## Chapter 12: The equity market

# Textbook Questions

### Review questions

*The following questions appear in the textbook on page 385.*

*Answer the following questions.*

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**Differentiate between debt and ordinary shares in terms of maturity, seniority of claim, tax treatment from the company’s point of view and voice in management.**

**See table below.**

**Table 12.2 Debt, preference shares and ordinary shares compared**

|  |  |  |  |
| --- | --- | --- | --- |
|  | **Debt** | **Ordinary shares** | **Preference shares** |
| **Maturity** | **Finite maturity – debt usually has a fixed maturity date** | **Perpetual claim – ordinary shares have no maturity date** | **Usually a perpetual claim** |
| **Seniority of claim** | **A contractual claim. Claims of debt-holders have priority over ordinary and preference shares** | **A residual claim, i.e. a claim to what is left after contractual claims are settled.**  **Claims of ordinary shareholders are subordinate to both debt and preference shares** | **A residual claim. Claims of preference shareholders are subordinate to debt but have priority over ordinary shares** |
| **Tax treatment – company** | **Interest paid is usually deductible for income tax purposes** | **Dividends paid are usually not deductible for income tax purposes** | **Dividends paid are usually not deductible for income tax purposes** |
| **Tax treatment – investor** | **Income tax is usually payable on interest received.** | **Income tax is sometimes not payable on dividends received.**  **In South Africa tax will be payable on dividends received from 1 April 2012** | **Income tax is sometimes not payable on dividends received.**  **In South Africa tax will be payable on dividends received from 1 April 2012** |
| **Voice in management** | **Have no right to choose directors or vote on matters of importance to the company** | **Have the right to choose directors and vote on matters of importance to the company** | **Have a limited voice in management. Voting rights usually concern the issuance of securities with equal or higher seniority** |

**Discuss the two types of new share issue.**

**An initial public offer (IPO) is a new issue of shares when a company is first listed. A secondary public offer (SPO) is a new issue of shares when an already-listed company decides to issue further shares.**

**Differentiate between order- and quote-driven equity markets.**

**An order-driven or auction market is a market where buyers and sellers submit bid and ask prices of a particular share to a central location where the orders are matched by brokers. A quote-driven market is a market where prices are determined by dealers bid/offer quotations.**

**List the most important characteristics of ordinary shares.**

**The most important characteristics are that: (i) ordinary shares have no maturity date (perpetual claim) so individual shareholders can liquidate their investments in the shares of a company only by selling them to another investor; (ii) ordinary shareholders have a claim on the income and net assets of the company only after obligations to creditors, bondholders and preferred shareholders have been met (residual claim); and (iii) shareholders have the first option to buy new shares (pre-emptive right).**

**What do the returns to ordinary shareholders consist of?**

**Dividends and capital gains (losses).**

**List six types of equity investor.**

* **Individuals**
* **Companies**
* **Asset management firms**
* **Insurance companies**
* **Pension funds**
* **Collective investment schemes**

**Explain the statement: “Preference shares are hybrid securities in that they have features of ordinary shares and debt”.**

**Preference shares are a source of long-term equity funding that has features of both ordinary shares and debt. Like debt, preference shares pay their holders a fixed amount (dividend) per year, have no voting rights and in the event of non-payment of dividends, may have the cumulative dividend feature that requires all dividends to be paid before any payment to ordinary shareholders. Like ordinary shares, preference shares are perpetual claims and subordinate to bonds in terms of seniority in the event of liquidation.**

**Name five types of preference share.**

**Cumulative, non-cumulative, participating, convertible and redeemable preference shares.**

**Briefly describe five ways a new applicant may bring shares to listing on the JSE.**

* **An *introduction* is a method of bringing securities to listing when a company does not need to raise capital and its spread of shareholders already complies with the conditions for listing For example, a main board listing requires at least 20 per cent of each class of shares to be held by the public with at least 300 public shareholders for equity securities, 50 for preference shares and 25 for debentures. An introduction is the cheapest and quickest method because there is no offer to the public and minimum formalities are required. A prelisting statement is required that contains salient information about the company.**
* **An *offer for sale* is an invitation to the public to *purchase* the shares of existing shareholders. The proceeds of the sale accrue to the sellers – that is, existing shareholders. This method requires the publication of a prospectus. A public offer such as an offer for sale is generally the most expensive route to market, and is most often used by larger companies. The advantages of this method are that it allows for a wide spread of shareholders, which may increase the liquidity and improve the share price. Also, it provides an opportunity to gain public attention and interest, thereby boosting the company’s profile and visibility.**
* **A *placing* involves offering the shares to a selected base of investors following private negotiations. The investors may be institutional investors, customers, suppliers and/or staff. A placing is generally a low-cost alternative. It requires a prelisting statement that contains salient information about the company. The advantage of a placing is that it gives a company discretion to choose its investors. On the downside it may result in a narrower shareholder base than a public offer, which may result in less liquidity.**
* **An *offer for subscription* is an invitation to the public to *subscribe* for shares that are not yet in issue. The proceeds of the offer accrue to the company. This method requires the publication of a prospectus. A public offer such as an offer for subscription is generally the most expensive route to market, and is most often used by larger companies. Like an offer for sale, the advantages of this method are that it allows for a wide spread of shareholders, which may increase the liquidity and improve the share price. Also, it provides an opportunity to gain public attention and interest, thereby boosting the company’s profile and visibility.**
* **An *issue with participating or conversion rights* refers to an issue with participating rights to profits or equity conversion rights. Shares with conversion rights are shares that are convertible into or exchangeable for other shares, for example the conversion of ordinary shares into redeemable preference shares.**

**Using the Gordon growth model, calculate the value of a share that paid a dividend of 100 cents this year if shareholder’s required rate of return is 15 per cent and dividends are expected to grow at a constant rate of 10,5 per cent.**

**Value of share = DPS0 × (1 + growth rate)/(required rate of return – growth rate)**

**Value of share = 100 × (1 + 0,105)/(0,15 – 0,105)**

**Value of share = R24,56**

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