CHAPTER 2: THEORY OF BONUS ISSUE AND EFFICIENT MARKET HYPOTHESIS

2.1 BONUS ISSUES

2.1.1 Basic Concepts of Bonus Issue

When a company issues new shares to existing shareholders in a ratio based on their current holdings, the term "bonus issues" is used to describe the new shares. Bonus Issue is also known as stock dividend in the United States and some other stock markets. In Malaysia it is widely known as bonus issue. In the Malaysian market context, bonus issues are usually described as "1 for 1" or "3 for 5" or "2 for 1". In other stock markets especially in the United States a percentage is usually used usually described as "25 percent stock dividend" or "50 percent stock dividend".

It is common knowledge that no value is added when bonus issue occurs. What a company is doing is merely making an accounting transfer from retained earnings to equity capital. In the Malaysian context, the transfer is from reserves to equity capital. A bonus issue does not enhance earning power, change the firm's capital structure or result in expense reductions. Nor are new assets created through this process. As such a bonus issue should actually be a non-event.

Perhaps confusion is created because of the term "bonus issue". It is extremely misleading and conjures up the idea of a gift. The term implies erroneously that shareholders are being given something extra for nothing. Many researchers dislike its usage. Sutherland [1977] advocates outlawing its use and substituting an alternative expression "share issue". This term is unfortunately not widely used. The Americans refer to a bonus issue as "stock dividend" but this expression is no better because "dividend" suggest something of value being given to the shareholders.

Most textbooks on finance follow a standard approach when they deal with bonus issues. Brealey and Myers [1984] dismiss stock dividends and stock splits summarily with "Neither makes anybody better off". Van Horne [1986] says that a stock dividend "represents nothing more than recapitalization of the company". Other researchers acknowledge that regular payment of cash dividends by a firm might influence valuation by investors. Gup [1983] writes "One reason for the confusion is related to cash dividends. If the company continues to pay the same cash dividend per share in addition to increasing the number of their shares through a stock dividend or split, the investor will receive a greater monetary return on the stock". But no researchers says that a bonus issue in itself is beneficial and advantages to the investor.

2.1.2 Mathematics of a Bonus Issue

The calculation of what the price of a stock should be when it goes ex-date is straightforward. If the price for a stock is RM6.00 and the bonus issue ratio is 1 new share for 5 existing shares, the ex-bonus price can be calculated as follows.

5 existing shares at RM 6.00	=	RM 30.00
1 new share for "free"	=	-
6 shares are now worth	=	RM 30.00

Each share ex-bonus is now priced at RM 5.00 each.

Total value before and after the bonus issue stay the same at RM30.00.

2.1.3 Reasons for Issuing Bonus Shares

When the board of directors of a company approves the issue of bonus shares, there is a presumption that this is done rationally and is in furtherance of larger corporate strategy. Sutherland [1977] identifies five reasons why bonus issues are made. They are as follows.

1. To bring issued capital more in line with the real value of the business as measured by net assets employed and the earnings generated by those assets.

Companies might have a substantial gap between equity capital and shareholders' funds. This gap could be caused by past low dividend policy or revaluation of property assets. The purpose in this case is a balance sheet objective.

2. To reduce misunderstanding caused by expressing dividend (out of profits earned on total capital employed) as a percentage of the nominal value of the issued share capital.

An example will make this clearer. At first glance, a company that distributes 30 percent on 10 million shares appears on the surface to be distributing generously. This 30 percent dividend might in reality be only 8 percent of total shareholders funds. If the company is highly geared in financial terms, there is a real danger of creating a misunderstanding of the company's investment (and earnings) potential. The intention of a bonus issue in this case is to increase the original modest capital base.

3. To conserve cash by declaring a bonus issue in lieu of a cash dividend.

4. To improve marketability of the shares by making the price less "heavy" as well as making more shares available.

5. To make use of a company's share premium account.

When shares are issued at a premium, a share premium account is established. The amount in this account can be used only in a limited number of ways laid down by the Companies Act and the issue of bonus shares is one of them.

In Malaysia, effective 1 April 1997 the KLSE regulating body revised the listing requirement that all Main Board listed companies must have a minimum paid-up capital of RM 60 million, up from RM 40 million and Second Board listed companies must have a minimum paid-up capital of RM 40 million, up from RM 20 million. Undercapitalized firms already listed on the KLSE, was given until 31 December 2001, to comply with this new requirement.

As such undercapitalized firms who have no other reasons to raise additional capital via rights issues will have to utilize their existing share premium accounts to issue bonus shares in order to raise the share capital to meet the stipulated minimum requirement.

Extracted from the Bonus Issue Announcement of Yung Kong Galvanizing Industries Berhad (YKGI) published by the KLSE on the 21 of August 2002 (refer to Appendix IV), the reasons given as the rationale for the Proposed Bonus Issue are:

a) to increase the issued and paid-up share capital of the Company to a level that commensurates with the value of its assets employed
b) to increase the issued and paid-up share capital of the Company to meet the minimum share capital requirement for companies seeking listing on the Main Board of the KLSE
c) to enhance the marketability and liquidity of YKGI shares in the market
d) to reward the existing shareholders of YKGI for their continuing support by enabling them to have greater participation in the equity of the Company in terms of number of shares held.

2.1.4 Bonus Issue as a Signaling Device

Several researchers have used the signaling model to present the notion that financial decisions convey information about firm value. Ross [1977] and Bhattacharya [1979] have contributed to the understanding and development of a signaling concept.

Fundamental to this concept is the idea of information asymmetry. Information asymmetry is a situation where information of current and future earnings is not equally known by insiders (people with direct access to a company) and outsiders (the investing public in general). In such a situation managers might find that a bonus issue would provide a relatively low-cost signaling device through which a manager can convey his assessment of a firm's prospects to investors. Direct communication between the manager and investors about a company's prospects is considered to be risky to the manager's professional reputation and career due to the possibility that the manager's expectations may not be subsequently realized.

There are other methods of signaling such as dividends and stock repurchase. Bonus issues however are relatively cheap and tend to be unambiguous. Woolridge [1983] mentions that signaling costs in the form of financing expenses for raising unanticipated funds to fulfill dividend obligations are present. This is non-existent in a bonus issue signal.

A bonus issue from managers is totally unambiguous whereas a cash dividend signal may in some cases be ambiguous. For example, an increase in cash dividends is normally interpreted as a signal from managers that earning prospects are bright and times are good. On the other hand, it could be interpreted as a lack of lucrative investment opportunities. A bonus issue does not have this problem.

2.2 CONCEPTS OF MARKET EFFICIENCY

The concept of Market Efficiency (or Efficient Market Hypothesis, EMH) relates to the precision with which the market prices reflect current information. If prices respond to all relevant new information in a rapid fashion, the market is said to be relatively efficient. If, instead, the information disseminates rather slowly throughout the market, and if investors take time in analyzing the information and reaction, and possibly overreacting to it, prices may deviate from values based on a careful analysis of all new information. Such market could be characterized as being relatively inefficient.

The extent to which the market is strictly efficient or strictly inefficient is one of degree and depends on what type of information is reflected in the securities prices. The total set of all available information are reflected in Figure 2.1

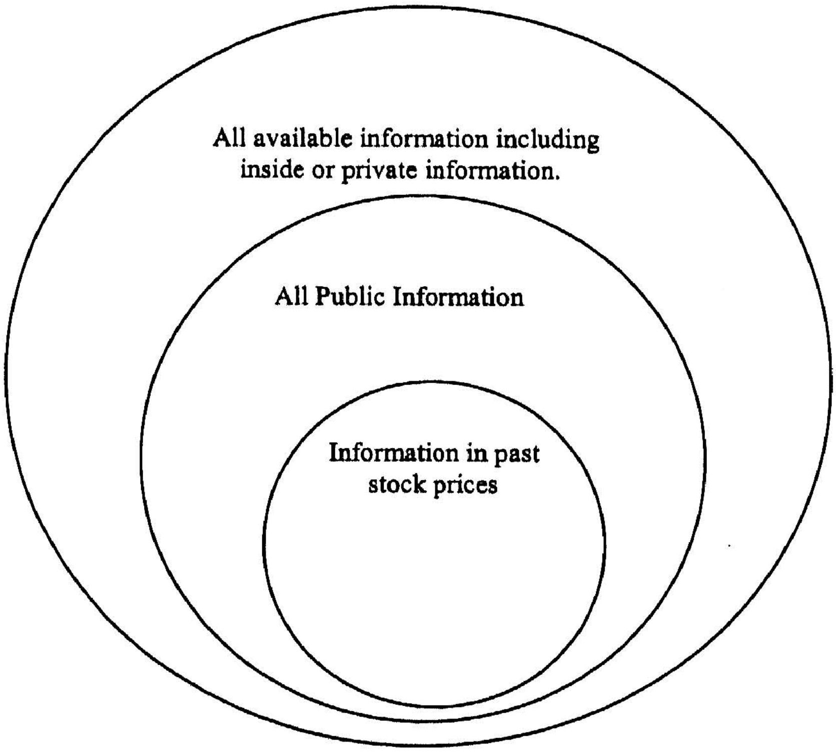

Figure 2.1: Subset of Available Information for a given stock.

The outer circle represents all information relevant to the valuation of a particular stock that is currently known. This includes publicly available information about the company, its industry and the domestic and world economy. It also includes information which is privately held by select groups of individuals.

Within the outer circle, is a second circle, which represents that part of the information set that has been publicly announced and therefore is publicly available. The information outside of this set, therefore, is inside information or private information.

Within the second circle, there is yet a third circle which represents a subset of the information that is publicly available. This third circle represents any information relevant to the valuation of the stock which can be learned by analyzing past information of the stock including its past market price, past volume, announcements, etc.

There are three forms of the Efficient Market Hypothesis as classified by Fama [1965, 1970]. Fama has done a great deal to operationalize the notion of capital market efficiency. Under each, different types of information are assumed to be reflected in the securities prices.

Under the weak form of the efficient market hypothesis, stock prices are assumed to reflect all information that may be contained in the past history of the stock price itself. Examples of such includes patterns of price series which will be detected and eliminated in similar fashion until it becomes impossible to predict the future course of the series by analysis its past behavior. If the weak form is valid, technical analysis or charting becomes ineffective.

Under the semistrong form of the efficient market hypothesis, all publicly available information is presumed to be reflected in the securities prices. This includes information in the stock price series as well as information in the firm's accounting reports, the reports of competing firms, announced information relating to the state of the economy, and any publicly available information relevant to the valuation of the firm. If the semistrong form of the efficient market hypothesis is in effect, no form of analysis will help you attain superior returns as long as the analysis is based on publicly available information.

The strong form of the efficient market hypothesis takes the notion of market efficiency to the ultimate extreme. Under the strong form of the efficient market hypothesis all information is reflected in stock prices. This includes private or inside information as well as that which is publicly available. Under this form, those who acquire inside information act on it, buying or selling the stock, and the price quickly adjust to reflect the inside information. If this form of market efficiency holds, then even insiders will not be able to earn abnormal returns in an efficient market.