BARRON'S

Split Decision

Reverse splits may be a sign of desperation -- say, when they're put in place as a stock tumbles toward Penny Lane. Extra diligence is in order.

By Eric Uhlfelder
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On May 9, Citigroup reverse-split its stock 1-for-10, instantly transforming the value of each of its shares from $4.52 to $45.20, without increasing each shareholder's equity. Based on Friday's mid-day price of $27.54, the stock has slid by nearly 40% since then.

Does that mean that the decision by Citi (ticker: C), aimed at boosting its real value in the stock market, won't ultimately pay off? Not necessarily. But it also doesn't mean that it will. In fact, research on the impact of reverse splits reveals a decidedly mixed picture.

Birinyi Associates, the Westport, Conn., market-analysis and investment firm, looked at the restorative powers of such actions on companies in the Standard & Poor's 500. (Citi is a component of the index.) Birinyi's equity-market analyst Kevin Pleines says nine of the 12 S&P stocks that executed reverse splits from 2000 to 2010 saw their share prices end higher a year following the split, with an average increase of 75%. "And because splits most frequently happen during market bottoms," Pleines observes, "longer-term post-split returns often look good."

BUT PLENTY OF UNIVERSITY STUDIES suggest that, unless a company makes significant operational improvements, doing a reverse split is simply putting lipstick on a pig.

Since Citigroup split its shares 1-for-10 last spring, the stock has moved sharply lower. Andrew Harrer/Bloomberg News

For example, April Klein of the Stern School of Business at NYU, along with Seoyoung Kim and James Rosenthal, both of Emory University's Goizueta School of Business, tracked more than 1,600 reverse splits done from 1962 through 2001. They found that, after the first year, the split shares underperformed comparable unsplit stocks by 15.6%, on average. After two years, the cumulative underperformance was 36%; after three, 54%. And stocks that were reverse-split after they had slipped below $5 (as Citi's had) were likely to underperform twice as badly as those split above $5.

Reverse splits often are implemented out of desperation. The Birinyi list includes former tech darling JDS Uniphase (JDSU), which reverse-split after suffering a string of losses in the 2000-2002 tech crash, and insurance giant American International Group (AIG), which went bankrupt in the fall of 2008. But shares can be reverse-split for benign reasons. Tyco International (TYC), Motorola Solutions (MSI) and Time

Warner (TWX) did reverse splits as they broke up their companies, wanting to spin off pieces at reasonable prices.

The Bottom Line

Buying reverse-split shares is a form of distressed investing, requiring the same high level of due diligence that any other deep-value play does.

Though Citi had already weathered the financial crisis by the time it took action, CEO Vikram Pandit explained the reverse split as part of a strategy of returning capital to shareholders. Some critics groused that the bank was trying to accomplish a share-price turnaround through a cosmetic fix that would boost investor interest -- some institutions and individuals won't buy stocks selling below $5.

THE MATTER IS FAR FROM ACADEMIC. The roster of U.S.-listed companies that have done reverse splits over the years includes such well-known names as Nortel Networks (NRTLQ), Ericsson (Eric), Priceline.com (PCLN), Royal Bank of Scotland (RBS.U.K.) and E*Trade Financial (ETFC).

Terrence Martell and Gwendolyn Webb, of Baruch College in New York, studied 1,668 reverse splits done from 1972 to 2003. Many were of penny stocks seeking to stay above the $1 threshold needed to avoid delisting by Nasdaq. But without recapitalization, new management and a new business plan, Martell and Webb found, many were wasting their time. Martell argues that some firms might be better off delisting and trading over-the-counter until they divine their way back to health. "Sort of like being sent to the minors when your swing is off," as he sees it.

Preston Athey, who runs T. Rowe Price's Small Cap Value Fund, is more sanguine: "Past a certain threshold, some decent stocks can get caught in a momentum trap that can make them appear worse off than they may actually be, especially [in] a broad market selloff. Pushing the price back above that threshold can help staunch the bleeding." But, he agrees, to reverse a stock's fortunes, a reverse split must be accompanied by fundamental corporate change.

Some Work, Some Don't

Here are some notable companies that have reverse-split their shares. Although the list is made up of mid- and large-cap names, most companies that do reverse splits are struggling small-caps

Company/Ticker	**Split Ratio**	**Date**	**Change in Price***			**Chng Since Split***	
			3-Month	**6-Month**	**1-Year**	**Stock**	**S&P 500**
AIG/AIG	1-for-20	7/1/09	150.11%	74.23%	87.39%	61.83%	29.18%
Citigroup /C	1-for-10	5/9/11	-24.28	N/A	N/A	-32.20	-11.40
Corrections Corp /CXW	1-for-10	5/18/01	60.25	91.87	95.88	633.68	-7.68
Ericsson /ERIC	1-for-10	10/23/02	32.60	13.79	163.64	238.87	33.10
infoSpace /INSP	1-for-10	9/13/02	125.28	100.89	341.69	458.68	34.05
JDS Uniphase /JDSU	1-for-8	10/17/06	-1.93	-6.75	-5.48	-28.25	-12.56
Nortel Networks/ NRTLQ	1-for-10	12/1/06	39.15	23.03	-20.38	-99.77	-14.60
Unisys /UIS	1-for-10	10/26/09	22.97	42.33	-10.71	-31.73	11.79

*Through Aug. 16 *Source: Birinyi Associates*