THAMMASAT

Overview of Equity Securities

EE532 Selected Topics in Monetary Economics 2

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Equity vs Debt

- Equity Financing vs Debt Financing
  - Pros / Cons

	Pros	Cons
Debt Financing		
Equity Financing		

What is equity security?

- It represents the ownership interest held by shareholders in an entity realized in the form of shares of capital stock
- Types of Equity Securities
  - Common / Preferred
  - Public / Private
  - Domestic / Non-domestic

Types and Characteristics of Equity Securities (Cont'd)

Common Shares vs Preference Shares

- What are the key differences between common shares and preferred shares?

Factor	Common Shares	Preferred Shares
Voting Rights	Yes • Statutory Votings • Cumulative Votings	• No
Dividend Received	• Not guaranteed and received only when the company has excess profit • Received after preferred shareholders	• Guaranteed by a fixed rate • Can be accumulated if the company doesn't pay the dividend in any given year
Company Liquidation Rights	Paid back investment after debtors and preferred shareholders	Paid back investment after debtors but before common shareholders
Risk		
Expected Return		

Types and Characteristics of Equity Securities (Cont’d)

Common Shares

- Common shares represent an ownership interest in a company and are the predominant type of equity security
  - Investors share in the operating performance of the company, participate in the governance process through voting rights, and have a claim on the company’s net assets in the case of liquidation
- Type of voting
  - Statutory Voting: Each share represents one vote
  - Cumulative Voting: Shareholders can direct their total voting rights to specific candidates; where
    - $\mathit{Total\ Voting\ Rights} = \mathit{Number\ of\ Shares\ Owned} \times \mathit{Number\ of\ Board\ of\ Directors\ Being\ Elected}$
- Type of Common Shares
  - Callable Common Shares
  - Putable Common Shares

Types and Characteristics of Equity Securities (Cont'd)

Preference Shares

- Preference shares rank above common shares with respect to the payment of dividends and the distribution of the company's net assets upon liquidation
  - Investors generally do not share in the operating performance of the company and don't have any voting rights, unless explicitly allowed for at issuance
  - Shares the same characteristics of both debt securities and common shares
- Type of Preferred Shares
  - Cumulative Preferred Shares / Non-cumulative Preference Shares
  - Participating Preference Shares / Non-participating Preference Shares
  - Convertible preference shares
    - To earn a higher dividend than the common shares
    - To expose to less volatility than the underlying common shares because the dividend payments are know and more stable
    - The opportunity to share in the profits of the company
    - To benefit from a rise in the price of common shares

Types and Characteristics of Equity Securities (Cont'd)

Private Equity Securities vs Public Equity Securities

- What is private equity?
  - Issued primarily to institutional investors via non-public offerings
  - Do not have market determined quoted prices
  - Highly illiquid
  - Require negotiations between investors in order to be traded
- Types of Private Equity Investments
  - Venture Capital Investments
  - Leverage Buyout (LBO) or Management Buyout (MBO)
  - Private Investment in Public Equity (PIPE)
    - When the public company is in need of additional capital quickly and is willing to sell a sizeable ownership position to a private investor or investor group

Learn More About Venture Capital

Types and Characteristics of Equity Securities (Cont'd)

Domestic vs Non-domestic Equity Securities

- What is the main barrier to invest globally?
- Why do many countries still impose foreign restrictions?
  - To limit the amount of control that foreign investors can exert on domestic companies
  - To give domestic investors the opportunity to own shares in the foreign companies that are conducting business in their country
  - To reduce the volatility of capital flows into and out of domestic equity markets
- Why are some companies listed outside their home countries?
  - No longer have to be concerned with capital constraints
  - No longer have to be concerned with lack of liquidity in their domestic markets

Types and Characteristics of Equity Securities (Cont'd)

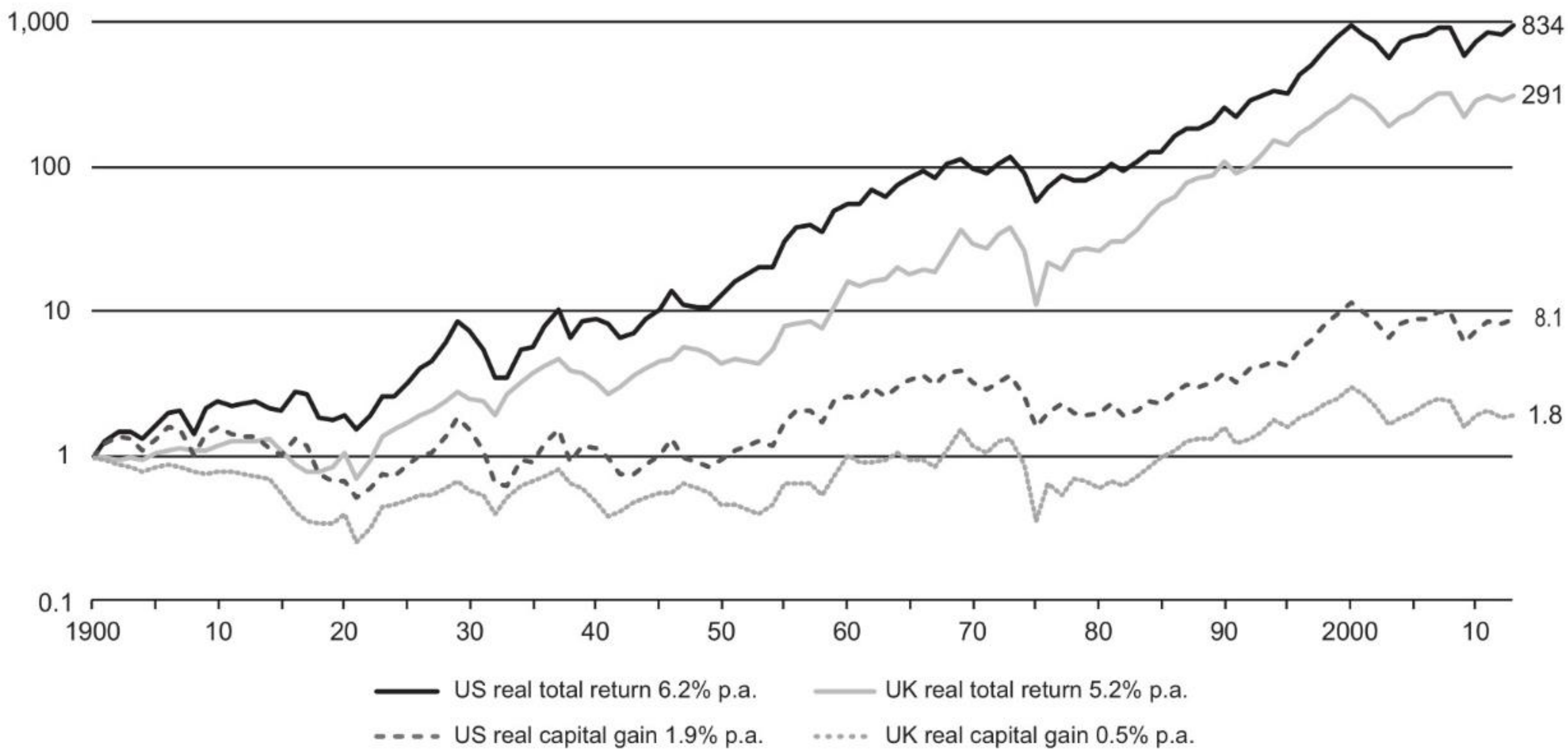
Domestic vs Non-domestic Equity Securities

- Type of Non-domestic Equity Investment
  - Direct investment
  - Depository receipts ("DR")
- What is DR?
  - Security that trades like an ordinary share on a local exchange
  - Security that represents an economic interest in a foreign company
- Process of Creating Depository Receipt
  - A depository receipt is created when the equity shares of a foreign company are deposited in a bank (i.e. the depository) in the country on whose exchange the shares will trade
  - The depository then issues receipts that represent the shares that were deposited
  - The number of receipts issued and the price of each DR is based on a ratio, which specifies the number of depository receipts to the underlying shares
- Types of DR
  - When the foreign company whose shares are held by the depository has a direct involvement in issuance of the receipts, the DR is called **"Sponsored DR"**
  - When the underlying foreign company has no involvement with the issuance of the receipts, the DR is called **"Unsponsored DR"**

Return Characteristics of Equity Securities

- What are the main sources of equity securities' total return?
- Total return (R_t) = (P_t - P_{t-1} - D_t) / P_{t-1}; where
  - Return from Price Change = (P_t - P_{t-1}) / P_{t-1}
  - Return from Dividend = D_t / P_{t-1}

Impact of Reinvested Dividends on Cumulative Real Returns



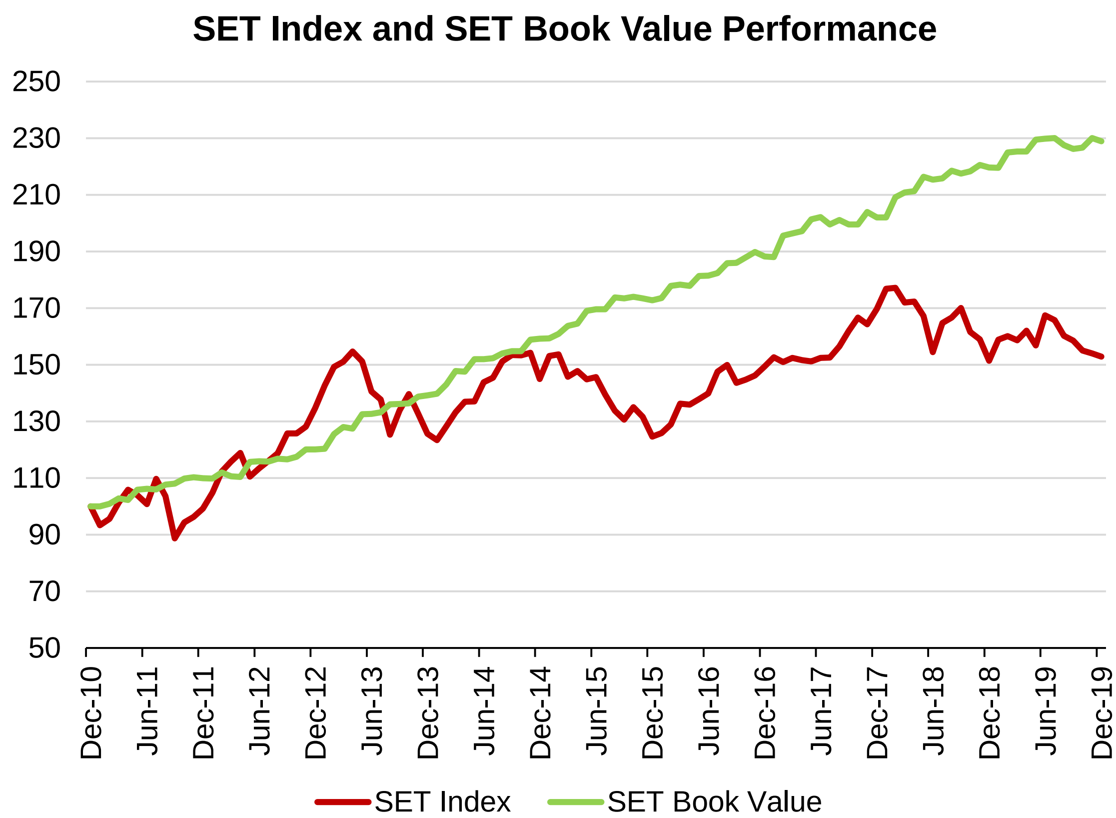
Source: Dimson, Marsh, and Staunton (2012b)

Risk of Equity Securities

- The risk of any securities is based on the uncertainty of its future cash flows
- How do the future cash flows impact risk and the volatility of security's price?
- Risk of an equity security is most often measured by calculating the standard deviation of the equity's expected total return

Equity Securities and Company Value

- Companies issue equity securities on primary markets to raise capital and increase liquidity
- The primary goal of raising capital is to finance the company's revenue-generating activities in order to increase its net income and maximize the wealth of its shareholders
- Does book value is the same as market value?
- The ultimate goal of management is to increase the book value of the company and maximize the market value of its equity
- Key measure to evaluate the effectiveness of management in increasing the book value is Return on Equity ("ROE")



Source: Stock Exchange of Thailand

Return on Equity ("ROE")

- What is ROE?
  - $ROE_t = \frac{NI_t}{Book\ Value\ of\ Equity_t}$
- Can ROE be manipulated by the management?
- Does the increase in ROE indicate the good sign?
  - Dupont formula can be used to analyze the sources of changes in a company's ROE
  - $ROE = Net\ Profit\ Margin \times Asset\ Turnover \times Equity\ Multiplier$
  - $ROE = \frac{Net\ Profit}{Sales} \times \frac{Sales}{Average\ Total\ Assets} \times \frac{Average\ Total\ Assets}{Book\ Value\ of\ Equity}$

Cost of Capital and Required Rates of Return

- **Weighted Average Cost of Capital (WACC)** = $K_d(1 - T) + K_e$; where
  - K_d = Cost of Debt
  - K_e = Cost of Equity
  - T = Tax Rate
- In order to maximize profitability and shareholder wealth, companies attempt to raise capital efficiently so as to minimize these costs
- **Capital Budgeting** is the decision-making process that companies use to evaluate potential long-term investments
  - WACC represents the minimum required rate of return that the company must earn on its long-term investments to satisfy all providers of capital
  - The company then chooses among those long-term investments with expected returns that are greater than its WACC