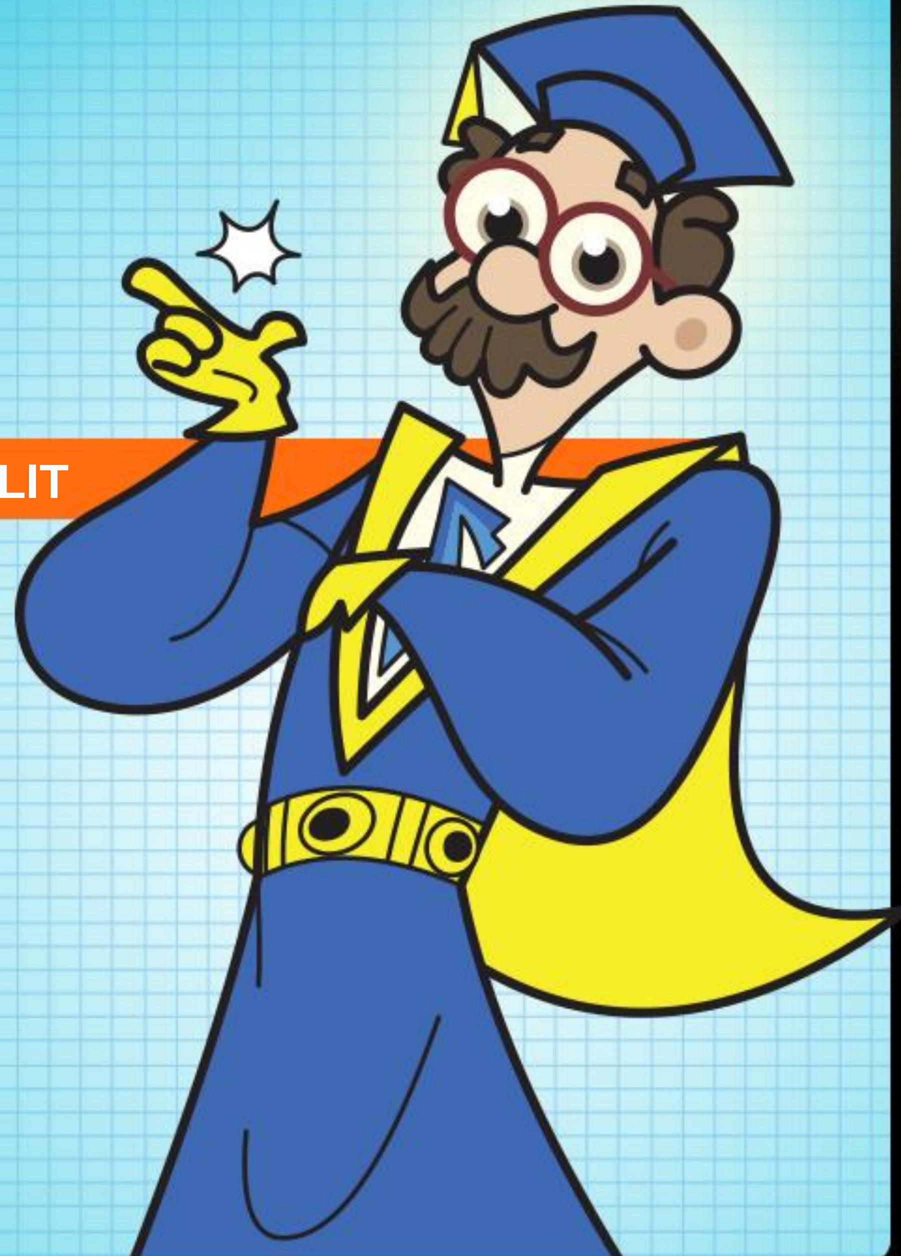
BONUS SHARES VS. STOCK SPLIT



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TATA MUTUAL FUND

Understanding

Bonus Shares vs. Stock Split

– By Prof. *Simply* Simple ™

BONUS SHARES VS. STOCK SPLIT

In both bonus shares and stock split the number of shares of a company increases.

But what are bonus shares and what are stock splits and more importantly what's the difference between them?

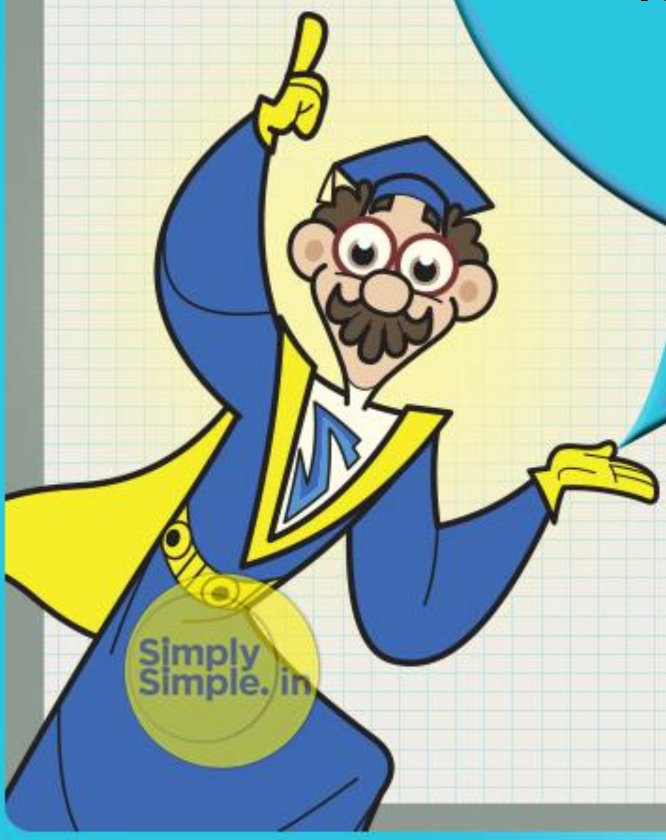
BONUS SHARES VS. STOCK SPLIT

When a company earns a profit, it either distributes part of its profits as dividends and keeps the other part as reserves for future investments.

Or sometimes it could keep the entire profit as reserves as well.

BONUS SHARES VS. STOCK SPLIT

Over the years, after the payout of dividend, it is possible that the reserve amount grows and becomes substantial.



BONUS SHARES VS. STOCK SPLIT

At this stage the company might want to capitalize on this reserve.

By this we mean that it will convert part of the reserves into shares.

This is called *expanding the authorized share capital.*

BONUS SHARES VS. STOCK SPLIT

Now how does the company do this?

Let’s say the company wants to capitalize Rs. 100,000 (Reserves)

At Rs. 10 per share this translates to 10,000 shares.

Let’s say there were a total of 10,000 shares in the market at this point in time.

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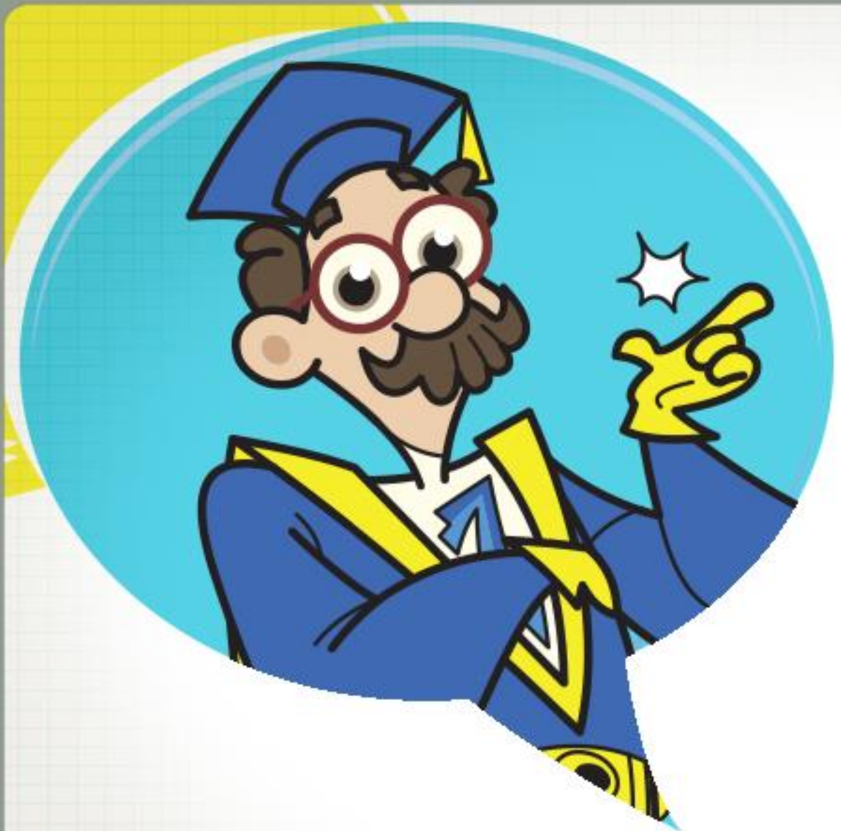
BONUS SHARES VS. STOCK SPLIT



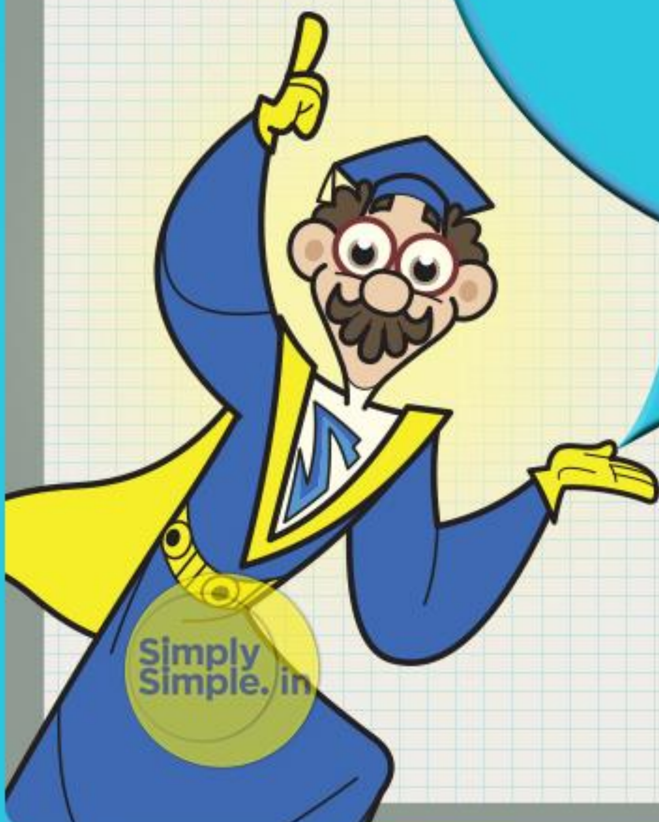
So there are 10,000 shares in the market & there are 10,000 shares created from reserves.

In other words for every share the company can provide one bonus share.

In this situation, we say that the company has declared a 1:1 bonus.

BONUS SHARES VS. STOCK SPLIT

Thus, after the bonus issue there would be 20,000 shares in the market.

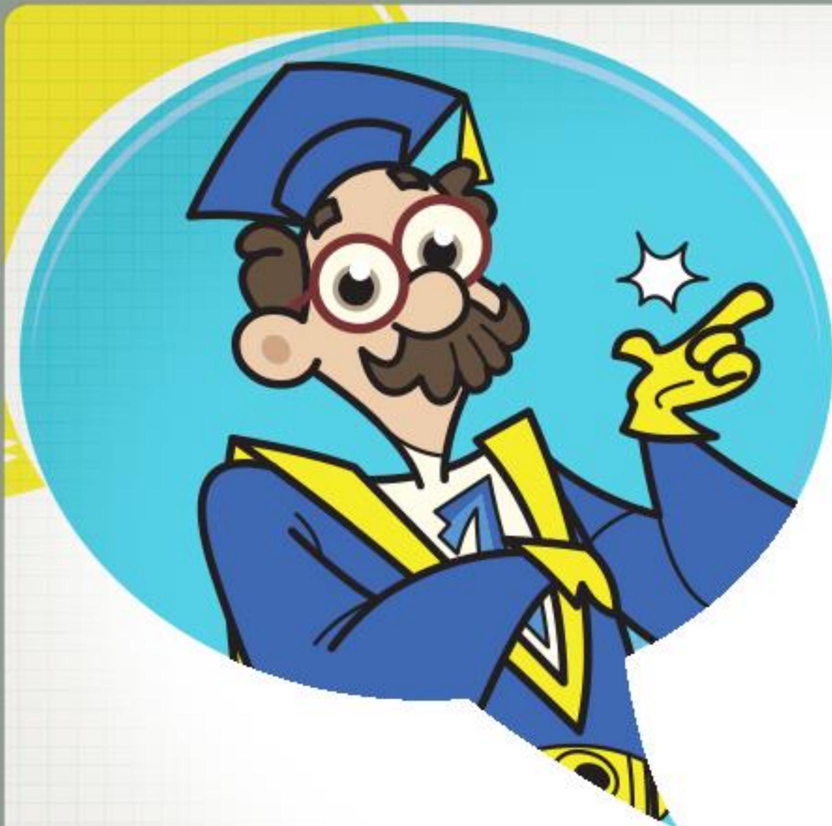


BONUS SHARES VS. STOCK SPLIT

At this point, it’s important to understand that the market value of the 20,000 shares would be the same as that of the erstwhile 10,000 shares.

Hence the value of a single share would fall proportionately.

BONUS SHARES VS. STOCK SPLIT



Thus if the market price of 10,000 shares was Rs 15 each, the market capitalization was Rs 150,000.

Now, after the bonus shares have been released the total number of shares goes up to 20,000 but market capitalization stays at Rs 150,000 and hence the price per share falls to Rs 7.5 (150,000/20,000).

BONUS SHARES VS. STOCK SPLIT

Remember market capitalization is a function of the profits of the company during a year. Therefore just by issuing shares the profits of the company made during the year does not get affected. Hence market capitalization does not change.

BONUS SHARES VS. STOCK SPLIT

So to sum up when shares are formed from the reserves and distributed to shareholders we say the company has issued bonus shares.

In the case of bonus shares, the market capitalization remains unchanged and price of the share in the market drops proportionately in keeping with the number of bonus shares issued.

BONUS SHARES VS. STOCK SPLIT

I hope you've understood bonus shares with this example.

Now let's see what's stock split…

BONUS SHARES VS. STOCK SPLIT

Over a period of time as companies grow and get more profitable their market prices too start rising.

For example let's say company's share value has risen to Rs 10,000 per share over a period of time.

BONUS SHARES VS. STOCK SPLIT

Many people would find it difficult to transact in such a stock because of its high price. For example an investor may have only Rs 5000 to invest. Such a person would not be able to buy this stock because its price is Rs 10,000 which is beyond his means.

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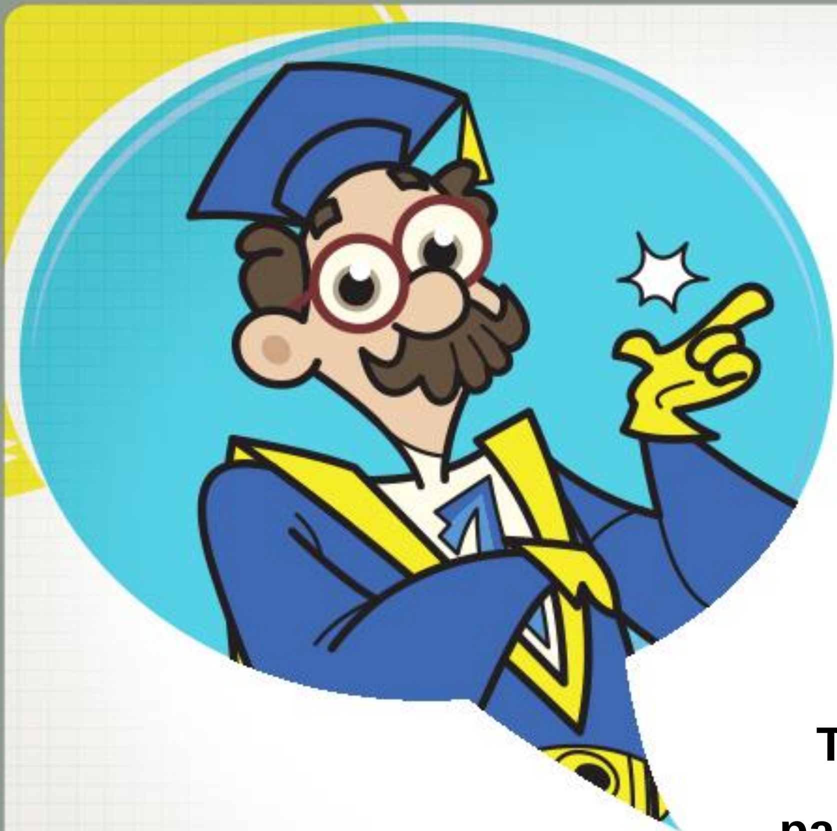
BONUS SHARES VS. STOCK SPLIT



Thus to help such investors to participate in stocks where prices have gone up, the companies goes for a stock split.

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BONUS SHARES VS. STOCK SPLIT

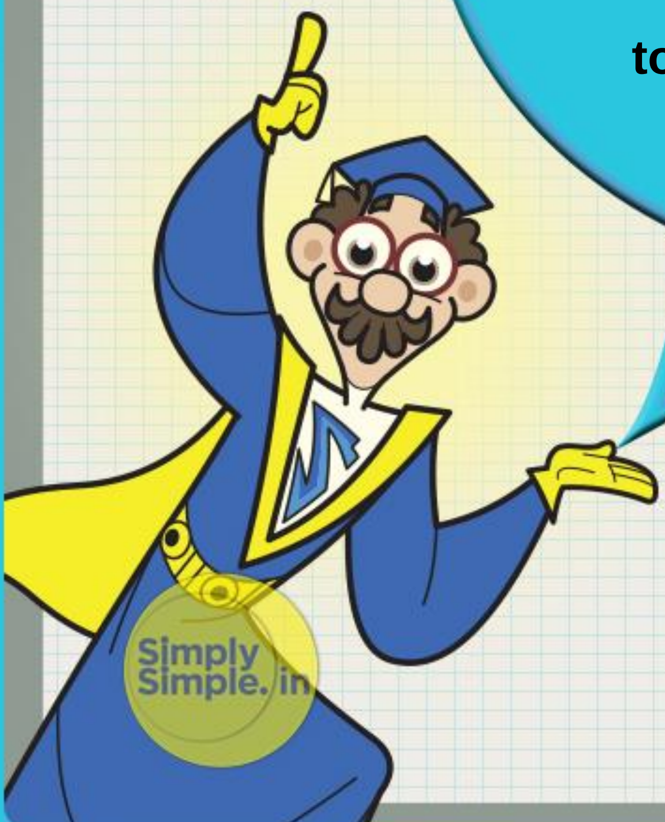
Essentially what it means is to split the stock into smaller units of less value such that its liquidity in the market increases and more investors can participate.

BONUS SHARES VS. STOCK SPLIT

So in our example, the Rs 10,000 stock could be split in 4 parts, each of Rs 2,500 in value.

So whosoever owns a stock of this company, will now have 4 stocks instead.

BONUS SHARES VS. STOCK SPLIT



So again Rs 10,000 x 1 stock =

Rs 2500 x 4 stocks

Just like in a bonus share here too the market capitalization does not increase.

BONUS SHARES VS. STOCK SPLIT

Thus in the case of bonus shares, we saw that the company created new shares out of the reserves of the company while in the case of stock split, the split was to reduce the market price of the stock to increase liquidity.

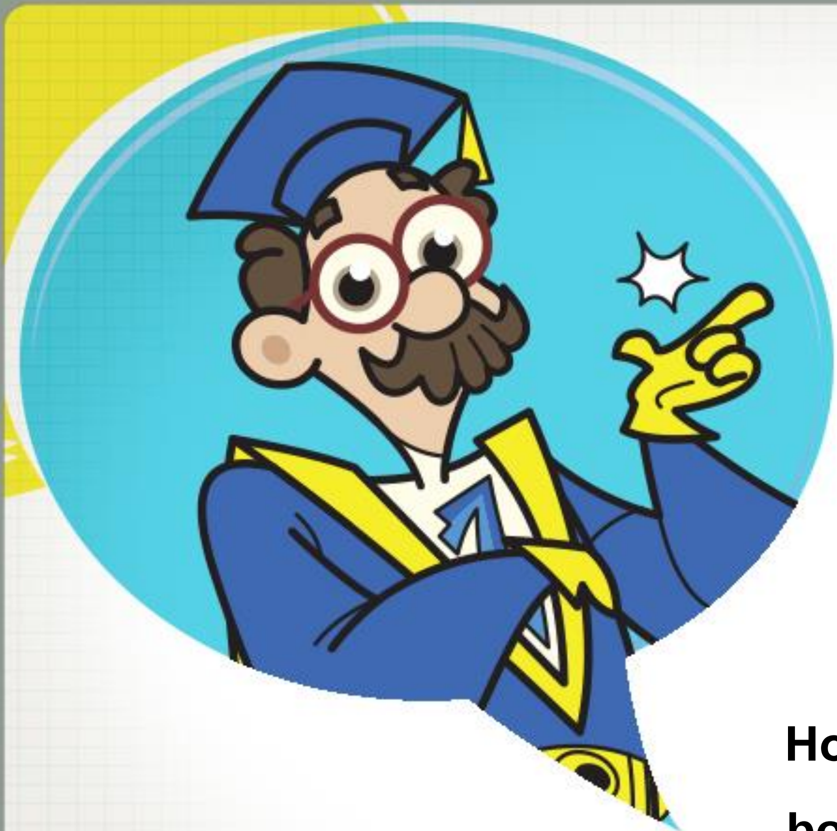
BONUS SHARES VS. STOCK SPLIT

In case of bonus shares, the market reacts positively because by issuing bonus shares the company indicates that it is expected to increase profitability in order to regain the market value of its share.

BONUS SHARES VS. STOCK SPLIT

In case of a stock split the market would react positively as the split was engineered due to high stock price (which also indicates that the stock is good). So in a sense the market takes notice and reacts positively.

BONUS SHARES VS. STOCK SPLIT



Hope you've now understood both bonus shares and stock splits and more importantly the difference between the two.

BONUS SHARES VS. STOCK SPLIT

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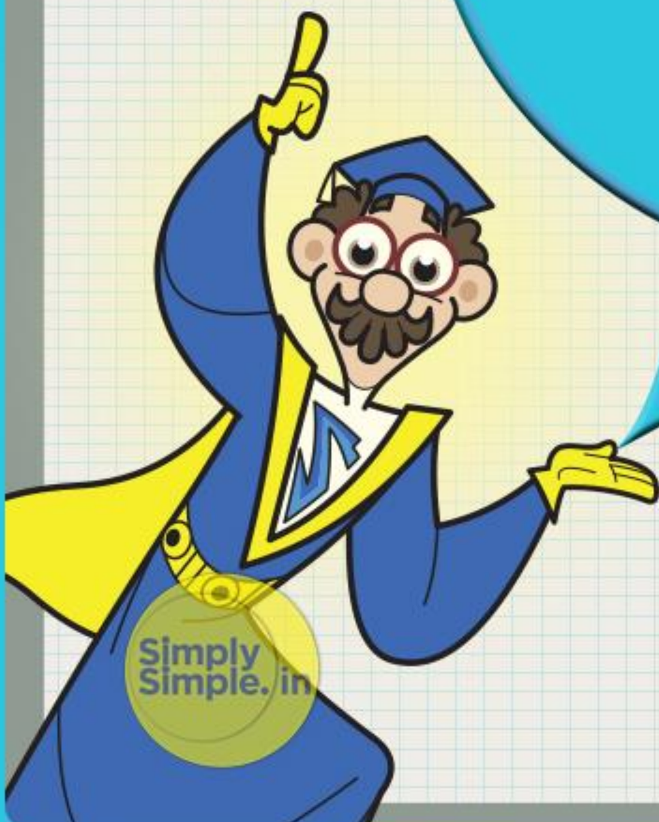
as it helps us improve our

product offering.



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