The Impact of Stock Consolidations and Capital Reductions on Equity Valuation: Preliminary Evidence for Hong Kong[1]

By Paul B. McGuinness[2]

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'

[1] *This paper, "The Impact of Stock Consolidations and Capital Reductions on Equity Valuation: Preliminary Evidence for Hong Kong", can be downloaded from the website of the SFC, Research Papers and Statistics, http://www.hksfc.org.hk/eng/statistics/html/index/index0.html. This summary should be read in conjunction with the full report.*

[2] *The author is a Professor in the Department of Finance at the Chinese University of Hong Kong, Shatin, New Territories, Hong Kong (E-Mail: mcguinne@baf.msmail.cuhk.edu.hk). The author would like to acknowledge the help of the Department of E-Business and Information Services at HKEx for assistance in identifying and dealing with enquiries about the listed companies examined in this paper, as well as to Mr. Calvin Lai for his help in retrieving data from Datastream. Thanks are also due to Geng Xiao and Charles Grieve for their comments on this paper. Views expressed in this article are those of the authors and do not necessarily represent those of the SFC.*

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 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).