

Categorization Effects and Shareholders' Attitude in Bangladesh

Serajul Islam*

Md. Rizwan Hassan**

Abstract

This paper briefly presents research findings regarding the categorization effects on the shareholders' attitude in Bangladesh. The Securities and Exchange Commission classifies all listed companies into different categories on the basis of some specific criteria in order to protect the interest of investors. This paper reveals that there are two schools of thought regarding categorization effects on shareholders' attitude. One school views that investors prefer and buy the company's shares on the basis of categorization. They want to invest in the companies on the priority basis from the various categories serially in order to reduce risks. Thus they encourage categorization system and think that they are getting benefit from the categorization system. The other school views that categorization is irrelevant, as it cannot affect the value of the firm in a perfect market. It reveals that investors prefer to invest in the companies' shares on the basis of growth rate and future prospects. They do not emphasize more on payout ratio and on AGM. They think that categorization cannot be useful for valuation of growth companies.

Keywords

Categorization, Shareholders, CSE, DSE

1.1 Introduction

There are a lot of listed companies in the stock exchanges. All of the companies are classified in different categories based on the some specific criteria given by the SEC in order to facilitate the investors to identify good/bad shares to some extent specially the new investors in the capital market. This classification is called categorization. The categorization system was introduced on the 15th April, 2001.

Securities and Exchange Commission classifies the listed companies in consultation with DSE and CSE so that the investors can get accurate information about the listed companies as well as their weakness and strengths and know the actual position of individual company on the basis of its performances. Then new investors can invest in the best performance companies and also can minimize the risks. But categorization does not always represent the actual performances of the listed companies. This paper is an

* Lecturer, Department of Business Administration, IIUC

** Lecturer, Department of Business Administration, IIUC

attempt to reveal the categorization effects on the shareholders’ attitude in Bangladesh.

1.2 Rationale of the Study

In our country, scrip settlement system is different for different categories of scrips. In the one hand, categorization system provides positive effect on shareholders attitude to invest in the scrips on the basis of categories. On the other hand, it sometimes misleads the investors about many companies. This dilemma is a myth in our capital market. This study has been conducted to clarify this dilemma on the basis of empirical study.

1.3 Objectives of the Study

Attempt has been made to fulfill the following specific objectives.

- a) To conceptualize the legal and operating framework of categorization system in Bangladesh.
- b) To identify investors preference of different categories of scrips.
- c) To evaluate performance of different categories of scrip.

1.4 Methodology of the Study

To make the effort a success data have been collected from both primary and secondary sources. Secondary data have been collected from different national and international publications. Different related research articles have been reviewed for having a deep insight into the concept. Primary data have been collected from different investors through face-to-face interview. Various statistical tools have been used to analyze the collected data. The research has been conducted from April 2004 to August 2004.

2. Legal Framework of the Aspect

Securities and Exchange Commission classifies the listed companies in to four categories as follows:

- i) ‘A’ category
- ii) ‘B’ category
- iii) ‘G’ category
- iv) ‘Z’ category

2.1 ‘A’ Category Companies

A category companies are those companies that are regular in holding the current annual general meetings and declared dividend at the rate of ten percent or more in the last English calendar year. The settlement procedures of all listed mutual funds and ‘A’ category companies are similar.

Settlement Cycle in Order	
Category – A	
Trading day	T + 0
Settlement day/Pay in	T + 2
Settlement day/Pay out	T + 4

2.2 B – Category Companies

'B' category companies are those companies that are regular in holding the annual general meeting but failed to declare dividend at least at the rate of ten percent in the last English calendar year.

In case of the newly listed securities, the rate of earning per share (EPS) based on the audited accounts of a full year of twelve months, as contained in the prospectus of the concerned companies, shall be treated as substitute of the rate of dividend applicable for 'A' and 'B' category of companies if no dividend were declared by such companies in the last English calendar year.

Provided, however, that the net profit after tax or net profit after adding back the tax holiday provision, as the case may be shall be the basis for calculating the EPS.

Settlement Cycle in Order	
Category – B	
Trading day	T + 0
Settlement day/Pay in	T + 2
Settlement day/Pay out	T + 4

2.3 Z – Category Companies

'Z' category companies are those companies which failed to hold the current annual general meetings or have failed to declare any dividend or which are not in operation for more than six months or whose accumulated loss after adjustment of revenue reserve, if any, is negative and exceeded its paid-up capital.

Provided further that the words in the aforesaid paragraph or whose accumulated loss after adjustment of revenue reserve, if any, is negative and exceeded its paid-up capital shall not be applicable for the companies which have declared dividend out of the current profits in the last English calendar year and held annual general meeting(s) relating to all outstanding financial year(s) despite having such accumulated loss exceeding the paid up capital.

Provided further that the chief executive officer of the exchange may bring any other company under this category, if deemed necessary, with the prior-written consent from the Commission.

Settlement Cycle in Order	
Category – Z	
Trading day	T + 0
Settlement day/Pay in	T + 4
Settlement day/Pay out	T + 7

2.4 G – Category Companies

G category companies are those companies, which do not fall under any of the above categories. Provided that incase of failure to declare dividend, the shares of such companies shall continue to remain in this category until the date of

annual general meeting held after two full years from the date of commercial operation as described in the prospectus.

Settlement Cycle in Order	
Category – G	
Trading day	T + 0
Settlement day/Pay in	T + 2
Settlement day/Pay out	T + 4

3. Company Classification Criteria and Clearing & Settlement System

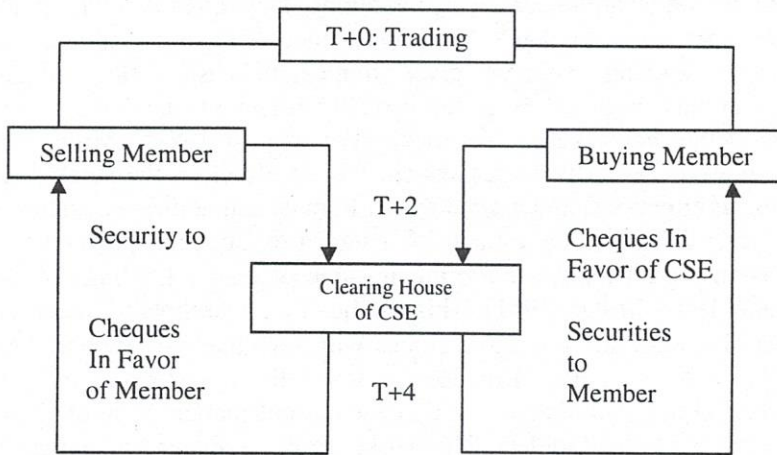
3.1 Company classification criteria and trading and settlement system is given below:

Category	Criteria/Eligibility	Trading and Settlement
'A'	Held the current AGM; Declared dividend @ 10% or more in the last English Calendar Year.	Automated trading and scrip settlement on trade for trade basis and money settlement on net basis through clearing house.
'B'	Which do not fall under category "A" or "Z". i.e. Held the current AGM; Declared dividend less than 10% in the last English calendar year.	Automated trading and scrip settlement on trade for trade basis and money settlement on net basis through clearing house.
'Z'	Failed to hold the current AGM Or Failed to declare any dividend Or Not in operation continuously for more than 6 months Or Accumulated loss after adjustment of revenue reserve, if any, is negative and exceeds its paid-up capital.	Automated trading and scrip settlement on trade for trade basis through clearing house.
'G'	New listed company that do not fall under "A","B" or "Z".	Similar to B Category.

Source: Bangladesh Capital Market: Chittagong Stock Exchange; March 2001; p-19

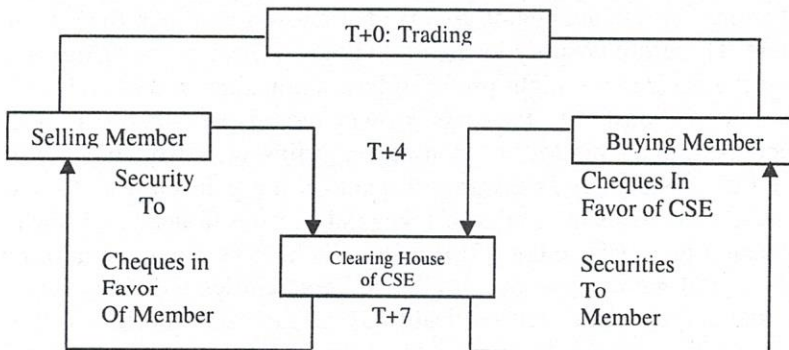
Members receive a securities deliverable/receivable obligation and monetary obligation statement on every trading day in the post closing session. Accordingly they deliver their dues, both money and scrips to the Exchange Clearing house on the pay-in day i.e. T+2 for A, B and G category companies and T+4 for Z category companies. The CSE clearing house sorts and checks the scrips and gets the cheques cleared from commercial banks and then delivers scrips and money to the recipient members on the pay out day i.e., T+4 for A, B and G category companies and T+7 for Z category companies.

3.2 Flow Chart of Settlement Cycle of A, B & G Category Shares



Source: CSE Homepage

3.3 Flow Chart of Settlement Cycle of Z Category Shares



Source: CSE Homepage

4. Theoretical Framework

The most important factors of categorization system are annual general meeting and dividend payment. But dividend is the key factor among them. Most of the investors prefer to invest in the category 'A' companies. The companies of 'A' category declare high dividend. So investors are interested to buy this category shares. Thus the demand of the shares of 'A' category company is increased. Hence its share price goes up. It has also signaling effect on the share price. Some investors like to invest in the 'Z' category companies, which have high growth potentials. They do not prefer dividend. So categorization system cannot be useful for evaluation of growth companies. Typically new companies retain most of their earnings for further investment. Therefore new companies cannot satisfy the important criteria of categorization. From the above discussion, we see that categorization effect mostly depends on the dividend effect on the shareholders value. The empirical studies and findings are given below.

Porterfield's¹ intuitive argument is that the cash dividend is merely a way of giving reward to the shareholders that something they already own in the company. Therefore, cash dividends, in simplest theory, have no value to the shareholders. A dividend payment gives immediate cash inflow to the shareholders, but this cash inflow is theoretically offset by decline in stock value (via reducing book value of stock) (Porterfield, 1959). Millar and Modigliani² showed that a dividend payment has no effect on the stock price subject to some assumptions, and argued that firm must sell additional shares to maintain the desired level of investment if it increases dividend payments. A dividend payment would reduce the terminal value of equity holdings by the original shareholders (Millar, 1961). This implies that shareholders receive a cash flow (via dividend) and buy more stocks with it to maintain their current level of equity holdings in the firm. Hence, given the investment policy in place, a dividend policy would affect neither the current market price of shares nor the total returns of shareholders. The market price of shares will rather be determined by the earning power of firm's assets and its investment policy- not by repackaging the distribution of earnings. And also there are three tax related reasons for thinking that investors might prefer a low dividend payout to a high payout: (1) The long-term capital gains are taxed at a lower rate than the rate on dividend income. Therefore wealthy investors (who own most of the shares and receive most of the dividends) might prefer to have companies retain and plow earnings back into the business. Earnings growth would presumably lead to stock price increases, and thus lower-taxed capital gains would be substituted for higher-taxed dividends. (2) Taxes are not paid on the gain until a stock is sold. Due to time value effects, a taka of taxes paid in the future has a lower effective cost than a taka paid today. (3) If a share is held by someone until he or she dies, no capital gains tax is due at all- the beneficiaries who receive the share can use the share's value on the death day as their cost basis and thus completely escape the capital gains tax. Because of these tax advantages, investors may prefer to have companies retain most of their earnings. If so, investors would be willing to pay more for low pay-out companies than for otherwise similar high-payout companies (Brigham, 2000).

On the other hand, Walter's³ model postulates that current stock price would reflect the present value of all expected dividend payments in future. Thereby, we should find an empirical relationship between the dividend payments and market prices of the stock. His model shows that the value of stock of a growth company, with rate of return on additional investment is higher than the market capitalization rate, is determined by constant cash flow from current dividend and additional cash flow from investment of retained earnings (Walter, 1956). In a later work, Gordon formalized the stock valuation model by showing that current stock price is the present value of expected future cash flow streams, e.g. expected future dividends. His dividend valuation model showed that value of a stock could be determined by discounting the next period's expected dividend by a discount rate, net of the dividend growth rate. This was a significant breakthrough in the valuation of common stocks. He further

explained that the discount rate is a positive function of the dividend growth rate, because the dividend in near future is less risky than the dividends from investment of retained earnings in the remote periods. Hence, investors would discount the remote dividends at a higher rate. Therefore he argued that dividend payments would positively affect the stock prices (Hamid, 2001).

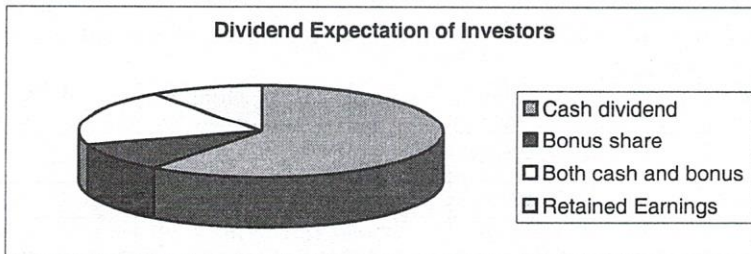
The both streams of dividend theories are similar to the both schools of thought regarding categorization effects on shareholders' attitude. The conclusion on both schools of thought is that categorization system does affect the shareholders attitude, which could be due to dividend effect. The analysis about these issues has been given below:

4.1 Findings and Analysis

Since dividend is the important key factor of categorization the companies. We surveyed on 80 investors in order to know their dividend expectation. The following table shows the dividend expectation of various investors:

Nature of Payment	No. of Investors	Percentage
Cash dividend	48	60%
Bonus share	8	10%
Both cash and bonus	16	20%
Retained Earnings	8	10%
Total	80	100%

We can also show the above table by a pie chart as follow:



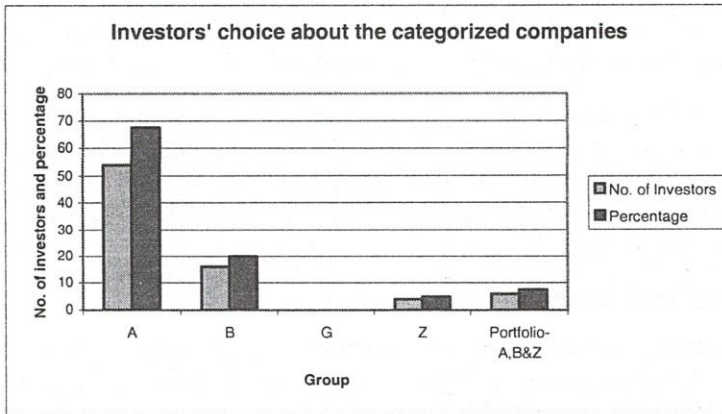
From the above table and pie chart it is found that most of the investors prefer dividend to capital gain. Due to this dividend effect, investors want to invest in those shares that declare high and regular dividend. As a result the demand of 'A'-category shares increases.

4.2 Investors' Category Preference

Investors' choice on the categorized companies according to our survey is shown below:

Category	No. of Investors	Percentage
A	54	67.5
B	16	20
G	0	0
Z	4	5
Portfolio- A,B&Z	6	7.5
Total	80	100%

We can also show the graphical representation of the above table by the following bar diagram:



Here we see that 20% and 5% investors like B-category and z category shares respectively. From the above table it is clear to us that only a few investors criticize the categorization system and they think that there is no effect of categorization system on their investment attitude. But most of the investors (67.5% of the surveyed investors) like A-category shares and they think that there is a positive effect of categorization system on their investment attitude.

4.3 Performance evaluation of different companies of different categories:

The following table shows the monthly performances of various companies of different categories:

Name of the Company	Category	Last date of AGM	Earning Per Share	Dividend Per Share	Share Price	% Change in Month
Beximco Infusion	A	26/06/2004	27.48	15	280	30.08
National Tea	A	28/04/2004	35.41	18	845.25	28.07
NCC Bank	A	25/07/2004	48.41	10	279.25	17.7
Apex Weaving	B	18/10/2003	5.07	5	68.25	30
Mita Textile	B	24/12/2003	0.27	5	47	29.66
Prime Textile	B	29/12/2003	7.23	5	73.5	13.08
Lafarge Surma Cement	G	13/05/2004	-	-	263	16.63
M.H. Garments	Z	8/9/2002	8.97	5	20.5	18.84
Bd. Dyeing	Z	28/09/2002	36.68	10	52	26.83
Raspit Inc (BD) Ltd.	Z	24/12/2002	0.12	0.3	1.8	0

Source: CSE Bazar Porikroma, June-2004

From the above table we see that Beximco Infusion, National Tea and NCC Bank are in the A-category. Their EPSs are 27.48, 35.41 and 48.41 respectively. The EPS of Apex weaving, Mita Textile and Prime Textile (B-category

company) are 5.07, 0.27 and 7.23 respectively. The EPS of M.H. Garments, BD. Dyeing & Rasmit Inc (BD) Ltd. (Z-category Company) are 8.97, 36.68 and 0.12 respectively. Though BD. Dyeing is a 'Z' category company its EPS is higher than many 'A' Category companies like Beximco Infusion, National Tea etc. and also than all 'B' category companies. It also paid dividend Tk.10. BD. Dyeing only failed to arrange AGM in time. For this it has been categorized as a 'Z' category company.

We selected some companies randomly from the various categories to determine the average earning per share and coefficient of variation.

From the above table we get,

Average EPS of 'A' category companies, $x_a = 37.1$

Average EPS of 'B' category companies, $x_b = 4.19$

Average EPS of 'Z' category companies, $x_z = 15.26$

Coefficient of variations of 'A', 'B' and 'Z' category companies are $C.V._a = 0.285$, $C.V._b = 0.850$ and $C.V._z = 1.250$ respectively.

According to the above data, most of the new investors should invest (choose) in the A-category share first and then in Z and B. Therefore categorization system cannot express the 100% accurate performance by the various categories. The system need to be improved by adding some additional factors- as company's financial position, companies future prospects and current performances.

5. Conclusion

All the listed companies in the stock exchange in Bangladesh are classified into A, B, G and Z categories in order to create awareness about the companies' performances among the new investors and to reduce the risks of investment. The categorization system also encourages the weak companies for developing their position. The dividend decision is one of the major criteria of categorization system, which has significant implications for valuation of firms as well as shareholders attitude. There are two groups of views regarding the dividend effects on shareholders attitude. One group viewed that dividend do affect shareholders attitude, because investors do buy future cash flow streams by purchasing shares of a company. Another group viewed that dividend don't affect shareholders attitude in perfect market condition, because dividend payments are merely distribution of shareholders own money to them, which have to be replaced by new equity issues. However, this group conceded that dividend policy might be important for evaluating shareholders attitude because of market imperfections differential tax rates for dividend and capital gains and that for the investors that belong to different income classes.

Given the above theories, found that dividend payments do affect the shareholders attitude because of tax effects, information effects and signaling effects. We can conclude that there are positive effects of the categorization

system on shareholders' attitude. But it cannot be useful for valuation of growth companies. Therefore, it needs to improve the categorization system by adding some criteria such as earning power of firm's assets and its investment policy.

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Endnotes

- ¹Porterfield (1959) made first contribution by presenting an intuitive argument for dividend irrelevancy.
- ²Millar and Modigliani (1961) (often called MM) developed the theory of dividend irrelevancy for an ideal economy with perfect capital market, rational behavior and perfect certainty
- ³Walter (1956) developed a theoretical stock valuation model relating stock price, current dividend and retained earnings.