WHY ARE BONUS SHARES ISSUED?

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Why Are Bonus Shares Issued?

– By Prof. *Simply* Simple ™

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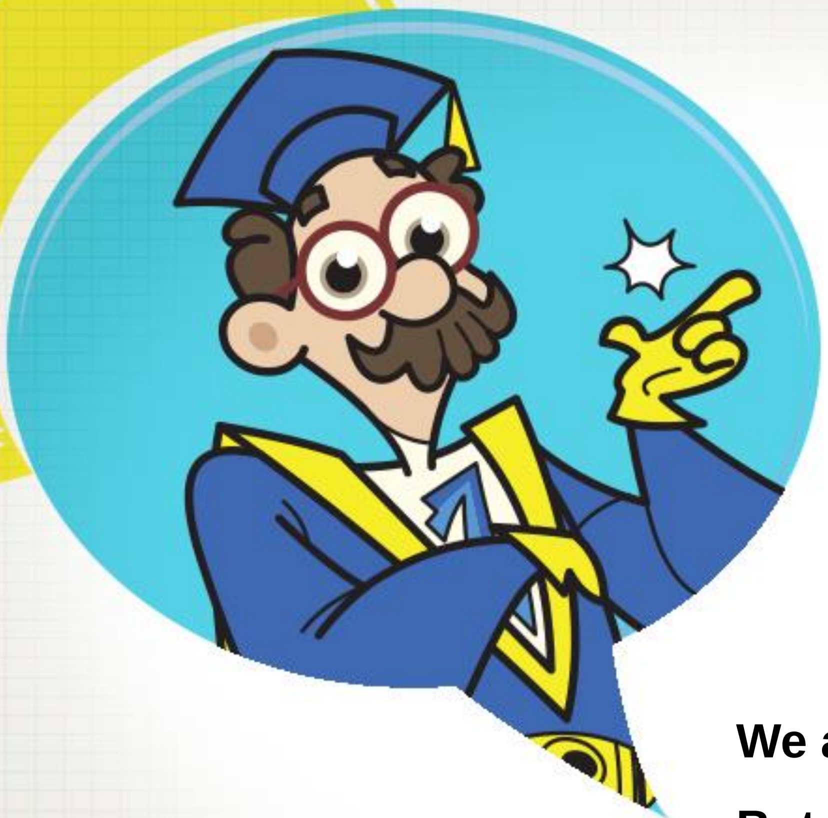

We all know that bonus shares exist.

But why are they issued in the first place?

Let me try & simplify this for you…

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WHY ARE BONUS SHARES ISSUED?

- Let's say a company makes Rs 1000 as profit
- Now suppose the company has 100 shares
- Then earning per share is profit/no. of shares

  = Rs. 1000/100 = Rs. 10

WHY ARE BONUS SHARES ISSUED?

Suppose there is a surge in the demand for company's product causing its profits to go up from Rs 1,000 to Rs 10,000!

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One should observe is that while the profit went up from Rs 1000 to Rs 10,000 the number of shares remains the same at 100.

Hence, by definition, earnings per share would be 100.

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Now, as we know that

Market Price = EPS x P/E

If we were to assume a P/E of 10,

the price per share

would become Rs 1000…

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At a price of Rs 1000, it would be very difficult to expect retail participation because any investor would need a minimum of Rs 1000 to purchase a single stock!

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But that's quite a large amount.

Say, an investor has only Rs 500 but wants to invest in this company.

What does he do??

Despite having the desire to buy the stock, he will not be able to participate for want of money.

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It, therefore, becomes essential for the company to increase the number of shares, so that the price per share is within the reach of retail participants.

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Let’s say the company declares a 1:4 bonus which essentially means that for every 1 share you get an additional 4 shares.

So, in effect, you get a total of 5 shares…

This would increase

the total number of

shares from 100 to 500!

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The earnings per share would

now become

EPS = Total Earnings/No. of Shares

(or) Rs (10,000/500 = Rs 20)

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And that would bring down the price per share from an unaffordable Rs 1000 to a more amenable Rs 200 (EPS x P/E = 20 x 10)

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So in other words 100 shares x 1000 = Rs 10,000 is reconfigured as 500 shares x 200 = Rs 10,000.

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This division of shares thus increases retail participation and hence liquidity to the stock, making it easily tradable as more buyers and sellers are able to participate because of a lower unit value per share.

And our friend is also in a better position & can buy at least two shares with his Rs 500 (2 x 200 = 400) & he will be left with Rs 100.

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WHY ARE BONUS SHARES ISSUED?

Thus we have seen how and why ‘Bonus Shares’ are issued in the stock market. Also we have understood that the overall capital remains the same even if bonus shares are declared.

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The only reason if at all for the stock price to go up would be because sentiments might turn positive by the news of bonus as it indicates that the company has earned good profit and hence could continue to do so and thereby attracting new investors and taking the price higher!

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I will be glad to receive your feedback on this lesson to understand if there any gaps.

Your feedback will help me improve my lessons going forward.

Also if you wish to demystify any other concepts, do write to me about them.

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Thinking of Investment

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