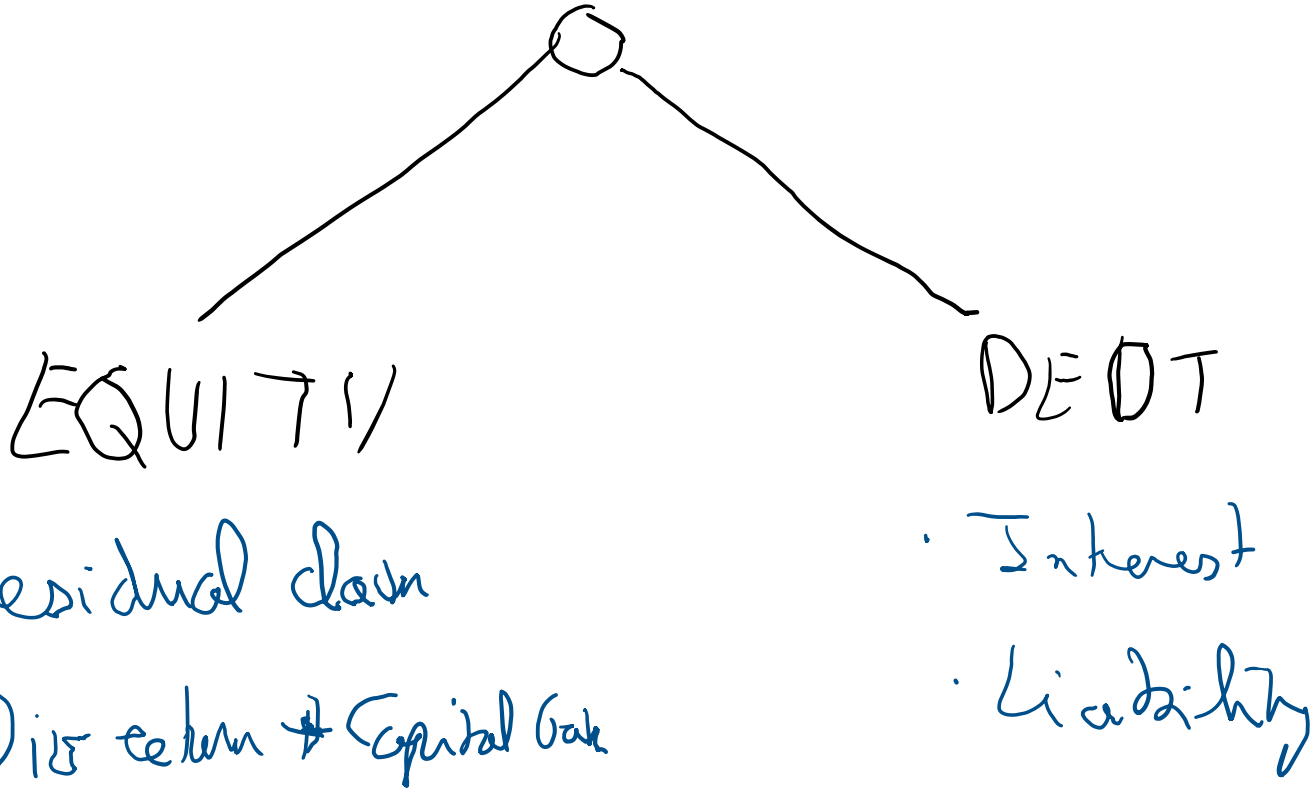
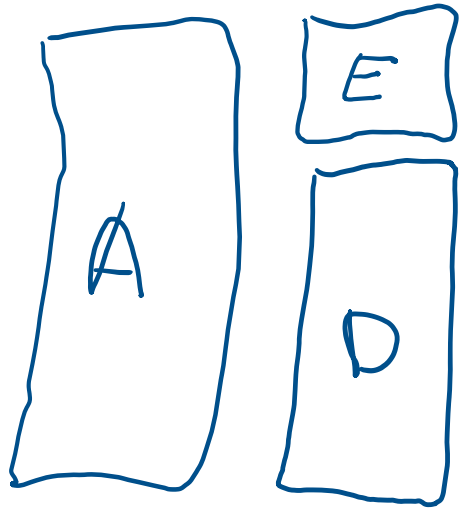
EQUITIES: OVERVIEW OF EQUITY SECURITIES


EQUITY
DEBT
- Residual claim
- Dividends & Capital Gain
- Interest
- Liability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EQUITY SECURITY CHARACTERISTICS

1. Dividends are variable → Companies have no obligation to pay any dividend
2. The common shareholders have a residual claim to company´s assets
3. The common shareholders have the right to vote for board members
4. Different classes of common shares may have different voting rights

Cumulative Voting

Allows minority shareholders a larger level of representation

1. Non-cumulative voting
2. Cumulative voting

Cumulative Voting

Allows minority shareholders a larger level of representation

If there is election for four board positions, and a shareholders owns 200 shares:

① Non-cumulative voting

One share gives one vote right

The shareholder can give a maximum of 200 votes for each of the four candidates

He can give 200 votes to candidate A, or 50 votes for each

② Cumulative voting

Total nº of votes = #of shares x # of directors

The shareholder can give a maximum of 800 votes for one candidate

He can give 800 votes to candidate A, or 200 votes for each

Different class of shares

Typical when the founders want to retain control

Class A

Voting rights

40% of total

Class B

No voting rights

60% of Total

Google

Daniel

Novo Nordisk

CALLABLE AND PUTABLE SHARES

CALLABLE SHARES

1. The firms has the right to repurchase the shares at an agreed upon price (call price)
2. Therefore they are more risky than common shares

PUTABLE SHARES

1. The shareholders have the right to sell the shares back to the firm at an agreed upon price (put price)
2. Therefore they are less risky than common shares

PREFERRED STOCK

Similarities to common stock:

1. Dividends are not an obligation
2. They don't mature

Similarities to debt:

1. Fixed payment (with scheduled dividends) that are payed before common shares
2. They usually have no voting rights
3. They do not participate in the upside of the firm
4. Dividend calculated as a % of par value (debt-like)

TYPES OF PREFERRED STOCK

CUMULATIVE PREFERRED

1. They have priority over common shares in the payment of dividends. They must be paid any unpaid dividend before common shares may pay any dividend
2. Less risky than non-cumulative preferred shares

CONVERTIBLE PREFERRED STOCK

1. Preferred shares can be converted to common shares at a conversion ratio
2. Preferred dividend is larger than common dividend
3. They participate of the upside of the stock by converting to common stock at good times
4. Less risky than common stock

PARTICIPATING PREFERRED

1. They receive an extra payment if the firm performs well
2. They may receive a value that exceeds par value if the firm is liquidated

NON-PARTICIPATING PREFERRED

Have a claim equal to par value in the event of liquidation but do not share in profits of the company

PRIVATE EQUITY

ADVANTAGES

1. The reporting requirements are smaller
2. They are more able to focus on long term profitability and avoid short term wall street next quarter pressure
3. Potentially much higher return to investors when the private firm ends up public after an IPO
4. Lower reporting costs

DISADVANTAGES

1. Less liquid
2. Reduced ability to raise capital (compared with public companies)
3. Much lower disclosure requirements that can lead to weaker corporate governance

PRIVATE EQUITY INVESTMENTS

① Venture Capital → Finances companies in their early stages.

② Leveraged Buy Out → Acquisition of more mature firms using debt to buy all outstanding stock

③ Management Buy Out → The management of the company led its acquisition

④ Private Investment in Public Entity (PIPE) → The private equity purchases stock of a public company at a discount when the company is willing to raise capital

DIRECT INVESTING

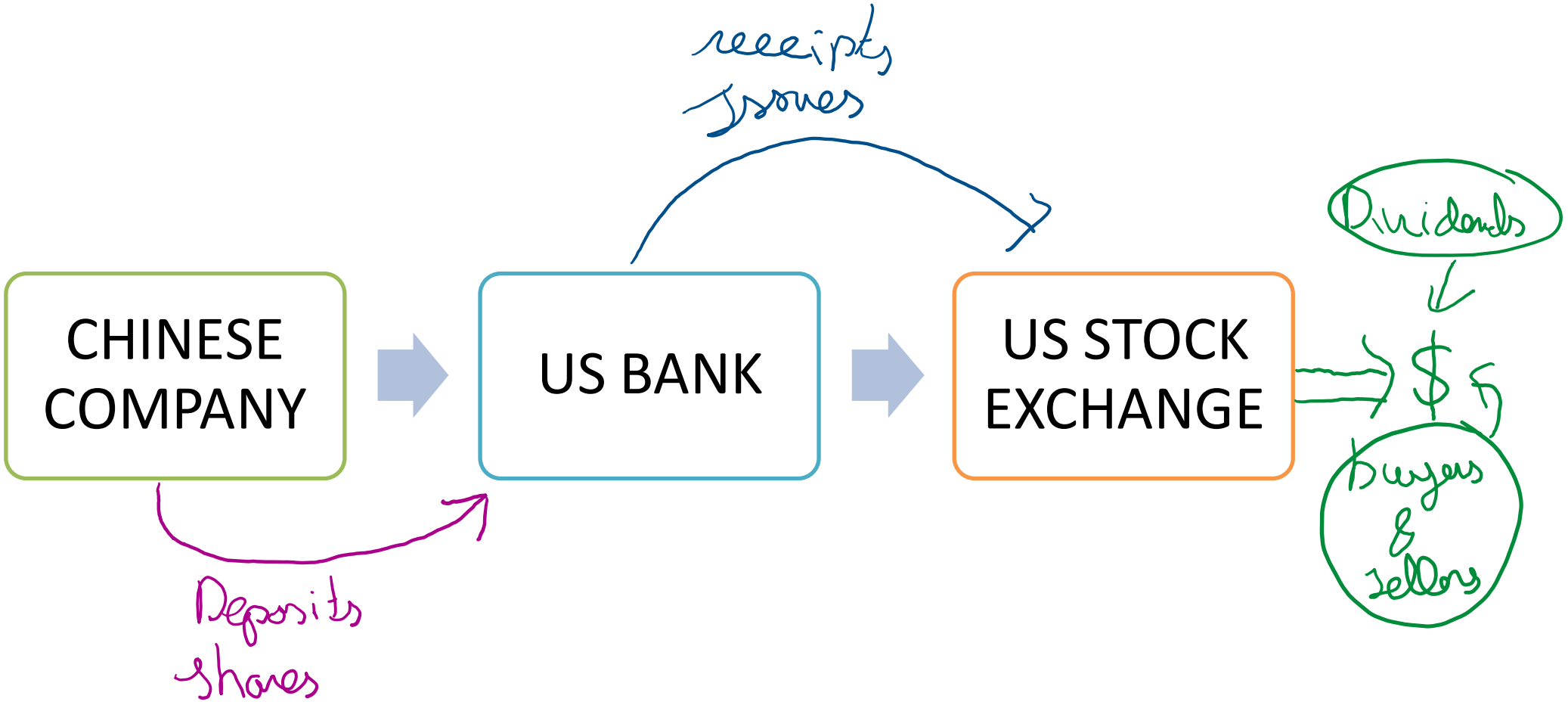
DISADVANTAGES

1. The investment, and thus the return, is denominated in foreign currency (exchange rate risk)
2. It is often less liquid
3. It is often less transparent
4. The regulation of Securities-Exchanges and their procedures are often very different

DEPOSITORY RECEIPTS

Represents ownership in a foreign firm and are traded in the local markets

1. Shares are deposited in a bank that act as a custodian
2. The Bank Issues receipts representing ownership of a number of foreign shares
3. The depository bank act as custodian, managing dividends, splits , etc…


receipts
Issues
CHINESE COMPANY
US BANK
US STOCK EXCHANGE
Dividends
$
buyers & sellers
Deposits
shares

DEPOSITORY RECEIPTS

SPONSORED DEPOSITORY RECEIPTS

1. The firm in question is involved in the issue
2. The investors have the same voting and dividend rights as foreign investors
3. It is subject to greater disclosure requirements

UNSPONSORED DEPOSITORY RECEIPTS

1. The depository bank retains the voting rights
2. The depository buys shares in the foreign market

DEPOSITORY RECEIPTS

AMERICAN DEPOSITORY RECEIPTS

They are denominated in US $ and listed in US stock exchanges

The most common type and oldest type of depository receipt

GLOBAL DEPOSITORY RECEIPTS

They are issued outside the US and outside the firm´s home country

The majority are denominated in USD and in Luxembourg or London

GLOBAL REGISTERED SHARES

Traded in different countries and in the local currencies of the countries where they are listed

GRS is a security that is issued in the United States but is registered in multiple markets around the world and trades in multiple currencies. With GRSs, identical shares **may trade on different stock exchanges and in various currencies** across country borders without needing to be converted into local currencies

BASKETS OF LISTED DEPOSITORY RECEIPTS

An ETF that is a collection of Depository Receipts

ETFs trade in markets just like common stocks

COMPONENTS OF EQUITY RETURN

1. Dividends
2. Capital Gain or Loss
3. Fx gain/loss

The effect of reinvesting and compounding dividends has been a large portion of total historical returns on equity securities (above 2/3)

RISK CHARACTERISTICS OF EQUITY

Preferred stock is less risky than common stock because of

1. A Dividend that is fixed beforehand
2. Distributions to preferred is done before distributions to common stock
3. In case of liquidation, they are paid before common shareholders (but after claims to debtholders)

CAPITAL RAISING

1. Make funds available to firms to buy productive assets to increase shareholder wealth
2. Funds received can be used to buy other companies or for employee incentive compensation
3. Reduced the dependence of companies on financial debt

Distinguish between the market value and book value of equity securities;

Compare a company's cost of equity, its (accounting) return on equity, and investors' required rates of return.

Distinguish between the market value and book value of equity securities;

BOOK VALUE OF EQUITY

The book value of the assets in the balance sheet minus the book value of the liabilities in the balance sheet

MARKET VALUE OF EQUITY

It included the investor expectations about:

1. Amount of future cash flows
2. Timing of future cash flows
3. Expectations about risk

Compare a company's cost of equity, its (accounting) return on equity, and investors' required rates of return.

ROE

$$ROE = \frac{Net\ Income}{Average\ Equity}$$

It measures whether management is generating return on equity capital

Examine and understand the causes of ↓/↑
ROE DUPONT

ROE -Ke

Price-to-Book Value

COST OF EQUITY

It is the minimum rate at which investors would be willing to provide equity capital to a Company

It is hard to estimate

CAPM, DDM