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Title of the topic: Various Corporate Actions in Equity Market and its Impact -Part (2)

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Various Corporate Actions in Equity Markets and its Impact – Part (2)

In the previous issue we have seen what are Mandatory "Corporate Actions" and its benefits to the Company and Shareholders; we also looked at the importance of Record date and Ex-Date during a corporate action. In this issue we will be looking at some other types of corporate actions namely Mandatory with choice Corporate actions and Voluntary corporate actions.

Mandatory with Choice Corporate Action:

This corporate action is a mandatory corporate action where shareholders are given a chance to choose among several options. An example is cash or stock dividend option with one of the options as default. Shareholders may or may not submit their elections. In case a shareholder does not submit the election, the default option will be applied.

A. Dividend:

A dividend is a distribution of profits by a corporation to its current shareholders. When a company earns a profit or surplus, it is able to pay a proportion of the profit as a dividend to shareholders. Any amount not distributed is taken to be re-invested in the business (called retained earnings). The current year profit as well as the retained earnings of previous years is available for distribution; a company is usually prohibited from paying a dividend out of its capital. Distribution to shareholders may be in cash (usually a deposit into a bank account) or, if the corporation has a dividend reinvestment plan, the amount can be paid by the issue of further shares or by share repurchase. In some cases, the distribution may be of assets. The dividend received by a shareholder is income to the shareholder and may be subject to income tax. The tax treatment of this income varies considerably between jurisdictions. The corporation does not receive a tax deduction for the dividends it pays.

After the declaration of a stock dividend, the stock's price often increases. However, because a stock dividend increases the number of shares outstanding while the value of the company remains stable, it dilutes the book value per common share, and the stock price is reduced accordingly.

A 2% stock dividend paid on shares trading at Rs.200 only drops the price to Rs.196.10, a reduction that could easily be the result of normal trading. However, a 35% stock dividend drops the price down to Rs.148.15 per share, which is pretty hard to miss.

Advantages of Dividend:

<u>From Investor's Point of View –</u>

1) The dividend declaration enhances the wealth of shareholders.
2) Dividend declaration gives the satisfaction to the investors that they have invested in the right organization where they get the proper return on the investments made. This attracts more investors.

From Company’s Point of View –

1) The company will stand in a benefited position in case of a further public issue for expansion or diversification.
2) Another advantage of dividend is that people who are old like to have constant source of income and if they invest in stock market they will more likely to invest in those companies which pay regular dividend rather than those company which pay irregular or no dividend and hence dividend attracts this class of investors to invest in the company.

Disadvantages of Dividend:

From Investor's Point of View –

1) On declaration of dividend the market price reduces and in return the volatility in the stock market increases.

From Company’s Point of View –

1) As in some countries, the dividend is tax free and the organization declaring the dividend has to pay taxes on it from the own pocket, this demotivates the organization to declare dividends.
2) The procedure and legal formalities involved in the declaration and payment of the dividend is lengthy and time consuming.
3) The biggest disadvantage of dividends is that by paying dividend company runs out of cash which could be utilized for investing into the business which in turn would have resulted in more growth for the company. In a way dividend results in sacrificing long term growth for short term benefit.
4) If company pays dividend in 1 year and fails to pay in other years then investors worry about the future of the company and starts selling stock which results in downward pressure on the stock price and unwanted negativity about the company.

Voluntary Corporate Actions:

A voluntary corporate action is an action where the shareholders elect to participate in the action. A response is required for the corporation to process the action.

A. Rights Issue:

A rights issue is an invitation to existing shareholders to purchase additional new shares in the company. This type of issue gives existing shareholders securities called rights. With the rights, the shareholder can purchase new shares at a discount to the market price on a stated future date. The company is giving shareholders a chance to increase their exposure to the stock at a discount price. Until the date at which the new shares can be purchased, shareholders may trade the rights on the market the same way that they would trade ordinary shares. The rights issued to a shareholder have value, thus compensating current shareholders for the future dilution of their existing shares' value.

For example, A company announces rights shares in the ratio of 1:5 i.e. one share for every 5 shares held at a discounted price of Rs. 250.The current market price is Rs. 300. As price falls after a right issue the security can be expected to trade around Rs.291.67 ex-rights.

Advantages of Rights Issue:

From Investor's Point of View –

1) Shareholders can buy new shares at a discount for a certain period on the right issue.
2) The number of additional share purchases allowed to an existing shareholder is always in proportion to his existing shareholding. Shareholders have the option to maintain their original proportion of share ownership.
3) Existing shareholders will have more certainty of getting shares, when a fresh issue is made to the existing shareholders, instead of the general public. The share price of the right issue will be less than the current share price which attracts the existing shareholders.

From Company's Point of View –

1) Issuing rights is the fastest method and the cheapest source of raising capital for a firm.
2) The right issue involves less rigorous rules and regulations as it is more of an internal matter in the company.
3) A company can initiate the rights issue process to its existing shareholders at indigent times without incurring underwriting fees. The company also saves money that is spent on advertising, underwriting fee, etc. The company does not have to incur such expenses compared with raising fresh equity from an IPO.
4) The right issue is a process to raise capital wherein the company can raise capital without any increase in debt. The company can raise the capital from its existing shareholders without altering the shareholder's holding percentage. The scope of the right issue is purely in the form of equity and it eliminates any scope for debt.

Disadvantages of Rights Issue:

From Investor's Point of View –

1) Existing shareholders have the option either to 'subscribe' to the right issue or 'ignore' to the right issue. If a shareholder 'ignore' the right issue then their shareholding percentage will get diluted.
2) Investors may lose the holding value if the share prices come down after the rights issue.

From Company's Point of View –

1) The right issue is an indication of liquidity crises that a company suffers. Generally, companies will practice the right issue option in the case of a financial crisis. The brand name of the company could negatively be affected when the right issue is announced. In another way, the shareholders also could assume that the company is struggling to run its business and could tend to sell their shares, which could then reduce the share price further.
2) The company may not be able to raise more funds and fail to achieve their target. This may happen if the existing shareholders of the company are not too keen to invest more.

B. Share Buyback:

A share buyback, commonly known as repurchase of shares, is a corporate action to buy back its own outstanding shares from its existing shareholders usually at a premium to the prevailing market price. It can be an alternative tax-efficient way to return money to shareholders. Share buybacks reduce the number of shares in circulation, which can increase the share value and the earnings per share (EPS). A company might buy back its shares to boost the value of the stock and to improve the financial statements. Companies tend to repurchase shares when they have cash on hand and the stock market is on an upswing. The company is under no compulsion to conduct the repurchase program. It can cancel it or modify it according to their needs.

For Example A Company has 1,000,000 shares of stock outstanding. The current trading price of the stock is Rs.10 per share, giving XYZ Company a market capitalization of Rs.10,000,000. The company is flush with cash, so the board of directors decides to buy back 200,000 shares of its stock. There are now 800,000 shares of stock outstanding, but the company is still 'worth' Rs.10,000,000, so the shares should now trade at Rs.12.50 each.

Advantages of Share Buyback:

From Investor's Point of View –

1) The shareholders are also under no compulsion to sell back the shares. They can choose to hold the shares if they want to.
2) After a Company announces to buy back shares, the stock price of that company often increases, this benefits the investors holding the shares of the company.
3) Buyback allows Shareholders to buy shares at a lower price and return them at a higher price and get a good capital gain in a short period of time.

From Company's Point of View –

1) Companies that are below their average industry profitability enjoy better share price appreciation after purchasing shares than companies with profitability above their industry average.
2) Companies whose sales growth was below their industry average had a higher share price rise after the repurchase of shares than those whose sales growth was above their industry average.
3) If a company / promoter is confident that the credit of their company is much higher than the market price, then the company can prove its confidence in the market by bringing a buy-back proposal.

Disadvantages of Share Buyback:

From Investor's Point of View –

1) Buy-back can cause shortage of shares in the market, resulting in liquidity issues.
2) Shareholders may receive a low dividend after a share buyback.

From Company's Point of View –

1) A Buyback could distract the funds of the organization from productive investments.
2) It might encourage unscrupulous promoters to use the money of the company to increase their stakes.
3) Companies often end up buying their stock at what turns out to be high levels, making the buyback a bad use of capital.

4) The buyback process is time-consuming and requires disclosures to stock exchanges and approvals from regulatory bodies. It also involves hiring investment bankers, which becomes an expensive affair for the company.
5) It may also give a negative signal about the company's confidence in itself and promoters may decide to sell their stake.

This issue gave us an insight about what is Mandatory with choice corporate actions and Voluntary corporate actions. Now we know the importance of corporate actions and how they affect the stock price, what all benefits they offer to a company and investor.

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