FitchLearning

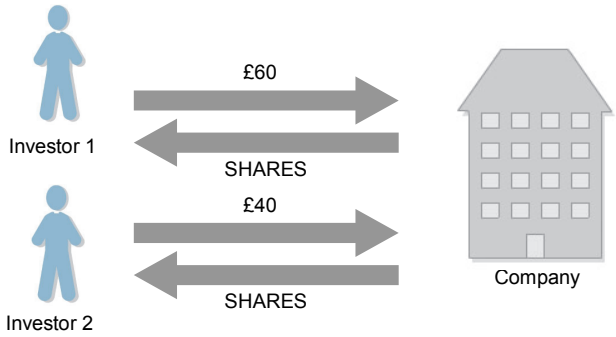
Chapter 4
Equities: Types and Features

5-8 questions

2. Ordinary and Preference Shares

Incorporation

Shareholders



Ownership vs. management

Links

Ownership and management can lead to the agency problem covered in Unit 1 Investment Environment.

3. Ordinary and Preference Shares

Ordinary shares

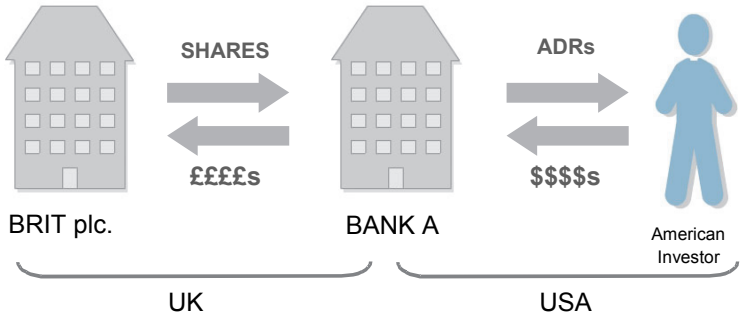
- Variable dividends dependent on profits
- Last to be paid in dividends and on liquidation
- Generally have voting rights
- 'A' shares
  - Ordinary share with different rights

Preference shares

- Fixed dividends
- First shareholder to be paid (still paid after creditors)
- Generally no voting rights
- Cumulative
- Participating
  - Opportunity for further dividend if ordinary shareholders receive more than the fixed amount
- Convertible
- Redeemable

7. American Depositary Receipts

ADRs: Features



Brit plc. will pay dividends in sterling to Bank A. Bank A will convert them into US dollars and pass them on to the ADR holder.

Further information

American Depository Receipts

American Depository Receipts (ADRs) are used by non-US companies in order to encourage US Dollar investors to buy an equity stake.

4. Quotation of Share Prices and Dividends

Share prices

- Nominal value vs. share price
- Market capitalisation

Dividends

- Net of 10% tax credit
- Franked investment income

Dividend policy

- A balance between income and growth
  - Dividend signalling theory
    - A high dividend is a positive signal
  - Stable dividend theory
    - A stable dividend attracts institutional investors
  - Uncovered dividend
    - Paid out of reserves to maintain a stable dividend

5. Absolute Valuation Models

Holding period return

- The total return to a share purchased for 40p and sold after 18 months for 65p, having received dividends of 2p, 3p, and 4p is:

$$\text{Total return} = \frac{(\text{end value - start value}) + \text{dividends received}}{\text{start value}}$$

Further information

Absolute vs. relative valuation

Absolute valuation – based on absolute returns or discounting models

Relative valuations – using multiples to compare with similar companies, e.g. price to book values

Keeping on target

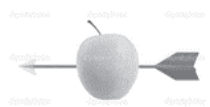
Rosa purchases a share for £15 and receives a dividend of 50p in year one and 25p in year two before selling it for £12. She also buys a 2 year 3% bond for £98. Rosa's total return on the assets is closest to:

A. 5%

B. 6%

C. 7%

D. 8%



5. Absolute Valuation Models

Dividend valuation model

Gordon's Growth model calculates the ex-div price of a share using an assumed growth rate of dividends:

$$\text{Ex - div share price} = \frac{D_0(1+g)}{(r-g)}$$

Where:

- D_0 is the most recent dividend
- g is the growth rate of the dividend
- r is the investor's required rate of return

Example: Calculate the ex-div price of a share if the dividend is 8p, the dividend growth rate is 15% and the investor's required rate of return is 20%.

Example: If next year's dividend is $5, the required rate of return is 12%, and the sustainable growth rate is 8%, what is the price of the stock according to Gordon's Growth Model?

Keeping on target

If Stock C has a current dividend of £20 a market price of £530 and an expected return of 10% p.a., what is the historical growth rate?

A. 3%
B. 6%
C. 9%
D.12%

Keeping on target

If Stock A has a current dividend of £10, a market price of £80 and a historical growth rate of 4% p.a., what is the expected return?

A. 13%
B. 15%
C. 17%
D. 19%

Answer to the question on the previous slide:

Share

Capital £12 - £15 = (£3)

Income £0.50 + £0.25 = £0.75

(£2.25)

Bond

Capital £100 - £98 = £2

Income £3 + £3 = £6

£8

Total

£5.75/£113 = 5.09%

6. Warrants

Warrants: background

- Right to subscribe for **new** shares from the issuer at a fixed price on a future date

Warrants: issuance and trading

- Usually offered as a sweetener with other investments
  - Detachable or non-detachable
- Traded in the UK on the LSE

Answers to the questions on the previous slide:

B $\dfrac{(£20x1.06)}{(0.10-0.06)} = £530$

C $\dfrac{£10x1.04}{£80} + 0.04 = 17\%$

6. Warrants

Components of warrant value

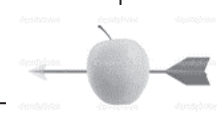
Warrant value = Formula value + Premium value

- Formula value = Price of equivalent shares - Cost on exercise
- Premium value = An additional value added to reflect a potential increase in the price of the share

Keeping on target

A warrant in B company gives the right to 3 shares at £1.20 each and the premium on the warrant is 40p. What is warrant value if the current share price is £1.50?

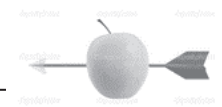
A. 70p
B. £1.30
C. £2.10
D. £4.00



Keeping on target

A warrant in C company is currently trading at £2. If it gives the right to 4 shares at £1.10 each and the current share price is £1.00. What is the premium value?

A. 20p
B. £1.20
C. £1.80
D. £2.00



6. Warrants

Percent premium

$$\text{Percent premium} = \frac{\text{Warrant price - Formula value}}{\text{Number of shares created x Current share price}}$$

- Calculate the percent premium of a warrant giving the holder the right to buy 100 shares at £1.25, if the warrant is trading at £30 and the current share price is £1.50.

Keeping on target

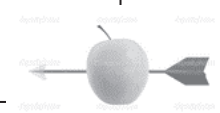
A warrant in C company is currently trading at £5. If it gives the right to 10 shares at 57p each and the current share price is £1.00 what is the percent premium?

A. 5%

B. 7%

C. 8%

D. 10%



Answer to the questions on the previous slide:

B

FV 3 x (£1.50 - £1.20) = 90p

WV = 90p + 40p = £1.30

D

FV = 4 x (£1.00 - £1.10) = £0 (note: minimum value is zero)

WV = FV + Premium

£2 = £0 + Premium

Premium = £2

6. Warrants

Covered warrants: a comparison with traditional warrants

	Warrants	Covered warrants	Options
Issued by	Companies	Investment banks	Writer
Shares delivered	New shares	Existing shares	Existing shares
Maturity	Normally >1 year	Normally 6 to 12 months	Normally 3 to 12 months
Traded on	LSE	LSE	Derivatives exchange
Types	Right to buy the underlying share only	Call and put warrants available (right to buy and sell)	Call and put options available (right to buy and sell)
Exercise/ Settlement	Physically settled contracts	Cash and physically settled contracts available	Cash and physically settled contracts available

Answer to the question on the previous slide:

B

$$Formula Value = 10x(£1.00 - £0.57) = £4.30$$

$$\text{Pr}\,emium = £5 - £4.30 = £0.70$$

$$Percent\,\text{Pr}\,emium = \frac{£0.70}{(10x£1)} = 7\%$$