



Class: FYBSc

Subject : Business Finance 1

Subject Code:

Chapter:

Chapter Name: Issue of shares

Today's Agenda

1. Obtaining a stock exchange quotation
 1. Reasons for seeking a quotation
 2. Methods – Offer for sale at a fixed price
 1. Timetable for an Offer for sale
 3. Methods – Offer for sale by tender
 4. Methods – Offer for subscription
 5. Methods – Placings
 6. Methods - Introductions
 7. Underwriting process
2. Issues made by companies already quoted
 1. Methods to issue
 2. Rights issue
 1. Purpose of a Rights issue
 2. Timetable
 3. Impact on shareprice
 4. Possible courses of action for shareholders
3. Scrips issues
 1. Purpose of scrips issue
 2. Arguments against issue of scrips
 3. Impact on share price

1 Obtaining a stock exchange quotation

If a company successfully obtains a quotation on a stock exchange, the price of its securities will be included on the exchange's official list. Such quoted securities are called listed securities.

1.1 Reasons for seeking a quotation

1. To raise capital for the company :

Getting a quotation allows the company to sell new shares to a wide market and to raise large sums of money as cheaply as possible. The majority of companies choose a method of obtaining a quotation which raises new funds at the same time.

2. To make it easier for the company to raise further capital :

Once a company has a quotation, it will be easier for it to sell new shares in the future. In addition, providers of debt finance will be happier to lend money to a quoted company because they will feel safer in the knowledge that the company has to meet the Stock Exchange's on-going quotation requirements.

3. To give existing shareholders an exit route :

Similarly, specialist providers of equity capital to small unquoted businesses (known as venture capitalists) usually want to realise their investments after a few years. A quotation provides an exit route for venture capital investment (often referred to as 'private equity').

1.1 Reasons for seeking a quotation

4. To make the shares more marketable and easy to value :

- The fact that shares can be easily valued helps with inheritance and capital gains tax calculations.
- Because the shares are more marketable and more easily valued, shareholders will find the shares more useful as backing for their own borrowing.
- Quoted companies often use their own shares to offer to the target company's shareholders in a takeover bid. Quoted shares are much more effective for this purpose.
- Some companies offer employee share schemes to help motivate their staff. Such schemes will be more attractive if the shares are quoted

1.2 Methods - Offer for sale at a fixed price

- The usual method for obtaining a stock exchange quotation while also raising new money is an offer for sale. In an offer for sale at a fixed price, a predetermined number of shares (or other securities) is offered to the general public at a specified price.
- Rather than selling shares directly to the public, the company or existing shareholders sell the shares to an issuing house. The issuing house is then responsible for selling shares to the public. In this way the issuing house 'underwrites' the issue.
- Issuing houses role is to act as professional advisers to the company, overseeing the whole process and co-ordinating the activities of the other professional advisers.

1.2.1 Timetable for an offer for sale

About one year before the offer

The issuing house will try to ensure that pre-launch comments appearing in press are favourable. The company will also need to prepare itself eg by changing its documentation to make it a public limited company.

The weeks leading up to the issue

In this period the issuing house will advise on the price which should be set. The tradition is to be cautious in pricing new issues. The final price will not be set until the formal prospectus is published.

Issuing the prospectus – ‘Impact day’

Once the offer price is set, the prospectus (or listing particulars) is made available to the public. The prospectus, or alternatively an offer notice, will be reproduced in at least one national newspaper, and the prospectus may be made available through other channels.

The prospectus contains a great deal of information about the company, its activities, financial position, reasons for the issue and people involved in the issue. There is a duty on the professional advisers to disclose all relevant information.

The prospectus will also include an application form.

1.2.1 Timetable for an offer for sale

Applications

Typically, applications from the public to buy securities can be made for a period of about a week following the issue of the prospectus.

Usually, the issue will have been oversubscribed by the time the offer is closed. In these cases the issuing house needs to determine the basis of allocation ie how it will determine which offers to accept in full, which to reject, or scale down.

Letters of acceptance

Letters of acceptance are sent out to successful applicants, and refund cheques sent to those whose applications were rejected, or were scaled down. It takes some time for share certificates to be issued, and in the meantime the letters of acceptance can be used in place of share certificates for trading. In many countries, electronic 'paperless' share registration has replaced the traditional physical certificate, particularly for major listed companies. Official trading on the Stock Exchange starts the day after acceptance letters are posted.

1.3 Methods - Offer for sale by tender

- An offer for sale by tender is similar to an offer for sale at a fixed price. However, instead of inviting applications at a specified price, the issuing house invites members of the public to submit a tender stating the number of shares which they are prepared to buy, and the price which they are prepared to pay.
- After the offer closes, the issuing house will determine a single strike price. This may be the highest price at which all the stock can be allocated. However, a lower strike price will be chosen if this is necessary to ensure a sufficient spread of shareholders. All applicants who bid at least as much as the strike price will have their applications accepted.
- All successful applicants will pay the strike price, regardless of how much more they had bid. Applicants who bid less than the strike price will have their applications rejected.

1.4 Methods - Offer for subscription

These are similar to offers for sale. They are normally at a fixed price, but can be by tender. However, the whole issue is not underwritten. The company sells shares directly to the public. The issuing company bears (at least part of) the risk of under subscription. An issuing house will still be employed as an adviser to the issue.

1.5 Methods - Placings

- A simpler, cheaper method of making small issues is known as a 'placing' or 'selective marketing'.
- The issuing house first buys the securities from the company. It will then individually approach institutional investors such as pension funds and life offices directly. The institutions will be offered securities, but no public applications will be invited.

1.6 Methods – Introductions

- Introductions do not involve the sale of any shares. They simply mean that the existing shares will in future be quoted on the London Stock Exchange.
- For a full listing, 25% of shares must be in public hands, that is, the 'free float' of shares available for purchase excluding strategic holdings in subsidiaries or cross-holdings must be at least 25% of the issued shares. The Stock Exchange only allows introductions in cases where this requirement is already met.

1.7 Underwriting process

1. Rather than run the risk of not managing to sell all the shares and raise enough money, the company arranges to sell all the shares at an agreed price to the issuing house. The company will pay the issuing house a fee. Alternatively, in the case of an offer for sale, the fee can be included in the difference between the price at which the shares are sold to the issuing house and the price at which the issuing house sells them to the public.
2. The issuing house accepts the risk that all the shares may not be bought. However, the issuing house will not want to retain the entire risk. The issuing house will arrange sub-underwriting. In return for a commission the sub-underwriters agree to take a proportion of the shares that are not bought by the public.
3. Issues are priced so that they should be successful. Issuing houses take care not to over-price issues. The main risk faced by underwriters is that an unexpected event occurs between agreeing to accept the underwriting and the closing date for the offer for sale.

1.7 Underwriting process

- 4a. Fully subscribed issue: the issue goes ahead, and is fully subscribed. The issuing house and the sub-underwriters will have made an underwriting profit equal to their underwriting commission less any administrative expenses.
- 4b. Partly subscribed issue: the issue goes ahead, but not all of the shares are purchased. The underwriters and sub-underwriters get their fee/commission, but they also need to pay for all the shares that have not been purchased.

2 Issues made by companies already quoted

Reasons for the issue:

1. Company wanting to raise new ordinary share capital
2. Company wanting to increase the number of shares in issue, without raising new money
3. Company wanting to raise new loan (or preference share) capital
4. Existing shareholders wanting to sell a large block of shares

2.1 Methods to issue

1. Rights issue
2. Scrips issue

2.2 Rights issues

- Under Stock Exchange requirements, when companies want to raise more capital through a further issue of shares, they are obliged to offer the new shares to the existing shareholders. This forms part of the rights of a shareholder. A rights issue is where a company offers further shares, at a given price, to existing shareholders in proportion to their existing holdings.
- The price will be at a discount to the current share price.

The **main effects** of a successful rights issue are:

- new shares are created
- new money is raised for the company
- the total value of the whole company should be increased by the extra money raised
- the price per share will fall depending on the extent of the discount and the number of new shares issued.

2.2.1 Purpose of a rights issue

- The company's objective in a rights issue is to raise more money. The reasons for needing more money will vary.
- The reaction of the stock market to individual rights issues will depend on the reasons for the issue.

2.2.2 Timetable for a rights issue

- A few weeks before the rights issue, the company will discuss the possibility of an issue with its advisers. Companies often like to have a rights issue when the stock market is high because they see this as raising more money for a given cost.
- The company will publish a rights offer document which will explain why the rights issue is being made. Shareholders are then sent provisional allotment letters and the shares start to trade ex-rights.
- The rights themselves can also be traded. Shareholders will be given three or more weeks in which to accept the offer or to sell their nil-paid rights.

2.2.3 Impact on share price

Market capitalisation is defined as:

Market capitalisation = $P \times \text{number of shares}$

Here, P is the share price.

Before a rights issue, the share price is given by:

$$P = \frac{\text{market capitalisation}}{\text{number of shares}}$$

The price per share after a rights issue is:

$$P^* = \frac{\text{original market capitalisation} + \text{extra value}}{\text{total new number of shares}}$$

2.2.3 Impact on share price

To estimate the ex-rights share price it is necessary to estimate the extra value component in the above equation. The factors incorporated within the extra value are:

- + the amount of new money raised by the rights issue
- the expenses of the issue
- +/- the change in value based on the market's revised perception of the company and the use to which the money is being put.

Ignoring expenses and ignoring the market's reaction

When only the first of the three factors given above is considered when trying to calculate the price of the shares following the rights issue, this is known as calculating the theoretical ex-rights price.

Allowing for expenses and market reactions

Although the expenses item is easy to incorporate into the calculation, it is impossible to calculate explicitly the market's reaction. Often the share price immediately following the rights issue will be depressed below the theoretical weighted average price.

2.2.4 Possible courses of action for shareholders

- There may be several reasons why a shareholder chooses not to accept the rights, such as not having available cash, or not wanting to increase their exposure in that company.
- In these cases, shareholders can sell their rights. What they would sell is their nil-paid right. The theoretical market value of the nil-paid right is the difference between the exrights share price and the rights issue price.

2.3 Scrip issues

A scrip issue (sometimes called a 'capitalisation' or 'bonus' issue) is where the company gives free shares to all ordinary shareholders in proportion to their existing holding. No payment is required from the shareholders.

The basic impact of a scrip issue should be:

- new shares are created
- no money is raised
- the fundamental value of the whole company is unchanged
- the price per share should fall in proportion to the increase in the number of shares
- the total value of each investor's holding should be unchanged
- shareholders' reserves in the statement of financial position are converted to share capital (hence the name capitalisation issue).

2.3.1 Purpose of scrip issues

1. Marketability

By having more, lower priced shares, the marketability (ease of selling / buying a share) is improved.

2. Something for nothing

Shareholders might like the idea of being given extra shares free of charge. Hence the name bonus issue.

3. Past profitability

Scrip issues can take place only if there are sufficient reserves to be capitalised. This means that scrip issues tend to be associated with successful companies which have built up large reserves from retained profits.

4. Future confidence

A scrip issue reduces the price of a share. Therefore, having a scrip issue may reduce a company's ability to have a future rights issue if its share price declined following the scrip issue. If the directors decide to have a scrip issue, they must be confident about the company's prospects.

5. Increased dividends

Some companies have a habit of having light scrip issues (eg 1 for 10) and subsequently keeping the same dividend per share. In these cases, a scrip issue may lead to, or be a sign of, higher dividends

2.3.1 Purpose of scrip issues

6. More reasonable rate of dividend

If dividends are expressed as a percentage of the nominal value the figure may seem excessive. This could cause public relations problems, or problems with employees who feel that dividends are too high. This could be avoided by a scrip issue.

2.3.2 Arguments against issue of scrip issues

1. Cost to the company

The administrative costs such as issuing new shares and informing shareholders are met by the company.

2. Cost to everyone else

Whenever records of dividends or share prices are needed, for example for investment research or CGT calculations, care is needed to eliminate the artificial effect of a scrip issue.

2.3.3 Impact on share price

On theoretical grounds, an n-for-m scrip issue should reduce the share price from P to:

$$P \times \frac{m}{m+n}$$

This assumes that the market is totally indifferent to the scrip issue.

The actual change in the share price might move slightly one way or the other:

- up slightly if the psychological factors win through,
- or**
- down slightly if the market decides that the cost of the issue outweighs the benefits.