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Basics of a share split

A share split is the division of a share into multiple shares. For example, if a company splits its shares in the ratio of 2:1, it divides one share into two. So, if the value of a share is Rs 10, it becomes Rs 5 following the split. In effect, by adjusting the face value of share, the company tries to boost the liquidity of its shares.

In a 3-for-1 share split, each shareholder receives an additional 2 shares for each share they hold.

A share split does not involve a conversion of reserves into ordinary shares.

With a share split, the number of shares issued by the company increases and both earnings per share and book value per share will decline proportionately.

Share splits tend to have a similar impact when compared to bonus issues. The key difference is that with a bonus issue, the company will need to capitalize certain reserves.

Example

XYZ Ltd, a listed company, currently has 10 million outstanding shares and its Board of Directors recently announced a 4-for-1 share split. The market value of the shares of XYZ Ltd is Rs 5 billion.

a) How many shares will be on issue after the share split?

One share will be exchanged for 4 shares, giving each investor 3 additional shares for every share they own. Therefore 10 million x (4/1), i.e 40 million shares will be on issue after the share split.

b) How much cash is raised from the share split?

Share splits do not raise cash. The higher number of shares outstanding causes a proportionate reduction in the share price, but the company does not raise cash from it.

c) What is the share price before and after the share split?

Share price before share split= Rs 5 billion/10 million shares= Rs 500.

Theoretical share price after share split= Rs 5 billion/40 million shares= Rs 125.

d) If an investor held 10,000 shares before the share split, how many will he hold after the split?

10,000 x (4/1) = 40,000 shares

Benefits of a share split

Improved liquidity

Share splits are generally expected to improve liquidity of shares, as there will henceforth be more shares in circulation following the split.

Cheaper shares

Furthermore, given the lower price, the shares will appear cheaper to investors. Certain companies worry when the share price gets too high as this could scare off some investors, especially small investors. Splitting the stock brings the per share price down to a reasonable level.

Bullish indicator

A share split is usually seen as a bullish indicator – the share price is increasing and the company is doing well. According to a Credit Suisse First Boston Report covering share splits, share splits may be appropriate for good quality companies having strong growth opportunities. These companies' share prices tend to perform well after the share split.

Bonus issue

A bonus issue is achieved by converting company reserves into share capital. When there is a bonus issue, a company will give free shares to its existing shareholders on a pro rata basis. If a company declares a bonus of 2:1, the investor will get two additional shares for each share he holds. It is important to note that just like a share split, the company does not raise additional cash with a bonus issue.

A bonus issue increases the number of shares issued by a company and therefore, its post bonus earnings per share (EPS) and book value per share will decline proportionately. Face value per share is typically not affected with a bonus issue.

Impact on Shareholder Funds

Total Shareholder Funds (share capital + reserves) remain unchanged under both a bonus issue and share split. Think of a Rs 1,000 bank note. Exchanging it into two notes of Rs 500 does not imply that the holder is now better off. He still has Rs 1,000 on him!

The Mauritian context

Share splits have been less common when compared to bonus issues in Mauritius. Companies like Harel Frères, MDIT, Fincorp, Union Flacq and RHT Holding have resorted to share splits between 1990 and 2011. Most recently (May 2012), the Boards of State Bank of Mauritius and Gamma Civic announced a share split.

Other major local listed companies have mainly announced bonus issues.

A look at past trends indicates that share splits/bonus issues have benefited investors in Mauritius.

Trends abroad

According to Businessweek, share splits have become less frequent since the 2008 financial crisis. Only four companies in the Standard & Poor 500 index have so far split their shares during 2012, whereas 16 companies did so in 2011. In contrast, the 2004-2007 annual average stood at 35. It should also be noted that 102 companies went for share splits in 1997!

The famous investor, Warren Buffett, is typically known for being against stock splits. He claims that companies which avoid them encourage investors to think like "owners" instead of traders.

Conclusion

A share split is a corporate action which increases the number of shares issued by dividing each share issued by a company. A bonus issue is carried out by converting company reserves into share capital. The main objective behind a share split/bonus issue is to improve liquidity of the shares. Total shareholder funds are typically unaffected by either share splits or bonus issues. A share split moreover does not guarantee that the share price will go up in the long-term. Other factors such as company fundamentals and prospects (e.g profitability, growth, new projects) also have a major impact on share price.