If a Split Is in Reverse, the Company May Be, Too

By MARK HULBERT

Plans for reverse stock splits have been announced recently by companies like Lucent Technologies and Nortel Networks. If recent research is a guide, such stocks are likely to lag behind the market over the coming year.

In a reverse split, a company reduces the number of its outstanding shares, which results in a correspondingly higher price. Palm Inc., for example, had a 1-for-20 reverse split on Oct. 15. It reduced the company's outstanding shares from nearly 580 million to just under 29 million and increased the share price to nearly $13 from 64 cents.

None of Palm's fundamentals, of course, changed as a result of the company's action. Its total market capitalization remained the same, and so did its ratios of price to earnings and price to book value. The value of investors' holdings didn't change either.

Companies often say they are undertaking a reverse split to prevent shares from being delisted. When a company's stock trades below $1 per share for an extended period, the major stock exchanges, at their discretion can force those shares to be traded elsewhere. (The Nasdaq market, however, is considering relaxing this requirement.) Undoubtedly, another — though unspoken — reason for a reverse splits is to avoid the embarrassment of being a penny stock.

A company's real reasons may be far more complex. Only a small minority of companies whose stocks trade at less than $1 a share ever reverse-split their shares. Some other factors may account for why only a few choose to do so.

One such factor has emerged from academic research. Perhaps the most important study, which appeared in the July 1997 issue of The Journal of Business, measured all reverse splits in the United States from 1926 to 1991. The authors were two accounting professors — Hemang A. Desai of Southern Methodist University and Prem C. Jain of Georgetown. They found that, over the year after the announcement, the average stock undergoing a reverse split performed 8.5 percent worse than the stock market, defined as the total market capitalization of all publicly traded companies in the United States. According to the professors, this poor performance cannot be explained by the tiny market capitalizations of most companies undergoing these splits or the negative momentum of their stock prices.

David L. Ikenberry, a finance professor at the University of Illinois at Urbana-Champaign, and Sundaresh Ramnath, an accounting professor at Georgetown, have developed a theory that does explain it. They believe that when management lacks confidence in its company's stock, it is more likely to use a reverse split. By contrast, they say, if management believes that the low price is just temporary, it will be more likely to leave the stock alone. The professors presented their research in the spring 2002 issue of The Review of Financial Studies.

Confirmation of this confidence factor comes from the performance of stocks undergoing the opposite type of split — the regular type, known formally as a forward split — in which a company increases the number of shares while reducing their price.

The shares of such companies fare particularly well. From 1926 to 1991, according to Professors Desai and Jain, the average stock undergoing a forward split outperformed the market by 6.8 percent over the year after the split's announcement. As in the case of the reverse splits, this difference remained even after adjusting for market cap and momentum.

Stock splits of both varieties appear to be part of a larger class of events in which management signals its opinions of the company's prospects. Such events also include insiders' purchases and sales of a company's stock, as well as a company's repurchase of its shares in the open market.

Researchers now believe that in all such cases, not just stock splits, many investors initially underreact to the signals. That creates an investment opportunity for those who react quickly. In the case of reverse splits, that means selling immediately after the split is announced.

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