The Effectiveness of Bank Stock Splits on Stock Performance and Stockholder Liquidity

After several years of depressed bank stock valuations, we have witnessed a rapid recovery in publicly traded bank valuations over the past two years. With the KBW and Nasdaq Bank Indices up roughly 29% and 26% year-to-date, respectively, many boards of directors and management teams are discussing a potential stock split. With more than a thousand publicly traded banks in the United States, we thought the industry and its observers would find value in a thoughtful review of stock splits, which remain a widely utilized and debated financial tool. Positive stock price and liquidity effects were found to be pronounced and at a statistically significant level, particularly for publicly traded banks with market capitalizations below $500 million.

Despite heavy industry and academic exploration, stock splits remain a relatively enigmatic financial tool frequently utilized by publicly traded companies. At first glance, a stock split appears to be little more than an accounting change. In theory, a stock split creates nominal changes in the value of a stock, with no change in cash flow or earnings. Additionally, splits come with some administrative, legal, and professional costs. This is some of the common rationale for tabling a discussion surrounding the merits or timing of a split.

However, the fact that stock splits are executed as frequently as they are implies that corporations believe splits are beneficial and provide some level of benefit. Empirical evidence suggests that stock splits create positive abnormal returns, although the reasons behind these gains are somewhat elusive and continue to be explored. Previous research finds ambiguous changes in liquidity, depending on the choice of proxy for measuring liquidity and timeframe studied. The objectives for this article are to highlight and explain the effects of stock splits, demonstrate that the effects are consistent in the community banking sector, and provide insight into how stock splits may be used in order to increase value for community banks.

The most commonly proposed and accepted explanation for why firms decide to execute stock splits is the optimal trading range hypothesis. According to this hypothesis, stock splits are executed to keep prices in a range that appeal to both institutional and retail investors. While this was much more relevant prior to fully electronic trading when stock trading costs were higher, if a company’s stock price was too low, large investors might face an incentive to not invest because transaction costs reflect a greater proportion of the stock price. However, more relevant today given how far transaction costs have fallen in equities trading is the psychological impact that a lower stock price may play in discouraging investors. Although it may purely be a matter of perception, some investors seem to equate a lower priced stock with a small, cheap or struggling company. This is one factor that drives reverse stock splits, even if they result in reduced trading float.

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Conversely, if a company’s stock price is too high, retail investors face an incentive not to invest because a higher price may be prohibitive to those who may have limited resources to invest, and may reduce their diversification potential. Additionally, a higher stock price may be perceived as having more downside, as many retail investors may tend to perceive it to be more likely for a stock to appreciate from $15 to $50 versus $50 to $100. Stock splits theoretically keep the splitting company’s trading price at a price beneficial for both retail and institutional investors. However, an increased trading float as a result of a stock split is often a critical need for institutional investors, and we revisit this later in the article.

Ironically, Berkshire Hathaway BRK-B shares demonstrate both sides of the stock split argument. Trading at more than $100 per share, these shares might be considered expensive to retail investors. Yet even Warren Buffett, who has generally been a critic of stock splits, approved and encouraged a 50:1 split of Class B shares in 2010 to give more investors access to the stock and lowering the $3,300 per share price to $66 per share (still not a low-priced stock, but certainly more accessible).

The decision to split Berkshire Hathaway’s stock was driven, in part, by the massive acquisition of Burlington Northern Santa Fe Railway. Berkshire Hathaway offers multiple classes of shares, and the B shares priced around $117 currently are certainly cheaper than the firm’s Class A shares priced around $175,000 per share, which have not been split.

Another suggested reason for stock splits is the signaling hypothesis. According to this hypothesis, stock splits serve as a signal to investors that the company has favorable future prospects. A company may split its stock with the intention of communicating to the market that the company is successful, its business prospects will improve in the near-term, or that the stock is undervalued.

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A final motivation comes from the spotlight hypothesis, which is closely related to the signaling hypothesis. According to this hypothesis, stock splits serve to attract attention to lesser known companies by placing them on “center stage.” When companies undertake stock splits, media coverage increases. Additionally, stock split announcements may pique the interest of investors who previously had not noticed the company.

These three hypotheses come with certain limitations. Advances in technology have all but eliminated the transaction costs and diseconomies of scale that fuel the optimal trading range hypothesis. For retail investors, “per trade” transaction pricing enables them to pay the same transaction costs for 50 shares at $20 per share as they do for 25 shares at $40 per share. However, the psychological impact of placing a stock in a perceived investor “sweet spot” remains a prevailing thesis worth exploring.

The signaling hypothesis might be questioned because there is no apparent disincentive for false signaling, so rational investors should not necessarily respond to signaling effects. However, because a stock split reduces the splitting company’s stock price, it might be illogical to assume that near term corporate financial performance or news could be perceived as weak, because most management teams would understand poor split timing could lead to a compounding effect further reducing the company’s stock price. Costs associated with splits could make them an expensive way of drawing attention to a firm, which further challenges the spotlight hypothesis. However, these administrative costs have also likely fallen in recent years with technology (and a lack of paper stock certificates), and this could bolster the signaling hypothesis.

Although the theoretical rationale behind stock splits is not fully understood, studies provide extensive evidence demonstrating the positive effects of stock splits. The results of these studies provide the most believable rationale for stock splits—their consistent effects on stock price. We summarize the findings of several academic studies dating back to 1984, to provide some historical perspective on the topic of stock splits. It is also important to note that retail investors are far more educated today due to the Internet, online stock trading, and the wealth of educational resources that have become available to non-professional investors since the Internet was created.

Grinblatt, Masulis, and Titman (1984) conducted an event study on a sample of companies that had undergone stock splits with a ratio of at least 5:4. In an event study, a “normal” return is calculated for the time period leading up to an event—in this case a stock split. A second return is then calculated in the time around the event. The difference in the normal return and the event return is called “excess” or “abnormal return”, and provides a measure for the effect the event had on return. The results of this study indicated that companies that had undergone a stock split generated positive abnormal returns of 3% on announcement date and an additional positive excess return of 1% around the execution date, even without a coinciding market or specific company event. The event study methodology also accounts for the possibility that the abnormal returns were due to improving financial performance. In a separate study, Lamoureux and Poon (1987) again discovered abnormal excess returns, and found that the abnormal returns were statistically significant for as long as two months after the execution date.

The effects on stock price were later examined by Ikenberry, Rankine, and Stice (1996) and Desai and Jain (1997). The two studies again used event studies, and found excess returns of 7.93% and 7.05%, respectively, in the first year following the stock split, with excess returns of 12.15% and 11.87% for the three years following the stock split.

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Additionally, a multi-variable regression found that excess returns were lower for value stocks (0.40%) than growth stocks (8.74%), although both had significant positive returns. One-year abnormal returns were much larger for the smallest 10 percent of the sample (10.04%) than largest 10% of the sample (1.01%), although both groups had significant positive returns.

The impact of stock splits on stockholder liquidity has been explored as well, although the results are somewhat ambiguous. Depending on the timeframe and the proxy used for liquidity, stock splits have been shown at times to increase liquidity, decrease liquidity, or have no effect at all. Much depends on the market capitalization of the company conducting a stock split and its existing level of institutional ownership. An increase in shares available for trading can have positive implications for liquidity and trading volume for all classes of investors, and many institutional investors find stock splits attractive as a float-building endeavor.

The most significant industry research related to stock splits in the community banking industry comes from Michael Impson (2010) in an article titled “Attention and Liquidity Effects of Stock Splits by Small Commercial Banks.” In this study, return and liquidity were tested for a sample of 114 small to mid-size commercial banks with an average market capitalization of $411 million, as well as 114 non-banks for comparison. The tests performed in this study were more robust than those in prior referenced studies because they account for variances around the event date, which were not addressed in earlier studies.

Impson’s results indicate that the price effect of stock splits in the small banking sector matches the effects of stock splits in previous studies. Stock splits generated statistically significant positive abnormal returns at the 99% confidence level during the execution date and five days around the execution date, even after accounting for variance in the five days around the execution date. Additionally, the excess returns were found to be higher for banks than non-banks, which experienced insignificant excess returns.

It is also noteworthy that Impson found strong evidence that liquidity also significantly increased following a stock split for small banks. In the 51 days before and after a split, turnover, defined as number of shares traded divided by shares outstanding, decreased slightly from 0.20 to 0.19, however, average split adjusted dollar volume traded increased significantly from $611,000 to $941,000, indicating that liquidity did increase after a stock split. Additionally, trade size, analyst coverage and trades per day significantly increased as well, further supporting an increase in liquidity. Finally, the liquidity ratio, the change in liquidity as a result of a change in return, also increased, indicating that the liquidity effect was not only a result of increased return. The liquidity effects of the split on bank stocks were again found to be more pronounced than the effects on non-banks.

Lamoureux and Poon found that split adjusted volume increased around the announcement and execution dates, but decreased at a statistically significant level in the 100 days after a split. The Impson study helps to clear up previous conflicting findings regarding the effects of stock splits on liquidity. Maloney and Mulherin (1992), like Impson, discovered a decrease in turnover, but an increase in the dollar volume of shares traded.

Dennis and Strickland (1998) discovered an inverse relationship between pre-split institutional ownership and post-split liquidity. Companies with insignificant institutional ownership before a split experienced significant positive liquidity effects, while companies with greater institutional ownership before the split either stayed the same or decreased in liquidity. These mixed results indicate that the liquidity effects of stock splits need further exploration, but the fact that later studies found positive results may suggest that positive liquidity effects exist today that didn’t exist in the 1980s and part of the 1990s due to improved market infrastructure or technology.

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It is possible that banks, which historically have been managed fairly conservatively given the regulatory environment (banks have failed at a much lower rate than non-banking companies), tend to execute splits less frequently than non-banking companies with similar market capitalizations, thus elevating the perceived importance or signaling effect of the split to investors. This possibility would need to be further explored.

Earlier research that we explored, and recently conducted analyses by Ambassador, indicate positive abnormal excess returns around stock split announcement and execution dates, with mixed overall results with regard to stockholder liquidity, depending on the splitting company’s size and shareholder base. Companies often execute a stock split based on an optimal trading range theory to signal favorable future prospects, or to place a company in the spotlight of analysts, industry observers, or the media. We believe all three strategies are relevant, particularly given the rapidly rising valuations of publicly traded banking companies.

Finally, we believe research indicates the effects of stock splits are greater for smaller public companies, including banks, and provide better results for high growth-oriented banks (higher Price/Earnings ratios but faster growing top and bottom line performance). Although stock splits provide no economic value, they remain an effective tool for helping community banks reach their market valuation and stockholder liquidity goals. With industry consolidation a topic of widespread discussion, the importance of a strong stock price and more liquid currency has never been greater.

— Jacob Eisen  
**Managing Director**

— Charles Du  
**Intern**

— Tad Gage  
**Managing Director**