The Impact of Stock Consolidations and Capital Reductions on Equity Valuation: Preliminary Evidence for Hong Kong

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Abstract

Stock consolidations (or 'reverse' splits) often occur during bear market periods as a means of elevating the value of lowly priced stocks. The action of a 'reverse split' allows existing shares in issue to be cancelled and replaced by a smaller number of shares, each with higher par value (than on the old shares). In this paper, consolidations, announced during the 'bear' market period of January 2001 to June 2002, are scrutinised to examine their effectiveness in elevating share prices. Interestingly, the majority of the 'reverse' splits scrutinised are conducted in tandem with capital reductions. The combined effect of a consolidation-cum-capital reduction (or capital reduction-cum-consolidation) is to allow a smaller number of new shares (to replace the old) but with par values at similar levels to those obtaining on the old (due to the cancellation of capital through par reduction). A key motivation for this action is to allow companies to issue new equity, which is made considerably easier – as explained in this paper – when share prices are raised to levels above par values.

For a number of the stock reorganisations scrutinised, some decline in the capitalisation value of the affected counters' equity was noted. Moreover, this decline in market capitalisation tended to be greater for shares whose pre-consolidation values were at levels just above, or at, HK$0.01 per share. Certain qualifications apply, however. First, the majority of the companies in the sample had pre-consolidation values of HK$0.11 or less. Consequently, reported results may not translate that well to stocks consolidating at higher levels in the 'penny' stock range (custom suggests the 'penny' sobriquet refers to prices between HK$0.01 and HK$1.00). Second, the consolidations examined were pitched during 'bear' market conditions. Results might differ for consolidations occurring in less inclement conditions. The third, and most important qualification, is that all of the reorganisations were announced prior to the release of the July 2002 HKEx Paper relating, *inter alia*, to possible moves to de-list certain lowly priced stocks. Even though a minimum price threshold may never be implemented, the Paper may have spawned a more pejorative view of the 'penny' stock mantle than hitherto. As such, the impulse for consolidation post-July 2002 may be quite different to the one prevailing earlier. Evidence in other markets [namely Peterson and Peterson (1992)] indicates that where

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consolidations may be driven by a de-listing price threshold, the effect on share price tends to be much more favourable (than in a so-called 'voluntary' consolidation). To reiterate, while such a threshold may never obtain in Hong Kong, share consolidations may now be imbued with a greater 'involuntary' impulse than before.

Finally, there was some evidence that the consolidations (with or without capital reductions) were useful in stimulating trading volumes (liquidity), especially in cases where the underlying companies sought new equity funding in the months following reorganisation. To summarise, even in cases where consolidations reduce market capitalisation levels, one can surmise that the reorganisations must still be driven by certain perceived benefits. An increase in liquidity may be one, the other may be renewed access to primary markets (where a capital reduction co-exists with the consolidation).

The Impact of Stock Consolidations and Capital Reductions on Equity Valuation: Preliminary Evidence for Hong Kong

1. Background

This paper focuses on the valuation impact of a spate of recent stock reorganisation exercises, involving consolidations (‘reverse splits’), for Hong Kong listed counters with prices at the lower end of the ‘penny' stock range. This study tries to assess the effectiveness of stock consolidations in raising tradable stock prices to levels near the top of, or outside of, the typical ‘penny stock’ trading range. While the motivations for stock consolidations are often varied, a key driver, at least for the company orchestrating such arrangements, is a desire to raise the stock’s tradable price to a more ‘attractive’ level. This and other motivations will be considered in detail a little later in this paper.

For the purposes of this study, the ‘penny stock’ trading range will be assumed to cover all stocks with market (tradable) prices between HK$0.01 and HK$1.00, though the precise definition of what constitutes a ‘penny stock’ is arbitrary and somewhat elusive. HK$0.01 is used as the minimum price because securities priced at a level below this are not admissible for trades through Hong Kong Exchanges and Clearing Ltd.'s (HKEx's) Automated trade-matching system, known as AMS[2].

Based upon a trading range of HK$0.01 to HK$1.00, Hong Kong's market is awash with 'penny' stocks, with something like 60% or more of listed counters falling within this

2 This point is clearly made in a recent Hong Kong Exchanges and Clearing Ltd. (HKEx) Consultation Paper [see HKEx (July 2000) Consultation Paper, Paragraph 140, p. 83]. However, the same Report notes that provision can be made for trades below this price via 'Semi-automatic Matching' (Paragraph 141, p. 83).

range[3]. Despite this, their contribution to the market's overall value (market capitalisation) is small[4]. Nonetheless, many of these counters are keenly followed by Hong Kong's legion of retail investors, due to the low cost of acquiring board lots (which often consist of 1,000 shares). Against this, most market watchers view the stock sobriquet 'penny' in pejorative terms. This largely arises from the potential such counters offer for market manipulation. As a number of 'penny' stocks are quite illiquid – with this problem likely to be most acute in stocks priced at the lower end of the 'penny' spectrum – small trades have the potential to trigger noticeable spikes in prices, generating handsome percentage returns for those favourably positioned. Even a movement of a few cents can generate double-digit percentage returns[5]. In addition, authorities at HKEx believe that lowly priced counters might mislead. In the face of such strong retail interest locally this seems highly plausible. They report that,

> *' ... if a security is priced at a low level, or even in cents, investors may believe, although possibly wrongly, that it is "cheap" in the sense of being good value for money without verifying the fundamentals of the issuer.' [HKEx (July 2000) Consultation Paper, Para. 89, p. 62].*

As one possible remedy, HKEx proposed, in its July 2002 'Consultation Paper on Proposed Amendments to the Listing Rules Relating to Initial Listing and Continuing Listing Eligibility and Cancellation of Listing Procedures' [hereafter the HKEx (July 2002) Consultation Paper], a mechanism for de-listing stocks trading at basement price levels. The essential principle was packaged as part of 'the continuing listing eligibility criteria', where a baseline for retaining a stock's listing would be HK$0.50. To allow the market time – and thus avoid the fear of forced privatisations – the Report (Paragraph 142, p. 83) proposed a transitional period of one year to give stock issuers time to reorganise their stock to meet the HK$0.50 baseline. Not surprisingly, the HKEx authorities remarked that '… one of the ways that an issuer can bring its share price in compliance with the minimum level of HK$0.50 is by consolidation.' [HKEx (July 2002) Consultation Paper, Paragraph 146, p. 83]. Despite the fact that the Paper contained nothing more than *proposals* for deliberation and consultation, its release caused some discomfiture amongst certain retail investors and brokers. Their feelings on the subject were mirrored by a decline in the value of several 'penny stocks' prompting HKEx, shortly after the July 2002 Paper's release, to extend the consultation period. Moreover, it decided to '… publish a supplementary paper relating to the proposed continuing listing eligibility criterion that a company will be de-listed if the market price of its shares over 30 consecutive trading days

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3 Xiao and Yan (2001, p. 6, Table 5) show that, as of August 2001, 456 of the 712 Main Board listed stocks had share prices at or below HK$1.00. Strikingly, the same table reveals that 12.8% of listed companies had prices below HK$0.10.

4 Xiao and Yan (2001, p. 6) also report that stocks priced at HK$1.00 or below represent less than 4.5% of the overall value of stocks listed on the Main Board.

5 See HKEx (July 2000) Consultation Paper, Paragraphs 88 and 142.

is less than $0.50.' (HKEx News Release, 27 July 2002)[6]. This supplementary paper was released in November (see 'Consultation on Continuing Listing Criteria and Related Issues', HKEx, 11/2002).

Even if a quantitative or benchmark share price level, for the consideration of stock de-listing, is no longer on the cards, the debate resulting from the release of the July 2002 HKEx Consultation Paper means that the pejorative 'penny' stock label probably carries greater resonance than hitherto. It is also noteworthy that some other major exchanges also set minimum price levels. As reported in the SFC Quarterly Bulletin (2002), the Nasdaq National Market, Nasdaq SmallCap Market and Neuer Markt are prime examples of markets that use a minimum share price as one of their criteria for de-listing[7].

As such, stock consolidations are likely to feature as an important vehicle in elevating stock prices to what may be deemed 'more reasonable' levels. Given this, it is important to ask how effective stock consolidations might be in transforming lowly priced stocks from 'penny' to 'non-penny' status? Can, for instance, a stock trading at HK$0.05 experience the necessary pro rata adjustment to its market price suggested from a consolidation on, let's say, 20 into 1 terms? This would lead to the cancellation of all the company’s scrip in issue and its subsequent replacement by new shares comprising 5% of the original number, but with par twenty times higher. Could this manoeuvre raise the stock’s price from HK$0.05 to a level at or slightly below HK$1.00? Moreover, how does the price adjustment relate to the size of the consolidation factor and the level of the pre-consolidation market price? These questions are examined using a sample of 21 issuers that initiated stock consolidations between January 2001 and June 2002. It should be borne in mind from the very beginning that the majority of counters examined had pre-announcement prices in the lower band of the 'penny' stock range: HK$0.01 – to HK$0.10. As such, there are obvious difficulties in generalising the findings to the wider group of 'penny' stocks.

2. *Stock Consolidations in Hong Kong*

2.1 Background

Stock consolidations in Hong Kong typically occur alongside capital reductions; that is a cancellation of part of the Issued Share Capital (ISC) of a company by paring down the stock’s par value (without any corresponding change in the number of shares in issue). To illustrate, the February 2001 case of Companion Building Material International Holdings’ stock consolidation-cum-capital reduction is apposite. Though coupled together, the

6 See Yiu (2002a, b) for accounts of the political and economic effects of the Paper’s Release.

7 Appendix I (pp. 29-32) of the SFC paper is very instructive as it contains, amongst other things, a summary of the de-listing criteria relevant to a number of major first and second board markets.

consolidation, on terms of 10 into 1, occurred prior to a capital reduction of HK$0.09 of the company's (post-consolidation) par value. The consolidation led to the replacement of 14,506 million HK$0.01 par Companion shares by 1,450.6 million 'new' shares of par HK$0.10 (thus keeping Companion's ISC account balance unchanged at approximately HK$145.06 million). A capital reduction then led to HK$0.09 being sliced off the par of the 'new' shares allowing the original shares in issue to be replaced, on the effective date of the consolidation-cum-reduction, by 1,450.6 million new shares of HK$0.01 par. The lowering of the ISC balance, from HK$145.06 million to HK$14.506 million, saw a transfer of around HK$130.55 million to 'the contributed surplus account of the company'[8].

2.2 Motivations for Combining Stock Consolidation with Capital Reduction

In several other examples, capital reductions were used to offset accumulated losses. This effect, of 'cleaning up' the affected company's balance sheet, appears to be one of the major motivations for cancelling capital.

Other motivations for stock consolidation-cum-capital reductions include preparing a company for a possible equity funding exercise. Listed companies with stock valuations below par are normally precluded from issuing new shares for capital-raising purposes. For Hong Kong-incorporated companies, Section 50 of the Hong Kong Companies Ordinance (Cap. 32) is relevant. Amongst other things, this requires a company, wishing to sell shares at a discount (to par), to seek both shareholder and court approval[9,10]. This imposes considerable burden, as summarised in China Strategic Holdings Ltd.'s 27 April 2001 announcement for its 'Proposed consolidation of shares and reduction of capital',

> *' ... a company may not issue shares at a discount ... unless, among other things, the issue is authorised by a resolution of the shareholders of the company and is sanctioned by the Court. Accordingly, the Capital Reorganisation will facilitate future capital raising exercise or asset acquisition ... when the Board considers the circumstances so require without the need for the Company to apply to the Court on each occasion ... which would involve considerable expense and also be time consuming.' (China Strategic Holdings Ltd. Announcement (2001, p. 5))*

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8 Figures were gleaned from Companion Building Material International Holdings Announcement (2001).

9 As the vast majority of companies listed on HKEx are either domiciled in Hong Kong or Bermuda, the statutory requirements imposed by the Bermudian Companies Ordinance are relevant in many cases. For example, Victory Group Ltd., a company incorporated in Bermuda, announced that, 'Under Bermuda law, a company may not issue shares at a discount to the nominal value of such shares.' [Victory Group Ltd. Announcement (2002)].

10 Low (2002, pp. 18-19) provides a useful historical account of Common Law provisions relevant to new issues of stock at a discount-to-par.

Other than China Strategic Holdings Ltd., the only other Hong Kong-incorporated issuer in the sample was Sen Hong Resources Holdings Limited. The remaining 19 companies were either incorporated in Bermuda or the Cayman Islands. Inspection of the announcement documents for the reorganisations in both Hong Kong-incorporated companies also revealed that a capital reduction is subject to Court confirmation[11].

Returning to the key issue – of companies seeking approval for the sale of stock on discount-to-par conditions – we might also suspect that major difficulties would arise for companies incorporated in other English Common Law jurisdictions. This has already been noted in the case of Bermuda (see note 9). However, there is recent precedent in Singapore, for companies incorporated in the Republic, to be given court sanction to issue new shares at a discount-to-par. Acma Ltd. gained approval from Singapore's High Court for such an action in August 2001[12]. A further case in Singapore, approved in June 2002, for Armstrong Industrial Corporation Limited, is also evident from a search of companies engaging in new stock issues at a discount-to-par[13]. For Hong Kong, my search of such issues did not reveal an obvious precedent. Even if such a precedent exists, one can still surmise that companies would see obvious difficulties in seeking approval for an issue of new stock under discount-to-par conditions.

As such, the consolidation-cum-capital reduction (and its reverse, a capital reduction-cum-consolidation) – due to its inflation of the affected company's *share price to par value* ratio (hereafter, the SPPV ratio) – has obvious appeal. As should be apparent from the foregoing, this is especially welcome where the SPPV ratio is transformed from a value below one (where share price is at a discount to par) to a level in excess of one. A consolidation, by itself, would not achieve this effect, as both the par and tradable value of the stock value would, according to established theory, inflate by roughly the same factor; thus leaving the SPPV ratio more or less at its original level. In practical terms, though, a consolidation might reduce the SPPV ratio, given a welter of evidence that stock consolidations often reduce market capitalisation values (the product of share price and number of shares in issue). For example, Woolridge and Chambers (1983), Spudeck and

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11 To illustrate, China Strategic Holdings Ltd. Announcement (2001), states, *inter alia*, that, ' The capital reorganisation is conditional on … the confirmation of the Capital Reduction by the Court … ' (p.4). A number of other conditions are also spelled out in the China Strategic announcement including EGM support for the necessary resolutions, pertaining to the reorganisation. In regard of court confirmation for capital reduction, Sections 58-60 of the Companies Ordinance (Cap. 32) are apposite. Thanks are due to Lisa Mi for alerting me to the court confirmation issue.

12 The Business Times Singapore (20 August 2001), reports *inter alia* that, 'Mainboard-listed Acma is the first such company in Singapore to issue new shares at a discount to the par … .' (p. 4).

13 Under 'Listed Companies' Announcement' for Armstrong Industrial Corporation Ltd. (at http://info.sgx.com), see 'Court Confirmation Pursuant to Section 68 of the Companies Act (Chapter 50) (the "Act")', 12 June 2002.

Moyer (1985), Peterson and Peterson (1992) and Desai and Jain (1997), for US-based studies, attest to such negative wealth effects[14 15].

Coupling the consolidation with a capital reduction helps with regard to the inflation of the SPPV variable. As illustrated in the Companion case, the consolidation-cum-capital reduction allowed the par value of Companion's new stock to be set at exactly the same level as the old: HK$0.01. However, with 90% fewer shares in issue, as a result of the consolidation, tradable prices on the stock rose substantially. This is illustrated in Table 2, where Companion's share price, between the announcement date of the stock reorganisation and its effective date, rose from HK$0.016 to HK$0.066. This clearly raised the SPPV ratio of the company’s stock from 1.6 to 6.6. Theory might suggest that this ratio should rise to a level of 16 times. However, it is quite common for stocks, particularly those trading at basement price levels, to experience a notable decline in market capitalisation following such reorganisations. In this case, the company’s capitalisation (when adjusting for movements in the Hang Seng Index (HSI) over the period of interest) shrank by around 60%.

The combined effect of a consolidation and capital reduction – in opening up access to new equity issues – is aptly demonstrated by the number of companies that simultaneously deploy such reorganisations with new stock issues. There are also many cases where new issues occur shortly after the deployment of consolidation-cum-capital reductions (or their reverse). This issue is commented upon further in Section 3 of this paper.

From perusal of announcement circulars, for the combined capital consolidation and reduction, three other motivations also feature. First, reorganisations enable companies to pay dividends sooner, by eliminating accumulated losses. Second, they help raise net asset valuations per share. Third, the reorganisations help lower transaction costs associated with board lot purchase. The last two reasons relate to the effect of the consolidation (by virtue of its lowering of the number of shares in issue), while the first relates to the capital reduction component. The first motivation may help in offsetting, to some degree, the negative signal that is often attributed to a straightforward consolidation ('reverse' split). Against this, Woolridge and Chambers (1983) argue that, 'By reverse splitting their shares, managers may be admitting to investors that they do not anticipate that share prices will increase in the near future … in the absence of the reverse split.' (p.7). Clearly, consolidations may be seen by some market-watchers as something of a desperation measure. A capital reduction announced concurrent with a consolidation may, especially if it opens up the company to new equity issues, signal something slightly more

14 As qualification, however, Peterson and Peterson (1992) find evidence that the reaction from a 'forced' consolidation is positive. Specifically, they categorise such 'forced' actions to subsume, ' … those required to satisfy a price-per-share listing requirement or creditors in a Chapter 11 reorganisation, since the split decision is coerced.' (p. 192).

15 In contrast, Masse, Hanrahan and Kushner (1997) find some evidence of a positive reaction for Canadian reverse 'splits'.

favourable. The spectre of new equity funding may also raise hopes of returns from corporate investments in new productive, real assets.

3. Data Sample

As noted, the data set for this paper is assembled using stock reorganisations, involving stock consolidations (or 'reverse splits') for Hong Kong listed counters, over the period January 2001 to July 2002. While this period could have been extended, it was noted that there were only 12 reorganisations, involving consolidation, in the year prior to the sample's commencement date. Moreover, 10 of the reorganisations in 2000 were subject to contemporaneous or confounding events, which could have obscured the impact of the consolidation on the underlying company's stock price. The confounding events mainly arose from rights offerings and other new issue proposals, announced contemporaneously with the stock reorganisation proposals[16].

For the period January 2001 to July 2001, data made available through Hong Kong Exchanges and Clearing Ltd., indicated that there were 39 stock reorganisations, involving stock consolidations (or 'reverse splits'), for Hong Kong listed counters. From this number, the majority (34) were executed for Main Board listed companies. The remainder (5) all occurred during 2002 for companies listed on Hong Kong's second board, the Growth Enterprise Market (GEM)[17].

Of the 39 consolidations considered, the final sample was pared down to eliminate cases where confounding effects might arise. This resulted in the deletion of 18 cases. In particular, it was thought that proposals, relating to events like rights and other new equity issues, concurrent with stock consolidation proposals, would obscure the impact of the consolidation exercise on the underlying stock's price[18]. Many of these reorganisations, with new stock issues, also occurred in tandem with capital reductions, which should not be too surprising given the point made earlier that such reductions are often necessary to move underlying share prices above par values (in order to facilitate primary market

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16 The remaining two reorganisations for 2000 were excluded from the final sample for other reasons. Sen Hong Resources Holdings Ltd.'s consolidation of October 2000 was excluded because the same company featured in a share consolidation (and capital reduction) in November 2001. This later reorganisation was analysed instead. The final omission related to the Millennium Group's January 2000 reorganisation. Approval for the reorganisation (announced on 19 April, 1999; see Listed Companies News at http://www.hkex.com) was protracted. Moreover, the proposal was complicated by announcements in the interim pertaining, amongst other things, to the issuance of convertible bonds. All announcement details were gleaned from the HKEx website, with effective dates for the reorganisation determined from the HKEx Fact Book 2000.

17 These figures were obtained, for 2001, from the HKEx Fact Book 2001 (p. 51) and, for 2002, from the Department of E-Business and Information Services) at HKEx.

18 Other confounding or contemporaneous events, typically related to acquisitions, major and connected transactions and debt restructuring plans.

transactions). Of the final sample, involving 21 cases (13 for 2001 and 8 for 2002), all but three also entailed a capital reduction. Details of the characteristics of all of these cases are set out in Table 1.

To illustrate the importance of the share price to par ratio (SPPV), the ratio, for the 18 cases involving both consolidation and capital reduction, ranged from 0.17 to 10 times using closing share prices 30 days prior to the reorganisation announcement. More interestingly, 13 of the 18 cases had SPPV ratios, using such pre-announcement closing prices, of 1.0 or less. The 18 cases had a mean share price of only HK$0.056 (this was raised to HK$0.074 when including all 21 cases).

Where consolidations and capital reductions were entwined, the joint effects usually occurred on the same price determination date. 11 of the 21 cases were constructed as consolidations followed by capital reductions. Seven were organised as capital reductions-cum-consolidations, with the remaining three, as commented earlier, constituted simply as consolidations. The difference between a consolidation-cum-capital reduction, as opposed to capital reduction-cum-consolidation, is best illustrated through example. The Companion Building Material International Holdings' case, considered earlier, aptly illustrates the former (see Table 1). An example of the opposite – a capital reduction-cum-consolidation – is Peace Mark (Holdings) Ltd.'s January 2002 cancellation of HK$0.095 of its stock's par value, followed by a consolidation of 20 shares into 1. With a par value, prior to the event of HK$0.10, the first effect resulted in 'new' par values being pared down to HK$0.005. These 'new' shares were then consolidated, reducing the number in issue by 95%, to form the actual pool of *new* shares issued to replace the old. The new shares came into being with the same HK$0.10 par value obtaining on the old shares.

4. Results

The principal result, as shown in Table 2, is that stock consolidations (more often than not with adjoining capital reductions) – orchestrated in stocks priced at the lower end of the 'penny' range in Hong Kong – often generate negative wealth effects for incumbent shareholders. This is apparent from the change in market capitalisation (i.e., change in the value of all stocks in issue) of the affected counters over the period 30 days prior to announcement to the effective date in the reorganisation[19]. When adjusting this percentage change for the corresponding percentage change in the HSI – tantamount to assuming stock betas of 1.00 in all cases – a measure denoted as $CHMC_{t-30,ed}$ is formed. Table 2

[19] This date occurs around 30 days after the announcement of the consolidations (and associated capital reduction, if applicable). However, the precise number of days from the announcement date varies case by case.

reports mean changes in this variable of -25.0% for the whole sample[20]. Some caution is advised, however, in interpreting results in this way. For counters with pre-announcement closing prices of HK$0.01 – and three such stocks were identified – closing prices might mislead if traded prices were at levels below HK$0.01. For two of the three stocks with minimum pre-announcement closing prices, the price of the final trade of the relevant day were at levels below HK$0.01: HK$0.004 in the case of Digital World Holdings and HK$0.008 for Credit Card DNA[21]. Using these values, rather than closing pre-announcement values for the two stocks, resulted in a new sample mean for the $CHMC_{t-30,ed}$ variable of -23.1%[22].

Taking the -23% figure as an indicator, an investor with 1,000 shares, in a typical stock subject to consolidation on, let's say, 20 into 1 terms, would receive 50 new shares with total value around 77% of the value of his prior holdings[23]. Also of note, is the correlation of +0.312 between $CHMC_{t-30,ed}$ and stock price 30 days prior to the reorganisation announcement[24]. Essentially, this correlation result tells us that the percentage decline in market capitalisation tends to be greater for stocks with lower pre-announcement share valuations. This means – as intuition would suggest – that it is more arduous to 'jump-start' a stock as its price descends further and further towards HK$0.01.

Certain obvious qualifications apply in interpreting results in the foregoing. First, to reiterate, most of the companies scrutinised had pre-consolidation prices near, or at the bottom, of the 'penny' stock range. In fact, 19 of the 21 sample constituents had share prices, using prices 30 days prior to the reorganisation announcement, of HK$0.132 or less. As such, the average decline in market capitalisation of -23.1% may not be that indicative of the situation facing issuers consolidating 'penny' stocks in the intermediate or upper levels of the 'penny' range. In fact, it is quite likely that such counters would experience a more favourable response from such reorganisations.

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20 This result is based upon a $CHMC_{t-30,ed}$ value for Symphony Holdings of -15.9%. If adjusting this value to 44.7%, to reflect a capital return (see Table 2), the result becomes -22.1%.

21 Thanks are due to the Department of E-Business and Information Services of the HKEx for supplying such intra-day trading details. Both prices were based upon manually-input trades.

22 If using a $CHMC_{t-30,ed}$ value for Symphony Holdings of 44.7% (instead of -15.9%), the value becomes -20.2%.

23 $CHMC_{t-30,ed}$ provides only a proxy for investment return, as income (dividend payments) returns are not reflected by such a capitalisation change. If any ex-dividend dates occur during the period, then the investor returns would exceed – albeit, probably only slightly – the percentage change in market capitalisation for the company paying the dividend.

24 This correlation is based upon a $CHMC_{t-30,ed}$ value for one of the sample, Symphony Holdings, of -15.9%. If adjusting for the capital return, this value can be re-interpreted as 44.7% (see Table 2). Using this value, the correlation result between $CHMC_{t-30,ed}$ and the level of stock price 30 days prior to reorganisation announcement, was +0.308.

Nonetheless, for those stocks with values that have slipped to levels close to, or at the very bottom, of the 'penny' price range, stock consolidation still raise the prospect of not only a significant increase in share price but also a significant increase in liquidity. If holdings prior to consolidations are difficult to sell, shareholders may see consolidation as a way of 'escaping' moribund investments.

Increases in liquidity may arise for a number of reasons, and have been documented elsewhere in relation to 'reverse' splits [notably Han's (1995) US study]. First and foremost, consolidations, by elevating 'penny' stock prices, may place the stock prices in what is commonly referred to as 'a more favourable trading range'. This may be particularly relevant in retail markets where some investors rather spuriously see some congruency between absolute share price levels and value. Liquidity may also be spurred by the possibility of new stock issues, opened up when capital reductions are used alongside consolidations. This may be especially so when stocks trade at sub-par values. As such, the reorganisation may signal the renewed possibility of accessing primary markets to fund 'untapped' positive NPV projects. This argument takes on greater import if such projects cannot easily be funded via banks or organised debt markets. The absence of thriving debt markets in most of Asia, and banks' recognised preoccupation with securing collateral (often using the shares in issue of the borrower) before even considering a loan advance[25], suggest that ‘penny’ stock companies may well have difficulties in ‘tapping’ conventional non-equity funding sources. This suggests something of a 'catch-22': borrowers need funding to generate real investment returns to enhance the value and liquidity of collateral (their issued equity) but funding can only be obtained if that collateral already has value and liquidity.

The argument pertaining to new equity issues can also be framed less favourably: new equity issues may give off negative signals relating to cashflow weakness, which may be compounded by the dilution of existing ownership stakes (where placings, rather than rights issues are used).

To assess whether or not stock reorganisations in Hong Kong generate liquidity benefits, changes to trading volume (number of shares traded), rather than trading turnover (i.e., the value of trading volume), are scrutinised. As it is apparent that prices, after the effective date in a consolidation in Hong Kong, may only partially adjust to the consolidation factor, comparisons of trading turnover before and after the effective date might result in spurious results. Instead, it is preferable to compare trading volumes prior to the reorganisation announcements with those multiplied by the consolidation factor after the effective date in the reorganisations. Particular attention is given to a comparison of the percentage change in average daily volumes for the variables $A_{-51,-1}$ and $ED_{1,\ 50}$(Adj),

[25] Dalhaise's (1998) account of banking problems in the midst of the Asian Financial Crisis (AFC) is pertinent. He identifies collateral as key in many Asian banks' lending decisions. Even though the focus in Dalhaise's account is not on Hong Kong, this point may have some relevance. However, it should be noted that Hong Kong's banking system withstood the AFC storm far more effectively than many of its neighbours' systems.

where the former captures the average daily volume for the 50 consecutive business days immediately prior to the reorganisation announcement and the latter the average adjusted daily volume (adjusted by the consolidation factor) for the 50 business days following the effective date. This percentage change variable is referred to as CHTR. Across the whole sample, the mean for CHTR is strongly positive. However, only 8 of the 21 cases reflect positive values for this variable. Clearly the magnitude of the CHTR values, of the 8 positively-valued CHTR cases, is substantially higher than those on the negatively-signed CHTR cases[26].

The interesting issue, however, is whether there is anything significantly different about the cases that experience an increase in adjusted volumes. One avenue of exploration is to assess the sample constituents' fund-raising activities within a limited time frame of the stock reorganisation announcement. Five of the sample constituents announced new equity funding ventures within five months of such announcements. These cases are detailed in Exhibit 1 and relate to new equity issues through rights, open offer and placement. Equity enlargement through the conversion of equity stock option plans, convertible debentures/bonds and equity warrants are ignored, as the new shares triggered from these conversions are obviously carried out at the behest of the option holder rather than issuer. Events that led to a contraction in the supply of shares in issue, notably share repurchases (or company buy-backs), are also ignored. In any case, the numbers of shares cancelled in repurchases in Hong Kong is generally small, relative to the supply in issue in the affected Hong Kong-listed companies[27].

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[26] Detailed results are not reported here, but can be made available upon request.

[27] See McGuinness (1999, pp. 209 ff) for discussion of such activities.

Exhibit 1 – New Equity Issues via Rights Issues, Open Offers or Placings in the 5-Month Period Subsequent to the Announcement of Stock Reorganisation

Company	Terms	Preceding Stock Reorganisation Date	Announcement Date
G-Prop	Open offer of 1 for 2 at HK$0.25 per share[a]	29 Mar 2001	9 Jul 2001
Wing Lee	Rights offer of 1 for 1 at HK$0.50[b]	9 Oct 2001	31 Dec 2001
Credit Card DNA	Subscription of shares to 2 placees, coincident with general offer proposal to Star Bio-Tech's shareholders [c]	17 Oct 2001	27 Feb 2002
Global Food	New share issue via placement [d]	18 Jan 2002	20 Mar 2002
Simsen	Subscription for new shares [e]	22 Jan 2002	8 Apr 2002

a Announcement: ('G-Prop (Hold) - Proposed Open Offer of New Shares', 9 July 2001)

b Announcement: ('Wing Lee Hold - Proposed Rights Issue', 31 December 01)

c Announcement: ('WIN CHANNEL/SHEUNG HAI/STAR BIO-TECH - Joint Announcement', 27 February 2002)

d Announcement: ('Global Food Culture Group Limited, Placement of 11,900,000 New Shares')

e Announcement: ('Simsen International Corporation Ltd., Placing of Existing Shares and Subscription of New Shares', 8 April 2002)

All announcements obtained from http://www.hkex.com.hk/index.htm under Listed Companies Information (under 'Exchange Listings and Listed Companies')

A variable EF was created by assigning a value of 1 to each of the five companies announcing equity funding ventures within five months of the reorganisation announcement, and value 0 otherwise. The correlation of EF with the change in trading volume variable (CHTR) produced a coefficient of +0.125, suggesting only limited support for the hypothesis that increased trading volumes (relative to pre-reorganisation announcement volumes) might result for companies engaging in new issues shortly after reorganisation. However, a stronger correlation was obtained when comparing EF with a variable CHSPPV, denoting the percentage change in the share price to par value ratio between pre- and post consolidation dates. The correlation here was +0.551, providing strong support, albeit based upon relatively few observations, that equity funding is more likely to emerge for counters whose share price has moved markedly above par. This is consistent with earlier arguments that the raison d'être, of many combined consolidations and capital reductions, was to raise share prices to levels above par values in order to facilitate new equity issues. Comparison of EF with the percentage change in market capitalisation variable ($CHMC_{t-30,ed}$) produced a correlation of -0.30[28].

For the final correlation result, the sign and magnitude is suggestive of new issues emerging in companies with more dramatic declines in market capitalisation. While this conjecture can only be drawn very tentatively - given the limited number of observations – the result could be due to share prices, in the immediate post reorganisation period, reflecting investors' expectations of not only the incidence of forthcoming issues but also a view that such issues convey negative information. The latter could be predicated on new issues signalling weakness in relation to a company's ability to generate future cash and earnings returns. However, this statement is made tentatively given the limited number of data points available.

5. Conclusions

The results in this paper relate to consolidations (often with accompanying capital reductions) in stocks with pre-announcement share values at the lower end of the 'penny' stock spectrum. In fact, the majority of counters had share prices of HK$0.10 or less, based upon levels 30 days prior to reorganisation. Given this, it was, perhaps, not too surprising to see some decline, on average, in the market capitalisation levels of the underlying companies' equity. As such, the results may not translate that well to companies with share prices above these levels. In fact, one might well see a much more favourable price response – than is reported here – when consolidations are orchestrated for counters priced in the intermediate or upper part of the 'penny' range. Clearly, as a stock's price moves closer and closer to the minimum price of HK$0.01, prices are likely to become 'stickier'. However, for stocks with prices of, let's say, HK$0.10 or more, the increase in share price may more fully reflect the consolidation factor used (i.e., a 10 into 1 consolidation may raise share price by a factor approaching 10 times).

Other qualifications should also be made in interpreting the results from the data sample used here. First, the sample period January 2001 to June 2002 essentially takes in a 'bear' market. As such, the reported market capitalisation changes – albeit with adjustments for movements in the HSI - may be a product of market conditions. A second important point is that other announcements and events, during the period of the reorganisations, may drive prices in an unpredictable way. However, one might expect the net effect of these events to bias sample results only moderately. The third qualification is that all of the reorganisations were announced prior to the release of the July 2002 HKEx Paper. Even though a minimum price threshold may never be implemented, the debate spawned by this Paper may have reinforced investors' and issuers' perceptions of the 'penny' stock. As such, the motivations surrounding moves to consolidate – post-July 2002 – may be quite

28 All correlation data involving EF were based upon unadjusted CHMC values (see Table 1).

different to the ones prevailing beforehand. As noted in Peterson and Peterson (1992)[29] for the US, where consolidations may be driven by a de-listing price threshold, the effect on share price tends to be much more favourable (than in a so-called 'voluntary' consolidation). While a de-listing price threshold may never become a reality in Hong Kong, the recent 'penny' stock debate may well have imbued a greater 'involuntary' impulse into consolidation decisions than was, perhaps, prevalent before.

For the sample of companies featured here, there is also some limited evidence that the reorganisations were able to stimulate trading volumes (liquidity). This effect was more apparent where underlying companies announced equity issues in the months following reorganisation. In sum, then, the potential benefits of increased liquidity and renewed access to primary markets – where capital reductions co-exist with consolidation – probably drive decisions to consolidate stock.

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[29] As, of course Peterson and peterson (1992) found in relation to their analysis of the effects of 'discretionary' and 'non-discretionary' consolidations.

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Table 1 – Stock Consolidation Sample: January 2001 – June 2002

		Restructuring Terms		Par Values		Announcement Date	Effective Date	Place of Listing
		Consolidation or Par Reduction (=Canc.)	*Consolidation or Par Reduction (=Canc.)*	*Old*	*New*			
1.	Companion Building Material Int. Holdings Ltd.	Cons. of 10 into 1	Canc. of HK$0.090 par	0.010	0.010	18/31 Jan 01@	26 Feb 01	MB
2.	Digital World Holdings Ltd.	Cons. of 80 into 1	Canc. of HK$0.070 par	0.001	0.010	15 Feb 01	23 Mar 01	MB
3.	G-Prop (Holdings) Ltd.^^	Cons. of 20 into 1	Canc. of HK$1.990 par	0.100	0.010	29 Mar 01	15 May 01	MB
4.	South East Asia Wood Industries Holdings Ltd.	Cons. of 5 into 1	-	0.010	0.050	5 Jun 01	27 Jun 01	MB
5.	Victory Group Ltd.	Cons. of 10 into 1	Canc. of HK$0.190 par	0.020	0.010	16 May / 3 Jul 01$	26 Jul 01	MB
6.	Graneagle Holdings Ltd.^^	Cons. of 50 into 1	Canc. of HK$0.990 par	0.020	0.010	27 Jun 01	06 Aug 01	MB
7.	China Strategic Holdings Ltd.	Cons. of 10 into 1	Canc. of HK$0.900 par	0.100	0.100	27 Apr 01	10 Aug 01	MB
8.	B-Tech Holdings Ltd.^^	Canc. of HK$0.009 par	Cons. of 10 into 1	0.010	0.010	7 Aug 01	18 Sep 01	MB
9.	Symphony Holdings Ltd. (&)	Canc. of HK$0.060 par	Cons. of 25 into 1	0.100	1.000	11 Sep 01	23 Oct 01	MB
10.	South East Asia Group Ltd.^^	Canc. of HK$0.090 par	Cons. of 10 into 1	0.100	0.100	18 Sep 01	26 Oct 01	MB
11.	Sen Hong Resources Holdings Ltd.	Cons. of 10 into 1	Canc. of US$0.99 par	0.100*	0.010*	12 Mar / 8 Oct 01^	09 Nov 01	MB
12.	Wing Lee Holdings Ltd.	Cons. of 5 into 1	-	0.100	0.500	9 Oct 01	12 Nov 01	MB
13.	Credit Card DNA Security Sys. H. Ltd (previously known as Star Bio-Tech H. Ltd.)	Cons. of 40 into 1	Canc. of HK$0.39 par	0.010	0.010	17 Oct 01	29 Nov 01	MB
14.	Peace Mark (Holdings) Ltd.	Canc. of HK$0.095 par	Cons. of 20 into 1	0.100	0.100	30 Nov 01	25 Jan 02	MB
15.	Global Food Culture Group Ltd.	Canc. of HK$0.0995 par	Cons. of 20 into 1	0.100	0.010	18 Jan 02	25 Feb 02	MB
16.	Simsen International Corporation Ltd.^^	Canc. of HK$0.099 par	Cons. of 10 into 1	0.100	0.010	22 Jan 02	5 Mar 02	MB
17.	Celestial Asia Securities Ltd.	Cons. of 20 into 1	Canc. of HK$1.90 par	0.100	0.100	15 Mar 02	26 Apr 02	MB
18.	CASH Financial Services Group Ltd.	Cons. of 20 into 1	Canc. of HK$1.90 par	0.100	0.100	15 Mar 02	26 Apr 02	GEM
19.	Champion Technology Holdings Ltd.	Cons. of 25 into 1 #	Canc. of HK$2.40 par	0.100	0.100	11 Feb 02	6 May 02	MB
20.	Sing Pao Media Group Ltd.^^ (previously known as STAREASTnet.com Corp.)	Canc. of HK$0.0975 par	Cons. of 20 into 1	0.100	0.050	28 Jan 02	29 May 02	GEM
21.	Smartech Digital Manufacturing Holdings Ltd. (New Universal Int. Gr.)	Cons. of 10 into 1	-	0.005	0.050	13 Jun 02	12 Jul 02	GEM

MB the Main Board of the Hong Kong stock market, run by HKEx (GEM is the Growth Enterprise Market of HKEx)
* Par in US$; all other par values are in HK$;
# also involved a change of domicile for the company
& Symphony case involved a Capital Reduction by way of Capital Return. The face value of the shares was reduced by HK$0.06 via a Capital Return to shareholders. The 'Last day of Dealings in Shares on a cum-Capital Return Basis' was 15 October 2001 according to company announcements (see 'Symphony Holdings Limited - Despatch of Circular and Expected Timetable', 28 September 2001). This preceded the effective date for Symphony's consolidation.
@ Company first announced a stock consolidation on the 18th. and subsequently, on the 31st, revised the proposal to also include a capital reduction.
$ First proposal made on 16 May with revised proposal of 3 July including a consolidation
^ Company announced an earlier stock consolidation on 21 September 2000. For the later reorganisation proposal of 12 March, the proposal was amended as of 8 October.
^^ Sing Pao, B-Tech, G-Prop, Graneagle, Simsen and South East Asia Group's reorganisations also involved proposals for share premium reduction [see StarEastnet.com Corporation Announcement (28 January, 2002); B-tech announcement (7 August, 2001); G-Prop (Holdings) Ltd.'s announcement (29 March, 2001); Graneagle Holdings Ltd's announcement (27 June 2001); Simsen's announcement (22 January, 2002); and South East Asia Group's announcement (18 September, 2001)].

<u>Table compiled from various sources</u> [HKEx Fact Book 2001 (p. 51); HKEx ((Department of E-Business and Information Services); and company announcements posted on the HKEx website).

Table 2 – Comparison of Market Capitalisation Levels Pre- and Post- Stock Reorganisation Announcement											
		Par Values			**Unadjusted Stock Prices**		**No. of Shares in Issue (000's)**		**Market Capitalisation (HK$000)**		**Change in M. Capital. Adj. for HSI^ $CHMC_{t-30,ed}$)**
		Old	*New*	*Consol. Factor*	*30 Days Prior to Announcement*	*Effective Date Post Announcement*	*30 Days Prior to Ann..*	*Effective Date Post Ann.*	*30 Days Prior to Ann..*	*Effective Date Post Ann.*	
1	Companion Building Material Int. H.	0.010	0.010	10	0.016	0.066	14,506,122	1,450,610	232,098	95,740	-60.2%
2	Digital World Holdings Ltd.	0.001	0.010	80	0.010 (0.004)##	0.158	51,174,960	639,687	511,750 (204,670)##	101,071	-62.8% (-33.2%)##
3	G-Prop (Holdings) Ltd.	0.100	0.010	20	0.107	0.620	1,442,280#	72,589	154,324	45,005	-54.9%#
4	South East Asia Wood Industries H. Ltd.	0.010	0.050	5	0.285	1.800	9,600,000#	2,119,998	2,736,000	3,815,996	41.5%#
5	Victory Group Ltd.	0.020	0.010	10	0.016	0.236	1,470,744	147,074	23,532	34,709	47.7%
6	Graneagle Holdings Ltd.	0.020	0.010	50	0.017	0.450	8,539,857#	168,560	145,178	75,852	-38.9%
7	China Strategic Holdings Ltd.	0.100	0.100	10	0.110	0.720	4,609,786	460,979	507,077	331,905	-21.6%
8	B-Tech Holdings Ltd.	0.010	0.010	10	0.010 (0.010)##	0.021	25,659,136	2,565,913	256,591 (256,591)##	53,884	-50.8%
9	Symphony Holdings Ltd. (&)	0.100	1.000	25	0.099	1.660	5,131,747	205,270	508,043	340,748 (648,653)**	-15.9% (44.7%)**
10	South East Asia Group Ltd.	0.100	0.100	10	0.017	0.125	3,305,717	330,572	56,197	41,322	-13.1%
11	Sen Hong Resources Holdings Ltd.	0.100*	0.010*	10	0.090	0.400	672,191	67,219	60,497	26,888	-48.1%
12	Wing Lee Holdings Ltd.	0.100	0.500	5	0.245	0.730	280,000	56,000	68,600	40,880	-34.1%
13	Credit Card DNA Security Sys. H. Ltd	0.010	0.010	40	0.010 (0.008)##	0.145	19,584,608	489,616	195,846 (156,677)##	70,994	-65.1% (-56.0)##
14	Peace Mark (Holdings) Ltd.	0.100	0.100	20	0.037	0.610	3,678,220	183,911	136,094	112,186	-27.2%
15	Global Food Culture Group Ltd.	0.100	0.010	20	0.096	1.380	1,190,489	59,524	114,287	82,143	-19.1%
16	Simsen International Corporation Ltd.	0.100	0.010	10	0.030	0.195	2,272,160	227,216	68,165	44,307	-29.0%
17	Celestial Asia Securities Ltd.	0.100	0.100	20	0.098	1.360	6,394,352	319,718	626,647	434,817	-37.1%
18	CASH Financial Services Group Ltd.	0.100	0.100	20	0.031	0.620	2,015,200	100,760	62,471	62,471	-6.5%
19	Champion Technology Holdings Ltd.	0.100	0.100	25	0.081	1.930	14,215,864#	569,168	1,151,485	1,098,494	-7.6%#
20	Sing Pao Media Group Ltd.	0.100	0.050	20	0.132#	2.400	4,163,768#	208,188	549,617	499,651	-8.8%
21	Smartech Digital Manufacturing H. Ltd.	0.005	0.050	10	0.018	0.140	4,699,998	470,000	84,600	65,800	-12.6%
									Mean		**-25.0% (-22.1%)****
									Mean (using last recorded prices for stocks with closing pre-announcement prices HK$0.01)		**-23.1% (-20.2%)****

* Par in US$; all other par values are in HK$;

^ Measures the % change in market capitalisation between 30 days prior to the announcement and the determination date, less the corresponding % change in the HS Index over the same period.

** The face value of Symphony shares was reduced by HK$0.06, with the 'Last day of Dealings in Shares on a cum-Capital Return Basis' being 15 October 2001, (see 'Symphony Holdings Limited - Despatch of Circular and Expected Timetable', 28 September 2001). As this occurred prior to the effective date in the reorganisation, the market capitalisation at the effective date is also shown in adjusted form by adding an amount of HK$307,904.82 (=HK$0.06*5,131,747,000). Computations marked with ** indicate that the Symphony's adjusted market capitalisation is used.

At announcement, there were 1,451.780 m. shares in issue in G-Prop [HSBC (Broking Data Services) Ltd. cards for the Co., 15/4/2002/ 3, indicate share option conversions during period].

At announcement, there were 10.6 bn. shares in issue in South East Asia WH [HSBC (Broking Data Services) Ltd. cards for the Co., 28/10/2002/ 2, indicate a placement of 1 bn. shares in 4/01]. These new shares for South East Asia WH came into being 23 days prior to the consolidation announcement, and gave a market cap for the Co. of HK$270.3 m. at that point.

Just prior to the effective date, there were 8,463,398,000 shares in issue in Graneagle [HSBC (Broking Data Services) Ltd. cards for the Co., 3/12/2001 / 3, indicates share repurchase activities between July and August 2001].

Just prior to the effective date, there were 14,229,199,000 shares in issue in Champion [HSBC (Broking Data Services) Ltd. cards for the Co., 21/5/2002 / 4, indicates a warrant exercise of 13,333,424 shares in the period January-May, 2002].

For stocks with a closing price of HK$0.01, the price of the last recorded trade for that day (figures shown in parentheses) were also used to compute capitalisation figures (see parentheses).

Table compiled from various sources [HKEx Fact Book 2001 (p. 51); HKEx (Department of E-Business and Information Services); and Datastream (for closing share prices and no. of shares in issue).