

Are your bonus shares adding value to your investments?

Have you attended an AGM of a company where investors are demanding bonus shares from the management of the company? It is a very common phenomenon: novice investors demand bonus shares from company management, as they believe that more bonus shares would increase the value of their investment. On the contrary, bonus shares usually do not add value, unless the company issuing the bonus shares increases the dividend payout per share. To understand this concept, let us first understand what are bonus shares?



Bonus shares are free shares given to the existing shareholders of a company without any extra cost. Bonus shares are issued in a particular ratio (eg 1:1, 1:2 etc). This means that the company will issue one bonus share for every one share held by the existing shareholders and

one bonus share for every two shares held by the existing shareholders, respectively.

A question that arises in one's mind is this: whether a higher number of bonus shares increases the value of one's existing investment? Let us understand this with the help of an example.

Let's say that the stock price of XYZ company is trading at Rs100 and the company announces bonus in the ratio of 1:1. Due to bonus shares, the number of outstanding shares goes up. So, if the outstanding shares prior to the bonus issue were 10 lakh, then post the bonus issue, that number would rise to 20 lakh shares. Simultaneously, the price of the stock will fall to Rs50. So, if a shareholder was holding 10 shares at Rs100 before the bonus issue (value Rs1,000). Post the bonus issue, this value will remain Rs1,000 (20 shares x Rs50). Therefore, there is no addition to the value of investment due to the issue of bonus shares.

Why does the stock price fall when bonus shares are issued?

The reserve of the company contracts and the share capital expands post a bonus issue. The absolute book value of the company remains the same, but due to the increase in the number of outstanding shares, the book value per share falls. Similarly, the earnings per share of the company decreases and in order to maintain the valuation, the stock price is adjusted on a proportionate basis (1:1, 1:2 etc).

Why does a company issue bonus shares?

A company issues bonus shares to increase liquidity of the stock and increase participation of investors. Secondly, the stock price drops to a reasonable range post a bonus issue, which makes it affordable for investors to purchase more shares. Thirdly, if the company decides to increase the dividend payout per share, then it would add value to the investment.

If you like to understand more about the basics of stock investing, then register for one of our free “Power Money Workshops” and join our investing education program “Stock Investor” to polish your investing skills.