Corporate Actions

As an investor or shareholder in a company it is important that we understand why companies undertake certain corporate actions. A corporate action is any event undertaken by a company that brings material change to the company which in turn affects its stakeholders. There are many corporate actions which a company can undertake, some examples include: stock splits, bonus issues, mergers and acquisitions, and spin-offs. In this article I will address the corporate actions of a bonus issue and a stock split as there are various similarities between the two and one can often mistake them for being one and the same.

Firstly, I will begin by defining the two terms: a bonus issue is an issue of additional shares to existing shareholders at no charge to the shareholder. For example, a company may do a 1 for 3 bonus issue: which means that for every three shares a shareholder owns he or she will receive one additional share for free. Thus, the shareholder who had 900 shares prior to the bonus issue will have 1,200 shares post issue. However, the total value of the shares does not change so if the 900 shares were valued at $10.00 each and the total value was $9,000, then after the bonus issue each of the 1,200 shares would be valued at $7.50, a total value of $9,000. Thus as can be seen from the example, after a bonus issue the total shares outstanding increases while the market capitalization value (i.e. the total shares outstanding multiplied by the market price of the share) remains the same.

A stock split is also a corporate action which has the effect of increasing the number of shares outstanding without affecting the market capitalization value of the company. As the name implies, a stock split divides each of the outstanding shares of a company thereby lowering its par value as well as its price. For example, if a company does a 2 for 1 stock split, then each share in the company is split in half and the par value and market price of the share is also halved. So, if a company issued 100 shares at a par value of $1.00 and these shares were trading at $10.00 each prior to the split, then after the split, the company would have 200 shares outstanding at a par value of 50 cents and the share price would be adjusted to $5.00 each.

The reason for the adjustment in price in both cases is to ensure that the company is trading at a realistic price to earnings multiple and that total shareholders wealth remains unchanged.

Based on the two definitions above it would appear to the average investor that there is no real difference between a bonus issue and a stock split, since they both have the same effect of increasing shares outstanding while keeping the market capitalization value constant. However, there is a difference, as with any corporate action there is always a reason behind the choice of one over the other. In the case of a bonus issue versus a stock split, the difference lies in the accounting entries in the listed company’s financial statements.

Basically, when a company does a bonus issue, it is issuing fresh or new shares as per the approved ratio and in the company's books the issued share capital is increased. The issued share capital is stated at par value in the books. As a result, the company has to show how the issue is financed as it is being given to shareholders at no cost. The financing is usually taken from the retained earnings of the company. As we know from basic accounting methods, for every credit there is a debit and vice versa. Thus, when the company debits its retained earnings the subsequent entry is a credit to the issued share capital account.

However, with a stock split, while the shares outstanding are increasing, the par value is actually decreasing. Thus there is a null effect in the books and the value of issued share capital remains unchanged, thus there is no reason to do an accounting entry.

The following local example of a bonus issue will give some more clarity as to how and why this is done.

On September 26th 2006, Scotiabank Trinidad and Tobago Limited (SBTT) had a 1 for 2 Bonus Share Issue. Thus, for every two shares that a shareholder owned he or she received one additional share. The price was adjusted to $25.50 from $38.25 to account for the increase in shares and the company's issued share capital went from 117,562,500 to 176,343,750. In order to carry out this issue the Bank had to finance the issue by capitalizing $150,000,000 standing to the credit of the Bank's Retained Earnings Account. This had the effect of increasing the Issued Share Capital Account by $150,000,000. The question now is – why would the bank want to do this, after all it is just a matter of moving money from one account that belongs to shareholders to another account that also belongs to shareholders.

The answer- according to the Financial Institutions Act (1993), a licensed financial institution's ability to take deposits is limited to twenty times its issued share capital and statutory reserves. Thus, by increasing its issued share capital, SBTT has increased its ceiling for deposit liabilities and changed its capital structure, thereby improving its prospects for growth. Thus we can now see why an institution such as SBTT may choose to do a bonus issue as opposed to a stock split.

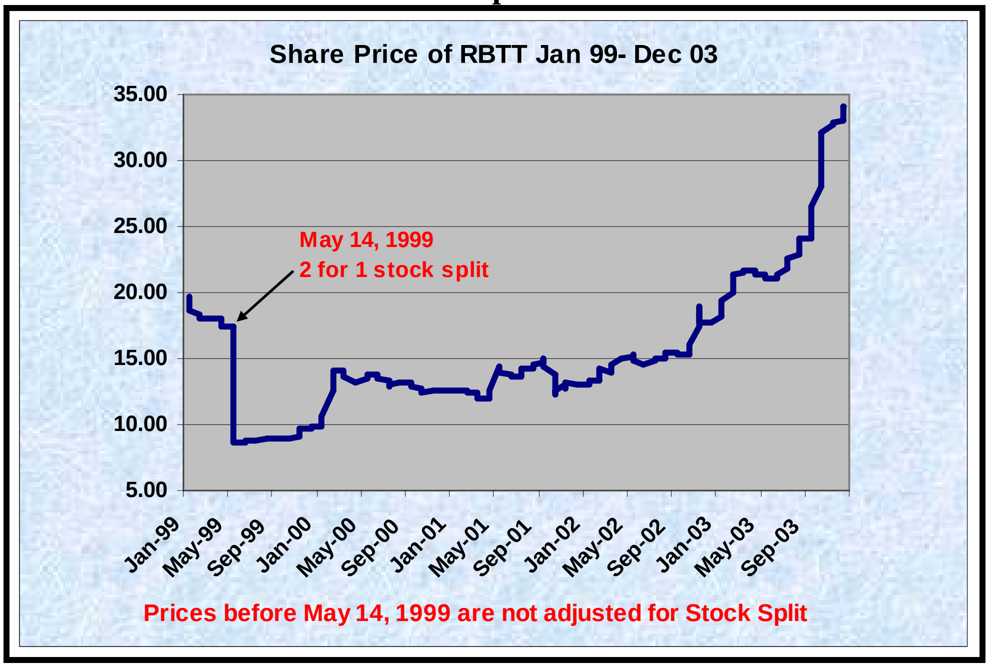
Effects of Bonus Issues and Stock Splits on Market Sentiment and Share Price

After a bonus issue or a share split, the market sentiment is usually bullish. One reason is that a bonus issue is seen as a gesture of confidence. This is because the amount available to pay shareholders is reduced (i.e. retained earnings), thus management is signaling to shareholders that amount capitalized is not needed to pay dividends. Although a stock split cannot be taken as gesture of confidence, the fact that the price is lower has the psychological effect of making it more desirable, especially if the old share price was so high that it made trading in small blocks seem awkward.

Another reason for the bullish sentiment is the fact that there is greater liquidity as there are now a larger number of shares outstanding. Thus, people are more willing to trade as they are more confident that they can buy and sell easily.

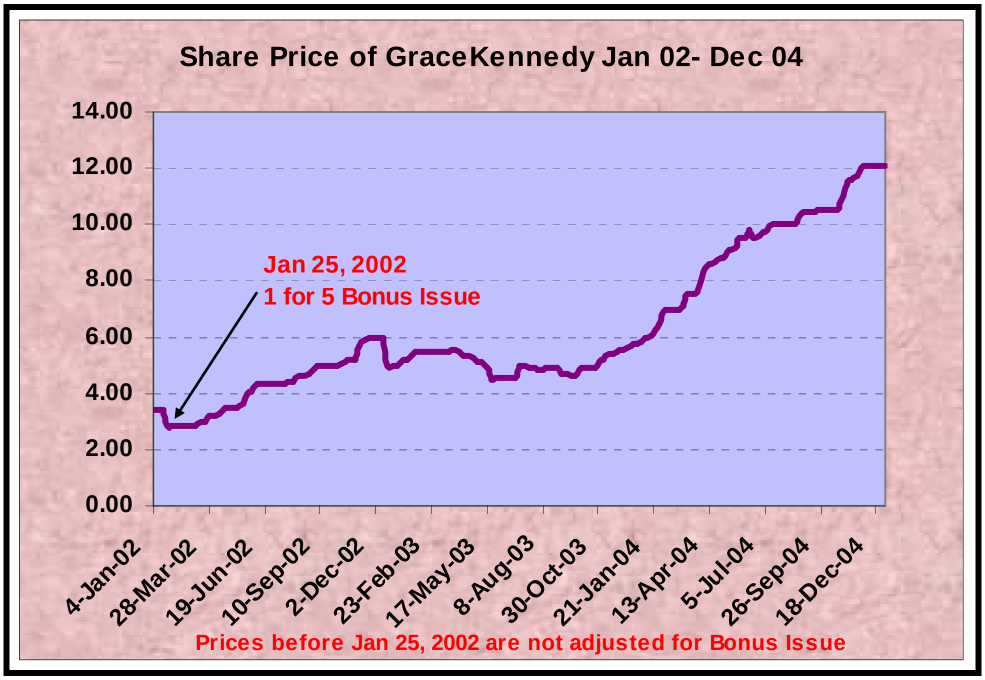
Graph 1 and **2** shows the share price movement for RBTT Financial Holdings Limited (RBTT) and GraceKennedy Ltd. (GK) following a stock split (1999) and bonus issue (2002), respectively. It shows clearly, that following a bonus issue or stock split the share price of the company tends to be on a bullish swing.

Graph 1



Graph 1 *shows a 2 for 1 stock split, thus the price on May 14, 1999 was adjusted downwards to account for the increase in the number of shares. It is very important to note that the fall in price does not mean a fall in value of RBTT or the share. As discussed earlier, the* ***total value*** *of RBTT shares in the shareholders portfolio is the same- before and after the split.*

Graph 2



***Graph 2** shows a 1 for 5 bonus issue, thus the price on January 25, 2002 was also adjusted downwards to account for the increase in the number of shares.*

While the market sentiment is bullish and the share price is usually on the upswing post bonus issue or stock split, this can be seen as somewhat misleading since there has been no real change in the value of the company. For example, if you divide a pie into smaller pieces it does not mean that the pie is larger or smaller or even that it tastes better. Thus, if you divide the value of a company over a larger number of shares, it does not mean that the value of the company has increased. Also, in reality, after bonus issue or stock split, the value of the stock is the same as it was pre issue or split, since the price is adjusted to reflect unchanged wealth. It is only perceived to be better simply because it is cheaper!

Suffice to say, while there are many similarities between a bonus issue and a stock split there are differences in accounting procedures, changes in par values and signals to the market. However, the end effect is usually the same- increased shares outstanding and thus improved liquidity; lower and more attractive share price leading to increased demand and a bullish market sentiment. Whether the effects on the share price movements are justified depends on if you believe in fundamental analysis or technical analysis!