

PRINCIPLES OF FINANCE 2

FINANCE

The background features a collage of financial-themed illustrations. At the top left, a line graph shows a fluctuating trend with two points highlighted by red dots. To its right, a green plant with three leaves grows out of a stack of gold coins. Below the plant, a pie chart is divided into three segments: a blue segment labeled 'investment', a white segment labeled 'income', and a grey segment labeled 'tax'. In the bottom left corner, a large dollar sign (\$) is visible. The entire collage is overlaid with a pattern of white and grey diagonal lines forming a grid-like structure.



LEARNING JOURNAL UNIT 7

BUS 4404-01 PRINCIPLES OF FINANCE 2 - AY2024-T3



MARCH 16, 2024

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EQUITY DILUTION AND THE EPS PUZZLE

THE MECHANICS BEHIND IT

When a company issues additional shares of stock, its total earnings get divided among a larger pool of outstanding shares. This phenomenon directly leads to a decrease in the company's earnings per share (EPS). It's simple math - if the earnings (the numerator) stay constant while the number of shares (the denominator) increases, the resulting fraction inevitably gets smaller. “If a company issues more shares to investors, then this increases the number of shares outstanding and decreases the company's EPS” (Beers, 2022).

EXAMPLE

Let's use an example to illustrate. Suppose a company currently has 1 million shares outstanding and reports \$10 million in annual earnings. Their EPS would be \$10 ($\$10\text{M} / 1\text{M}$ shares). Now, if they issue 500,000 new shares while earnings remain at \$10 million, the updated EPS becomes \$6.67 ($\$10\text{M} / 1.5\text{M}$ shares). Despite no change in profitability, the company's EPS dropped by overcrowding the earnings with more shares.

THE CAPITAL RAISING DILEMMA

This EPS dilution creates a dilemma when companies need to raise capital. On one hand, selling new shares generates cash proceeds to fund investments or growth initiatives. However, the associated EPS decrease could make the company's stock look less appealing to investors focused on per-share earnings. A declining EPS often translates to a lower stock price and valuation.

As a result, some companies may lean towards debt financing options like issuing bonds instead of equity. Debt avoids EPS dilution since it doesn't increase the share count. But this approach comes with its own set of risks - interest costs, repayment obligations, and potential bankruptcy concerns if unable to service the debt.

NAVIGATING THE CAPITAL STRUCTURE

Seasoned managers must carefully evaluate their capital structure to strike the right balance between equity and debt. If the capital raised through new equity can quickly generate incremental earnings growth, it may offset the initial EPS hit. Strong profit trajectories enable companies to absorb the dilution over time as earnings expand.

For mature companies with limited high-return investment opportunities, debt may seem more appealing to avoid EPS deterioration. But overleveraging raises default risks. Finding the optimal equity-debt mix requires considering various factors like the company's growth prospects, existing financial obligations, interest rates, and overall risk profile.

CONCLUSION

In essence, the EPS dilution effect doesn't necessarily make equity inferior to debt for capital raising purposes. It underscores the need for a nuanced financing strategy aligned with a company's fundamentals, cash flow dynamics, and long-term objectives. As with many corporate finance decisions, there's no one-size-fits-all prescription - context shapes the suitable path.

Wordcount: 431

REFERENCE:

Beers, B. (2022, March 8). Earnings Per Share (EPS) vs. Diluted EPS: What's the Difference?

Investopedia. <https://www.investopedia.com/ask/answers/051115/what-difference-between-earnings-share-eps-and-diluted-eps.asp>