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CORPORATE ANNOUNCEMENTS EFFECT: A STUDY OF DIVIDEND ANNOUNCEMENTS

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ABSTRACT

This study tests the semi-strong form of market efficiency by investigating the reaction of stock prices to dividend announcements. This study belongs to event study methodology. The focus of present study lies in the sample period from 2011 to 2013 for finding out significant change in the abnormal stock returns before and after dividend announcement by 34 sample companies from 12 different sectors which are listed at NSE 100. The results indicate that there are significant positive abnormal returns can be observed from the day five (t_{+5}) of dividend announcement in line with evidence of developed stock market. On the announcement day there is negative AAR of -0.4% which is very low and significant at 1% level (z value = 3.57). The results provide stronger evidence of semi-strong efficiency of the Indian stock market.

KEYWORDS
AAR, CAAR, dividend, semi-strong form.

1. INTRODUCTION

In the corporate finance world, companies don't have any obligation to pay dividends. However, we still see a large number of corporations paying out dividends regularly. The crucial question is why do companies pay dividend? Dividend pay-out decision is among the basic policy choices that corporate financial officers make. How much to pay is still an open issue. The dividend is the cost of equity capital to equity shareholders. The dividend announcement has an impact on the market price of the shares; the market will react positively, if the dividend is up to the expectation level of the equity shareholders. At the same time if the dividend announcement is not the expectation level of the equity investors, the market reaction will in bear trend for that particular scrip. Dividend announcements are one of the most important events and the studies on stock market reaction to earnings information are included in the semi-strong form of efficient market hypothesis (EMH). It is therefore a matter of concern that firms announcing Dividend experience rise in their stock prices on an average supporting semi-strong form Efficient Market Hypothesis (EMH).[1]

Most recurrent form of dividend announcement is in the form of cash. When a company has either contained the ideas regarding better investment alternatives in its hands, or is suffering from liquidity crunch, the company will not think it wise to give cash to the shareholders and the company will go for the other option that is bonus shares. Dividend announcement is one of the most important corporate announcements, as this does not only entail cash flow from company to shareholders but also send signals regarding companies' present and future plans and performance. Why companies pay dividend at all and incur double taxation? This remained a debatable issue in the earlier financial research.[2] But daniels, Shin and Lee (1977) focused on level of market efficiency and argued that since managers have private and superior information which is not available to general public they use dividend announcement and payout to signal company's present and future earning cash flow potential and consequently the magnitude of dividend increase/decrease the value of share.[3]

The aim of this paper is to examine the stock price reaction to dividend announcement with a view of examining whether the Indian stock market is semi-strong efficient or not. The Event Study Methodology (Dolley 1933; Fama et al. 1969; and Brown and Warner 1980, 1985) has been used to contribute further evidence on the efficiency characteristics of the Indian stock market.

2. LITERATURE REVIEW

According to the dividend information content hypothesis, dividend changes trigger stock returns because they reflect changes in management's assessment of a firm's future profitability. This hypothesis has motivated a considerable amount of theoretical can empirical research. The general procedure used in prior research begins with classifying the dividend change announcement into either favorable or unfavorable. Ball, R. and Brown, P. (1968), Bhattacharya, S.(1979) and Bae Gil S. (2008) found out that the announcement increased (decreased) earnings over the previous year by a chaebol-affiliated firm had a positive (negative) effect on the abnormal return for the value -weighted portfolio of other non-announcing affiliates in the same group. Dasilas Apostolos (2008) investigated the stock market reaction of the Athens Stock Exchange to cash dividend announcements for the period 2000-2004. In particular, the study examined both the stock price and trading volume response to company announcements about dividend distributions. Eriotis Nikolaos (2007) discovered that existence of a long term dividend policy stood partly unaffected by the level of current period earnings. Hazak Aaro (2007) presented a theoretical model on dividend policy for distributed profit taxation which is the corporate taxation regime of Estonia. Henry Elaine (2006) examined market reactions to firm's earnings announcements. The study extended the examination to include a broad range of concurrent disclosure contained in earnings press releases, the financial disclosures captured as accounting ratios and verbal components of disclosure which were captured using elementary computer based content analysis. Hochberg Yael V. (2003) examined the effects of venture capital backing on the corporate governance of the firm following the IPO. How Janice C. Y. (2007) observed that in a relatively less litigious environment like Australia it was common to find IPO firms that voluntarily provided forecasts in their prospectus. Hribar Paul (2004) examined how institutional investors respond to accounting restatements. The study showed that transient institutional investors defined as institutions with shorter investment horizons and higher portfolio turnover significantly reduced their holding in a restating firm at least one quarter prior to the quarter of the restatement. Jegadeesh Narasimhan (2002) examined the relation between revenue surprises and future stock returns. The study investigated how analysts updated their earnings forecasts followed by announcements of revenue and earnings surprises. The results indicated that the stock price reaction on the earnings announcement date was significantly related to both revenue surprises and earnings surprises. Kato, K. and Loewenstein, U. (1995), Kanniainen Juho (2007) examined of stock return volatility by questioning the assumption that the conditional expectations of future dividends react to the same new information. Kanwal Anil (2008) observed profitability as always been considered as a primary indicator of dividend payout ratio. Apart from profitability, numerous other factors like cash flows, corporate tax, sales growth and market to book value ratio were also considered rampant. Koerniadi Hardjo (2008) examined in their study whether managers deliberately used accruals to convey information regarding firm future profitability. The contemporaneous earnings and dividend announcement data was used as research setting as it reduced the possibility of opportunistic income smoothing by managers and hence increased the validity of the inference on the accrual signaling hypothesis.

Kumar Praveen (2006) derived a conditional CAPM in a general equilibrium model where investors faced estimation risk on mean returns and learnt from information of uncertain quality or precision. Minnick Kristina L. (2004) examined the cross sectional determinants of the decision to take write offs. A hand collected dataset on write-offs was used that was much more comprehensive than existing write-off datasets. It was found that quality of governance was positively related to write-off decisions in the cross section. Narayana moorthy Ganapathi (2003) identified previously undocumented source of predictable cross-sectional variation

[1] According to the Efficient Market Hypothesis (EMH), if the stock prices reflect the announcement of public information instantaneously and unbiased, the market should be classified as semi-strong form efficient market. (Fama (1970)

[2] "Miller and Modigaliani (1961)", were the pioneers to establish that it is the investment policy and not dividends which add to the value of company.

[3] Their research give raise to Linter (1956) proposition of "information content of dividend hypothesis" or "dividend signaling hypothesis" which was further refined by "Fama, Jensen and Roll (1969) and John and Williams (1987)"

in Standardized Unexpected Earnings' autocorrelations viz. the sign of the most recent earnings realization and presented evidence that the market ignored this variation (loss effect).[4] Padgett Carol (2007) tested the signaling and free cash flow hypotheses of the information content of share repurchases using UK open market share repurchases between January 1999 and December 2004. The five day mean announcement abnormal return of the sample was low at 1.28% but it was statistically significant at the 5% level. Rees Lynn (2001) examined the importance attached to revenue forecasts by firms and the market and whether these forecasts were value-relevant conditional on earnings forecasts. Sadka Ronnie (2005) investigated the components of liquidity risk that were important for asset pricing anomalies. The unexpected systematic variations of the variable component rather than the fixed component of liquidity were shown to be priced within the context of momentum and post earnings announcement drift portfolio returns. Servaes Henri (2008) studied responses of industry when another firm in the same industry was put to a hostile takeover attempt. The study documented some major responses i.e. the industry peers cut their capital expenses, free cash flows, cash holdings, increased their leverage and payouts to shareholders. Shu Tao (2008) analyzed the impact of trader composition i.e., the fraction of total trading volume of a stock accounted for by institutional trading on the cross section of stock returns. The study found that trader composition had significant effects on stock returns beyond institutional ownership. Subramani Mani R. (2002) examined the returns to e-commerce events in the period from 1999 to 2000 which employed a set of short time windows (1 day, 5 days, 10 days bracketing the event) as well as a set of long event windows (6 months, 9 months and 1 year from the event). The results reflected little consistency between abnormal returns in short 1 day, 5 days and 10 days event windows. In contrast, the abnormal returns observed in 6, 9 and 12 months windows were reasonably consistent. Zhu PengCheng (2008) examined the short term stock performance of a sample of Indian firms who acquired U.S. firms in the period 1999-2005.

3. DATA AND METHODOLOGY

3.1 DATA AND SAMPLE

The sample consisted of 34 companies of dividend announcements (from 12 sectors) listed on the NSE 100 index in the sample period from 2011 to 2013. The information regarding dividend announcement dates, daily price of companies as well as of NSE 100 index are obtained from CMIE Prowess Database and from NSE websites. First media announcements date is defined as the event date. This approach was taken on the assumption that the information was first known to the market on the event date only.[5]

3.2 ANNOUNCEMENT EFFECTS

The study used the event study methodology to examine the market reaction to dividend announcement on stock prices by using daily adjusted prices for sample stocks for 115 days prior and 15 days after the event date. The respective media announcement dates of dividend are obtained from CMIE Prowess Database, along with the necessary share price data and the value of the NSE 100 index. The procedure adopted in using the Event Study Methodology[6] is also discussed.

3.3 ESTIMATION PROCEDURE

The purpose of our study is to determine whether there is any abnormal return around the event window and how fast the information is absorbed in the security prices. For the purpose of the study, we constructed null hypotheses (H_0) as follows:

(H_0) There are no significant average abnormal returns (AAR) around the dividend announcements date i.e. $1/n \sum AR = 0$ Where n is the number of sample companies.

NSE 100 index is used as a proxy for the market portfolio. In order to carry out an event study, we determine the event window as t = -15 to t = +15 relative to the event day t = 0 (date of dividend announcement). An estimation period of -115 to -16 days is used for computing expected returns using market model given in equation 3.

The daily returns for each sample company have been computed for the estimation window period and also for the event window period as:

$R_{it} = (P_{it} - P_{it-1}) / P_{it-1}$ ...(1)

Where, P_{it} and P_{it-1} are respective daily prices for company i at time t and t-1. Analogously, the actual returns for the market are also computed as:

$R_{mt} = (I_t - I_{t-1}) / I_{t-1}$ ...(2)

Where, I_t and I_{t-1} are daily index values at time t and t-1 respectively.

The expected returns on a stock have been estimated using the market model given in the following equation:

$R_{it} = \alpha_i + \beta_i R_{mt} + \varepsilon_{it}$ ...(3)

Where R_{it} is the observed daily return for the share of a company i at time t, R_{mt} is the observed daily return for the market index at time t,

α_i is the estimate of the intercept for share of company i,

β_i is the estimate for beta of share of company i, and

ε_{it} is the independently and identically distributed residual error term.

In the next step we compute the "abnormal" returns for each of the sample company for the window period. Abnormal return is defined as the actual return minus the expected return. The abnormal return for company i on day t calculated as:

$AR_{it} = R_{it} - \alpha_i - \beta_i R_{mt}$ ...(4)

In order to eliminate the effect of any one or group of securities on the abnormal returns, the ARs are averaged over the number of companies. The ARs of individual companies are averaged for each day surrounding the event-day (i.e., -15 to +15 days) using the following model:

$$(AAR_t) = \sum_{i=1}^{N} AR_{it} / N \quad \dots (5)$$

With a view to know the cumulative effect of AARs on days surrounding the event the Cumulative Average Abnormal Return (CAAR) are calculated for event days t_1 through t_2 by summing the average abnormal returns for these days, that is:

$$(CAAR_d) = \sum_{t=t_1}^{t_2} AAR_t \quad \dots (6)$$

3.4 SIGNIFICANT TEST

Standard deviation of abnormal returns for the estimation period -115 days to -16 days is computed first. Then the Standardized Abnormal Returns (SAR) for each company is obtained, by dividing abnormal returns of the event period (i.e., -15 to +15) by the standard deviation obtained. For event day t, the z-statistics for the Average Abnormal Returns (AARs) on N securities will be calculated as:

$$Z_t = \sum_{i=1}^{N} SAR_{it} / \sqrt{N}$$

For testing cumulative excess returns for N securities over T days (event days t_1 through t_2) the Z-statistic is:

$$Z_T = \sum_{i=t_{1i}}^{t_{2i}} SAR_{it} / \sqrt{T * N}$$

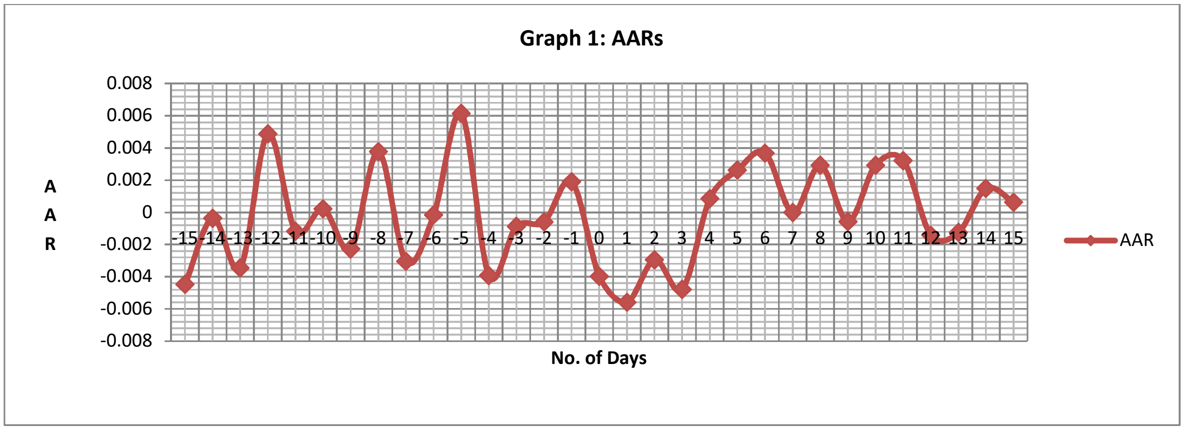
[4] It was possible to earn returns higher than from the "Bernard and Thomas" strategy by incorporating this feature.

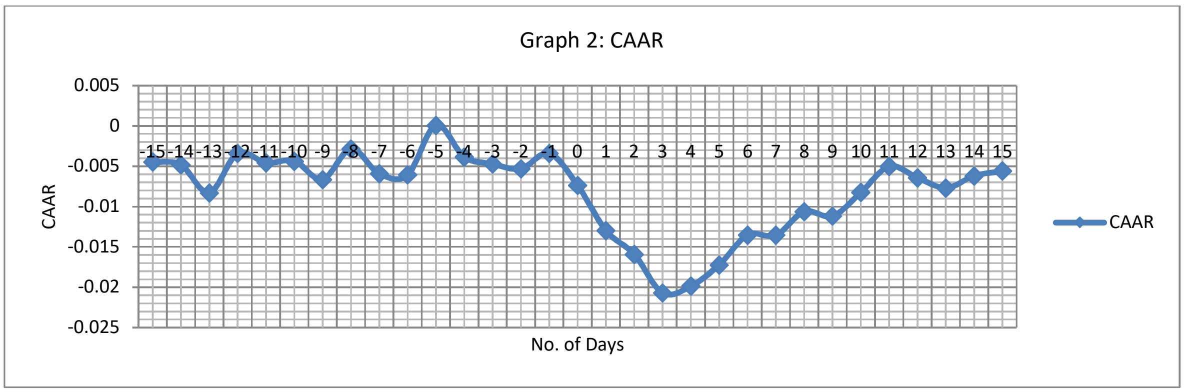
[5] First media announcements date has been taken by ignoring the probability of insider trading.

[6] For details, see Elton and Gruber, (1996); Ball and Brown, (1968).

4. RESULTS

In an efficient market, if there is some information content associated with dividend announcement, then the same should be incorporated in the stock price on the announcement day. The result of the event study concerning the announcement dates of dividend are presented in Table 2. However the researches in the past have documented a significantly positive abnormal return on the event day i.e. on dividend announcement day. But this study documents dissimilar results. On the announcement day there is negative AAR of -0.4% which is very low and significant at 1% level (z value = 3.57). On the days t_{+1}, t_{+2}, t_{+3}, market earn a significant negative AAR as observed, z values have exceeded the critical values. Whereas, on the day t_{+5}, t_{+6}, the market earn a significant positive AAR, it continues to build up to three days i.e. t_{+8} t_{+10}, t_{+11}. There are significant positive excess returns before run up to the dividend announcement date on the days t_{-12}, t_{-8}, t_{-5}, whereas, on the day t_{-1}, AAR is insignificant positive is observed, which depicts that there was not any substantial leakage of information before the event.





We observed a randomly trend in the prior event period i.e. from the day t_{-15} to t_{-2} the mean CAAR is -0.0047 and during this period fluctuation can be seen. From the day t_{-12} to t_{-2} the CAAR gradually drift down to 0.53%, which continue till the day t_{+4} (1.98%). But from the day t_{+5} the market reacts positively and goes with the flow of the announcement till the day t_{+10}. However, during the period under consideration investor initially appear to respond negatively to announcement of dividend offering, but the CAAR shows an upward trend shortly thereafter. On the event day a radical downfall to 0.74% can be observed i.e. t_0. The CAAR of -1.3% on the day t_{+1} decline to 1.98% by t_{+4} indicating the acceptance of our Null Hypothesis (H_0) that there is no significant abnormal returns (AAR) around the dividend announcement date.

5. CONCLUSIONS

This study documents the market behavior around the dividend announcement date for 34 stocks listed on the NSE 100 index over the period 2012-13. An event study was conducted using a 30 days event window. It was found that on an average the stocks start showing negative abnormal returns from the day t_{-11th} day. On the announcement day there is negative AAR of -0.4% which is very low and significant at 1% level (z value = 3.57). In this study it is observed that the generally stocks don't react immediately but gradually from the third or fourth day of the announcement. Thus there appears to be no announcement effect associated with dividend announcement in India. In general, the behavior of AARs and CAARs is found to in accordance with expectation, thereby lending support to the hypotheses that the Indian Stock market is Semi Strong Efficient.

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ANNEXURE

TABLE 1: SAMPLE DESCRIPTIVE CHARACTERISTICS

Sr. No.	Industry Classification	No. of Sample Companies	% to Total
1	IT	3	8.82
2	INDUSTRY	6	17.6
3	AUTO	4	11.8
4	BANKING	7	20.6
5	CEMENT	2	5.88
6	FMCG	1	2.94
7	OIL & GAS	3	8.82
8	PHARMA	3	8.82
9	ENERGY	2	5.88
10	FIN SERVICES	1	2.94
11	COMMUNICATIONS & NETWORK	1	2.94
12	REAL ESTATE	1	2.94
Total	12	34	100

Source: Information extracted from CMIE Prowess Database

TABLE 2: AVERAGE ABNORMAL RETURNS (AARS) AND CUMULATIVE AVERAGE ABNORMAL (CAARS) RETURNS AROUND DIVIDEND ANNOUNCEMENT DATES

Event Day	AAR	Z value	CAAR	Event Day	AAR	Z value	CAAR
-15	-0.00447	-6.42446*	-0.00447	0	-0.00397	-3.57428*	-0.00738
-14	-0.00037	-0.42576	-0.00484	1	-0.00559	-3.88857*	-0.01296
-13	-0.00345	-4.59538*	-0.00829	2	-0.00295	-2.8161*	-0.01592
-12	0.004886	5.095132*	-0.00341	3	-0.00478	-5.25497*	-0.0207
-11	-0.00117	-1.47133	-0.00457	4	0.000854	1.042731	-0.01984
-10	0.000208	0.265768	-0.00436	5	0.002632	3.375135*	-0.01721
-9	-0.00227	-2.45939**	-0.00664	6	0.003686	3.859489*	-0.01353
-8	0.003777	5.343411*	-0.00286	7	-1.4E-05	-0.01966	-0.01354
-7	-0.00305	-3.29522*	-0.00591	8	0.002928	3.315552*	-0.01061
-6	-0.00016	-0.17227	-0.00607	9	-0.00057	-0.67445	-0.01118
-5	0.006152	6.402866*	7.76E-05	10	0.002941	3.538729*	-0.00824
-4	-0.00392	-4.53973*	-0.00385	11	0.00322	3.452511*	-0.00502
-3	-0.00087	-0.86557	-0.00472	12	-0.00142	-1.71758	-0.00644
-2	-0.00059	-0.78024	-0.00531	13	-0.00125	-1.52123	-0.00769
-1	0.001908	1.85136	-0.0034	14	0.001486	1.754476	-0.0062
				15	0.000631	0.653513	-0.00557

Note: *Significant at 1% level, **Significant at 5% level of significance

TABLE 3: CAAR ACROSS THE EVENT WINDOW

Days	Mean CAAR	Variance
t-15 to t-2	-0.004659306	3.78289E-06
t-1 to t-0	-0.005390502	7.88901E-06
t0 to t+1	-0.010169624	1.56022E-05
t+2 to t+15	-0.011549967	2.85661E-05

Source: Information extracted from CMIE Prowess Database

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