

A horizontal banner with a light blue background. On the left, there is a vertical teal stripe. The word "Equity" is written in white, bold, sans-serif font. To the right of the text is a large, stylized white arrow pointing to the right, composed of two parallel lines.

**Equity**

A horizontal banner with a light blue background. On the left, there is a vertical teal stripe. The text "Overview of Equity Securities" is written in white, bold, sans-serif font. To the right of the text is a large, stylized white arrow pointing to the right, composed of two parallel lines.

**Overview of Equity Securities**



## Exam Focus

- Understanding the key features of shares
- Nondomestic equities
- Return on equity (ROE) vs. required return

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## Key Features of Common vs. Preferred Stock

	Common Stock	Preferred Stock
Voting rights	<ul style="list-style-type: none"><li>• Right to vote at AGM and by proxy</li><li>• Cumulative voting can help minorities</li><li>• May be nonvoting classes of equity</li></ul>	<ul style="list-style-type: none"><li>• No voting rights</li></ul>
Dividends	<ul style="list-style-type: none"><li>• Variable, no contractual right</li></ul>	<ul style="list-style-type: none"><li>• Usually fixed % of par</li><li>• May be:<ul style="list-style-type: none"><li>• Cumulative</li><li>• Participating</li></ul></li></ul>
Features	<ul style="list-style-type: none"><li>• Residual claim on assets</li><li>• Perpetual</li></ul>	<ul style="list-style-type: none"><li>• May be perpetual</li><li>• May be convertible/callable/putable</li></ul>
Risk/return	<ul style="list-style-type: none"><li>• Return through divs. and capital gains</li><li>• Higher risk/return</li></ul>	<ul style="list-style-type: none"><li>• Return largely through divs.</li><li>• Lower risk/return</li></ul>

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## Investing in Nondomestic Securities

- Opportunities increasing through direct investment and dual listings, but administrative challenges may remain
- Depository receipts
  - A domestic bank purchases overseas shares, then issues certificates of ownership to domestic investors
  - DRs ratio indicates number of underlying shares
  - DRs trade on domestic exchanges
  - Details:
    - GDRs vs. ADRs
    - Sponsored/unsponsored
    - SEC registered: Level I/II/III vs. Rule 144A

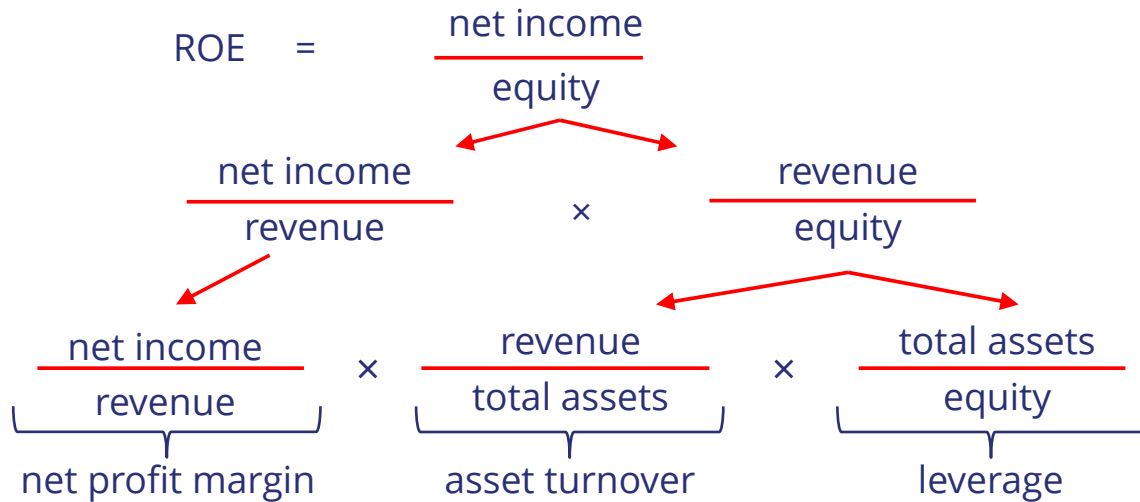
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## Return on Equity: ROE

- **Accounting ROE** (net income / equity) measures the return management is generating on equity capital; based on **book values** and accounting profits
  - Can be increased by gearing up (but increases risk)
  - Management account choices can impact values
  - Changes in ROE can be analyzed using DuPont formula
    - Don't assume an increase is always good
  - Book value of equity reflects historic operating and financing decisions
    - Price-to-book ratio shows how favorably investors view future investment opportunities
      - Tesla vs. traditional motor manufacturers

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## DuPont System: Original Equation



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## Required Return on Equity

- The **cost of equity** is the investors' minimum **required rate of return** on the firm's equity securities:
  - Discount rate
  - If company fails to meet this, the share price will fall
  - Commonly estimated through CAPM or DDM
  - Feeds into WACC for NPV analysis

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## Other Points to Note

- Private equity securities
  - Smaller market, but can enable longer-term focus
    - Venture capital investments
    - Leveraged buyout
    - Private investment in public equity
  - Aim is often to take company public again after certain targets have been met