Meltdown 101: 'Reverse split' reflects GM woes

By Dave Carpenter (excerpt)
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…Reverse stock splits are uncommon for large companies. GM's planned 1-for-100 reverse stock split — under which it proposes to give shareholders one share of new stock for every 100 shares they own — is even rarer…

Here are some questions and answers about reverse splits and GM's situation.

Q: What is a reverse stock split?

A: It's a largely cosmetic procedure that reduces the number of shares outstanding while increasing each share's price proportionally. The maneuver doesn't affect the company's overall market value. Think of a 1-for-100 reverse split as the equivalent of getting a hundred-dollar bill back for 100 $1 bills.

Q: Why would a company do this?

A: Usually a company does it to raise the price of its outstanding shares because it thinks the price is too low to attract investors. Hedge funds and other institutional buyers generally avoid buying stocks priced at or around $1 a share. At $1.66, down 93 percent from a year ago, GM is getting dangerously close to penny-stock territory.

A 1-for-100 reverse split at the current price would peg each GM share at $166 — more than 75 percent higher than the stock's all-time high of $93.63 in April 2000. On the surface, at least, that might lure more buyers.

Of course, that $166 figure assumes that GM shares would maintain their current value, which is not at all expected. Part of the point of the reverse split is to compensate for a dramatic drop in share value that will almost certainly happen if a restructuring deal with Washington goes through.

Q: Why is GM proposing to do this now?

A: It's designed to boost its stock prospects as part of the restructuring deal, in which the government would assume at least half of its debt in exchange for company shares. The better the stock fares, the better for both GM and the government.

"Typically we see a reverse stock split so the company doesn't fall out of the window where certain institutional funds can't buy it due to price limitations," said CEO David Kudla of Mainstay Capital Management in Grand Blanc, Mich., which advises GM employees and retirees on their investment portfolios. "But what's more at work here is just positioning itself ... to make this restructuring deal."