BUSINESS FINANCE AND BUSINESS VALUATIONS

Chapter 11

SOURCES OF FINANCE – EQUITY

1. Introduction

In order to finance long-term investments and the overall working capital, the company needs to raise long-term capital. It is part of the role of the Financial Manager to decide how best to raise this capital. Overall the choice is between equity finance (from shareholders) and debt finance (from lenders). In this chapter we consider the different ways of raising equity finance and in the following chapter the different ways of raising debt finance. In the third chapter on this topic we consider the factors involved in choosing between equity and debt finance.

2. Methods of issuing shares

2.1. New shares – quoted companies

If a company is already quoted on a stock exchange then the following methods are available for the issue of new shares:

Public issue (offer for subscription)

A sale direct to the general public. Shares are advertised at a fixed offer price and the public are invited to buy them.

Public offer for sale by tender

A sale direct to the general public. However a price for the shares is not fixed and the public are invited to bid for shares.

Placing

With a placing, a sponsor (usually a merchant bank) arranges for its clients to buy shares. However, at least 25% of the shares placed must be made available to the general public.

Rights issue

An offer to existing shareholders to buy new shares in proportion to their existing shareholdings. You can be asked to perform calculations regarding rights issues and these are explained later in this chapter.

2.2. New shares – unquoted companies

If a company is unquoted, then they essentially have two choices:

Remain unquoted

In this case new shares can only be issued by way of a rights issue or a private placing

Become quoted

If they choose (and are able) to become quoted on a stock exchange, then the methods listed above become available to them.

It is difficult for a small company to become quoted on a stock exchange and have access to more finance because it is necessary that the company is already of a certain size before it will be accepted on to a stock exchange.

To help smaller companies, there exist two stock exchanges in the UK – the full exchange (or Official List) which is for large companies, and the AIM (Alternative Investment Market) which is for smaller companies.

You are not required to learn the detailed requirements for the two exchanges but the purpose of the AIM is to enable smaller companies to get their shares traded on a stock exchange so that they can then raise more share finance more easily and become bigger.

3. Rights issues

A rights issue is an issue of shares to existing shareholders.

The number of shares that each shareholder is offered is in proportion to their existing shareholding. The shares are offered at a relatively low price and the effect of the issue is to reduce the market value of all the shares in issue.

Example 1

Current share price is $5 per share.

The company makes a rights issue of 1 for 4 at $3.

(a) What is the theoretical ex-rights value per share?

(b) What is the value of a right?

Example 2

The current share price is $8 per share.

The company makes a rights issue of 1 for 3 at $6 per share.

(a) What is the ex-rights market value?

(b) What is the value of a right?

(c) Mrs X owns 1,200 shares. She takes up half her rights and sells the other half. Calculate the effect on her wealth.

4. Bonus issues / Stock splits / Scrip dividends

4.1. Bonus issues

Bonus issues (or **scrip issues**) are the turning of reserves into share capital and issuing free shares to existing shareholders. The new shares are issued in proportion to shareholders' existing shareholdings.

They are issued free and are therefore not a source of finance.

They have the effect of reducing the market value per share of all the shares in issue, and can thus make the shares more marketable.

4.2. Stock splits

Stock splits occur when shares are split in value. For instance each existing $1 share might be split into two 50c shares.

The total share capital of the company is unchanged, but there will be more shares in issue.

No cash is raised and therefore this is not a source of finance. It will have the effect of reducing the market value per share of all the shares in issue, and can thus make the shares more marketable.

4.3. Scrip dividends

This is the offering to shareholders of new shares instead of a cash dividend.

Shareholders are given the choice of whether to take the dividend in the form of cash or new shares. The incentive for shareholders is that it is a cheaper way of acquiring new shares then buying them on the stock exchange, and also there can be tax advantages.

For the company, this is a source of new finance in that new shares are issued (effectively) for cash. It is a cheap way of raising finance and does not risk upsetting the shareholders in the same way that a reduction in dividend may do.

5. Internally generated finance

The most common source of finance for most companies is to use retained earnings. This is equity finance in that all the earnings of the company belong to the shareholders. However, most companies do not pay out all their earnings as dividends, but instead retain a proportion of them as a source of finance in order to expand the company.

Retained earnings are the best source of finance in that they avoid issue costs and the cash is immediately available.

5.1. Dividend irrelevancy theory

In theory it is irrelevant whether a company pays out all its earnings to shareholders as dividend, or retains all the earnings for investment (or any combination of the two).

The reason for this is that although a lower dividend obviously means less immediate cash for the shareholders, this is compensated for by the fact that the extra investment by the company will increase the value of the company (and its share value).

In theory the shareholders will be indifferent because the increase in the value of their shares will compensate them for the lower dividend.

5.2. Dividend policy in practice

Although in recent years it has become common for companies to have high retention of earnings and pay low dividends (or even to pay no dividends – e.g. Microsoft), it is risky for a company to change its dividend policy without considering the consequences.

In particular they need to consider the following:

5.3. The Clientele effect

A constant dividend policy (e.g. always distributing 20% of earnings, or always increasing dividend by
5% p.a..) will attract a group of shareholders to whom the policy is suited (in terms of, for example, their tax position, or their need for income). Changing the dividend policy will upset these shareholders.

5.4. The Signalling effect

A reduction in dividend might be seen by the financial markets as a sign of company weakness.

When you finished this chapter you should attempt the online F9 MCQ Test