

3.13 Capital structure change announcement effect and market efficiency – Evidence from the Sri Lankan stock market

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ABSTRACT

An efficient market is one in which prices fully reflect available information. Market efficiency depends on the ability of traders to devote time and resources to gather and disseminate information and the ability of market participants to absorb new information. Investors care about market efficiency because stock price movements affect their wealth.

The overall aim of this study is to test the Sri Lankan stock market efficiency. Announcements regarding capital structure changes are used as the basis. Capital structure changes are a common occurrence on any investment markets, via companies try to find out different ways to find out the finance support they need for investments.

This paper uses event study methodology to verify the effects of announcements on significant capital structure changes on stock returns. This study analyses 37 cases which carried significant (more than 10%) capital structure changes. To determine the reaction of stock price to capital structure changes, market adjusted returns are calculated for the sample for 31 day event window. Market adjusted abnormal return to a firm is calculated compared to pure play company assuming that the pure play company will control the other macro economic changes in the market. The results finds significant positive and negative stock reaction to capital structure changes, before and after the event date. Information leakage that a firm will do a capital structure change, can explain the significant returns prior to the event day. Post event changes signify that even after 2 weeks of the event which reflects still the prices have not fully absorbed this information.

These findings, consistent with theories, would appear to suggest that Sri Lankan capital market is not much efficient in absorbing capital structure changes information.

As future research, an investigation of change in the value of a firm at the time financing decisions are disclosed to the market is to be conducted.

Key words: Optimal capital structure, capital structure changes announcements, Market efficiency, Company Value.