Equity Financing

Meaning

Equity finance is a method of raising fresh capital by selling shares of the company to public, institutional investors, or financial institutions. The people who buy shares are referred to as shareholders of the company because they have received ownership interest in the company.

Equity financing is a method of raising funds to meet liquidity needs of an organization by selling a company's stock in exchange for cash. The portion of the stake will depend on the promoter's ownership in the company.

One of the most sought after methods of raising cash, apart from public issue, is via Venture Capital. Venture Capital (VC) financing is a method of raising money via high net worth individuals who are looking at diverse investment opportunities.

They provide the company with much needed capital to sustain business in exchange of shares or ownership in the company.

A start-up might need various rounds of equity financing to meet liquidity needs. They (VC) may like to go for convertible preference share as form of equity financing, and as the firm grows and reports profit consistently, it may consider going public.

If the company decides to go public, these investors (Venture Capitalists) can use the opportunity to sell their stake to institutional or retail investors at a premium. If the company needs more cash, it can go for right offer or follow on public offerings.

When a company goes for equity financing to meet its liquidity needs, for diversification or expansion purpose, it has to prepare a prospectus where financial details of the company are mentioned. The company has to also specify as to what it plans to do with the funds raised. Equity financing is slightly different from debt financing, where funds are borrowed by the business to meet liquidity requirement. Ideally, to meet liquidity needs an organization can raise funds via both equity as well as debt financing.

Advantages of Equity Finance

Raising money for your business through equity finance can have many benefits, including:

- The funding is **committed to your business and your intended projects**. Investors only realize their investment if the business is doing well, e.g. through stock market flotation or a sale to new investors.

- You will not have to keep up with costs of servicing bank loans or debt finance, allowing you to **use the capital for business activities**.

- Outside investors expect the business to deliver value, helping you **explore and execute growth ideas**.

- Some business angels and venture capitalists can bring **valuable skills, contacts and experience** to your business. They can also assist with strategy and key decision making.

- Like you, **investors have a vested interest** in the business' success, ie its growth, profitability and increase in value.

- Investors are often prepared to **provide follow-up funding** as the business grows.

Disadvantages of Equity Finance

However, there are drawbacks of equity finance too. It's worth considering that:

- Raising equity finance is **demanding, costly and time consuming**, and may take management focus away from the core business activities.

- Potential investors will seek **comprehensive background information** on you and your business. They will look carefully at past results and forecasts and will probe the management team. However, many businesses find this process useful, regardless of whether or not any fundraising is successful.

- Depending on the investor, you will **lose a certain amount of your power** to make management decisions.
- You will have to invest management time to **provide regular information** for the investor to monitor.
- At first you will have a **smaller share in the business** - both as a percentage and in absolute monetary terms. However, your reduced share may become worth a lot more in absolute monetary terms if the investment leads to your business becoming more successful.
- There can be **legal and regulatory issues** to comply with when raising finance, eg when promoting investments.

Preferential Shares

Preference shares are those shares which carry certain special or priority rights. Firstly, dividend at a fixed rate is payable on these shares before any dividend is paid on equity shares.

Secondly, at the time of winding up of the company, capital is repaid to preference shareholders prior to the return of equity capital. Preference shares do not carry voting rights. However, holders of preference shares may claim voting rights if the dividends are not paid for two years or more on cumulative preference shares and three years or more on non-cumulative preference shares.

Preference shares have the characteristics of both equity shares and debentures. Like equity shares, dividend on preference shares is payable only when there are profits and at the discretion of the Board of Directors.

Preference shares are similar to debentures in the sense that the rate of dividend is fixed and preference shareholders do not generally enjoy voting rights. Therefore, preference shares are a hybrid form of financing.

Types of Preference Shares

There are various types of preference shares according to the clause contained in the agreement at the time of issue, some important kinds are listed below:

- **Cumulative Preference Shares:**

Shares having right of dividend even in those years in which it makes no profit are known as cumulative preference shares. In case the companies do not declare dividends for a particular year then they are treated as arrears and are carried forward to next year. When the arrears pertaining to dividend are cumulative in nature and such arrears are cleared before any dividend payment to equity shareholders then it is said to be as cumulative preference shares.

- **Non-cumulative Preference Shares:**

A non-cumulative preference share does not accumulate any dividend. In case the dividend by the company is not paid then they have the right to avail dividends from the profits earned from the particular year. Dividends are paid only from the net profit of each year. In case there is no profit accumulated for a particular year then the arrears of dividends cannot be claimed in subsequent years.

- **Participating Preference Shares:**

These shares have the right to participate in surplus profits of the company during liquidation after the company had paid to other shareholders. The preferential shareholders receive stipulated rate of dividend and also participate in the additional earnings of the company along with the equity shareholders.

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- **Non-participating Preference Shares:**

Preference shares having no right to participate in the surplus profits or in any surplus on liquidation of the company are referred to as non-participating preference shares. Here, preference shareholders receive only stated dividend and nothing more.

- **Convertible Preference Shares:**

These shares are those which are converted into equity shares at a specified rate on the expiry of a stated period. The shareholders have a right to convert their shares into equity shares within a specified period.

- **Non-convertible Preference Shares:**

The shares that cannot be converted to equity are referred to as non-convertible shares. These can also be redeemed.

- **Redeemable Preference Shares:**

Redeemable preference shares are referred to as shares that can be redeemed or repaid after the fixed period as issued by the company or even before that.

- **Non-Redeemable Preference Shares:**

Non redeemable preference shares are referred to as shares that cannot be redeemed during the lifetime of the company.

Advantages

1. Appeal to Cautious Investors:

Preference shares can be easily sold to investors who prefer reasonable safety of their capital and want a regular and fixed return on it.

2. No Obligation for Dividends:

A company is not bound to pay dividend on preference shares if its profits in a particular year are insufficient. It can postpone the dividend in case of cumulative preference shares also. No fixed burden is created on its finances.

3. No Interference:

Generally, preference shares do not carry voting rights. Therefore, a company can raise capital without dilution of control. Equity shareholders retain exclusive control over the company.

4. Trading on Equity:

The rate of dividend on preference shares is fixed. Therefore, with the rise in its earnings, the company can provide the benefits of trading on equity to the equity shareholders.

5. No Charge on Assets:

Preference shares do not create any mortgage or charge on the assets of the company. The company can keep its fixed assets free for raising loans in future.

6. Flexibility:

A company can issue redeemable preference shares for a fixed period. The capital can be repaid when it is no longer required in business. There is no danger of over-capitalisation and the capital structure remains elastic.

7. Variety:

Different types of preference shares can be issued depending on the needs of investors. Participating preference shares or convertible preference shares may be issued to attract bold and enterprising investors.

Preference shares can be made more popular by giving special rights and privileges such as voting rights, right of conversion into equity shares, right of shares in profits and redemption at a premium.

Disadvantages

1. Fixed Obligation:

Dividend on preference shares has to be paid at a fixed rate and before any dividend is paid on equity shares. The burden is greater in case of cumulative preference shares on which accumulated arrears of dividend have to be paid.

2. Limited Appeal:

Bold investors do not like preference shares. Cautious and conservative investors prefer debentures and government securities. In order to attract sufficient investors, a company may have to offer a higher rate of dividend on preference shares.

3. Low Return:

When the earnings of the company are high, fixed dividend on preference shares becomes unattractive. Preference shareholders generally do not have the right to participate in the prosperity of the company.

4. No Voting Rights:

Preference shares generally do not carry voting rights. As a result, preference shareholders are helpless and have no say in the management and control of the company.

5. Fear of Redemption:

The holders of redeemable preference shares might have contributed finance when the company was badly in need of funds. But the company may refund their money whenever the money market is favorable. Despite the fact that they stood by the company in its hour of need, they are shown the door unceremoniously.

Equity Shares

Equity shares are also known as ordinary shares. They are the form of fractional or part ownership in which the shareholder, as a fractional owner, takes the maximum business risk. The holders of Equity shares are members of the company and have voting rights. Equity shares are the vital source for raising long-term capital.

Equity shares represent the ownership of a company and capital raised by the issue of such shares is known as ownership capital or owner's funds. They are the foundation for the creation of a company.

Equity shareholders are paid on the basis of earnings of the company and do not get a fixed dividend. They are referred to as 'residual owners'. They receive what is left after all other claims on the company's income and assets have been settled. Through their right to vote, these shareholders have a right to participate in the management of the company.

Types of Equity Share

- **Authorized Share Capital-** This amount is the highest amount an organization can issue. This amount can be changed time as per the companies recommendation and with the help of few formalities.

- **Issued Share Capital-** This is the approved capital which an organization gives to the investors.

- **Subscribed Share Capital-** This is a portion of the issued capital which an investor accepts and agrees upon.

- **Paid Up Capital-** This is a section of the subscribed capital that the investors give. Paid-up capital is the money that an organization really invests in the company's operation.

- **Right Share-** These are that type of share that an organization issue to their existing stockholders. This type of share is issued by the company to preserve the proprietary rights of old investors.

- **Bonus Share-** When a business split the stock to its stockholders in the dividend form, we call it a bonus share.

- **Sweat Equity Share-** This type of share is allocated only to the outstanding workers or executives of an organization for their excellent work on providing intellectual property rights to an organization.

Merits of Equity Shares

- Equity capital is the foundation of the capital of a company. It stands last in the list of claims and it provides a cushion for creditors.
- Equity capital provides creditworthiness to the company and confidence to prospective loan providers.
- Investors who are willing to take a bigger risk for higher returns prefer equity shares.
- There is no burden on the company, as payment of dividend to the equity shareholders is not compulsory.
- Equity issue raises funds without creating any charge on the assets of the company.
- Voting rights of equity shareholders make them have democratic control over the management of the company

Limitations of Equity Shares

- Investors who prefer steady income may not prefer equity shares.
- The cost of equity shares is higher than the cost of raising funds through other sources.
- The issue of additional equity shares dilutes the voting power and earnings of existing equity shareholders.
- Many formalities and procedural delays are involved and they are time-consuming processes