1 to day 3 in post announcement window and zeroth day is the event day. Moreover, vertical line is presenting the cumulative average abnormal return earned during the study period. For analysis purpose we have divided bonus announcements in four categories blue line is representing CAARs for all sample announcements based on all bonus ratios, red line is representing 1:1 bonus ratio, grey line is showing 1:2 bonus ratio and yellow line is representing other ratios. As we can observe a positive drift in stock prices during the announcement window. Furthermore, we have recorded a significant positive CAAR on announcement day for ratio 1:1, 1:2 and whole sample but negative return for other ratios category. The positive CAARs have evidenced in post announcement window for first three categories. The CAAR has experienced an overall increase around the announcement period. This implies that market reacts in a positive direction.

Furthermore, the pattern of CAAR is found to be highly positive for the sample of 1:1 bonus ratio as compare to other ratios. On announcement day, highest CAAR has recorded as 2.24% in category of 1:1 ratio followed by whole sample CAAR near to 1.5% and 0.984% by sample of 1:2 bonus ratio respectively. But we have observed negative return for samples included in category of other ratios. Moreover, study has documented highest CAARs in case of 1:1 ratio for whole event window as comparison to other ratios. This positive drift of high bonus ratio confirms the positive correlation between the bonus ratio and abnormal return on and around the bonus issue announcements. CAAR trend of other ratios category is volatile and giving nearly 1% return at the end of window. For whole event window, sample included in bonus ratio 1:1 is giving highest returns followed by all ratios (whole sample) and 1:2 bonus ratio while for fourth category, we have recorded lowest returns.

Table 4 is representing t-values based on different bonus ratios. As we can see t-value for 1:1 ratio is found to be extremely significant at 5% significance level. Moreover, 1:2 and all ratios (whole sample) are also found to be very significant. On the other hand, sample of other ratios category is not significant at 5% level of significance i.e., stock prices of these sample companies have not changed significantly after the bonus issue announcements. These findings clearly showing that the stock prices of sample companies including in 1:1 ratio have significantly positively changed after the bonus issue announcements followed by companies of bonus ratio 1:2 and all ratios (whole sample). Our findings are in line with McNichols and Dravid (1989) and Fernando and Gunaratne (2009) and in contrast with results of Obaidullah (1992) who evident that market reaction is not based on bonus ratios.

CONCLUSION

Bonus shares are free shares issue by a company to its existing shareholders without any extra cost. Bonus issues increases the number of outstanding shares in the stock market without having effect on shareholders proportional ownership of stocks. The present paper has examined the impact of bonus ratio in adjustment of stock prices of selected 55 large cap companies listed on BSE for the period of 1st April 2011 to 31st December 2018. We have found a positive relationship between bonus ratio and abnormal return for the selected sample and period. The study has documented highest returns for ratio 1:1 and lowest for lower ratios. The bonus ratio is a measure of information content of bonus announcements. Generally, investors perceive high bonus ratio as the indicator of higher future earnings of the company. We have observed significant correlation between abnormal returns and bonus size for the announcement period. Large size bonus issues have more information content than small size issues. The findings of our study suggest that higher bonus ratio gives higher abnormal return. Hence, bonus ratio plays a major role in price adjustment of stocks in Indian stock market.

The result of the study is useful for policy makers, management, students and especially investors to make their investment decisions. The study is limited to large cap companies only. The results can be different for mid cap and small cap companies. Also, large sample can make more generalize results.

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TABLE AND FIGURE

TABLE 1: CLASSIFICATION OF BONUS ANNOUNCEMENTS ACCORDING TO THEIR BONUS RATIO

S. No.	Bonus ratio	No. of announcements	% of announcements
1.	1:1	28	50.90
2.	1:2	16	29.09
3.	1:3	3	5.45
4.	1:4	2	3.63
5.	1:10	2	3.63
6.	2:1	3	5.45
7.	3:2	1	1.81
T. A		55	100.00

Source: Calculated by authors

TABLE 2: CUMULATIVE AVERAGE ABNORMAL RETURN (CAAR) FOR SAMPLE COMPANIES

S. No.	Company Name	CAAR	
		On event day	At the end of window
1.	Ashok Leyland Ltd.	-0.936	-4.758
2.	Aurobindo Pharmaceuticals Ltd.	2.314	1.911
3.	Bajaj finance Ltd.	12.95	17.41
4.	Bharat Forge Ltd.	1.733	4.518
5.	Bharat Petroleum Corporation Ltd.2	-3.128	1.754
6.	Bharat Petroleum Corporation Ltd.3	1.219	-1.056
7.	Britannia Industries Ltd.	-3.495	-7.177
8.	Colgate-Palmolive India Ltd.	1.582	-3.689
9.	Divis Laboratories Ltd.	5.106	12.96
10.	Engineers India Ltd.	4.797	6.197
11.	Federal Bank Ltd.	1.556	5.218
12.	Godrej Consumer Products Ltd.2	-4.991	-3.625
13.	HCL	9.125	16.05
14.	Infosys Ltd.1	2.389	3.278
15.	Infosys Ltd.2	-7.066	-7.827
16.	Infosys Ltd.3	0.293	1.291
17.	Indian Oil Corporation Ltd.1	5.715	4.416
18.	Indian Oil Corporation Ltd.2	7.404	8.962
19.	Kotak Bank Ltd.	4.698	-0.186
20.	Marico Industries Ltd.	2.31	5.394
21.	Mahindra & Mahindra Ltd.	3.533	7.033
22.	Petronet lng Ltd.	-0.677	1.063
23.	Reliance Industries Ltd.	2.287	3.496
24.	Sun pharma Ltd.	-0.716	5.588
25.	Tata Consultancy Services Ltd.	-1.422	4.237
26.	Tech Mahindra Ltd.	2.79	3.206
27.	Titan Company Ltd.	3.754	4.119
28.	Wipro Ltd.	-3.032	-3.113
29.	Bharat petroleum corporation Ltd.1	0.568	-5.368
30.	Bharat Heavy Electricals Ltd.	-5.456	-3.939
31.	Container corporation of India 3	0.675	0.863
32.	Emami Ltd.	4.16	4.978
33.	Godrej Consumer Products Ltd.1	6.926	6.038
34.	Hindustan Petroleum Corporation Ltd.1	4.831	12.27
35.	ITC Ltd.	2.262	7.969
36.	Larson & Toubro Ltd.1	-3.567	-6.617
37.	Larson & Toubro Ltd.2	0.748	0.63
38.	Motherson sumi Ltd.1	5.552	4.41
39.	Motherson sumi Ltd.2	-0.403	9.615
40.	Motherson sumi Ltd.3	4.178	4.357
41.	Motherson sumi Ltd.4	2.019	2.64
42.	Motherson sumi Ltd.5	0.116	-2.035
43.	Oil India Ltd.1	-0.692	-3.836
44.	Oil & Natural Gas Corporation Ltd.	4.871	5.819
45.	Bharat Electronics Ltd.1	1.553	9.91
46.	ICICI Ltd.	-1.258	12.46
47.	Bharat Electronics Ltd.2	-1.541	-0.255
48.	Biocon Ltd.	0.552	-7.291
49.	Hindustan Petroleum Corporation Ltd	-4.272	-3.156
50.	GAIL1	0.918	-0.348
51.	GAIL2	1.657	3.043
52.	Oil India Ltd.2	-1.888	-2.324
53.	Container Corporation of India1	-2.31	-6.455
54.	Container Corporation of India 2	3.135	-2.042
55.	Oil India Ltd.3	-0.692	-3.836
	Positive/ Negative return	36/19	34/21

Source: calculated by authors

TABLE 3: CAARS FOR SELECTED WINDOW DAYS FOR DIFFERENT BONUS RATIOS

Window days	All ratios	1:1	1:2	Others
T-3	0.265	0.358	0.318	-0.051
T-2	0.787	0.545	0.476	1.854
T-1	0.784	0.342	0.879	1.769
T0	1.53	2.249	0.984	-0.508
T+1	2.339	3.253	1.507	0.219
T+2	2.521	3.523	1.509	0.438
T+3	2.731	3.40	2.021	1.059

Source: calculated by authors

FIGURE 1: GRAPHICAL REPRESENTATION OF CAAR BASED ON DIFFERENT RATIOS

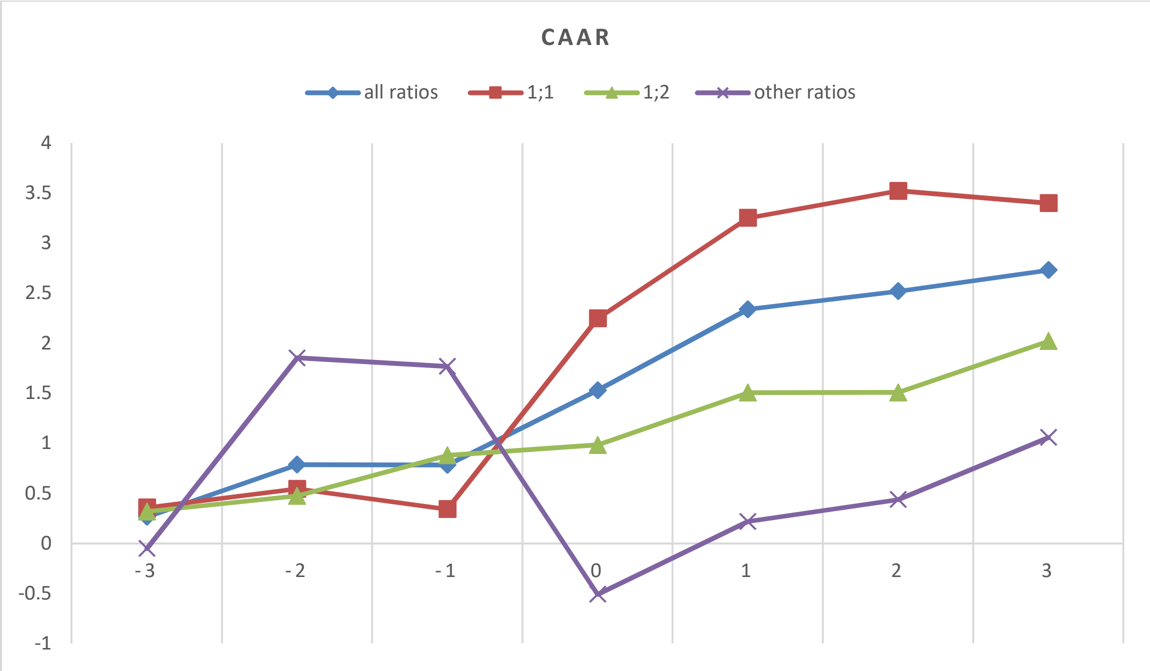

TABLE 4: T-TEST RESULT

Particulars	Bonus ratios			
	All ratios	1:1	1:2	Other ratios
t-value*	19.3399	63.264	24.2694	1.2656
p-value	0.0027	0.0002	0.0017	0.3331
SED**	0.099	0.047	0.046	0.489
Degree of freedom	2	2	2	2
Significance (95%)	Very sig.	Extremely sig.	Very sig.	Not sig.

* significant level at 5%, **standard error of difference

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