Issuing equities

1. Introduction

1.1. Chapter overview

Companies issue shares to raise cash or **capital**.

This chapter starts by explaining the two markets in which shares are traded: the **primary** and **secondary** markets. Issues into the primary market occur when a company is seeking to raise long-term capital from investors - new shares are therefore issued by the company in return for finance from investors. Secondary market trading, however, is the market in 'second-hand' shares. In the secondary market, no new finance is raised by the company as the trading is done directly between investors.

It is, however, important to know that in the primary markets there can be secondary issues. This is where a company that has already raised capital by issuing shares chooses to make a subsequent issue (or follow on issue) of shares.

Despite the general idea that shares are issued to raise capital, this chapter also identifies limited situations where shares are issued **free**. This does not raise any new money for the company but can have the effect of making shares more attractive to investors by reducing the share price and encouraging trading.

1.2. Learning outcomes

On completion of this module, you will:

Equities: methods of issue

- 11.2.1 Distinguish between primary and secondary share issuance
- 11.2.2 Describe the key features of the following equity issuance methods: placing, intermediaries offer, offer for sale, offer for sale by subscription
- 11.2.3 Define and explain the purpose of a rights issue, a bonus / scrip issue and a stock split
- 11.2.4 Calculate the theoretical ex-rights price and the value of the right (nil-paid) given the cum-rights price, the issuance ratio and the subscription price
- 11.2.5 Calculate the theoretical ex-scrip price given the scrip ratio and the cum-scrip price
- 11.2.6 Evaluate the options open to an investor in response to a rights offer and explain the effect on the investor's wealth
- 10.7.5 Explain the effect of the following on the major accounting ratios: rights issue, bonus / scrip issue, stock split, share repurchases

Share buy-backs

- 11.2.7 Identify and explain the motivations behind a company buying back its own shares

2. Methods of issuing equity

2.1. The primary market

The **primary market** is the market on which securities are sold for the first time. Companies use the primary market as a means of **raising** new long-term **capital** (for both equity and debt). In the UK, new issues usually settle T+1.

Primary market activities can be:

- **Primary offers**, where a company issues shares for the first time (this is often called an initial public offer (IPO)); or

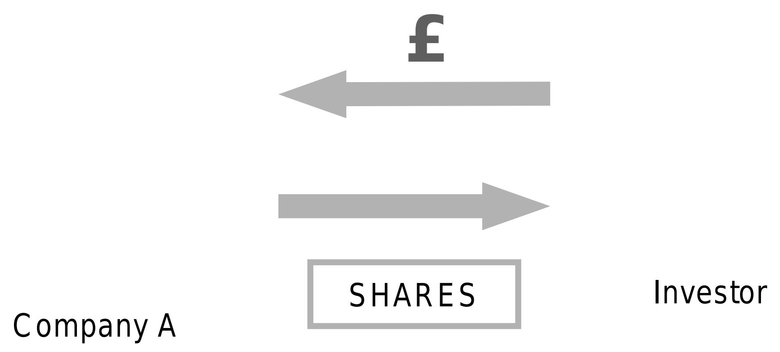
- **Secondary offers**, where the company already has issued shares, but chooses to issue more, for example, via a rights issue or bonus issue.

The **secondary market**, on the other hand, is the market on which existing securities are traded. The secondary market exists to support the primary market. It provides subscribers to shares in the primary market with a place to sell them on again, and also acts as a benchmark for primary market pricing decisions. Secondary market activity does **not** raise new capital for the company.

Many international stock exchanges, including the London Stock Exchange, fulfil the role of both primary and secondary markets.

The following illustrations describe the various means by which a company can issue shares in the primary market.

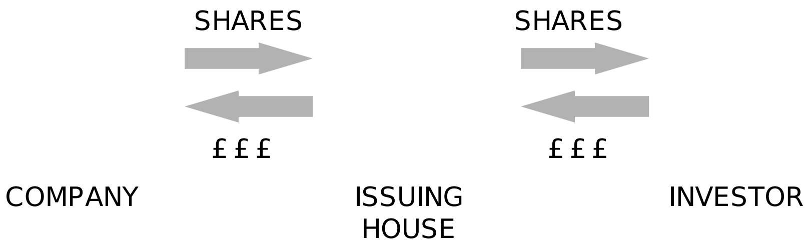
2.2. Offer for subscription



An offer for subscription involves a company issuing shares directly to the general public (a **general marketing activity**). As a general marketing activity, the company will need to produce a **prospectus** to give investors a good indication of the company and its prospects..

Offers for subscription are typically used by larger issuers, who are likely to have the resources and the knowledge to manage the issue themselves.

2.3. Offer for sale



An offer for sale is similar to an offer for subscription, in that it is a general marketing activity. However, in this case, the issuing house initially buys up new shares from the issuing company before re-selling them to the investing community. In this way, the issuing company is guaranteed to sell all of its shares.

A fair price is established based on the price of a similar company's security that is already trading in the market. An offer is then made to the public, with purchasers stating the number of shares they wish to buy at the fixed price. In the event of over-subscription, allocations are dealt with on a pro rata basis.

An offer for sale is not restricted to the issue of new securities. It can also be used for a large shareholding being sold into the market place, e.g. government privatisations.

Offers for sale by tender

- Tender offer: where interested investors make bids and the issuing house then selects the applications with the highest bids. Note that once an acceptable price has been determined from the bids, successful applicants actually pay a **common strike price**.

2.4. Placing

A placing is similar to an offer for sale; however, the issuing house does **not** offer to resell the shares to the investing community at large. Instead, the shares are only offered to selected investors such as asset managers and wealthy individuals. This is often referred to as **selective marketing**.

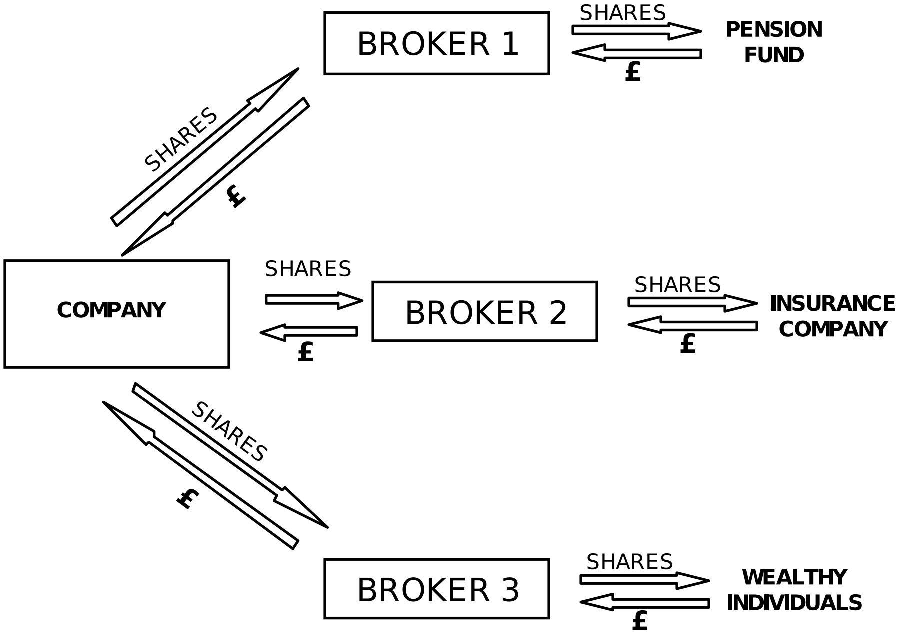
Small investors would **not** be offered shares in a placing

Institutions and wealthy individuals would be offered shares in a placing

This method of marketing is often cheaper and quicker than other methods, so is popular with smaller companies.

2.5. Intermediaries offer

An intermediaries offer involves making a **placing** through several brokers. The use of several brokers widens the investor base.



2.6. Introduction (method of listing)

An introduction is **not** a marketing operation. That is, a company does not raise new capital by way of an introduction.

An introduction involves a company obtaining a listing on, say, the London Stock Exchange, without issuing new share capital. Since no new shares are being issued, the preparation of a prospectus is not necessary. Instead, the company will prepare Listing Particulars.

This process may be undertaken by a company that is already quoted on an overseas stock exchange and is seeking to expand its potential shareholder base.

Approval by the UK Listing Authority for a company to introduce its shares onto the London Stock Exchange is likely to be given:

- If the shares are already listed on an overseas exchange
- If the shares have already achieved a reasonably wide distribution
- Where two previously listed companies have agreed to merge in order to form a new company, the new company's shares will be introduced to the market place

2.7. Rights issue

Features

A rights issue is an invitation to shareholders to buy new shares in proportion to their existing holding of shares. The name arises from the company law principle of **pre-emption rights**. It is a form of secondary issuance on the primary markets. These rights are attached to ordinary shares in the UK.

Rights issues are described as a ratio between new and existing shares. For example, during a 1 for 5 (1:5) rights issue, shareholders would be asked to buy one new share for every five they already hold. The pro-rata basis of issue means that, if an investor takes up all the shares offered, there will be be no dilution of ownership. For this reason, rights issues are often referred to as **anti-dilution issues**.

Rights are offered at a discount to the existing market price of the shares.

Theoretical ex-rights price

Because the shares are issued at a discount to the current market price, the effect of a rights issue will be to dilute share price in the market. The theoretical ex-rights price is the expected price of the shares after the rights issue has taken place.

The theoretical ex-rights price can be determined by a simple calculation.

Example

A company undergoes a 1:4 rights issue. The subscription price is £1.50. The share price of the existing shares before the rights issue is £1.75 (commonly known as the 'cum rights' price). Calculate the theoretical ex-rights price.

Calculation

To make it simple, assume the company only has four shares in issue.

Before the rights issue:	4 shares @ £1.75 each	= £7.00
During rights issue:	1 share @ £1.50 each	= £1.50
After rights issue:	5 shares	= £8.50

$$\text{So, after the rights issue each share is worth: } \frac{£8.50}{5 \text{ shares}} = £1.70$$

The theoretical ex-rights price = £1.70 per share

Note that the calculation does not take account of market sentiment before, during or after the rights issue. Consequently the value calculated is only a theoretical price. In reality the price may differ from the theoretical price.

Theoretical nil paid price

Consider an existing shareholder who doesn't want to take up their rights. In this situation, the shareholder may sell their rights ‘nil paid’, i.e. sell the **right** to buy the share at a discount to someone else.

The nil paid price is the price an investor would (theoretically) receive/pay for the right to subscribe for a discounted share in a rights issue.

It is possible to calculate the theoretical nil paid price. From the previous example, the nil paid price is worked out in the following way:

Calculation (continued)

Theoretical ex-rights price	£1.70
Less subscription price	£1.50
Theoretical nil paid price	£0.20

This is the maximum price someone would (theoretically) pay for the right to buy the share at £1.50

2.8. Scrip issue

Features

A scrip issue is a method of issuing new shares to the existing shareholders. It is also called a bonus issue or **capitalisation issue**. Like the rights issue, new shares are issued to the shareholders, in proportion to their existing holding. However, in a scrip issue they are given, free of charge. The company raises no new ,capital; therefore, there is no change in net assets or shareholders' funds.

The effect of a scrip issue is to dilute the existing market price of a share. Consequently, a scrip issue is useful when a company's share price has reached a level that is causing a lack of liquidity (or marketability) in the market place. In the UK, market sentiment typically shuns higher value shares, for example £40 per share, and prefers those shares between £2 and £10. A scrip issue has the effect of reducing the price and making it more attractive to investors. It can also be used as a substitute for paying out a dividend.

Although the scrip issue has the effect of reducing the price per share, it does this through increasing the number of shares held by investors. The net effect of this on the investor's portfolio is that the total value of the holding does not change. You will see this illustrated in the example below.

The price of the shares after the scrip issue is called the ex-scrip price.

Theoretical ex-scrip price

The ex-scrip price is the price of a company's shares **after** a scrip issue.

It is possible to calculate the theoretical ex-scrip price. The calculation is very similar to the one used when calculating the ex-rights price.

Example

A company undergoes a 1 for 2 scrip issue. The current share price is £15 (commonly known as the 'cum scrip' price). Calculate the theoretical ex-scrip price.

Calculation

Before the scrip issue	2 shares @ £15.00 each	= £30.00
During the scrip issue	1 share @ no cost	= £0.00
After the scrip issue	3 shares	= £30.00

So, after the scrip issue each share is worth: $\frac{£30.00}{3 \text{ shares}}$ =£10.00

The theoretical ex-bonus price = £10.00 per share

2.9. Stock/Share splits and consolidations

A share split is where shares in issue are split into a greater number, each with a smaller nominal value.

For example, one £1 ordinary share is split into two 50p ordinary shares.

The opposite of a share split is a share **consolidation**, where existing shares are consolidated into a smaller number, each with a higher nominal value.

2.10. The impact of scrip issues, splits and consolidations on financial ratios

Financial ratios that use the **number** of shares in issue in their calculation will have to be restated after a scrip issue or share split. Failure to do so will lead to a lack of comparability over time. Examples of such ratios include:

- Net asset value per share (NAV/share)
- Earnings per share (EPS)

These ratios are discussed in more detail in the ratio analysis chapter.

2.11. Underwriting

Underwriting is a means of guaranteeing a minimum level of proceeds from a share issue. The cost of the guarantee is a fee, payable to the underwriter (normally an investment bank).

In the event that demand is insufficient to generate the minimum level of proceeds, the underwriter agrees to take up any shortfall, paying cash for the unwanted stock.

Underwriting is used in all situations where share issues are generating proceeds, e.g. offers, placings and rights issues. It is not necessary for scrip issues and introductions, which are not marketing operations (i.e. no new capital is being raised).

3. Share buy-backs

3.1. Introduction

A share buy-back is not a method of issue. Share buy-backs are the purchase by the issuing company of its own shares. Regulatory as well as shareholder approval is required before a company is allowed to buy back its shares. Once bought, the company can choose to cancel them or hold them as **treasury shares**.

Treasury shares can be subsequently used for purposes, such as:

- Reissue at a later date
- Transfer to an employee share scheme
- Cancellation

3.2. Reasons for share buy-backs

The net effect of a share buy-back should be neutral; the company has reduced the supply of shares, but they have also reduced the assets of the company by distributing cash. However, generally speaking, share buy-backs are positively received by investors and the share price typically rises.

There can be several reasons for share buy-backs:

- A signal to shareholders that the company is undervalued, so the company purchases its own (cheap) shares
- An alternative to dividends. The company substitutes dividend payments for capital redemptions
- To deploy surplus cash held by the company that cannot be profitably utilised elsewhere. The company essentially allows the investors to choose where the surplus cash is reinvested
- To rationalise the capital structure to include more debt and less equity. The company believes it can sustain a higher debt-equity ratio and borrows money through a bond issue or from banks to purchase its own shares
- To increase the value of the stock, and valuations of the firm (e.g. earning per share will increase)

4. Issuing equities: summary

4.1. Key concepts

Equities: methods of issue

- 11.2.1 Distinguish between primary and secondary share issuance
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Share buy-backs

- 11.2.7 Identify and explain the motivations behind a company buying back its own shares

Now you have finished this chapter you should attempt the chapter questions.