

PART I

LEARNING OBJECTIVES, SUMMARY OVERVIEW, AND PROBLEMS

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OVERVIEW OF EQUITY SECURITIES

LEARNING OUTCOMES

The candidate should be able to:

- describe characteristics of types of equity securities;
- describe differences in voting rights and other ownership characteristics among different equity classes;
- distinguish between public and private equity securities;
- describe methods for investing in non-domestic equity securities;
- compare the risk and return characteristics of different types of equity securities;
- explain the role of equity securities in the financing of a company's assets;
- 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.

SUMMARY

Equity securities play a fundamental role in investment analysis and portfolio management. The importance of this asset class continues to grow on a global scale because of the need for equity capital in developed and emerging markets, technological innovation, and the growing sophistication of electronic information exchange. Given their absolute return potential and ability to impact the risk and return characteristics of portfolios, equity securities are of importance to both individual and institutional investors.

This chapter introduces equity securities and provides an overview of global equity markets. A detailed analysis of their historical performance shows that equity securities have offered average real annual returns superior to government bills and bonds, which have provided average real annual returns that have only kept pace with inflation. The different types and

characteristics of common and preference equity securities are examined, and the primary differences between public and private equity securities are outlined. An overview of the various types of equity securities listed and traded in global markets is provided, including a discussion of their risk and return characteristics. Finally, the role of equity securities in creating company value is examined as well as the relationship between a company's cost of equity, its accounting return on equity, investors' required rate of return, and the company's intrinsic value.

We conclude with a summary of the key components of this chapter:

- Common shares represent an ownership interest in a company and give investors a claim on its operating performance, the opportunity to participate in the corporate decision-making process, and a claim on the company's net assets in the case of liquidation.
- Callable common shares give the issuer the right to buy back the shares from shareholders at a price determined when the shares are originally issued.
- Puttable common shares give shareholders the right to sell the shares back to the issuer at a price specified when the shares are originally issued.
- Preference shares are a form of equity in which payments made to preference shareholders take precedence over any payments made to common stockholders.
- Cumulative preference shares are preference shares on which dividend payments are accrued so that any payments omitted by the company must be paid before another dividend can be paid to common shareholders. Non-cumulative preference shares have no such provisions, implying that the dividend payments are at the company's discretion and are thus similar to payments made to common shareholders.
- Participating preference shares allow investors to receive the standard preferred dividend plus the opportunity to receive a share of corporate profits above a pre-specified amount. Non-participating preference shares allow investors to simply receive the initial investment plus any accrued dividends in the event of liquidation.
- Callable and puttable preference shares provide issuers and investors with the same rights and obligations as their common share counterparts.
- Private equity securities are issued primarily to institutional investors in private placements and do not trade in secondary equity markets. There are three types of private equity investments: venture capital, leveraged buyouts, and private investments in public equity (PIPE).
- The objective of private equity investing is to increase the ability of the company's management to focus on its operating activities for long-term value creation. The strategy is to take the "private" company "public" after certain profit and other benchmarks have been met.
- Depository receipts are securities that trade like ordinary shares on a local exchange but which represent an economic interest in a foreign company. They allow the publicly listed shares of foreign companies to be traded on an exchange outside their domestic market.
- American depository receipts are US dollar-denominated securities trading much like standard US securities on US markets. Global depository receipts are similar to ADRs but contain certain restrictions in terms of their ability to be resold among investors.
- Underlying characteristics of equity securities can greatly affect their risk and return.
- A company's accounting return on equity is the total return that it earns on shareholders' book equity.
- A company's cost of equity is the minimum rate of return that stockholders require the company to pay them for investing in its equity.

PRACTICE PROBLEMS

1. Which of the following is *not* a characteristic of common equity?
 - A. It represents an ownership interest in the company.
 - B. Shareholders participate in the decision-making process.
 - C. The company is obligated to make periodic dividend payments.
2. The type of equity voting right that grants one vote for each share of equity owned is referred to as:
 - A. proxy voting.
 - B. statutory voting.
 - C. cumulative voting.
3. All of the following are characteristics of preference shares *except*:
 - A. They are either callable or puttable.
 - B. They generally do not have voting rights.
 - C. They do not share in the operating performance of the company.
4. Participating preference shares entitle shareholders to:
 - A. participate in the decision-making process of the company.
 - B. convert their shares into a specified number of common shares.
 - C. receive an additional dividend if the company's profits exceed a pre-determined level.
5. Which of the following statements about private equity securities is *incorrect*?
 - A. They cannot be sold on secondary markets.
 - B. They have market-determined quoted prices.
 - C. They are primarily issued to institutional investors.
6. Venture capital investments:
 - A. can be publicly traded.
 - B. do not require a long-term commitment of funds.
 - C. provide mezzanine financing to early-stage companies.
7. Which of the following statements *most accurately* describes one difference between private and public equity firms?
 - A. Private equity firms are focused more on short-term results than public firms.
 - B. Private equity firms' regulatory and investor relations operations are less costly than those of public firms.
 - C. Private equity firms are incentivized to be more open with investors about governance and compensation than public firms.
8. Emerging markets have benefited from recent trends in international markets. Which of the following has *not* been a benefit of these trends?
 - A. Emerging market companies do not have to worry about a lack of liquidity in their home equity markets.
 - B. Emerging market companies have found it easier to raise capital in the markets of developed countries.
 - C. Emerging market companies have benefited from the stability of foreign exchange markets.

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9. When investing in unsponsored depository receipts, the voting rights to the shares in the trust belong to:
 - A. the depository bank.
 - B. the investors in the depository receipts.
 - C. the issuer of the shares held in the trust.
 10. With respect to Level III sponsored ADRs, which of the following is *least likely* to be accurate? They:
 - A. have low listing fees.
 - B. are traded on the NYSE, NASDAQ, and AMEX.
 - C. are used to raise equity capital in US markets.
 11. A basket of listed depository receipts, or an exchange-traded fund, would *most likely* be used for:
 - A. gaining exposure to a single equity.
 - B. hedging exposure to a single equity.
 - C. gaining exposure to multiple equities.
 12. Calculate the total return on a share of equity using the following data:
Purchase price: \$50
Sale price: \$42
Dividend paid during holding period: \$2
 - A. -12.0%
 - B. -14.3%
 - C. -16.0%
 13. If a US-based investor purchases a euro-denominated ETF and the euro subsequently depreciates in value relative to the dollar, the investor will have a total return that is:
 - A. lower than the ETF's total return.
 - B. higher than the ETF's total return.
 - C. the same as the ETF's total return.
 14. Which of the following is *incorrect* about the risk of an equity security? The risk of an equity security is:
 - A. based on the uncertainty of its cash flows.
 - B. based on the uncertainty of its future price.
 - C. measured using the standard deviation of its dividends.
 15. From an investor's point of view, which of the following equity securities is the *least* risky?
 - A. Puttable preference shares.
 - B. Callable preference shares.
 - C. Non-callable preference shares.
 16. Which of the following is *least likely* to be a reason for a company to issue equity securities on the primary market?
 - A. To raise capital.
 - B. To increase liquidity.
 - C. To increase return on equity.

17. Which of the following is *not* a primary goal of raising equity capital?
- A. To finance the purchase of long-lived assets.
 - B. To finance the company's revenue-generating activities.
 - C. To ensure that the company continues as a going concern.
18. Which of the following statements is *most accurate* in describing a company's book value?
- A. Book value increases when a company retains its net income.
 - B. Book value is usually equal to the company's market value.
 - C. The ultimate goal of management is to maximize book value.
19. Calculate the book value of a company using the following information:

Number of shares outstanding	100,000
Price per share	€52
Total assets	€12,000,000
Total liabilities	€7,500,000
Net Income	€2,000,000

- A. €4,500,000.
 - B. €5,200,000.
 - C. €6,500,000.
20. Which of the following statements is *least accurate* in describing a company's market value?
- A. Management's decisions do not influence the company's market value.
 - B. Increases in book value may not be reflected in the company's market value.
 - C. Market value reflects the collective and differing expectations of investors.
21. Calculate the return on equity (ROE) of a stable company using the following data:
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- | | |
|---|-------------|
| Total sales | £2,500,000 |
| Net income | £2,000,000 |
| Beginning of year total assets | £50,000,000 |
| Beginning of year total liabilities | £35,000,000 |
| Number of shares outstanding at the end of the year | 1,000,000 |
| Price per share at the end of the year | £20 |
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- A. 10.0%.
 - B. 13.3%.
 - C. 16.7%.
22. Holding all other factors constant, which of the following situations will *most likely* lead to an increase in a company's return on equity?
- A. The market price of the company's shares increases.
 - B. Net income increases at a slower rate than shareholders' equity.
 - C. The company issues debt to repurchase outstanding shares of equity.

23. Which of the following measures is the *most difficult* to estimate?
- A. The cost of debt.
 - B. The cost of equity.
 - C. Investors' required rate of return on debt.
24. A company's cost of equity is often used as a proxy for investors':
- A. average required rate of return.
 - B. minimum required rate of return.
 - C. maximum required rate of return.