BUSINESS FINANCE - EQUITY

"*Raising Capital*"

THEME OF THE TOPIC

All the companies, at varying times, obtain capital (finance). To do so, a firm must either borrow the money (Debt Finance), sell a portion of the firm (Equity Finance), or both. How company raises finance depends on size of the company and its growth prospects. For the depth of this topic we can say that a company can arrange its Long Term Source of Finance by following ways:

- **EQUITY FINANCE**
- **DEBT FINANCE**
- **VENTURE CAPITAL**

DYNAMICS OF EQUITY FINANCE

1.INTERNAL SOURCE OF FINANCE

Internal sources of finance Include ***retained earnings*** and ***increasing working capital management efficiency.***

Retained earnings

Retained earnings is surplus cash that has not been needed for operating costs, interest payments, tax liabilities, asset replacement or cash dividends. For many businesses, the cash needed to finance investments will be available because the earnings the business has made have been retained within the business rather than paid out as dividends.

Retained earnings belong to shareholders and are classed as equity financing.

"It is important not to confuse retained earnings with the accounting term 'retained profit' from the income statement and balance sheet. 'Retained profit' in the accounting statements is not necessarily cash and does not represent funds that can be invested, It is the cash generated from retention of earnings which can be used for financing purposes".

A company may have substantial retained profits in its balance sheet but no cash in the bank and will not therefore be able to finance investment from retained earnings.

Advantages of using retentions

1. Retentions are a flexible source of finance: companies are not tied to specific amounts or specific repayment patterns.
2. Using retentions does not involve a change in the pattern of shareholdings and no dilution of control.
3. Retained earnings have no issue costs.

Disadvantages of using retentions

1. Shareholders may be sensitive to the loss of dividends that will result from retention for re-investment, rather than paying dividends.
2. Not so much a disadvantage as a misconception, that retaining profits is a cost-free method of obtaining funds.
3. There is an opportunity cost in that if dividends were paid, the cash received could be invested by shareholders to earn a return.

Increasing working capital management efficiency

It is important not to forget that an internal source of finance is the savings that can be generated from more efficient management of trade receivables, inventory, cash and trade payables. Efficient working capital management can reduce bank overdraft and interest charges as well as increasing cash reserves.

2.EXTERNAL SOURCE OF FINANCE

(A) SHARES SUBSCRIBE (LIST) IN STOCK EXCANGE

A company can obtain a listing on the stock market by following methods:

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

2. **Offer for sale by tender**
   Investors are able to bid for shares and the shares are issued only to those investors who have bid at the striking price or above.

3. **Placing**
   Shares are placed with / sold to institutional investors, keeping the cost of the issue to a minimum.

   A listed or quoted company is better able to raise equity finance.

Advantages of a stock market listing:

- Access to wider pool of finance
- Easier to seek growth to acquisition
- Enhanced public image
- Improved marketability of shares

Disadvantages of stock market listing:

- 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.

<u>(B) RIGHT ISSUE</u>

A rights issue is the right of existing shareholders to subscribe to new share issues in proportion to their existing holdings. This is to protect the ownership rights of each investor.

<u>Advantages:</u>

1. Low cost
2. Protect ownership rights
3. Rarely fail.
4. Consumes less time

<u>Deciding the issue price for a rights issue</u>

The offer price in a rights issue will be <u>*lower than the current market price*</u> of existing shares. The size of the discount will vary, and will be larger for difficult issues. The offer price must however be <u>*at or above the nominal value*</u> of the shares, so as not to contravene company law.

A company making a rights issue must set a price which is <u>*low enough to secure the acceptance of shareholders,*</u> who are being asked to provide extra funds, <u>*but not too low, so as to avoid excessive dilution*</u> of the earnings per share.

A question could ask for discussion on effect of a rights issue, as well as calculations, eg of the effect on EPS.

Example: Rights issue (1)

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
	300,000

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

Required

(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.

<u>The market price of shares after a rights issue: Theoretical Ex-Rights Price TERP</u>

When a **<u>rights issue is announced,</u>** all existing shareholders have the right to subscribe for new shares, and so there are rights attached to the existing shares. The shares are therefore described as being ‘cum rights’ (with rights attached) 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’ (without rights attached).

<u>After the announcement of a rights issue,</u> share prices normally fall. The extent and duration of the fall may depend on the number of shareholders and the size of their holdings. This temporary fall is due to uncertainty in the market about the consequences of the issue, with respect to future profits, earnings and dividends.

<u>After the issue has actually been made,</u> the market price per share will normally fall, because there are more shares in issue and the new shares were issued at a discount price.

In theory, the new market price will be the consequence of an adjustment to allow for the discount price of the new issue, and a **<u>theoretical ex rights price</u>** can be calculated.

Example: Rights issue (2)
Fundraiser has 1,000,000 ordinary shares of $1 in issue, which have a market price on 1 September of $2.10 per share. The company decides to make a rights issue, and offers its shareholders the right to subscribe for one new share at $1.50 each for every four shares already held, After the announcement of the issue, the share price fell to 1 .95, but by the time just prior to the issue being made, it had recovered to $2 per share. This market value just before the issue is known as the cum rights price. What is the theoretical ex rights price?

The value of rights

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

(a) Using the above example, if the price offered in the rights issue is \$1.50 per share, and the market price after the issue is expected to be \$1.90, the value attaching to a right is \$1.90— \$1.50 = \$0.40. A shareholder would therefore be expected to gain 40 pence for each new share he buys.

If he does not have enough money to buy the share himself, he could sell the right to subscribe for a new share to another investor, and receive 40 pence from the sale. This other investor would then buy the new share for \$1.50, so that his total outlay to acquire the share would be \$0.40 + \$1.50 = \$1.90, the theoretical ex rights price.

(b) The value of rights attaching to existing shares is calculated in the same way. If the value of rights on a new share is 40 pence, and there is a one for four rights issue, the value of the rights attaching to each existing share is 40 + 4 = 10 pence.

The Theoretical Gain or Loss to Shareholders

The possible courses of action open to shareholders are:

(a) To ‘take up’ or ‘exercise’ the rights, that is, to buy the new shares at the rights price. Shareholders who do this will maintain their percentage holdings in the company by subscribing for the new shares,

(b) To ‘renounce’ the rights and sell them on the market. Shareholders who do this will have lower percentage holdings of the company’s equity after the issue than before the issue, and the total value of their shares will be less.

(c) To renounce part of the rights and take up the remainder. For example, a shareholder may sell enough of his rights to enable him to buy the remaining rights shares he is entitled to with the sale proceeds, and so keep the total market value of his shareholding in the company unchanged.

(d) To do nothing. Shareholders may be protected from the consequences of their inaction because rights not taken up are sold on a shareholder's behalf by the company. The Stock Exchange rules state that if new securities are not taken up, they should be sold by the company to new subscribers for the benefit of the shareholders who were entitled to the rights.

QUESTION **Rights issue**

Gopher has issued 3,000,000 ordinary shares of $1 each, which is at present selling for $4 per share. The company plans to issue rights to purchase one new equity share at a price of $3.20 per share for every three shares held. A shareholder who owns 900 shares thinks that he will suffer a loss in his personal wealth because the new shares are being offered at a price lower than market value. On the assumption that the actual market value of shares will be equal to the theoretical ex rights price, what would be the effect on the shareholder's wealth if:

(a) He sells all the rights

(b) He exercises half of the rights and sells the other half

(c) He does nothing at all?

The actual market price after a rights issue

The actual market price of a share after a rights issue may differ from the theoretical excluding rights price. The investment opportunity related to equity finance have the return potential so the shareholder's Gain and Loss can be evaluated with the comparison the expected share price after rights issue and TERP.

This analysis will work out with the question Tirwin and Bar Company (Refer the 3rd Video and Question Bank)