



## Chapter 3 – Equities and Stocks

9 Questions



# Company Formation

Large and small companies are set up as companies.

Process depends upon jurisdiction.

Documents are required for registration

For UK  
(Registrar of Companies)

Memorandum of Association

Articles of Association

For US  
(Secretary of State)

Certificate of Incorporation



# Private and Public Companies

## Public Companies

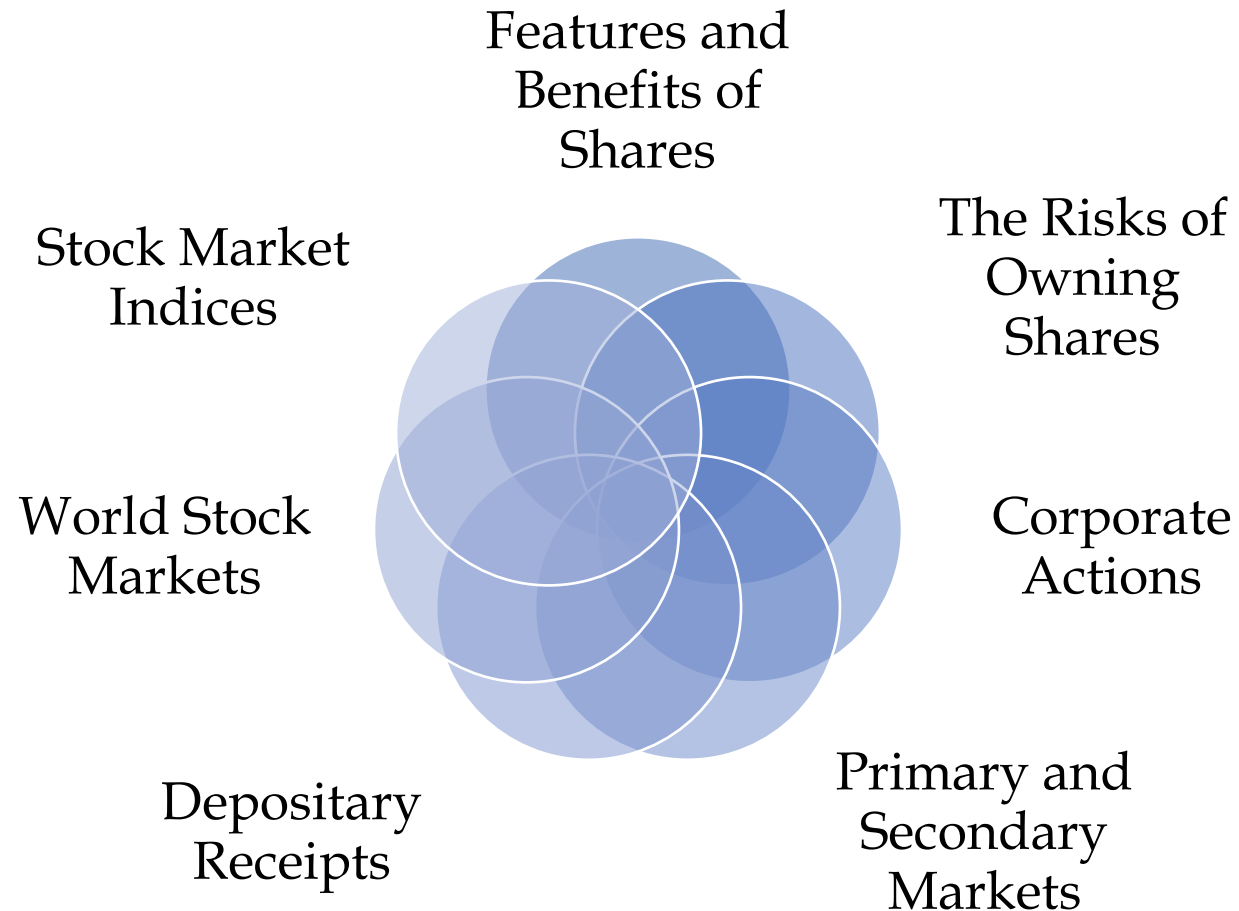
- Permitted to issue shares
- All listed companies are public
- But all public companies are not listed
- In UK, they are named 'plc'
- In US, shareholders have limited liability

Limited liability means that a shareholder's obligation to pay a company's debts is restricted to the amount they initially agreed to contribute to the business.

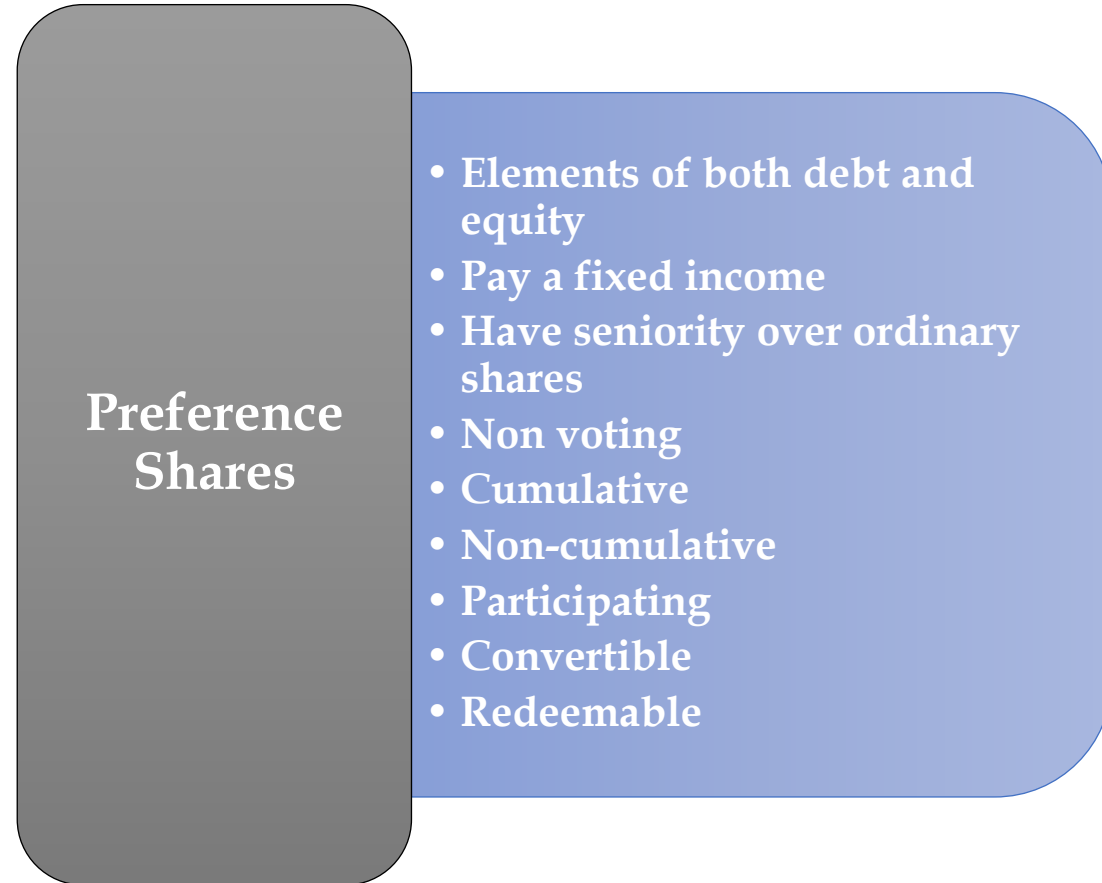
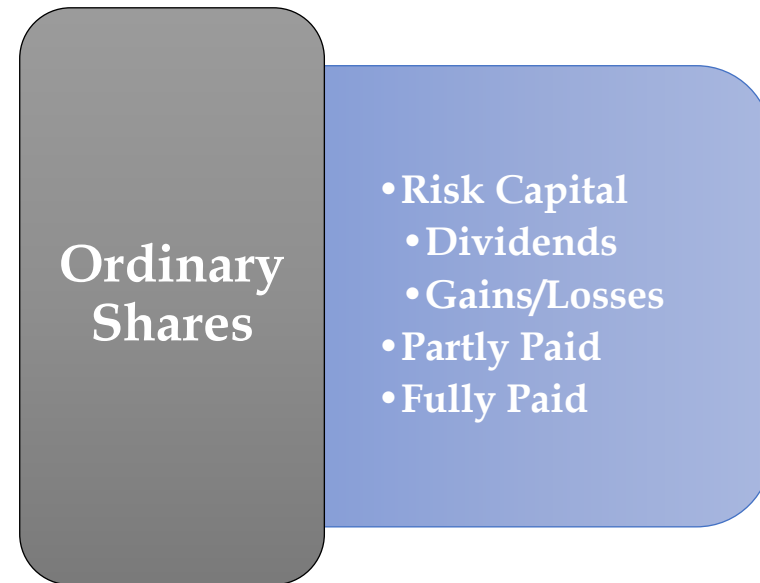
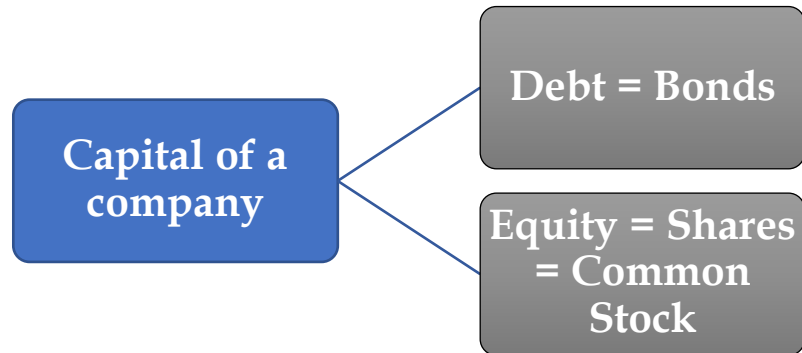
## Private Companies

- Cannot issue shares
- In UK, they are named 'limited' or 'ltd'





# Features of Shares



# Benefits of Owning Shares

- **Dividend:** is the return that an investor gets for providing the risk capital for a business. Paid out of their profits, which form part of their **distributable reserves** - post-tax profits made over the life of a company, in excess of dividends paid
- **Naked or Uncovered dividend:** where the current year's profits are insufficient to fully cover the dividend payment
- **Dividend Yield:** Allows potential shareholders to compare the dividend paid on a company's shares with alternative investments
- **Example**
- ABC plc has 20 million ordinary shares, each trading at US\$2.50. It pays out a total of US\$1 million in dividends. What is its dividend yield?
- Dividend Yield = Dividend/Market Capitalisation x 100  
= **USD 1,000,000/(20,000,000 x USD 2.50) x 100 = 2%**

**Why do some companies have high or low dividend yields?**



**Capital Gains:** Can be made on shares if their prices increase over the purchase price.

- If not sold, then the gain is described as being **unrealised**
- Need to be aware of CGT

**Pre-Emptive Rights: Right to Subscribe for New Shares**

- Shareholders have the option to subscribe for any new share offering before it is offered to the wider public.
- In many cases they receive some compensation if they decide not to do so.
- A **rights issue** is one method by which a company can raise additional capital, complying with pre-emptive rights

**Right to Vote** on matters presented to them at company meetings – e.g. on proposed dividends appointment of directors, resolutions etc.

- The votes are normally allocated on the basis of one share = one vote.
- Can attend the meeting or appoint a proxy.



# The Risks of Owning Shares

## Market and Price risk

- Risk that share prices in general might fall
- E.g. Black Monday – 19<sup>th</sup> Oct 1987, Dot.com bubble in 2000, Credit Crunch in 2008

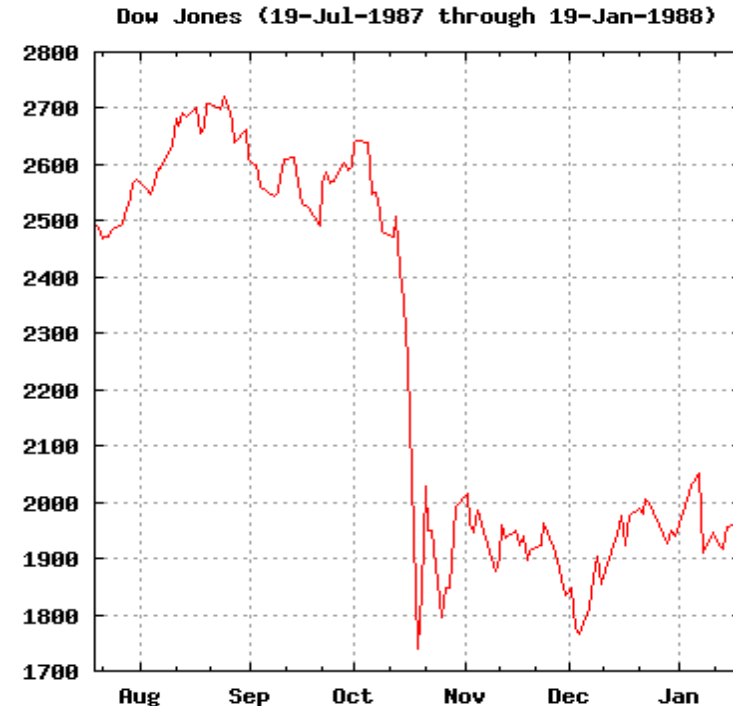
## Liquidity risk

- Risk that shares may be difficult to sell
- E.g. Smaller Companies, Emerging Markets

## Issuer risk

- Issuing company may go bankrupt and shares may be worthless
- E.g. Collapse of Enron and Lehman Brothers

## Exchange Rate Risk





# Corporate Actions

A corporate action occurs when a company does something that affects its **share capital** or its bonds.

More than 150 types of corporate action events that can be classified into 3 broad categories:

## Mandatory events

- Must be applied by companies across all shareholders of a particular class
- E.g. Payment of Dividend

## Mandatory events with options

- One where shareholders have a range of options prior to default event occurring
- E.g. A Rights Issue

## Voluntary events

- One where some shareholders may choose to proceed but others may not
- E.g. voting on a takeover bid

About a million corporate actions take place every year worldwide over and above three million fixed-rate interest payments and redemptions.



# Securities Ratios - Europe/Asia and US

It is necessary to know how the terms of a corporate action such as a rights issue or bonus issue are expressed – a securities ratio.

**Example** The terms of the bonus issue may be expressed as 1:4

- Investor will receive one new share for each existing four shares held.
- This is the standard approach used in European and Asian markets

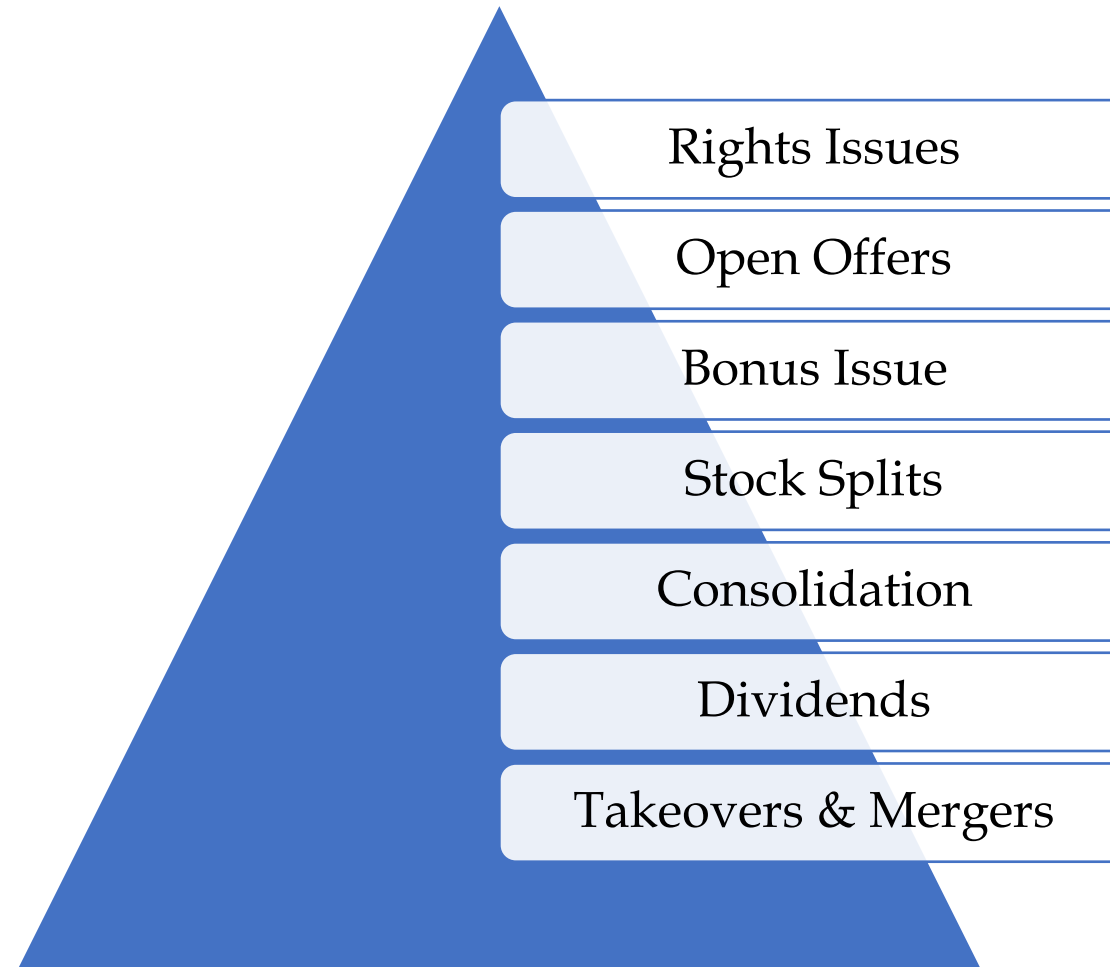
## US Approach

- The first number in the securities ratio indicates the final holding after the event The second number is the original number of shares held.
- In the above example expressed in US terms would be 5:4.

E.g. If a US company announced a 5:4 bonus issue and the investor held 10,000 shares, then the investor would end up with 12,500 shares.



# Types of Corporate Action



## Mandatory event with options

- Offer to existing shareholders of rights to purchase additional shares at a discounted price to raise additional finance
- Legal requirement of pre-emptive rights protects existing shareholders against dilution of holding

## Terms

## Options

- Take up the rights
- Sell the rights
- Do nothing and allow to lapse
- Sell sufficient to take up the balance



Is a variation on the rights issue theme

is used in many European, Middle Eastern and Far East markets

An open offer is made to existing shareholders to subscribe for additional shares normally in proportion to their holdings.

The difference is that the right to buy the offered securities is not transferable and so cannot be sold.



## Why do it?

Issue of new, free, shares to existing shareholders in proportion to existing holding e.g. 1:3

- Reduces share price so shares more marketable

Also known as capitalisation issue or scrip issue



Involves splitting the existing shares into new ones that have a lower nominal value - e.g.

- 2:1 subdivision of ordinary €2 shares into ordinary €1 shares - receive 2 ordinary €1 shares for each existing 1 ordinary €2 shares held
- 10:1 subdivision of ordinary €10 shares into ordinary €1 shares - receive 10 ordinary €1 shares for each existing 1 ordinary €10 shares held

Also known as a share split

Comparison with a bonus issue -

- Alternative way to reduce the share price
- Often used as part of a capital reorganisation
- Key difference to a bonus issue - a bonus issue does not affect the nominal value of the shares



# Consolidation or Reverse Stock Split

A capital reorganisation where shares are consolidated into a new holding with a higher nominal value - e.g.

- 1:10 consolidation of ordinary €0.1 shares into ordinary €1 shares - receive 1 ordinary €1 share for each existing 10 ordinary €0.1 shares held

Opposite of a share split - so also known as a reverse split

Used when share price falls to such a level that company wants to make shares more marketable or as part of a capital reorganisation





# Rights Issue Example

A company offers a 1 for 3 rights issue at a subscription price of £3. The pre rights share price is £4. Calculate the theoretical ex rights price (TERP):

- An investor owns 3 shares at £4 each = £12 holding.
- An investor can buy 1 share at £3
- Therefore in total the investor now has 4 shares, worth  $£12 + £3 = £15$
- The theoretical ex rights price is calculated as total value / number of shares.  $£15 / 4 \text{ shares} = £3.75$
- The nil paid price = TERP – subscription price =  $£3.75 - £3.00 = £0.75$   
[Discount to TERP = 20%]



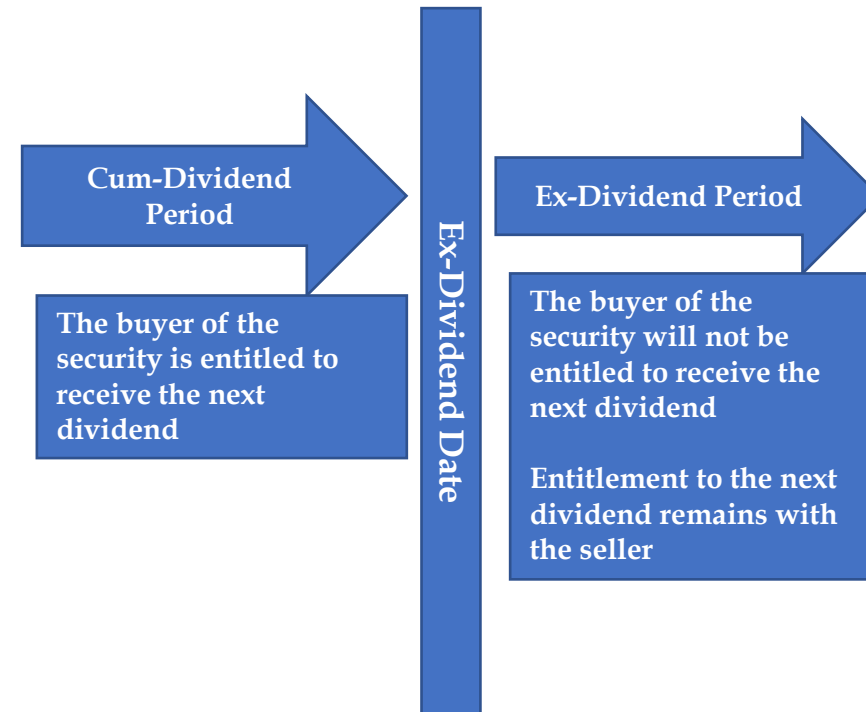
# Example

A company offers a 1 for 2 rights issue at a subscription price of \$1.50. The pre rights share price is \$2.25. Calculate the theoretical ex rights price (TERP):



# Dividends

- Distribution of realised profits to shareholders
  - Interim
  - Final dividends
- Dividend timetable:
  - Declaration date - Date on which amount and pay date announced
  - Record Date - Last date for the registration of shares for the payment of next dividend – ‘Books Closed Date’
  - Ex-dividend date - 1 business day before record date; Purchases after this date not entitled to dividend
  - Payment date - normally two weeks after record date



# Takeovers and Mergers

Attempt by a company to acquire all/part of the issued share capital of another company

May be friendly or hostile

Involves offer of cash and/or securities to shareholders of target company

Stages

- Takeover announced by board of bidding company
- Shareholders in target company given specified period in which to vote on whether to accept the offer
- If > 50% accept, bidding company gains control
- Proceeds of offer – cash and/or securities – distributed to shareholders in target

A merger is where two companies combine.

The characteristics of a merger are that:

- Both companies are of similar size
- Neither is portrayed as the acquirer
- The management structure of both businesses is combined
- the securities of the separate entities is swapped for a new security



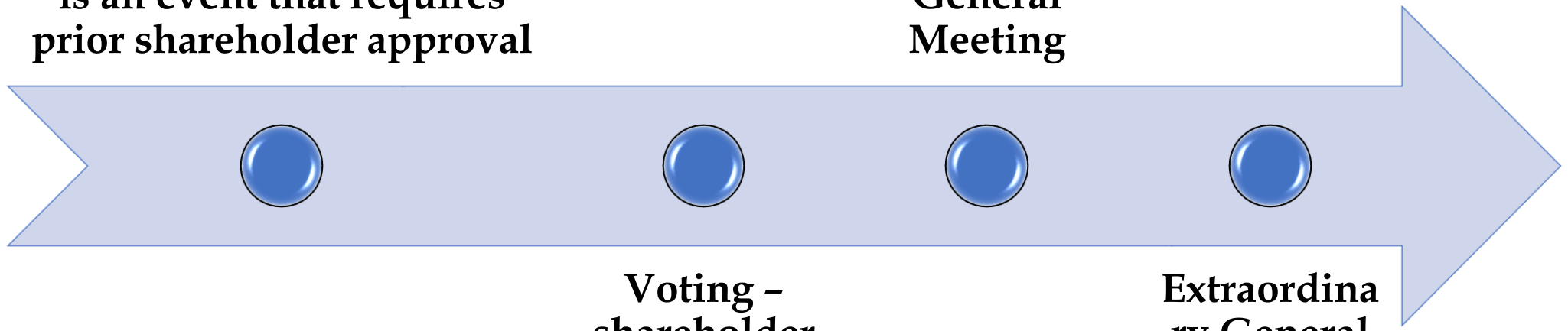
# Company Meetings

**Companies are required to hold shareholder meetings annually and when there is an event that requires prior shareholder approval**

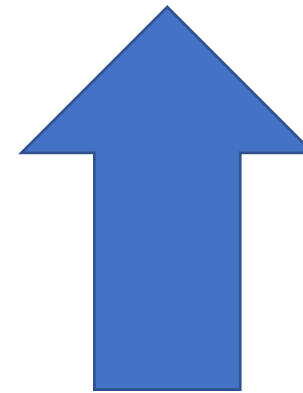
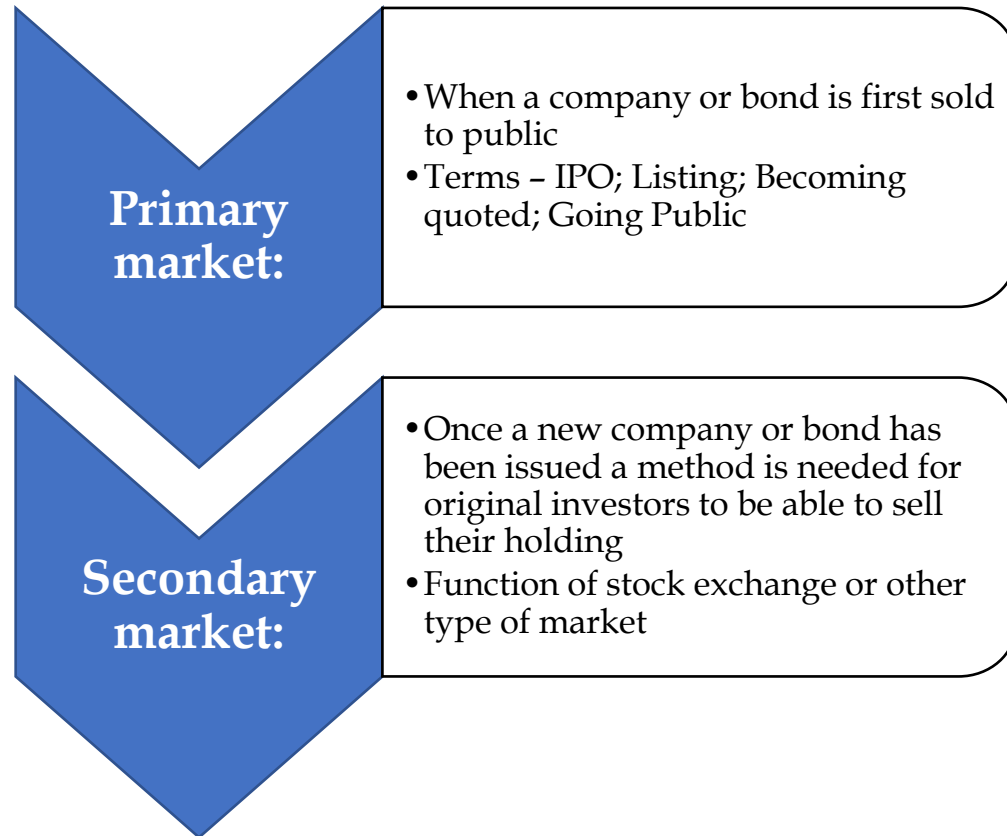
**Annual General Meeting**

**Extraordinary General Meeting**

**Voting - shareholder is an owner and uses vote to exercise control**

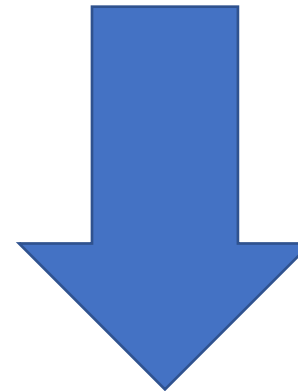


# Primary & Secondary Markets



## Advantages of Listing:

- Access to capital
- Exit route for existing investors
- Use shares to acquire other companies
- Status
- Employee benefits



## Disadvantages of Listing:

- Regulated environment
- Exposed to takeovers
- Short-termism



# Depository Receipts

American depository receipts (ADRs) were originally designed to enable

US investors to hold overseas shares without the high dealing costs and settlement delays associated with overseas equity transactions.

- Is dollar-denominated and issued in bearer form, with a depository bank as the registered shareholder.
- They confer the same shareholder rights as if the shares had been purchased directly.
- The beneficial owner of the underlying shares may cancel the ADR at any time and become the registered owner of the shares.
- ADRs enable non-US companies to attract US investors to raise funds.
- Listed and freely traded on the NYSE, NASDAQ and LSE
- Well-known companies, such as BP, Nokia, Royal Dutch and Vodafone, have issued ADRs

Those issued outside the US are termed **global depository receipts (GDRs)**

- GDR holders are not able to take up rights issues and instead these are sold and the cash distributed

Up to 20% of a company's voting share capital may be converted into depository receipts.



## Function

- Provide means to raise new capital
- Facilitate trading
- Created standardised instruments for trading

## Systems

- Order driven
- Quote driven





# Stock Markets – Order Driven

ABC Holdings		ABC		P Close		517½	GBX	
NMS 200,000		Segment SET1		Sector FT10		ISIN GB012345678		
						TVol		8.50m
Last	524½	AT	at 11:06		Vol	3,952		
Prev	524	525AT	524¼AT	524	524			
Trade Hi	530	Open		520		Total Vol	4.61m	
Trade Lo	517	VWAP		527		SETS Vol	2.58m	
BUY		TVol	543,906	Base	520	TVol	707,746	SELL
		MOVol				MOVol		
1		20,000	524 – 525			10,000		2
524.00	20,000	20,000	524	525	10,000	10,000	525.00	
523.62	77,780	57,780	523½	525½	21,900	31,900	525.34	
523.38	138,785	61,005	523	526	50,000	81,900	525.74	
522.88	188,785	50,000	521	526½	20,000	101,900	525.80	
521.49	189,185	400	519	529	50,000	151,900	526.25	

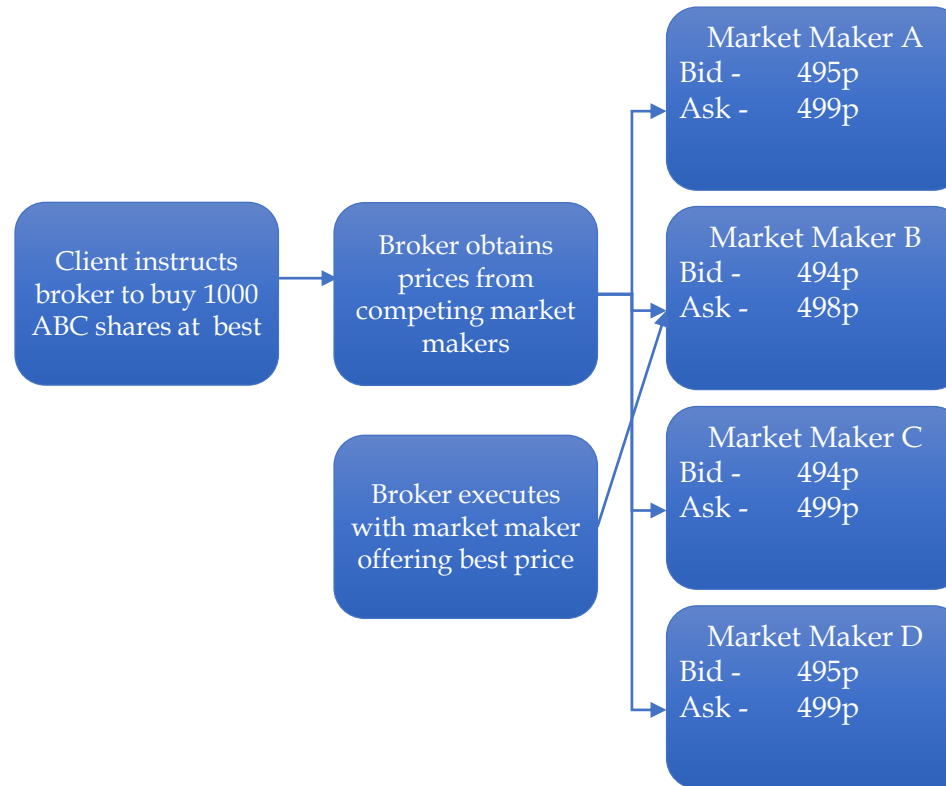


# Stock Markets – Quote Driven

Quote driven markets operate using market makers

These are market participants who are obliged to make, on demand, deal-able two-way prices

A market maker's price comprises of bid and offer prices



# Stock Exchanges

Exchange	Country	Trading Systems	Trading Type
New York Stock Exchange	US		Open outcry
NASDAQ	US	NASDAQ	Quote driven
London Stock Exchange	UK	SETS SEAQ	Order driven Quote driven
Euronext	Belgium; France; Netherlands; Portugal	Euronext	Order driven
Deutsche Borse	Germany	Xetra	Order driven
BME	Spain	SIBE	Order driven
Tokyo Stock Exchange	Japan	Stock/CB system	Order driven



Markets worldwide compute one or more indices of prices of the shares of their country's large companies

Calculation – may be weighted to take account of free float market capitalisation

## **Role:**

- Market barometer
- Performance measurement against benchmarks
- Basis for index derivatives contracts and many tracker products
- To support investment research and asset allocation

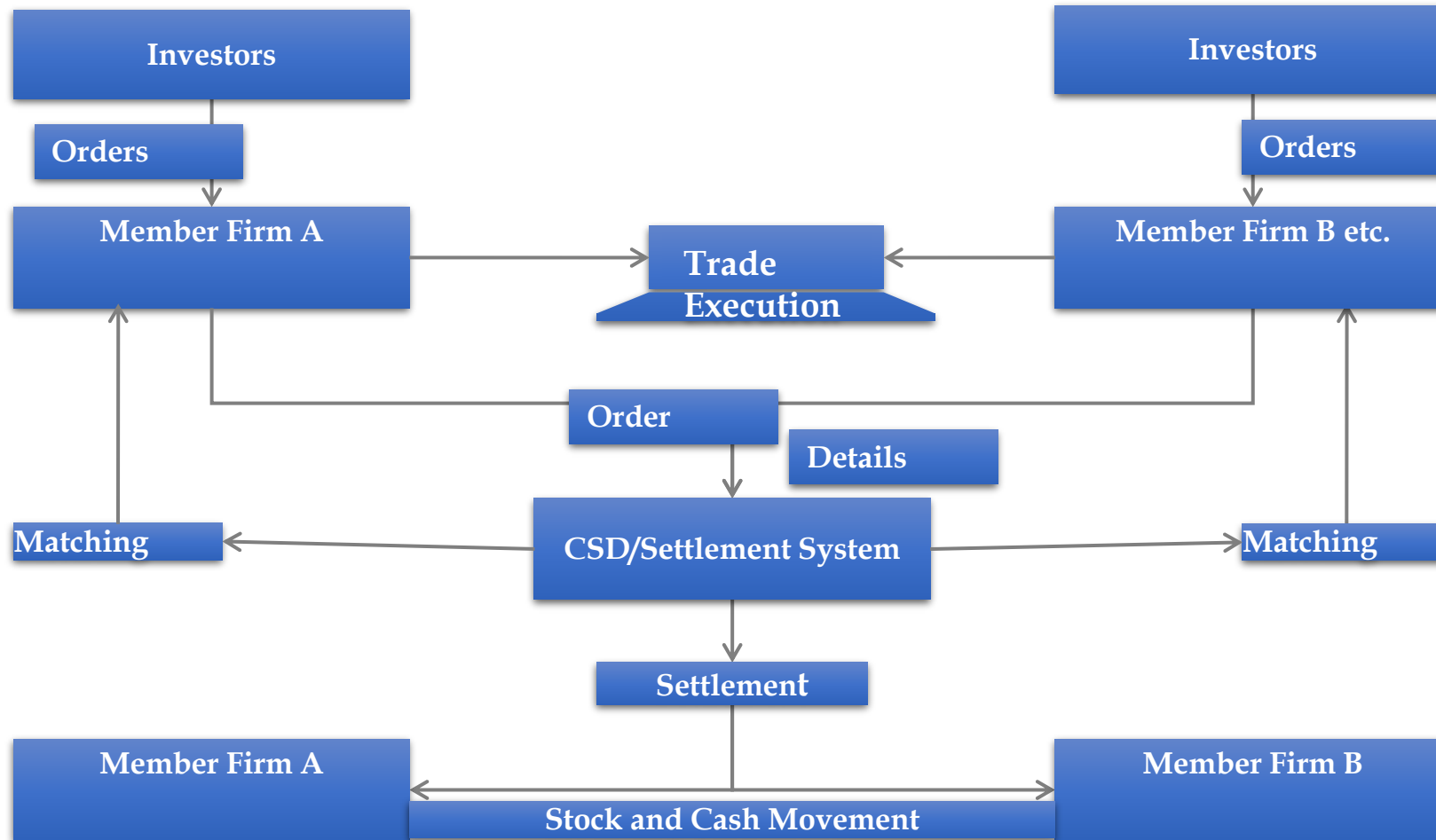


# Stock Exchange Indices

Country	Index Name	No of Stocks
US	DJIA (Dow Jones Industrial Average): providing a narrow view of the stock market	30
	S&P 500 (Standard & Poor's): providing a wider view of the stock market	500
	NASDAQ Composite: focusing on the shares traded on NASDAQ, including many technology companies	3,000+
UK	FTSE 100 - An index of the largest 100 UK companies. Covers about 70% of the UK market by value.	100
	FTSE All Share - Covers over 600 companies and accounts for about 98% of the UK market by value. It is often used as the benchmark against which diversified share portfolios are assessed.	600
Japan	NIKKEI 225	225
France	CAC 40	40
Germany	XETRA DAX	30
India	BSE Sensex	30
China	SSE Composite	800+
Singapore	Straits Times Index	50
Australia	S&P ASX200	200



# Settlement Systems



**Accepted Method - Delivery Versus Payment (DVP)**



# Registered and Bearer

