Lecture 5 – Equity and Valuation

Equity

- Two types of equity
  - Ordinary shares
  - Preference shares

Ordinary shares

- Holders of ordinary equity are the firm's owners
- Ordinary shares have certain features
  - Dividends
  - Voting entitlements
  - Residual claim to assets
  - Limited liability
- Publicly listed companies trade on the ASX

Preference shares

- Different to ordinary shares due to:
  - Preference shares have a face value
  - Preferential treatment for dividends
  - Preferential treatment in liquidation
- Usually a fixed dividend, but can be variable
- Has similar features to debt finance
  - Regular payments and redeemable
- Expected return on preference shares lower than return on ordinary shares

Dividends

- Represent a distribution of profits
- Is one form of shareholder return
- Payment is at discretion of directors
- Dividends are not tax deductible
  - Paid from profits after tax
- Share valuation can be based on future dividends

Initial Public Offering (IPO)

- IPO is the first sale of ordinary shares
  - Usually also apply to become a listed company
- Corporations Act requires a prospectus
  - A prospectus is a formal legal document that provides details about an investment offering for sale to the public. A prospectus should contain the facts that an investor needs to make an informed investment decision. It includes a description of the fund's strategies, the manager's background, the fund's fee structure and a fund's financials statements
- Requires the services of an investment bank
  - Role includes marketing and valuation
  - Which price would you advise to sell at?
- The issue may be underwritten
  - Underwriting agreement requires purchase of unsold shares

    - Ensures firm obtains required finance
- Advantages of IPO
    - Access to capital markets
    - Raise the firm's profile
    - Align managers' goal with shareholders'
    - Market valuation
- Disadvantages of IPO
    - Dilute control of existing owners
    - Greater demand for disclosure of information
    - Increased costs

Private Placement

- Issue of shares to an individual or group
    - May or may not be shareholders of firm
- Advantages
    - Quicker to implement and for smaller amounts
    - Greater certainty in pricing
    - Placed in friendly hands
    - Lower costs
- Disadvantages
    - Dilute interest of existing shareholders
    - Can lower share price
    - Cannot place over 15%

Right issue

- Secondary issue of shares to existing shareholders
- Shareholders offered right to buy new shares
- Number of new shares based in proportion to the current number owned (i.e. pro-rata)
    - Terms expressed as '1-for-2', '2-for-7'
- New shares issued at a discount to market price
- Percentage shareholding is not diluted
- May be underwritten
- Can see rights if the issue is renounceable

<u>Trading on securities exchange</u>

- When rights issue announced, shares trade cum-rights or right-on
    - Buyer entitled to the rights (Cum-rights refer to a shareholder of record that qualifies for a rights offering declared by a company)
- Then after a period of time, shares trade ex-rights
    - Buyer not entitled to the rights (Ex-rights are shares of stock that are trading but no longer have rights attached because they have either expired, been transferred to another investor or been exercised)