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ACCA F9

Financial Management (FM)

财务管理

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Part E：Business Finance——Equity Finance

1. Introduction of Equity Finance
2. Right Issues
3. Dividend Policy

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Introduction to Equity Finance

Equity finance is raised through the sale of ordinary shares to investors via a new issue or a rights issue.

Ordinary shares are issued to the owners of a company.

Rights of ordinary shares:

(a) Attend company general meetings.

(b) Vote on important company matters.

(c) Receive dividend.

(d) Receive the annual report and accounts.

(e) Receive a share of any assets remaining after liquidation.

(f) Participate in any new issue of shares, unless they agree to waive this right.

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Advantages and disadvantages of stock market listing

Advantages

- Wider pool of finance
- Easier to seek growth by acquisition
- Original owners selling holding to obtain funds for other projects
- Original owners realizing holding
- Enhance public image
- Improved marketability of shares

Disadvantages

- There will be significantly greater public regulation, accountability and scrutiny
- A wider circle of investors with more exacting requirements will hold shares.
- There will be additional costs involved in making share issues, including brokerage commissions and underwriting fees

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Introduction to Equity Finance

Methods of obtaining a listing:

- Initial public offering (IPO)

  An initial public offer (IPO) is an invitation to apply for shares in a company based on information contained in a prospectus.

- Placing

  A placing is an arrangement that the sponsoring investment bank arranges for most of the issue to be bought by a small number of investors, usually the institutional investors.

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Costs of share issues on the stock market

- Underwriting costs
- Stock market listing fee (the initial charge) for the new securities
- Fees of the issuing house (investment bank), solicitors, auditors and public relations consultant
- Charges for printing and distributing the prospectus: (the prospectus is the document in which the company offers its shares for sale)
- Advertising in national newspapers

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Right Issue

A rights issue provides a way of raising new share capital by means of an offer to existing shareholders, inviting them to subscribe cash for new shares in proportion to their existing holdings

advantages of a rights issue：

(a) Rights issues are cheaper than IPOs to the general public.

(b) Rights issues are more beneficial to existing shareholders than issues to the general public.

(c) Relative voting rights are unaffected if shareholders all take up their rights.

(d) The finance raised may be used to reduce gearing in book value terms by increasing share capital and/or to pay off long-term debt which will reduce gearing in market value terms.

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Right Issue

A question could ask for discussion on the effect of a rights issue,

as well as calculations, such as the effect on EPS

Example:

Seagull can achieve a profit after tax of 20% on the capital employed. At present its capital structure is as follows.

200,000 ordinary shares of $1 each	200,000
Retained earnings	100,000
Total	300,000

The directors propose to raise an additional $126,000 from a rights issue. The current market price is $1.80.

Requir:

(a) Calculate the number of shares that must be issued if the rights price is: $1.60; $1.50; $1.40; $1.20.

(b) Calculate the dilution in earnings per share in each case.

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Right Issue

Solution

The earnings at present are 20% of $300,000 = $60,000. This gives earnings per share of 30c. The earnings after the rights issue will be 20% of $426,000 = $85,200.

Rights price	*No of new share ($126,000 ÷ rights price)*	*EPS ($85,200 ÷ total no of shares)*	*Dilution*
$		Cents	Cents
1.60	78,750	30.6	+ 0.6
1.50	84,000	30.0	–
1.40	90,000	29.4	– 0.6
1.20	105,000	27.9	– 2.1

Note that at a high rights price the earnings per share are increased, not diluted. The breakeven point (zero dilution) occurs when the rights price is equal to the capital employed per share: $300,000/ 200,000=$1.50.

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Right Issue

the theoretical ex rights price:

The shares are therefore described as being ‘cum rights’ and are traded cum rights. On the first day of dealings in the newly issued shares, the rights no longer exist and the old shares are now 'ex rights‘

The value of rights is the theoretical gain a shareholder would make by exercising his rights

Stock split & scrip issue
Stock split: creating cheaper shares with greater marketability and liquidity
Scrip issue: occurs when a company issues new shares to existing shareholders in proportion to their existing holdings at no charge.

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Dividend Policy

The dividend policy of a business affects the total shareholder return and therefore shareholder wealth.

Shareholders normally have the power to vote to reduce the size of the dividend at the Annual General Meeting, but not the power to increase the dividend.

Dividends are always a signal to investors.

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Dividend Policy

Theories of dividend policy:

1) Residual theory

A 'residual' theory of dividend policy can be summarized as follows:

- If a company can identify projects with positive NPVs, it should invest in them.
- Only when these investment opportunities are exhausted should dividends be paid.

2) Traditional view

The 'traditional' view of dividend policy, implicit in our earlier discussion, is to focus on the effects of dividends and dividend expectations on share price.

3) Irrelevancy theory

Modigliani and Miller (MM) proposed that in a perfect capital market, shareholders are indifferent between dividends and capital gains, and the value of a company is determined solely by the 'earning power' of its assets and investments

Advantages of scrip dividends

(a) They can preserve a company's cash position if a substantial number of shareholders take up the share option.

(b) Investors may be able to obtain tax advantages if dividends are in the form of shares.

(b) Investors looking to expand their holding can do so without incurring the transaction costs of buying more shares.

(d) A small scrip dividend issue will not dilute the share price significantly.

(e) A share issue will decrease the company's gearing, and may therefore enhance its borrowing capacity.

Disadvantages of scrip dividends

(a) Assuming that dividend per share is maintained or increased, the total cash paid as a dividend will increase.

(b) Scrip dividends may be seen as a negative signal by the market

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Dividend Policy

Share repurchase: purchase by a company of its own shares can take place for various reasons and must be in accordance with any requirements of legislation.

For a smaller company with few shareholders, the reason for buying back the company's own shares may be that there is no immediate willing purchaser at a time when a shareholder wishes to sell shares.

For a public company, share repurchase could provide a way of withdrawing from the share market and 'going private'.

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Example

A scrip dividend is:

A A dividend paid at a fixed percentage rate on the nominal value of the shares

B A dividend paid at a fixed percentage rate on the market value of the shares on the date that the dividend is declared

C A dividend payment that takes the form of new shares instead of cash

D A cash dividend that is not fixed but is decided upon by the directors and approved by the shareholders

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Benefits of a share repurchase scheme

(a) Finding a use for surplus cash, which may be a 'dead asset'.

(b) Increase in earnings per share through a reduction in the number of shares in issue.

(b) Increase in gearing.

(c) Readjustment of the company's equity base to more appropriate levels, for a company whose business is in decline.

(d) Possibly preventing a takeover or enabling a quoted company to withdraw from the stock market.

Drawbacks of a share repurchase scheme

(a) It can be hard to arrive at a price that will be fair both to the vendors and to any shareholders who are not selling shares to the company.

(b) A repurchase of shares could be seen as an admission that the company cannot make better use of the funds than the shareholders.

(c) Some shareholders may suffer from being taxed on a capital gain following the purchase of their shares rather than receiving dividend income.

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