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Long-Term Financing Sources

Part 01

Chartered Accountancy
Strategic Level
Corporate Finance & Risk Management (CFRM)

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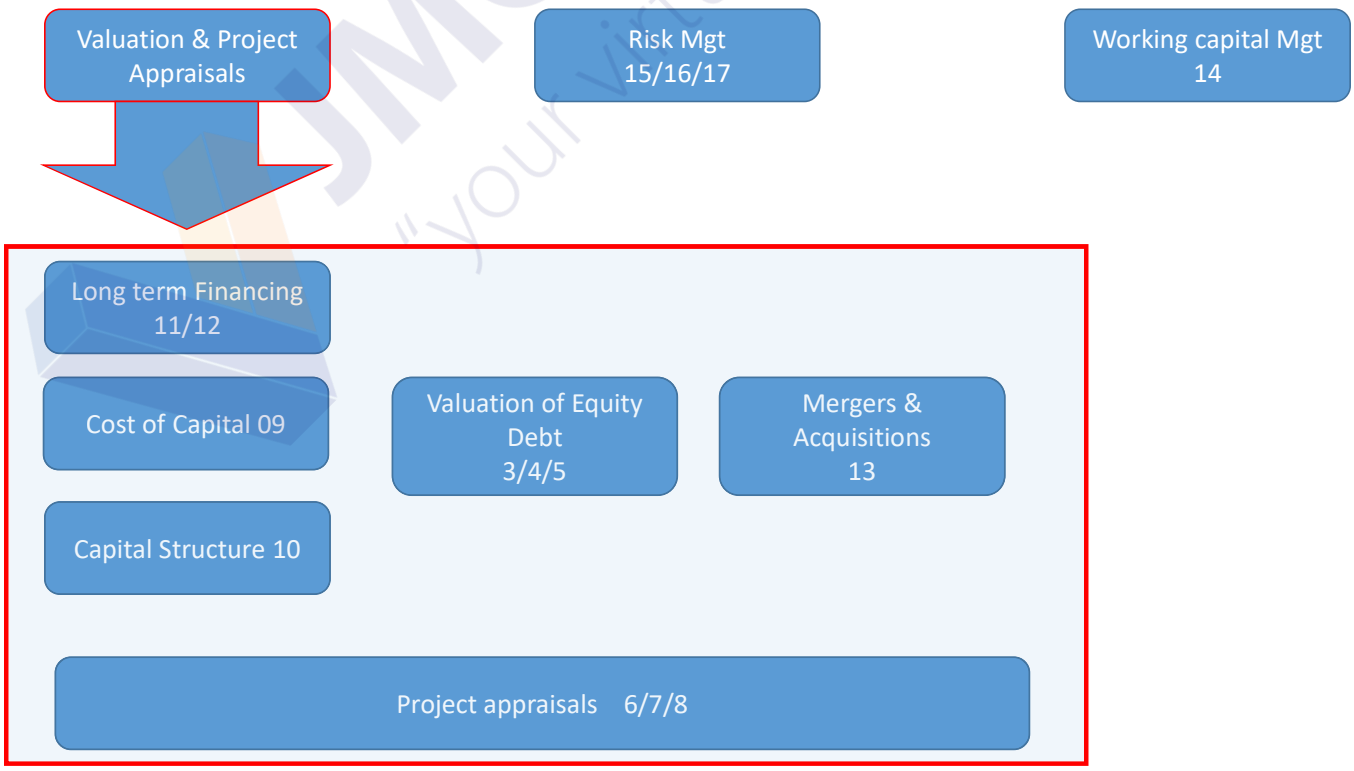
Corporate Finance and Risk Management
STRATEGIC LEVEL
June 2022

Long – Term Financing Sources 01
"Equity Financing"

Samira Anthony



Sources of Long Term Financing

- Loans,
- Bonds,
- Debentures,
- Leasing

DEBT FINANCING

- IPOs,
- Private Placements,
- Right Issues,
- Share Repurchase,
- Employee Share Ownership Schemes

EQUITY FINANCING

Capital markets

Stock markets

Capital markets are markets for trading in **long-term finance**, in the form of long term financial instruments. In Sri Lanka, the principal capital market is the **Colombo Stock Exchange (CSE)**.

The Stock Exchange is also the market for dealings in **government securities** (gilts). Gilts are traded through the **Central Depository System** (which is owned by the CSE). The Stock Exchange is regulated by the Securities and Exchange Commission (SEC).

The stock markets serve the following main purposes.

Primary markets

As **primary markets**, they enable organisations to **raise new finance**, by issuing new shares or new debentures. Capital markets make it easier for companies to raise new long-term finance than if they had to raise funds privately by contacting investors individually. In Sri Lanka, a company must have public company status (be a plc) to be allowed to raise finance from the public on a capital market.

Secondary markets

As **secondary markets**, they enable existing investors to sell their investments, should they wish to do so. The **marketability** of securities is a very important feature of the capital markets, because investors are more willing to buy investments if they know that they could sell them easily, should they wish to.

Realisation of value

When a company comes to the stock market for the first time, and 'floats' its shares on the market, the **owners** of the company can **realise** some of the **value** of their shares in cash, because they will offer a proportion of their personally held shares for sale to new investors.

Takeovers by share exchange

When one company wants to take over another, it is common to do so by issuing shares to finance the takeover. Takeovers by means of a share exchange are only feasible if the shares that are offered can be readily traded on a stock market, and so have an identifiable market value.

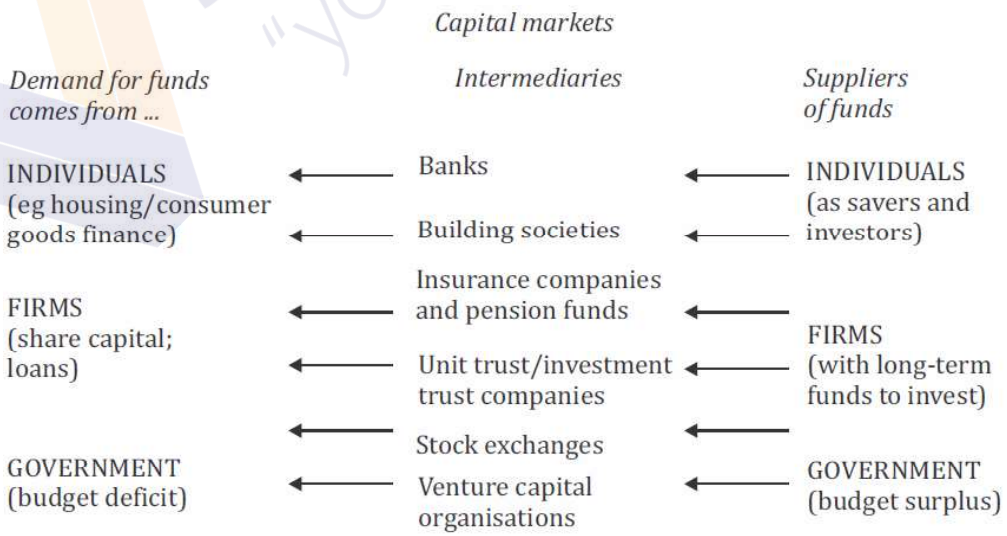
Institutional investors

Institutional investors are institutions which have large amounts of funds which they want to invest, and they will invest in bonds and shares or any other assets which offer satisfactory returns and security.

The institutional investors are now the biggest investors on many stock markets. The major institutional investors are pension funds, insurance companies, investment trusts, unit trusts, private equity and venture capital organisations.

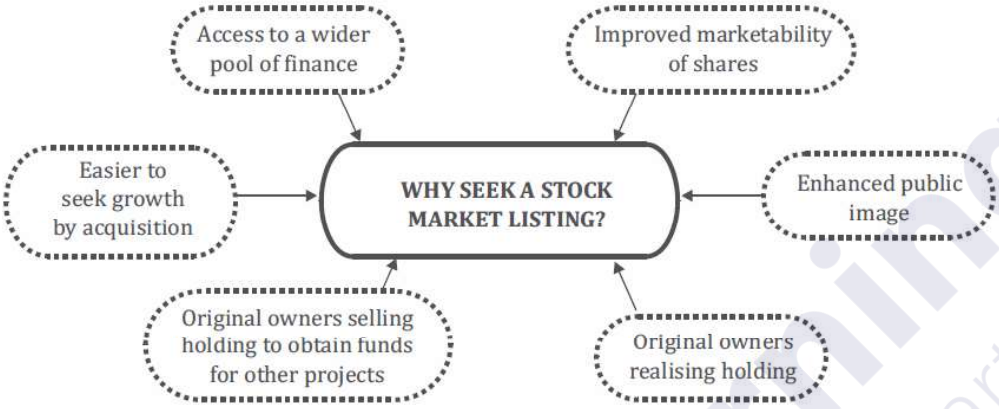
Capital market participants

The various participants in the capital markets are summarised in the diagram below.



EQUITY FINANCING

Advantages of a stock market listing…….



Disadvantages of a stock market listing

The owners of a company seeking a stock market listing must take the following disadvantages into account.

(a) There will be significantly greater **public regulation, accountability** and **scrutiny**. The legal requirements the company faces will be greater, and the company will also be subject to the rules of the stock exchange on which its shares are listed.

(b) A **wider circle of investors** with more exacting requirements will hold shares.

(c) There will be additional costs involved in making share issues, including **brokerage commissions** and **underwriting fees**.

Methods of obtaining a listing

The process of making shares available to investors by obtaining a quotation on a stock exchange is called **flotation**. An unquoted company can obtain a listing on the stock market by means of:

- An offer for sale
- Prospectus issue
- Placing
- Introduction

Of these, an offer for sale or a placing are the most common.

Initial public offer

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

An IPO entails the **acquisition by an issuing house** of a large block of shares of a company, with a view to offering them for sale to the public.
An **issuing house** is usually an investment bank (or sometimes a firm of stockbrokers).
It may acquire the shares either as a direct allotment from the company or by purchase from existing members.
In either case, the issuing house publishes an invitation to the public to apply for shares, either at a fixed price or on a tender basis.
The issuing house **accepts responsibility** to the public, and gives the support of its own reputation and standing to the issue.

It is often very difficult to decide on the price at which the shares should be offered to the general public. One way of trying to ensure that the issue price reflects the value of the shares as perceived by the market is to make an **offer for sale by tender**. A **minimum price** will be fixed and subscribers will be invited to tender for shares at prices equal to or above the minimum. The shares will be **allotted at the highest price** at which they will **all be taken up**. This is known as the **striking price**.

Example: Initial public offering

LMN Co is a new company that is making its first public issue of shares. It has decided to make the issue by means of an offer for sale by tender. The intention is to issue up to 4,000,000 shares (the full amount of authorised share capital) at a minimum price of Rs. 3.00. The money raised, net of issue costs of Rs. 1,000,000, would be invested in projects which would earn benefits with a present value equal to 130% of the net amount invested.

The following tenders have been received. (Each applicant has made only one offer.)

Price tendered per share	Number of shares applied for at this price
Rs	
6.00	50,000
5.50	100,000
5.00	300,000
4.50	450,000
4.00	1,100,000
3.50	1,500,000
3.00	2,500,000

- How many shares would be issued, and how much in total would be raised, if LMN Co chooses:
  - To maximise the total amount raised?
  - To issue exactly 4,000,000 shares?

- Mr X, a private investor, has applied for 12,000 shares at a price of Rs. 5.50 and has sent a cheque for Rs. 66,000 to the issuing house that is handling the issue. In both cases (a)(i) and (ii), how many shares would be issued to Mr X, assuming that any partial acceptance of offers would mean allotting shares to each accepted applicant in proportion to the number of shares applied for? How much will Mr X receive back out of the Rs. 66,000 he has paid?

Solutions

We begin by looking at the cumulative tenders.

Price Rs	Cumulative number of shares applied for	Amount raised if price is selected, before deducting issue costs Rs
6.00	50,000	300,000
5.50	150,000	825,000
5.00	450,000	2,250,000
4.50	900,000	4,050,000
4.00	2,000,000	8,000,000
3.50	3,500,000	12,250,000
3.00	6,000,000(4,000,000 max)	12,000,000

To maximise the total amount raised, the issue price should be Rs. 3.50. The total raised before deducting issue costs would be Rs. 12,250,000. To issue exactly 4,000,000 shares, the issue price must be Rs. 3.00. The total raised would be Rs. 12,000,000, before deducting issue costs.

Mr X would be allotted 12,000 shares at Rs. 3.50 per share. He would receive a refund of 12,000 × Rs. 2 = Rs. 24,000 out of the Rs. 66,000 he has paid.
If 4,000,000 shares are issued, applicants would receive two-thirds of the shares they tendered for. Mr X would be allotted 8,000 shares at Rs. 3 per share and would receive a refund of Rs. 42,000 out of the Rs. 66,000 he has paid.

Placing

A **placing** is an arrangement whereby the shares are not all offered to the public, but instead, the sponsoring market maker arranges for most of the issue to be bought by a **small number of investors**, usually institutional investors such as pension funds and insurance companies.

The choice between an offer for sale and a placing

Is a company likely to prefer an offer for sale of its shares, or a placing?

- **Placings** are much **cheaper**. Approaching institutional investors privately is a much cheaper way of obtaining finance, and thus placings are often used for smaller issues.
- Placings are likely to be **quicker**.
- Placings are likely to involve **less disclosure** of **information**.

However, most of the shares will be placed with a **relatively small number of (institutional) shareholders**, which means that most of the shares are **unlikely to be available for trading** after the flotation, and that **institutional shareholders** will have control of the **company**.

An introduction

By this method of obtaining a quotation, no shares are made available to the market, neither existing nor newly created shares; nevertheless, the stock market grants a quotation. This will only happen where shares in a large company are already widely held, so that a market can be seen to exist. A company might want an **introduction** to obtain **greater marketability** for the shares, a known share valuation for inheritance tax purposes and easier access in the future to additional capital.

Underwriting

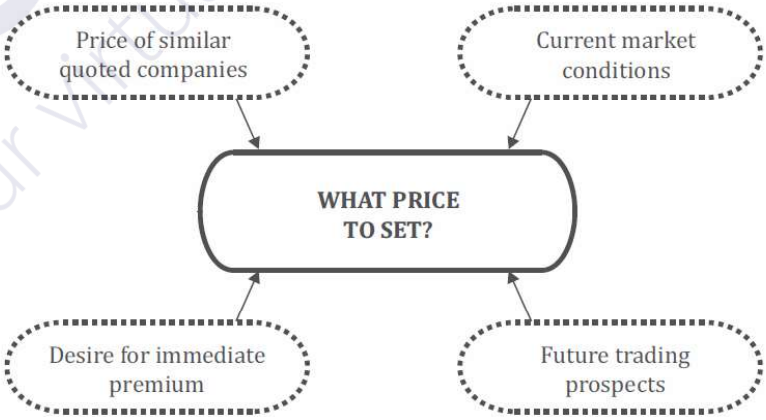
A company about to issue new securities in order to raise finance might decide to have the issue underwritten. **Underwriters** are financial institutions which agree (in exchange for a fixed fee, perhaps 2.25% of the finance to be raised) to buy at the issue price any securities which are **not subscribed** for by the investing public.

Underwriters **remove** the **risk** of a share issue being under-subscribed, but at a cost to the company issuing the shares. It is not compulsory to have an issue underwritten. Ordinary offers for sale are most likely to be underwritten although rights issues may be as well.

Costs of share issues on stock market

- **Underwriting costs**
- **Stock market listing fee (the initial charge) for the new securities**
- **Fees of the issuing house, solicitors, auditors and public relations consultant**
- **Charges for printing and distributing the prospectus**
- **Advertising in national newspapers**

Pricing shares for a stock market launch



Companies will be keen to avoid **overpricing an issue**, which could result in the **issue** being **undersubscribed**, leaving underwriters with the unwelcome task of having to buy up the unsold shares.

On the other hand, if the **issue price** is **too low** then the issue will be **oversubscribed** and the company would have been able to raise the required capital by issuing fewer shares.

The share price of an issue is usually advertised as being based on a certain P/E ratio, the ratio of the price to the company's most recent earnings per share figure in its audited accounts. The issuer's P/E ratio can then be compared by investors with the P/E ratios of similar quoted companies.

Venture capital

Venture capital companies make funding available to **young**, **unquoted companies** to help them to expand.

The requirements are **very high growth potential** and **very high returns** (in excess of 30% per annum). This return arises when the company that has been financed is **floated** on the stock market or **sold**.

Venture capitalists have been accused of **short-termism** by requiring early reported profits and an early exit. Failure to hit targets set by the venture capitalist can lead to an **equity ratchet** where extra shares are transferred to their ownership at no additional cost to the venture capitalist.

Private equity

Private equity describes a group of companies that raises funds from investors, typically pension funds, and uses the money to buy companies which they **run privately**.

Private equity deals are much bigger than venture capitalists' and typically use a **high proportion of debt** when making acquisitions.

This debt is placed on the balance sheet of the acquired company. Once a private equity firm has owned a company for six months or a year, it will **refinance** all the debt and pay some cash back to its investors. The private equity firm makes a series of often drastic changes to improve the business such as new management, cutting jobs and getting rid of loss-making divisions.

Preference shares

Preference shares are shares carrying a fixed rate of dividends, the holders of which, subject to the conditions of issue, have a prior claim to any company profits available for distribution. They are an example of prior charge capital. Preferred shareholders may also have a prior claim to the repayment of capital in the event of winding up

Irredeemable / non cumulative - EQUITY
Redeemable/ Cumulative - DEBT

Rights issues

A **rights issue** is the raising of new capital by giving existing shareholders the right to subscribe to new shares in proportion to their current holdings. These shares are usually issued at a discount to market price. A shareholder not wishing to take up a rights issue may sell the rights.
A **dilution** is the reduction in the earnings and voting power per share caused by an increase or potential increase in the number of shares in issue.

Right issue without underwrite
Underwritten Right issues **–** under writer will buy shares which existing shareholders not purchased.

Advantages of rights issues

(a) Rights issues are **cheaper** than offers for sale to the general public. This is partly because no **prospectus** is generally required (provided that the issue is for less than 10% of the class of shares concerned), partly because the **administration** is **simpler** and partly because the cost of underwriting will be less.

(b) Rights issues are **more beneficial** to **existing shareholders** than issues to the general public. New shares are issued at a **discount** to the current market price, to make them attractive to investors. A rights issue secures the discount on the market price for existing shareholders, who may either keep the shares or sell them if they wish.

(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.

Disadvantages of rights issues

(a) The **amount of finance** that can be **raised** by rights issues of unquoted companies is limited by the funds available to existing shareholders.

(b) **Choosing the best issue price** may **be problematic**. If the price is considered too high, the issue may not be fully subscribed; if too low, the company will not have raised all the funds it conceivably could have done.

(c) During the time between the **announcement of the rights issue** and the **date of subscription** the **market price of shares** may **fall**, and the issue price of rights will be above the market price, with the result that the rights issue will fail.

Pre Right issue Price : 100/-
Price after Right issue: in between 70 – 100 (TERP)
Right issue price: 70/- (Exercise price)

(d) Rights issues **cannot be used** to **widen the base** of shareholders.

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

	Rs Mn
200,000 ordinary shares	200
Retained earnings	100
Equity	300

The directors propose to raise an additional Rs. 126 million from a rights issue.
The current market price is Rs. 1,800.

Required

1. **Calculate** the number of shares that must be issued if the rights price is: Rs. 1,600; Rs. 1,500; Rs. 1,400 and Rs. 1,200.
2. **Calculate** the dilution in earnings per share in each case.

The earnings at present are 20% of Rs. 300 million = Rs. 60 million. This gives earnings per share of Rs. 300. The earnings after the rights issue will be 20% of Rs. 426 million = Rs. 85.2 million.

Rights price	No. of new shares (Rs. 126 million ¸ rights price)	EPS (Rs. 85.2 million ¸ total no. of shares)	Dilution
Rs		Rs	Rs
1,600	78,750	306	+5
1,500	84,000	300	–
1,400	90,000	294	– 6
1,200	105,000	279	– 21

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:

Rs. 300 million ÷ 200,000 = Rs. 1,500.

Note: Exercise price and EPS has a positive relationship. However, if entity can increase the return after the right issue this impact can be wiped out.

The market price of shares after a rights issue:

the theoretical ex-rights price (TERP)

XYZ Co has 1,000,000 ordinary shares of Rs. 100 in issue, which have a market price on 1 September of Rs. 210 per share. The company decides to make a rights issue, and offers its shareholders the right to subscribe for one new share at Rs. 150 each for every four shares already held. After the announcement of the issue, the share price fell to Rs. 195, but by the time just prior to the issue being made, it had recovered to Rs. 200 per share. This market value just before the issue is known as the cum-rights price.

Required

Calculate the theoretical ex-rights price.

New fund wont invest in a new strategic investment

New fund invest in a new strategic investment

	Rs
4 shares @ Rs. 200	800
1 share @ Rs. 150	150
	950

	Exis. product	New product
Exis. Mkt	penetration	P. Deve
New mkt	Mkt Deve.	Diversi

o the value per share after the rights issue (or ERP) is ?.....

950/5 = 190 or ((200*4)/5) + (150/5 x NR/OR) = 190

FORMULAR for TERP

1. New funds generate same return

$$\frac{\text{(no of shares before RI x price before RI) + (no of share at RI x RI price)}}{\text{shares before RI + RI shares}}$$

2. New Funds generate higher return

$$\frac{\text{(no of shares before RI x price before RI)}}{\text{(shares before RI + RI shares)}} + \frac{\text{(no of share at RI x RI price)}}{\text{(shares before RI + RI shares)}} \times \frac{\text{RoNF}}{\text{RoEF}}$$

Yield adjusted ex-rights price

We have assumed so far that the additional funds raised by the rights issue will generate the **same rate** of **return as existing funds**. If the new funds are likely to earn a **different return** from what is currently being earned, the **yield-adjusted** theoretical ex-rights price should be calculated. The yield-adjusted price demonstrates how the market will view the rights issue, and what will happen to the market value.

Calculate the yield-adjusted theoretical ex-rights price using the same data for XYZ Co as above, with the additional information that rate of return on new funds = 12%, and on existing funds = 8%.

$$\text{Yield-adjusted theoretical ex-rights price} = \left[\frac{200 \times 4}{5}\right] + \left[\frac{150}{5} \times \frac{0.12}{0.08}\right] = \text{Rs. } 205.$$

Note: An exam question may give you the net present value of the project which the rights issue has been raised for. The yield adjusted ex-rights price will then simply be:

$$\frac{\text{Original market capitalisation of the company + NPV of the project + Proceeds of rights issue}}{\text{New number of shares in issue}}$$

The value of rights

$$\text{Value of a right} = \frac{\text{Theoretical ex-rights price} - \text{Issue price}}{N}$$

Where N = the number of shares required to buy one share (right)

Using the above example:

$$\text{Value of a right} = \frac{200 - 150}{5} = \frac{190 - 150}{4} = \text{Rs. } 10$$

This means that the value of a right attaching to each **existing** share is Rs. 10. If a holder of four existing shares exercises their rights to buy one new share, and then sells it, their gain will be 190 – 150 = Rs. 40, in other words (4 × Rs. 10) or the difference between the theoretical ex-rights price and the rights issue price.

The value of rights is the **theoretical gain** a shareholder would make by exercising their rights.

BCD Co has the following long-term capital structure as at 30 November 20X3. Rs Mn

200 million ordinary shares Rs.	50.0
General reserve	22.5
Retained profit	25.5
	98.0

The company has no long-term loans.

In the year to 30 November 20X3, the profit from operations (net profit before interest and taxation) was Rs. 40m and it is expected that this will increase by 25 per cent during the forthcoming year. The company is listed on a major stock exchange and the current share price is Rs. 2.10.

The company wishes to raise Rs. 72m in order to **re-equip one of its factories** and is considering making a one-for-five rights issue at a discounted price of Rs. 1.80 per share. It is expected that the price earnings (P/E) ratio will remain the same for the forthcoming year.

Assume a tax rate of 30 per cent.

Required

1. **Calculate** the following, assuming the rights issue of shares is made:
    1. The theoretical ex-rights price of an ordinary share in BCD Co
    1. The value of the rights for each original ordinary share
2. **Calculate** the price of an ordinary share in BCD Co in one year's time assuming a rights issue is made.

(a)

	Rs
Current market value of 5 existing shares (× Rs. 2.10)	10.50
Rights issue price of one new share	1.80
Theoretical value of 6 shares	12.30

(i) Theoretical ex-rights price = Rs. 12.30/6 shares = Rs. 2.05 per share.

(ii) The value of the rights for each new share is Rs. 2.05 – Rs. 1.80 = Rs. 0.25. The value of the rights for each existing share is therefore Rs. 0.25/5 shares = Rs. 0.05 per share.

(b) Rights issue

Number of shares in issue (Rs. 50 million/Rs. 0.25 per share)	200
New shares in rights issue (1 for 5)	40
Total number of shares after the issue	240

Current earnings = Rs. 40 million less 30% tax = Rs. 28 million.
Current EPS = Rs. 28 million/200 million shares = Rs. 0.14.
Current P/E ratio = 2.1/0.14 = 15 times.

	Rs Mn
Profit before taxation (+ 25%)	50
Taxation at 30%	(15)
Profit after tax (earnings)	35

Earnings per share = Rs. 35 million/240 million shares = Rs. 0.146.
Assumed P/E ratio (no change) = 15.
Assumed share price in one year's time: Rs. 0.146 × 15 times = Rs. 2.19.

Shareholders Options

(a) Take up or Exercise

(c)Renounce the Right & Sell them on the Market

(c) **Renounce part of the rights and take up the remainder**

.

(d) **Do nothing**

The decision by individual shareholders as to whether they take up the offer will therefore depend on:

(a) The **expected rate of return** on the investment (and the risk associated with it)

(b) The **return obtainable** from other investments (allowing for the associated

BD Co has issued 3,000,000 ordinary shares of Rs. 100 each, which are at present selling for Rs. 400 per share. The company plans to issue rights to purchase one new equity share at a price of Rs. 320 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.

Required
On the assumption that the actual market value of shares will be equal to the theoretical ex-rights price, **discuss** the effect on the shareholder's wealth if:
(a) He sold all the rights
(b) He exercised half of the rights and sold the other half
(c) He did nothing at all

Value of the portfolio for a shareholder with 3 shares before the rights issue:

	Rs
3 shares @ Rs. 400	1,200
1 share @ Rs. 320	320
4	1,520

So the value per share after the rights issue (or TERP) is 1,520/4 = Rs. 380.

We will assume that a shareholder is able to sell his rights for Rs. 20 per existing share held.

(a) If the shareholder **sells all his rights**:

	Rs
Sale value of rights (900 × Rs. 20) or (300 rights × Rs. 60)	18,000
Market value of his 900 shares, ex rights (× Rs. 380)	342,000
Total wealth	360,000
Total value of 900 shares cum rights (× Rs. 400)	Rs. 360,000

The shareholder would neither gain nor lose wealth. He would not be required to provide any additional funds to the company, but his shareholding as a proportion of the total equity of the company will be lower.

(b) If the shareholder **exercises half of the rights** (buys 450/3 = 150 shares at Rs. 320) and sells the other half:

	Rs
Sale value of rights (450 × Rs. 20) or (150 × Rs. 60)	9,000
Market value of his 1,050 shares, ex rights (× Rs. 380)	399,000
	408,000
Total value of 900 shares cum rights (× Rs. 400)	360,000
Additional investment (150 × Rs. 320)	48,000
	408,000

The shareholder would neither gain nor lose wealth, although he will have increased his investment in the company by Rs. 480.

(c) If the shareholder **does nothing**, but all other shareholders either exercise their rights or sell them, he would lose wealth as follows.

	Rs
Market value of 900 shares cum rights (× Rs. 400)	360,000
Market value of 900 shares ex rights (× Rs. 3.80)	(342,000)
Loss in wealth	18,000

It follows that the shareholder, to protect his existing investment, should either **exercise his rights** or **sell them** to another investor. If he does not exercise his rights, the new securities he was entitled to subscribe for might be sold for his benefit by the company, and this would protect him from losing wealth.

Note. Make sure you practise the calculations in this chapter so that you can do them competently and quickly if required.

Scrip dividends, bonus issues and share splits
(Capitalization of Reserves)

Scrip dividends

A scrip dividend effectively converts retained earnings into **issued share capital**.
When the directors of a company would prefer to retain funds within the business but consider that they must pay at least a certain amount of dividend, they might offer equity shareholders the choice of a **cash dividend** or a **scrip dividend**. Each shareholder would decide separately which to take.

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.

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

(d) A small scrip issue will **not dilute the share price significantly**. If however cash is not offered as an alternative, empirical evidence suggests that the share price will tend to fall.

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

Bonus Issues

A **bonus/scrip/capitalisation issue** is the capitalisation of the reserves of an entity by the issue of additional shares to existing shareholders, in proportion to their holdings. Such shares are normally fully paid-up with no cash called for from the shareholders.

Share splits

Another way to create cheaper shares with a greater marketability is to **split** the ordinary shares into a **larger number** with a **lower nominal value**. For example, each ordinary share of Re. 1 is split into two shares of 50 cents each.
The difference between a bonus issue and a share split is that a **bonus issue converts equity reserves into share capital**, whereas a **share split leaves reserves unaffected**.

Share repurchase (share buyback)

In many countries companies have the right to **buy back shares from shareholders** who are willing to sell them, subject to certain conditions. 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**'.

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. This should lead to a higher share price than would otherwise be the case, and the company should be able to increase dividend payments on the remaining shares in issue.

(c) **Increase in gearing**. Repurchase of a company's own shares allows debt to be substituted for equity, so raising gearing. This will be of interest to a company wanting to increase its gearing without increasing its total long term funding.

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

(e) 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.