

**Analysis of Share Price Impact of Dividend Announcements
with Dividend Cover, Firm Size and Capital Leverage
in Sri Lankan Stock Market**

By

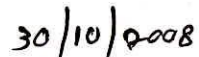
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“The work described in this thesis was carried out by me under the supervision of Dr. Y.K. Weerakoon Banda and a report on this has not been submitted in whole or in part to any university or any other institution for another Degree/Diploma”.





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“I certify that the above statement made by the candidate is true and that this thesis is suitable for submission to the University for the purpose of evaluation”.



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**Analysis of Share Price Impact of Dividend Announcements with
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Market**

By
Kavinda Dhanesh Kongahage

ABSTRACT

This paper examines the share price impact of dividend announcements and analyzes the informational content of dividend announcements by dividend cover, firm size and capital gearing using a sample from Sri Lankan stock market. The empirical results for the overall sample provide strong evidence consistent with previous work on other markets. The findings of the market reaction to dividend announcement support the informational content of the dividend hypothesis. We find that dividends have significant information content in Sri Lankan stock market and on average, market reacts positively to dividend announcements.

Our investigation of market reaction to dividend announcements varies with dividend cover, firm size and capital gearing and empirical results do align with the dividend cover and firm size hypothesis. We find that higher dividend cover events and smaller firms carry more informational content than low dividend cover events and larger firms. The analysis of market response by capital gearing ratio indicates that the empirical findings do not align with formulated hypothesis.

Results found here indicate that highly geared firms are more responsive to dividend announcements than low geared firms which are in contrary to formulated hypothesis.

We also find some anticipatory effects and delayed reaction for adjustment of prices in all three categories. The market takes about 30 days to fully adjust dividend information in price. Therefore, overall results are inconsistent with an informationally efficient stock market.

Overall, while dividend announcements seem to contain valuable information, there does appear to be a discernible relationship between announcement effect and dividend cover and firm size.

1. INTRODUCTION

1.1 Background

This research investigates the informational content of dividend announcements and analyzes the impact of dividend announcements by dividend cover, firm size and capital leverage using a sample from Sri Lankan Stock Market.

One of the central themes in the academic literature since 1960's has been the concept of efficient capital markets. Fama (1970) describes an efficient market as "prices fully reflect" all available information. When the prices fully reflect all the available information, no body can use these information to get an above average returns. But, in practice, this assumption is hardly remained valid. However, since then, many researchers have been trying to measure informational content of many company specific announcements. Out of these company specific announcements, dividend announcement effect has been the key and challenging event among many researchers. Most importantly, dividend announcement effect has become a quite interesting topic in emerging markets such as Colombo Stock Exchange.

The informational content of firm specific announcements such as dividends and earnings has been an interesting issue in theoretical and empirical research since the pioneering work of Fama, Fisher, Jensen and Roll (1969-70). There is a preponderance of evidence that dividends play an important informational role in capital markets. Specially, changes in dividends provide information about the changes in managers' expectations about future prospects of the firm.

This paper not only attempts to find the impact of share price due to dividend announcements but also emphasis share price behavior in response to varying dividend cover, firm size and capital leverage.

Many local and overseas researches have been done in this area emphasizing the high importance and relevance in the field of finance. Many of these studies find that changes in dividend announcements convey significant information to the market and investors depending on the level of efficiency of the market. Finance theory in general explains that prudent investor expectation is to maximize wealth in the form of dividends and earnings. Even-though many researchers try to correlate dividend announcements with share price, a few has tried to analyze the impact by considering interconnected variables such as dividend cover, firm size and capital leverage.

“Does share price reflect company specific announcements such as dividend announcements in Colombo Stock Exchange” is the theme of this research. Therefore we totally depend on the published information by the exchange. Since its revival in 1985, the CSE has been one of the fastest growing emerging capital markets. The CSE was one of the first exchanges in the region to successfully automate its activities, and has been able to notably enhance the transparency and efficiency of the securities market.

The Colombo Stock Exchange (CSE) has 235 listed companies representing 20 business sectors. The market capitalization as at 12th March 2008 was 835.3 billion rupees and the CSE recorded its highest daily turnover of Rs. 33.4 billion on the 01st of April 2008.

The listing of companies is on a tiered basis with the Main Board for the larger companies and the Second Board for medium and small companies and for start up companies. The SEC operates an Over-The-Counter market (OTC) for unlisted companies.

Foreign investment in stock market is freely permitted except in the case of few companies where there are certain restrictions imposed. Online and historical market information is made available internationally and local through data vendors and the CSE has taken necessary steps to prepare a Data library which is available in CD (compact disk) format.

With the objective of broad basing the stock market and providing wider access, the CSE opened branches in the Southern Province (Matara) in 1999, central Province (Kandy) in 2003 and North Western Province (Kurunegala) in 2005.

Stock return is one of the fundamental concepts used throughout the study. Event study methodology primarily depends on calculating individual stock returns. The daily return is a measure of the change in a shareholder's wealth from day to day after taking into account all changes in the share ownership and cash flows from or to the shareholder. The number of shares held in a company may increase as the result of a rights, bonus, or split. The number may reduce as the result of a consolidation. Shareholders may contribute additional capital as the result of a rights issue, or a call on partially paid shares. Shareholders may receive cash flows as a result of a dividend payment or return on capital. In all cases the return is simply the ratio of the increase or decrease in shareholders wealth today compared to yesterday.

Therefore, when calculating stock return, in addition to capital gains due to share price move, we also consider right issues, bonus issues and stock splits and adjusted returns at ex-right date assuming dividends cash flows are received at ex-dividend date and rights of shares are exercised at ex-right date.