Stock Splits: Impact of New Regulations

The Securities and Exchange Board of India (Sebi)'s secondary market advisory committee has suggested that only companies whose average share price over the previous six months was above Rs. 500 could go for a stock split. Corporates feel that the Sebi Committee's proposal would hurt the interests of shareholders in a host of mid- and small-cap companies, whose shares suffer from low trading volumes. Only a small set of companies with a large market capitalization will be eligible to split their stocks as they alone would fulfill the minimum market price criterion being proposed. Is this law justified? Are the arguments of the companies valid? This debate aims at answering these questions.

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❑ Logic behind fixing the limit of Rs. 500.

D Thyagarajan: Stock splits were important in the era of physical shares, minimum lot and odd lots. Given the current era of demat, the stock split concept itself is not greatly relevant. Today, in a demat stock, one can buy and sell even one share. Since even one share can be bought and sold, even Rs. 500 actually looks low.

Further, after the introduction of futures and options, any trader who wants to take a position in a stock need not block the entire value of the stock. This makes the issue of stock split even more of a non-issue.

Sundar Sankaran: The logic can be that if a share quotes above Rs. 500, then it is a 'good enough' company to make it affordable through a stock split. I do not, however, agree with this stretched logic.

❑ Stock splits as a capital-restructuring device.

D Thyagarajan: Stock splits are not a great restructuring device. The only impact of it is in making the shares more affordable.

Sundar Sankaran: We need to recognize that price discovery mechanisms in stock markets are not that mature—even more so for mid-cap companies, which are the ones likely to be stuck in the below Rs. 500 *Laxman Rekha*. Companies should be able to take their capital structuring decisions independent of the share market. Why should this right of the company and its shareholders be subject to a qualifying test—in this case, share market price—which is influenced by market players who may not have a long-term interest in the company?

The views expressed by the participants are their own and do not necessarily reflect those of the organizations they represent.

Alpa Shah: I agree with the fact that the companies and the shareholders are in the best place to decide whether a stock split is beneficial for a company or not. Sebi is not prohibiting a company for going into stock split or any kind of capital restructuring. The stipulation of Rs. 500 made by Sebi is only to protect the interest of investors and avoid confusion in their minds.

❑ Do stock splits create the illusion of high dividends?

D Thyagarajan: No, they don't. The convention is to express dividends in % terms. The face value of a stock therefore makes no difference.

Sundar Sankaran: If investors suffer from illusions, then they need to be educated. Here we seem to be changing the reality instead of addressing the illusion! Let us be clear that investor protection can be regulated only upto a point. Beyond that, investors will have to learn to protect themselves. Over-regulation kills creativity and markets.

I think we should go by the regulatory principle that the investor should have access to all the information that would help her take an informed investment decision. Therefore, minimum disclosures need to be mandated. If an investor does not have the knowledge or maturity to understand the disclosures or their implications, then her investment should be routed through a mutual fund.

Alpa Shah: Stock splits create no kind of confusion or high dividend illusion in the mind of the investors.

❑ In bull run, why do stock splits lead to increased volumes and share prices?

D Thyagarajan: It is simply due to higher demand, as now a larger poql of investors can afford it.

Sundar Sankaran: One packet of milk of one litre is equivalent to two packets of half-litre each. After a bonus issue or stock split, the same earnings potential is distributed over a higher number of shares. So in theory, market capitalization should not change post-bonus or post stock split. But in practice, share prices tend to settle at a higher price. There are several reasons (a) Investors see the bonus issue as a mark of confidence of the company in its prospects. (b) The shares become affordable to investors who could not afford it earlier. (c) Investors do not realize the bonus impact; they look at the apparent share price and believe that the shares have become cheaper. (d) Investors feel that their downside risk has come down because they are buying at a lower price.

A stock split is nothing but a conversion of a high-priced stock to a low-priced stock

The illusory reasons need to be addressed through disclosures and education, as suggested earlier.

Alpa Shah: A stock split is nothing but a conversion of a high-priced stock to a low-priced stock. It is merely a book entry, whereby the face value of a share reduces and on the other hand, number of the shares increases, leaving the total share capital unchanged. Stock splits help to increase the liquidity and market capitalization of a stock. Companies that are fundamentally good and are priced higher, normally go in for a stock split. In a bull run, what actually happens is that the market confidence is on a high and there is good liquidity with the participants and all of them want to take advantage of the bull run. Hence, in case of a stock spilt of a company that is fundamentally good, everyone wants to buy and thus the demand increases, leading to an increase in price, which then stabilizes at a higher level.

❑ Do stock splits really benefit the retail investors?

D Thyagarajan: Increased institutional participation will have a favorable impact on the price and liquidity of the stock, which is good for retail investors.

Sundar Sankaran: Increase in liquidity can never be bad—it can only be good for investors—specifically retail investors, who lack the means to handle illiquidity of their holdings. Post-bonus when a share becomes affordable, the onus is on the investor to ensure that she is buying shares at a price that is reasonable in the context of the company's prospects.

Alpa Shah: It is ultimately the retail investors that are benefitted, as they will be able to now buy shares and take advantage of companies that are fundamentally good and priced low after the stock split. Institutional investors will not be affected by stock splits as they can invest in a high priced stock, as funds are not a major concern to them.

❑ How would the regulations relating to stock splits affect the companies?

D Thyagarajan: This kind of restriction is necessary. It will not affect companies in any major way.

Sundar Sankaran: I think this would mark a complete circle towards the days of the Controller of Capital Issues.

Alpa Shah: Restriction that the company will not be able to again go for a stock split or consolidation for the next three years from the date of the split, if implemented, will impact only those companies that have already gone for a split. However, we believe that the impact should be minimal.

Increased institutional participation will have a favorable impact on the price and liquidity of the stock

❑ Would the interest of shareholders in a host of mid-cap and small-cap companies be hurt by the Sebi Committee's proposal?

D Thyagarajan: As I said earlier, I do not think that Rs. 500 is low. Besides, trading volumes are driven by other fundamental factors. Only if those factors are strong, the face value of the share will impact the trading volumes, that too only to a small extent.

Sundar Sankaran: Yes. We will end up preventing the mid-cap companies from reaching out to a larger audience. The resulting impact on liquidity would be harmful for the same investors that the proposed measure seeks to protect.

At a price-earnings ratio of 20 times, the earnings per share needs to be Rs. 25 for the market price to touch Rs. 500. A zero-debt company which issues shares at Rs. 10, that earns a compounded post-tax return of 15% p.a., can make its first bonus issue in Year 22—provided it does not distribute a dividend during the previous 21 years! However, by Year 5 it would have the reserves to declare a 1:1 bonus issue while retaining its post-bonus book value above par. When it does declare a bonus in Year 22, it would have the reserves to issue 20 bonus shares for every share issued.

Alpa Shah: No doubt that it will hurt the interest of the shareholders of small and mid-cap companies whose share prices are quoted below Rs. 500 and suffer from low trading volumes. However, the restriction is in the interest of all the investors as stock split is done not to increase the trading volume of shares but to make the shares available to all kinds of investors.♦