Is a share split an important factor for investors?

In my article published two weeks' ago, I mentioned that at a recent AGM, a representative of a number of shareholders asked a company to consider a share split since he argued that this will help a company's share price to continue rising.

In my opinion, this was a rather irresponsible recommendation which could send the wrong signal to retail investors and as such, I promised to write about share splits in one of my upcoming columns.

Today's article therefore deals with the concept of a share split, the real rationale for adopting such a corporate action as well as the more important factors that should be taken into consideration by retail investors before contemplating an investment.

Let me start off by explaining a share split.

When a company performs a share split, the nominal value of each share decreases and consequently the number of shares in issue rises. However, the total monetary value of the issued share capital remains unchanged and as such, this corporate action does not entail any dilution for shareholders. This means that the percentage stake held by each shareholder remains the same after a share split. Since the number of shares in issue changes as a result of the decrease in the nominal value, the price in the market is adjusted accordingly to reflect the increased number of shares in circulation. As an example, if a company performs a 2-for-1 share split, the nominal value drops by half, the number of shares doubles and as a result, the share price should theoretically also decline by half.

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Since the number of shares in issue rises, the financial metrics used to calculate some key investor ratios also change accordingly. On the other hand, the commonly used financial indicators remain unchanged. As such, while the book value per share, the earnings per share and the dividend per share naturally all change as a result of the higher number of shares in issue, the financial indicators such as the price to book value multiple, the price to earnings multiple and the dividend yield remain unchanged if the share price correctly adjusts by the same percentage as the increase in the number of shares. In other words, in such a situation, the company's valuation remains the same after a share split.

Some investors may be confused at the rationale for performing share splits.

The primary reason for such a corporate action is to increase the liquidity in an equity. If there are more shares in circulation at a lower price, the shares generally become much more liquid which is an advantage for the market at large. One of the main objectives of listing a company on a stock exchange is to have a liquid market enabling a relatively quick entry point for new investors and a speedy exit route for shareholders.

Psychologically, a share split is looked at more favourably by retail investors since they usually perceive a high absolute share price as too 'expensive'. Since some investors may feel uncomfortable buying shares priced at a high absolute figure, a share split reduces the share price down to a more 'acceptable' level for such investors.

However, retail investors should look at the various financial metrics and other ratios to gauge whether a share price is 'expensive' or 'cheap'. But more on this topic later on.

Across the local stockmarket, the first share splits took place in 1994 and these became more frequent over the last 11 years. While the ones conducted by HSBC Bank Malta plc, Lombard Bank Malta plc and Mapfre Middlesea plc (previously Middlesea Insurance plc) in 2005 and 2006 were aimed at achieving the objectives described above, that is of enhancing the liquidity aspect following the increase in the absolute price of their shares at the time, the few share splits conducted between 2008 and 2013 served a dual purpose.

Apart from achieving a lower absolute figure in the share price to enhance liquidity, the share splits conducted post-2008 also served to adjust the nominal value of a company's shares following the adoption of the euro in January 2008. In essence, all shares previously denominated in Malta Lira had extended to beyond two decimal places after 'euroisation'. By virtue of the recapitalization of reserves, the nominal value of a number of equities increased again to two decimal places and concurrently with this, companies also conducted a share split.

Notably, there are three companies that have not yet carried out a corporate action to amend their nominal value as a result of the adoption of the euro more than eight years ago. These are GO plc (nominal value of €0.582343), GlobalCapital plc (nominal value of €0.291172) and Loqus Holdings plc (nominal value of €0.232937).

The more recent share splits were conducted by Medserv plc in (December 2013), RS2 Software plc in (June 2015) and Grand Harbour Marina plc (July 2015).

A few weeks ago, RS2 announced that it will be carrying out another share split in the coming weeks. The proposed 5:3 share split will result in the nominal value decreasing from €0.10 per share to €0.06 per share as the number of shares in issue will increase from just under 95 million shares (including the latest 1 for 18 bonus share issue) to over 158 million shares. As such, the share price should adjust to around €2.088 assuming the price retains the current level of €3.48 at the time of the corporate action.

Although shares normally tend to undershoot at times of weak investor sentiment and overshoot when bullish sentiment prevails, share prices generally converge towards their fundamental value over the medium to long-term. As such, while share splits, bonus issues and similar corporate actions may initially lead to a 'feel good factor' among some investors, this should not automatically translate into an increased tendency to acquire these shares. Retail investors need to ignore the over-riding sentiment across the market and instead be guided by the fundamental value of a company and changes in business developments, profitability as well as future business strategy. In other words, retail investors need to understand the key indicators and metrics that portray whether an equity is cheap or expensive irrespective of the absolute price of an equity.

When looking at the recent share splits, it is worth noting that although the share prices of Medserv plc and RS2 Software plc moved higher following their respective share splits, the upward movement was more a reflection of the higher profitability as well as expectations of further improvements going forward. On the other hand, the share price of Grand Harbour Marina plc initially moved higher after the split, but this trend was short-lived as the Company's profitability only increased marginally due to the continued lack of super-yacht berth sales.

By way of example, a potential investor looking at RS2 should be indifferent whether to invest at the current share price of €3.48 or acquire shares at an adjusted price of €2.088 in the weeks ahead. The factors to consider (as opposed to the share price in isolation) are the current valuation compared to the profitability of the company and more importantly, the potential of increasing profitability as a result of its business strategy. Hence, the recent announcement of the engagement of two new clients for its managed services business (namely a payment service provider in Germany and one of the largest acquirers in Europe) and its resultant benefits on profits, should be more important factors to consider.

The value investing approach is the most successful long-term strategy for equity investors. This is another topic which should be of interest to many Maltese investors and should never be overlooked before contemplating any equity investment.