

KHOA KINH TẾ VÀ QUẢN TRỊ



LECTURE 6

Chapter 17:

Common and Preferred Stock Financing

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Horizontal lines for notes.

Chapter 17: Common and Preferred Stock Financing

Chapter Concepts

- Common stockholders are the owners of the corporation and therefore have a claim to undistributed income, the right to elect the board of directors and other privileges
- Cumulative voting provides minority stockholders with the potential for some representation on the board of directors
- A rights offering gives current stockholders a first option to purchase new shares
- Poison pills and other similar provisions may make it difficult for outsiders to take over a corporation against management's wishes
- Preferred stock is an intermediate type of security that falls somewhere between debt and common stock

Horizontal lines for notes.

Chapter 17: Common and Preferred Stock Financing

Main Contents:

- 1. Common Stockholders' Claim to Income
2. The Voting Right
3. The Right to Purchase New Shares
4. American Depository Receipts
5. Preferred Stock Financing
6. Provisions Associated with Preferred Stock
7. Comparing Features of Common and Preferred Stock and Debt

Horizontal lines for notes.

I. Common Stockholders' Claim to Income

- All income belongs to common stockholders if it is not paid to creditors or preferred stockholders
- The income will be paid out as common stock dividends and reinvested as a retained earning with the hope of providing even greater income, dividends, and price appreciation in the future
- The common stockholders do not have a legal or enforceable claim to dividends

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II. The Voting Right

- The stockholders are accorded the right to vote in the election of the board of directors and on all other major issues
- The "founders' stock" - marked as class B share for the founders, and preserve partial control of the company while at the same time raise new capital for expansion
- Both common and Class B stockowners share in dividends equally
- Class B is convertible into regular common stock on a share-for-share basis
- Bondholders and preferred stockholders may vote only when a violation of their corporate agreement exists (*)

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II. The Voting Right (cont'd)

❖ Cumulative Voting

- **Majority voting** - any group of stockholders owning over 50% of the common stock may elect all the directors
- **Cumulative voting** - it is possible for those who hold less than a 50% interest to elect some of the directors

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II. The Voting Right (cont'd)

❖ Cumulative Voting (cont'd)

- To determine the number of shares needed to elect a given number of directors under cumulative voting:

Shares required = $\frac{\text{Number of directors desired} \times \text{Total number of shares outstanding}}{\text{Total number of directors to be elected}} + 1$

 - Assume there are 10,000 shares outstanding, 9 directors are to be elected. How many shares would elect one director?

$$\frac{1 \times 10,000}{9 + 1} + 1 = 1,001$$

- How many shares would elect three directors? $\frac{3 \times 10,000}{9 + 1} + 1 = 3,001$ 7

II. The Voting Right (cont'd)

❖ Cumulative Voting (cont'd)

- To determine the number of directors that can be elected:

$\frac{(\text{Shares owned} - 1) \times (\text{Total number of directors to be elected} + 1)}{\text{Total number of shares outstanding}}$

 - Assume you own 3,001 shares, and 9 directors are to be elected, and there are 10,000 outstanding shares. How many director can you elect?

$$\frac{(3,001 - 1)(9 + 1)}{10,000} = 3$$

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2. The Voting Right (cont'd)

Example 1:
Assume there are 20,000 shares outstanding, 9 directors are to be elected.

- How many vote would you have to elect one director?
- How many shares would elect three directors ?

Example 2
Assume you own 3,001 shares, and 9 directors are to be elected, and there are 20,000 outstanding shares. How many director can you elect ?

III. The Right to Purchase New Shares

- In a rights offering, each shareholder is issued rights to buy a specified number of new shares at a specified price within a specified time
- Rights such as share warrant are traded on securities exchanges or OTC
- Rights are cheaper for the issuing firm than cash offers (a firm can do a right without underwriters)

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III. The Right to Purchase New Shares (cont'd)

1. The mechanics of a rights offering

- As receiving the rights offer, the existing shareholders have three choices:
 - i. Exercise their rights and subscribe for some or all of the entitled shares
 - ii. Order some or all of the rights sold
 - iii. Do nothing and let the rights expire

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III. The Right to Purchase New Shares (cont'd)

1. The mechanics of a rights offering (cont'd):

NATIONAL POWER COMPANY Balance Sheet		
Assets	Shareholders' Equity	
Assets	\$15,000,000	Common stock \$ 5,000,000
		Retained earnings 10,000,000
Total	\$15,000,000	Total \$15,000,000

Income Statement	
Earnings before taxes	\$ 3,030,303
Taxes (34%)	1,030,303
Net income	\$ 2,000,000
Shares outstanding	1,000,000
Earnings per share	\$ 2
Market price per share	\$ 20
Total market value	\$20,000,000

- To fund a planned expansion, the company intends to raise \$5 million worth of new equity funds through a rights offering

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III. The Right to Purchase New Shares (cont'd)

1. The mechanics of a rights offering (cont'd):

- The key questions in executing a rights offering:

- i. What should the price per share be for the new stock ?
- ii. How many shares will have to be sold ?
- iii. How many shares will each shareholder be allowed to buy ?
- iv. What is likely to be the effect of the rights offering on the per-share value of the existing stock ?

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III. The Right to Purchase New Shares (cont'd)

2. Number of rights needed to purchase a share

Income Statement	
Earnings before taxes	\$ 3,030,303
Taxes (34%)	1,030,303
Net income	\$ 2,000,000
Shares outstanding	1,000,000
Earnings per share	\$ 2
Market price per share	\$ 20
Total market value	\$20,000,000

Assuming that the subscription price is \$10 per share

$$\text{Number of new shares} = \frac{\text{Funds to be raised}}{\text{Subscription price}} = \frac{\$5,000,000}{10} = 500,000 \text{ shares}$$

- **Subscription price** – a static price at which existing shareholders can participate in a rights offering, so they may retain their proportional ownership of the business

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III. The Right to Purchase New Shares (cont'd)

2. Number of rights needed to purchase a share

Income Statement	
Earnings before taxes	\$ 3,030,303
Taxes (34%)	1,030,303
Net income	\$ 2,000,000
Shares outstanding	1,000,000
Earnings per share	\$ 2
Market price per share	\$ 20
Total market value	\$20,000,000

$$\text{Number of right needed to buy a share} = \frac{\text{Old shares}}{\text{New shares}} = \frac{1,000,000}{500,000} = 2 \text{ rights}$$

A shareholder will need to give up 2 rights plus \$10 for each new share

Subscription Price	Number of New Shares	Number of Rights Needed to Buy a Share of Stock
\$20	250,000	4
10	500,000	2
5	1,000,000	1

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III. The Right to Purchase New Shares (cont'd)

4. Ex rights (cont'd)

Exercising Your Rights: Part I

In the National Power example, suppose the subscription price is set at \$8. How many shares will have to be sold? How many rights will you need to buy a new share? What is the value of a right? What will the price per share be after the rights offer?

- To raise \$5 million, shares are needed to be sold are 625,000 ($5,000,000 / 8$)
- There are 1 million shares outstanding, it will take 1.6 rights to buy a new share ($1 \text{ million} / 625,000$)
- After the rights offer, there will be 1.625 million shares, worth \$25 million, so value per share will be \$15.38 ($\$25 / 1.625$)
- The value of the right is \$4.62 ($20\$ - \15.38)

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III. The Right to Purchase New Shares (cont'd)

4. Ex rights (cont'd)

Exercising Your Rights: Part II

The Lagrange Point Co. has proposed a rights offering. The stock currently sells for \$40 per share. Under the terms of the offer, stockholders will be allowed to buy one new share for every five that they own at a price of \$25 per share. What is the value of a right? What is the ex-rights price?

- Five rights on share can be bought for \$200 ($5 \times \40)
- To possess one new share, the shareholder will need to give up 5 rights plus \$25
- Your total investment is \$225, and you end up with 6 (ex-rights) shares
- The ex-right price per share is \$37.50 ($\$225 / 6$)
- The rights are worth \$2.50 a piece ($\$40 - \37.50)

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III. The Right to Purchase New Shares (cont'd)

4. Ex rights (cont'd)

Exercising Your Rights: Part II

The Lagrange Point Co. has proposed a rights offering. The stock currently sells for \$40 per share. Under the terms of the offer, stockholders will be allowed to buy one new share for every five that they own at a price of \$25 per share. What is the value of a right? What is the ex-rights price?

Right On

In Example 16.2, suppose the rights sell for only \$2 instead of the \$2.50 we calculated. What can you do?

- Buy 5 rights for \$10
- Exercise 5 rights and pay \$25 to get a new share
- Your total investment to get one ex-rights share is \$35 ($5 \times \$2 + 25$)
- Sell the share for \$37.50 and pocket the \$2.5 difference

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III. The Right to Purchase New Shares (cont'd)

5. Effect on shareholders

- If the shareholder sells the two right for \$3.33 each, and end up with two shares worth \$16.67, and the cash selling from the right:

- Share held = \$33.33 (2 x \$16.67)
- Right sold = \$6.67 (2 x \$3.33)
- Total = \$40.00

- The new \$33.33 market value plus \$6.67 in cash is exactly the same as the original holding of \$40.

⇒ Stockholders cannot lose or gain by exercising or selling rights 22

III. The Right to Purchase New Shares (cont'd)

6. Poison Pills



The boss



Hidden acquirer...accumulates 25% of the share

Trigger point

- Decide to issue the right to purchase the additional shares with the very low price to the other shareholders
- This makes the ownership percentage of the acquirer dilute

IV. American Depository Receipt

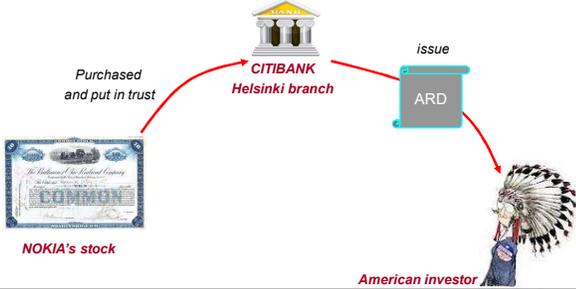
Offering the security for sale in the U.S



⇒ Issuing ADRs in American

IV. American Depository Receipt (cont'd)

– **American Depository Receipts (ARDs)** – certificates that have a legal claim on an ownership interest in common stock of a foreign company



IV. American Depository Receipt (cont'd)

❖ Characteristics of ARD

- ADRs are traded in dollars
- Dividends are paid in dollar
- Dividends are more easily collected than if the actual shares of the foreign stocks were owned
- ADRs are considered to be more liquid, less expensive, and easier to trade than buying foreign companies' stock directly on that firm's home exchange
- The ADRs' investors are subject to the foreign currency risk

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V. Preferred Stock Financing

- **Preferred stock** – an intermediate and hybrid form of security of bonds and common stocks
- Preferred stockholders are entitled to receive a stipulated dividend before the payment of dividends to common stockholders
- The right of the preferred stockholder to annual dividends is not mandatory for the corporation

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V. Preferred Stock Financing
(cont'd)

❖ **Justification for Preferred Stock**

 Why might the corporation issue the preferred stock ?

- A means to expand the capital base of the firm without diluting the common stock ownership position or incurring debt obligations

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V. Preferred Stock Financing
(cont'd)

❖ **Justification for Preferred Stock** (cont'd)

 Why are the investors willing to purchase the preferred stock ?

- Primary purchasers of preferred stock (corporate investors) have a very attractive advantage over bonds:
 - Only 30% of the dividend would be taxable, while all interest of bond is taxable except the municipal bond

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V. Preferred Stock Financing
(cont'd)

❖ **Justification for Preferred Stock** (cont'd)

Summary of Tax Considerations

- For issuing corporation, the after-tax cost of debt is cheaper than preferred stock
- For corporate investor, the receipt of preferred dividends is more valuable than corporate bond interest

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VI. Provisions Associated with Preferred Stock

1. *Cumulative Dividends*
2. *Conversion Feature*
3. *Call Feature*
4. *Participation Provision*
5. *Floating Rate*
6. *Dutch Auction Preferred Stock*
7. *Par Value*

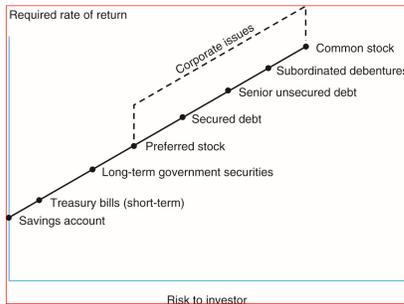
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VII. Comparing Feature of Common and Preferred Stock and Debt

	Common Stock	Preferred Stock	Bonds
1. Ownership and control of the firm	Belongs to common stockholders through voting rights and residual claim to income	Limited rights when dividends are missed	Limited rights under default in interest payment
2. Obligations to provide return	None	Must receive payment before common stockholders	Contractual obligation
3. Claim to assets in bankruptcy	Lowest claim of any security holder	Bondholders and creditors must be satisfied first	Highest claim
4. Cost of distribution	Highest	Moderate	Lowest
5. Risk-return trade-off	Highest risk, highest return (at least in theory)	Moderate risk, moderate return	Lowest risk, moderate return
6. Tax status of payment by corporation	Not deductible	Not deductible	Tax-deductible Cost = interest payment × (1 - Tax rate)
7. Tax status of payment to recipient	70 percent of dividend to another corporation is tax-exempt	Same as common stock	Municipal bond interest is tax-exempt

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VII. Comparing Feature of Common and Preferred Stock and Debt (cont'd)



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• The end

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