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Survivability following reverse stock splits: What determines the fate of non-surviving firms?



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ABSTRACT

Using a sample of 1206 reverse split stocks during the 1995–2011 period, we find only 500 reverse splitting firms are able to survive on their own for five or more years. Of the 706 firms, that are unable to survive independently, about 20% are acquired by another organization while 80% get delisted for other reasons, usually due to an inability to meet listing requirements or bankruptcy. We investigate the determinants of the outcome for these 706 non-surviving firms and show that firms that are less subject to information asymmetry problems (i.e., larger firms, firms with better pre-split operating and stock price performance, and firms that went public more recently) are more likely to attract an acquisition offer that is acceptable to major shareholders. Also, we examine the post-reverse-split survival time for these firms and show that firms with poor operating and stock price performance, high leverage, and low post-split stock prices fail more quickly. Lower ex-date returns are associated with shorter survival times indicating the market tends to partially anticipate the relatively shorter life span of these firms. We also show that in the period prior to delisting, larger size, better operating performance, and higher sales growth are associated with a higher likelihood of a completed acquisition rather than a delisting due to bankruptcy or failure to meet listing requirements.

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1. Introduction

A company may attempt to move its stock price into a more desirable trading range, maintain its exchange listing, or enhance its stock's liquidity by means of a reverse stock split. In a closely related paper, [Neuhauser and Thompson \(2014\)](#) examine the factors that determine which firms survive a reverse stock split and which firms do not. In their view, the objective of the majority of reverse stock splits is survival and avoidance of delisting. However, despite these reverse splitting firm's efforts to avoid delisting, the majority fail within five years. Out of a sample of 1206 firms that completed a reverse split between 1995 and 2011, only 352, or 29%, survive until the end of the sample period. Among the 854 firms that fail during the sample period, the mean (median) survival period is only 34 (22) months, with 706 firms or almost 60% failing within five years of the reverse split.

Not all non-surviving firms are alike however and we believe a distinction should be made between those companies that cease to exist via an acquisition and those that delist for other reasons, such as bankruptcy or failure to meet listing standards. Among the 1206 firms conducting a reverse stock split, we find that, within five years of the reverse split, 138 or about 11% are acquired by another company while 568 or about 47% enter bankruptcy or fail to meet listing standards.¹ Regardless of the type of delisting, a considerable amount of time passes between the reverse split and the delisting date suggesting that the original motive behind the reverse split is survival as an independent firm. For those firms that ultimately are unable to survive on their own, we show that firms with less information asymmetry are more likely to experience a completed acquisition outcome rather than a delisting due to bankruptcy or failure to meet listing requirements.

A forward split causes a small number of shares to convert into a larger number of shares with a proportional decrease in the share price while a reverse split reduces the number of shares with a proportional increase in share price. Existing literature puts forth a number of theories about why firms undertake reverse stock splits. [Peterson and Peterson \(1992\)](#) describe two main motives for reverse stock splits: discretionary motives include placing the stock price within a favorable trading range in order to reduce transactions costs for shareholders and avoiding the negative perceptions associated with low-priced or "penny" stocks, while non-discretionary motives are generally driven by a need to maintain the firm's exchange listing. [He and Wang \(2012\)](#) organize theories of stock splits into three major hypotheses: optimal price/tick, signaling, and procedure/structure. The optimal price/tick hypothesis, or optimal trading range hypothesis, is based on the premise that stocks have both an optimal price range and an optimal relative tick size. When the stock price is too low (and thus the relative tick size is too high), a reverse split moves it back into the optimal range. The signaling, or information effects, hypothesis is based on the idea that a split announcement conveys new information about the firm's future stock price performance. Under this hypothesis, a forward split is good news and a reverse split is bad news as the former suggests non-decreasing future stock prices while the latter indicates the opposite. The procedure/structure hypothesis attempts to explain various observed phenomena, such as record day and ex-split day returns and changes in stock price volatility after the ex-split date, by examining microstructure effects, specific features of the split procedure, and regulatory rules that affect splits. As noted by [He and Wang \(2012\)](#), most existing studies focus on forward splits which are far more common than reverse splits.

While forward stock split announcements elicit a positive stock price reaction ([Grinblatt, Marsulis & Titman, 1984](#); and [Desai & Jain, 1997](#)), reverse stock split announcements generally produce a negative stock price reaction. [Woolridge and Chambers \(1983\)](#), and [Peterson and Peterson \(1992\)](#) report negative average abnormal returns of -4.8% and -4.0% , respectively, around reverse split announcements, while both [Han \(1995\)](#) and [Kim, Klein, and Rosenfeld \(2008\)](#) report statistically significant negative abnormal returns around the ex-date for reverse splitting firms, which they attribute to lower post-split transactions costs. In addition, [Lamoureux and Poon \(1987\)](#) report three-day announcement

¹ In comparison, [Mikkelson and Partch \(1989\)](#), using a randomly selected sample of AMEX and NYSE-listed firms over 1972–1987 find that about 23% have been acquired, 4% have gone private, 3% have gone bankrupt or liquidated, and about 70% still trade fifteen years later. For reverse splitting firms, the survival rate is clearly much lower than that of firms in general and the incidence of bankruptcy and forced delisting outcomes is clearly much higher.

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