

When a company decides to raise capital, one of the key considerations revolves around its earnings per share (EPS) - that all-important metric followed closely by investors. The phenomenon of an EPS drops upon issuing new equity is an intricate dance between net income and outstanding shares. “EPS indicates how much money a company makes for each share of its stock and is a widely used metric for estimating corporate value” (Fernando, 2024).

EPS gets calculated by dividing a company's net income by its number of outstanding shares. It's a straightforward fraction, one would think. However, issuing new shares muddles the equation - the denominator increases while the numerator (net income) remains static, at least initially. Picture yourself splitting a \$20 bill; as more friends join, each person's share diminishes, right? The same principle applies to a company's hard-earned net income being dispersed across a larger pool of shares.

Let's illustrate with an example: a \$10 million net income company with 1 million outstanding shares would have an EPS of \$10 ($\$10\text{M}/1\text{M}$). Now, say they issue 500,000 new shares to raise capital. Suddenly, their outstanding count balloons to 1.5 million while that \$10M net income stays put. Simple math shows the new EPS drops to \$6.67 ($\$10\text{M}/1.5\text{M}$). This diminished EPS could spook investors, potentially depressing the stock price.

The EPS impact presents a paradox when it comes to financing choices. Companies zealously guard their EPS as it influences valuations and capital costs. An EPS decline signals delusion - spreading the same earnings pie across more slices. This sobering reality often swayed corporations towards debt financing via bonds or loans, avoiding immediate EPS dilution. Yet, prudence dictates monitoring interest costs and default risks associated with debt.

The optimal path balances EPS optics with capital needs. If funds raised from new equity can rapidly boost net income enough to outpace the EPS drag from share issuance, equity may still reign supreme. Seasoned management teams meticulously evaluate where their dollars will yield maximum bang for the buck before pulling the equity or debt trigger.

In essence, the EPS phenomenon sparks a calibrated tug-of-war between equity and debt - a delicate dance choreographed by financial pragmatism and growth opportunism. As with many corporate finance decisions, there are no universally correct answers, only prudent strategies tailored to a company's goals and realities.

Reference:

Fernando, J. (2024, March 6). Earnings per share (EPS): What it means and how to calculate it.

Investopedia. <https://www.investopedia.com/terms/e/eps.asp>