AF4 2023/2024
Asset Classes: Shares
Part 1: Background and basic principles

The milestones for this part are to understand:

- Share basics
- The differences between Bonds and Equity
- Rights issues and share buy backs

Share basics

Shares are issued by companies to raise capital. Both AF4 and J10 will focus on testing your ability to assess whether a share represents good value rather than the technicalities and properties of different share classes. This should have been covered in R02 but to refresh your memory here is a short summary.

- The bulk of a company's share capital will be in **ordinary shares**. These entitle the owner to 1 vote for each share held.
- In the past family companies would often split their shares into voting and non voting shares, usually termed A & B shares. This practice is not now encouraged
- **Preference share**s have priority over ordinary shares in terms of dividend payment. The dividend is normally fixed and they carry no voting rights. Neither can preference shareholders benefit if the company increases its profits. Preference shares are usually considered part of the company's debt structure
- **Cumulative preference shares** give the holder the right to receive a dividend in a later year if not made in an earlier one.
- **Non cumulative preference shares** don't have this right
- **Participating Preference shares** may get an additional dividend in addition to the fixed one
- **Redeemable means** that the preference share can be purchased by the company at some point in the future. This can be a fixed date or an unspecified date. In the latter case this will be at the discretion of the company.
- **Convertible preference** means that they can be converted into ordinary shares at some point in the future
- **Warrants** are issued by the company and are not classed as shares but give the right to buy ordinary shares at a fixed price at some future date

Preference shares behave more like bonds in that the price is determined by the link between the fixed dividend and other interest rates. Preference shares have no redemption date but the "small print" sometimes gives the company the right to redeem the shares at par at any time. This can disadvantage investors.

An investor holds preference shares that are trading at 150p. The par value is 100p and the company announces that it will redeem them at par which means that all investors who bought shares for more than 100p will lose money.

For 23/24 everyone has a dividend allowance of £1,000 which is effectively a 0% rate. Once this has been used dividends are taxed at 8.75% in basic rate, 33.75% in higher rate and 39.35% in additional rate.

Shares v Bonds

Companies can raise capital by issuing Bonds or Equity. From their point of view the advantages and disadvantages of each are

Bond advantages	**Bond disadvantages**
Interest rate is fixed	Interest must be paid as it falls due
Bond holders have no say in the business	Loan must eventually be repaid
Capital does not need to be repaid until maturity	

Share advantages	**Share disadvantages**
No requirement to pay dividend	Shareholders have a say in how the business is run
Shares have no expiry date	Can make it more vulnerable to the business being taken over
Buying and selling of shares is done on the secondary market	

From an investors point of view:

- Bonds offer a known return but will not benefit from any increase in the profits of the business
- Shares offer an unknown return but investors should benefit if profits increase.
- Bonds being a loan have an underlying value. Provided the business doesn't fail the bondholder knows what will be repaid.
- Bondholders must find a new place to invest the money once it is repaid
- Shares have no underlying value and if the business fails they will become worthless.

Rights issues and Share Buy Backs

Once shares are issued a company can only issue new shares by having a **rights issue**.

- A company does this to raise capital by issuing new shares.
- It offers existing shareholders the right to buy new shares at a discount.
- For example a company's shares may be trading at 120p and they offer each shareholder the right to buy one share for every four they hold for 60p.

When a rights issue is complete the share price will always be lower than it was pre-rights because the number of shares has been increased.

On the above basis if someone with 1,000 shares, exercising the rights issue would increase the number of shares to 1,250

The share price prior to the rights was 120p so their holding was worth £1,200. The 250 new shares would have cost, at 60p, £150. At the end there would be 1,250 shares with a value of £1,350. The theoretical value of the shares would therefore be £1,350/1250 = 108p

The shareholder can do one of three things with a rights issue.

- They can exercise the right to buy the shares
- They can decide not to exercise the right
- They can sell the rights

By exercising the right, a shareholder maintains the value of their holding.

Brian decides not to exercise the right. Because more shares have been issued his holding has been diluted. He owns less of the business than he did before. If he held 2000 shares before the rights issue his holding at 120p a share would have been worth £2,400. After the rights issue, assuming the price was 108p, the total value would have been worth £2,160.

Carol decides that she doesn't want to exercise the right but decides to sell her rights on the open market. This compensates her to some extent for the dilution

Rights issues are normally underwritten. There is a risk that existing shareholders will not take up the offer so for a fee the company will get other financial institutions to agree to buy up any of the new shares that aren't taken up by the existing shareholders.

A rights issue is normally offered to all shareholders. Occasionally it may only be offered to institutional investors which means that individual shareholders will see their holdings diluted and not worth as much as before the issue.

A rights issue should not be confused with a **bonus or scrip issue.** These are normally done to make the shares more marketable.

PDQ shares are trading at £50 a share. A scrip issue is made replacing every share with 5 new shares.
Ben has 1000 shares a £50 a share giving a total holding of £50,000

After the issue he has 5,000 shares worth £10 each so his holding remains £50,000

Share buybacks

Companies sometimes use its reserves to buy back shares from existing shareholders. This can be controversial because the implication is that the company cannot think of any better use for this money. Why isn't it investing in the business rather than just buying back its own shares?

Buybacks have been criticised for allowing directors and senior executives to manipulate the performance of the business. Since the company is buying shares, the price should rise. In addition, as the number of shares will be reduced, the earnings per share should increase. This could benefit senior management who may have a bonus structure that rewards them for increasing the share price or EPS.

These fell in popularity during the pandemic because companies are desperate to hang on to cash

That concludes this part so you should now understand:

- Share basics
- The differences between Bonds and Equity
- Rights issues and share buy backs