

Chapter 39

CAPITAL INCREASES

There are no victories at bargain prices

The previous chapters have already begun our study of equity financing. This chapter analyses the consequences for the shareholder of a capital increase via an issue of new shares for cash. Capital increases resulting from mergers and acquisitions will be dealt with in Chapter 43.

Section 39.1

A DEFINITION OF CAPITAL INCREASE

1/A CAPITAL INCREASE IS A SALE OF SHARES. . .

A capital increase is first of all a **sale of shares**. But who is the seller? The **current shareholder**. The paradox is that the seller receives no money. As we shall see in this chapter, **to avoid diluting his stake in the company at the time of a capital increase, the shareholder must subscribe to the same proportion of the new issue that he holds of the pre-existing shares**. Only if he subscribes to more than that is he (from the standpoint of his own portfolio) buying additional control; if less, he is selling control.

Up to now, we have presented market value as a sanction on the company's management, an external judgement that the company can ignore so long as its shareholders are not selling out and it is not asking them to stump up more money. A capital increase, which conceptually is a sale of shares at market value, has the effect of reintroducing this value-sanction via the company's treasury, i.e. its cash balance. **For the first time, market value, previously an external datum, interferes in the management of the company.**

2/ . . . THE PROCEEDS OF WHICH GO TO THE COMPANY, AND THUS INDIRECTLY TO ALL OF ITS INVESTORS, . . .

This may seem paradoxical, but it is not. The proceeds of the capital increase indeed go to the company. Shareholders will benefit to the extent that the additional funds enable the

company to develop its business and thereby increase its earnings. Creditors will see their claims on the company made less risky and therefore more valuable.

3/ ... WHICH IMPLIES SHARING BETWEEN OLD AND NEW SHAREHOLDERS

When a company issues bonds or takes out a loan from a bank, it is selling a “financial product”. It is contracting to pay interest at a fixed or indexed rate and repay what it has borrowed on a specified schedule. As long as it meets its contractual obligations, the company does not lose its *autonomy*.

In contrast, when a company issues new shares, the old shareholders are agreeing to share their rights to the company’s equity capital (which is increased by the proceeds of the issue), their rights to its future earnings and their control over the company itself with the new shareholders.

A capital increase is simply a sale of shares. It implies sharing the parameters of the company. The magnitude of this sharing depends on the market value of the equity capital, but it applies to a cake made larger by the proceeds of the capital increase.

To illustrate, consider company *E* with equity capital worth €1000m split between two shareholders, *F* (80%) and *G* (20%).

If *G* sells his entire shareholding (€200m) to *H*, neither the value nor the proportion of *F*’s equity in the company is changed. If, on the other hand, *H* is a new shareholder brought in by means of a capital increase, he will have to put in €250m to obtain a 20% interest, rather than €200m as previously, since the value of equity after a capital increase of €250m is €1250m (1000 + 250). The new shareholder’s interest is indeed 20% of the larger amount. **Percentage interests should always be reckoned on the value including the newly issued shares.**

After this capital increase has been made to the €1000m base, the value of *F*’s shareholding in the company is the same as it was (€800m) but his ownership percentage has decreased from 80% to 64% (800/1250), while *G*’s has decreased from 20% to 16%.

We see that if a shareholder does not participate in a capital increase, his percentage interest declines. This effect is called **dilution**.

In contrast, if the capital increase is reserved entirely for *F*, his percentage interest in the company rises from 80% to 84% (1050/1250), and the equity interest of all other shareholder(s) is necessarily diluted.

Lastly, if *F* and *G* each take part in the capital increase in exact proportion to their current shareholding, **the market value of equity no longer matters** in this one particular case. Their ownership percentages remain the same, and each puts up the same amount of funds for new shares regardless of the market value. This is illustrated in the table below¹ for equity values of €500m, €1000m and €2000m. In effect, *F* and *G* are selling new shares to themselves.

¹ The figures in parentheses indicate cash flows: positive means an inflow, negative an outflow.

(€ million)	Value of equity in <i>E</i>	Value of shares held by <i>F</i>	Value of shares held by <i>G</i>	Value of shares held by <i>H</i>
Before capital increase	1000	800 or 80%	200 or 20%	
<i>G</i> sells 20% of the shares to <i>H</i> for 200	1000	800 or 80%	0 or 0% (+200)	200 or 20% (−200)
<i>H</i> subscribes to a cash capital increase of 250	1250	800 or 64%	200 or 16%	250 or 20% (−250)
<i>G</i> sells 20% of the shares to <i>F</i> for 200	1000	1000 or 100% (−200)	0 or 0% (+200)	
<i>F</i> subscribes to a cash capital increase of 250	1250	1050 or 84% (−250)	200 or 16%	
<i>F</i> and <i>G</i> subscribe to a cash capital increase of 250 in proportion to their ownership percentage at different initial values of equity (1000, 2000 and 500, respectively)	1250	1000 or 80% (−200)	250 or 20% (−50)	
	2250	1800 or 80% (−200)	450 or 20% (−50)	
	750	600 or 80% (−200)	150 or 20% (−50)	

Section 39.2

CAPITAL INCREASES AND FINANCE THEORY

1/ CAPITAL INCREASES AND MARKETS IN EQUILIBRIUM

A capital increase is analysed first and foremost as a sale of new shares at a certain price. If that price is equal to the true value of the share, there is no creation of value, nor is any current shareholder made worse off. This is an obvious point that is easily lost sight of in the analysis of financial criteria that we will get to later on.

If the new shares are sold at a high price (more than their value), the company will have benefited from a low-cost source of financing to the detriment of its most recent shareholders. The Internet companies that were able to raise money on very advantageous terms until early 2000 can be cited as an example.

Recall that the cost entailed by a capital increase is neither the immediate return on the stock nor the accounting rate of return on equity. It is the rate of return required by shareholders given the market valuation of the stock (see Chapter 22 for the determination of cost of equity).

As we have seen, however, this cost is eminently variable. The sanction for not meeting it is that, other things being equal, the value of the share will decline. The company will be worth less, but in the short term there will be no impact on its treasury.

2/ TAXATION

A cash capital increase generally results in immediate de-leveraging, making the capital structure less advantageous from a tax standpoint. But the equity injection is usually part of a plan to achieve a new capital structure. For this reason, the tax factor is not a fundamental parameter of a capital increase.

3/ SHAREHOLDERS AND CREDITORS

For a company in financial difficulty, a capital increase results in a transfer of value from shareholders to creditors, since the new money put in by the former enhances the value of the claims held by the latter. According to the contingent claims model, the creditors of a “risky” business are able to appropriate most of the increase in the company’s value due to an injection of additional funds by shareholders. The value of the put option sold by creditors to shareholders has a lower value. This is the reason why recovery plans for troubled companies always link any new equity financing to prior or concomitant concessions on the part of lenders.

Recapitalisation increases the intrinsic value of the equity and thereby reduces the riskiness of the company, thus increasing the value of its debt as well. Creditors run less risk by holding that debt. This effect is perceptible, though, only if the value of debt is close to the value of operating assets – that is, only if the debt is fairly high risk.

4/ SHAREHOLDERS AND MANAGERS

A capital increase is generally a highly salutary thing to do because it helps to reduce the asymmetry of information between shareholders and managers. A call on the market for fresh capital is accompanied by a series of disclosures on the financial health of the company and the profitability of the investments that will be financed by the capital increase. This practice effectively clears management of suspicion and reduces the agency costs of divergence between their interest and the interest of outside shareholders. A capital increase thus encourages managers to manage in a way that maximises the shareholders’ interest.

The reader will already have applied the line of reasoning above, so familiar has it become by now. What is new here is the conflict between old and new shareholders, under the cover of the oft-repeated hypocrisy that “we are all partners” in the same company.

5/ CAPITAL INCREASE AS A SIGNAL

If one assumes that managers look out for the interests of current shareholders, it is hard to see how they could propose a capital increase when the share price is undervalued.

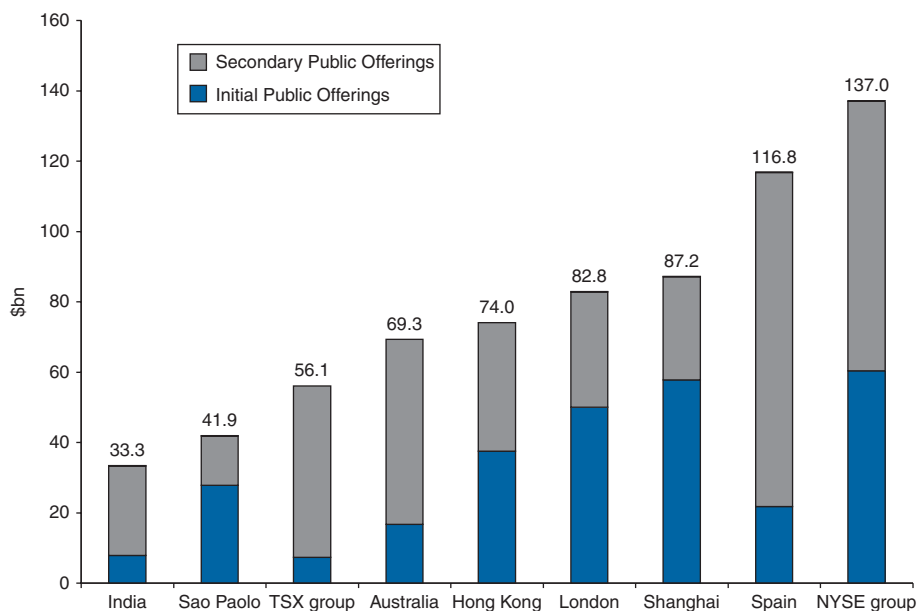
If one believes in asymmetry of information, a capital increase ought to be a signal that the share price is overvalued. A capital increase may be a sign that managers believe the company’s future cash flows will be less than what is reflected in the current share price. The management team takes advantage of the overvaluation by issuing new shares. The funds provided by the capital increase will then serve not to finance new investments but to make up for the cash shortfall due to lower-than-expected operating cash flows.

Furthermore, as we have already noted, a capital increase implies a change in capital structure. Following the injection of new funds, financial leverage is appreciably decreased. The company's risk diminishes, and there is a transfer of value from shareholders to creditors; the value of the company's shares does not increase by the full value of the funds that are raised.

In practice, the announcement of a capital increase produces a downward adjustment of 3–5% in the share price. Only the old shareholders suffer this diminution of value. Three major explanations have been proposed for this irregularity:

- Some claim that this effect is due to the negative consequences of the capital increase on the company's accounting ratios (cf. Section 39.4). We do not think so.
- Others explain it by invoking a market mechanism: a product sells for a bit less when there is a larger quantity of it; "you catch more flies with honey than with vinegar".
- Lastly, still others explain it as being due to the negative signal that a capital increase sends. The reader who wants to raise fresh capital for his company should take this effect into account and be able to respond in advance to the criticisms.

CAPITAL INCREASES IN 2007



Source: World Federation of Exchanges.

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Section 39.3

OLD AND NEW SHAREHOLDERS

1/ DILUTION OF CONTROL

Returning to the examples given above, we see that there is dilution of control – that is, reduction in the percentage equity interest of certain shareholders, whenever those

shareholders do not subscribe to an issue of new shares in proportion to their current shareholding.

The dilution is greatest for any shareholder who does not participate at all in the capital increase. It is nil for any shareholder who subscribes in proportion to his holding. By convention, we will say that:

Dilution of control is the reduction of rights in the company sustained by a shareholder for which the capital increase entails neither an outflow nor an inflow of funds.

Recall that if new shares are issued at a price significantly below their value, current shareholders will usually have pre-emptive subscription rights that enable them to buy the new shares at that price. This right of first refusal is itself tradeable and can be acquired by investors who would like to become shareholders on the occasion of the capital increase.

In the absence of subscription rights, the calculation of dilution of control by a capital increase is straightforward:

$$\frac{\text{Number of new shares}}{\text{Number of old shares} + \text{Number of new shares}}$$

When the capital increase is made with an issue of pre-emptive subscription rights, this calculation no longer holds.

With a rights issue of this kind, we have to distinguish between three measures of dilution. *The most important of these is **real dilution**, which is equivalent to what we just now called dilution (with no modifier) in the absence of pre-emptive subscription rights.*

(a) Apparent dilution

Any capital increase with subscription rights gives rise to **apparent dilution** (sometimes called “overall dilution”), which is expressed by the ratio:

$$\frac{\text{Number of new shares}}{\text{Number of old shares} + \text{Number of new shares}} = \frac{N'}{N + N'}$$

In the case of a rights issue, this degree of dilution is only apparent because it is the result of two distinct transactions:

- a capital increase in the strict sense; and
- a detachment of subscription rights, which is analysed as a distribution of bonus shares.

As we saw in Chapter 30, subscription rights enable current shareholders to participate partially in the capital increase with no outlay of funds. As a result, the dilution of their ownership is not as great as the apparent dilution would make it appear.

We therefore need to calculate only the dilution due solely to the capital increase, independently of the subscription rights mechanism. This degree of dilution is called **real dilution** and, in the analysis of the capital increase, real dilution is what we are interested in knowing.

(b) Real dilution

Real dilution is the dilution of control that occurs when the capital increase is cash-neutral for a shareholder who, on balance, neither pays nor receives any funds: the shareholder sells a portion of his subscription rights in order to buy new shares.

Method 1 The simplest way to calculate real dilution is to reckon on an aggregate basis rather than per share. Real dilution is then calculated as follows:

$$\text{Real dilution} = \frac{\text{Proceeds of capital increase}}{\text{Value of equity before capital increase} + \text{Proceeds of capital increase}}$$

Method 2 Regardless of the formal issue price, the existence of subscription rights ensures that the capital increase will always be subscribed at the company's market value. Every new shareholder will have to pay the issue price and the price of one or more rights in order to obtain one new share. Therefore, to calculate real dilution eliminating the bias due to subscription rights, one need only assume that the issue price is equal to the market value of the shares.

The theoretical number n' of shares that would have been issued under these conditions is:

$$n' = \frac{\text{Proceeds of the issue}}{\text{Market value of each share}}$$

Real dilution is then equal to $n'/(N + n')$ where n' is the number of shares that would have brought in the same funds if the issue price had been equal to the market value.

(c) Technical dilution

Technical dilution is apparent dilution less real dilution. It is due to the distribution of "free" bonus shares that automatically accompanies any capital increase via a rights issue.

Technical dilution represents the additional dilution attributable to the sale of subscription rights by shareholders who take the occasion of the capital increase to reduce their investment in the company.

As with any distribution of bonus shares, the various parameters of the company – earnings per share, dividend per share, value of the share – must be adjusted to correct for this technical aspect of the operation, which in no way changes the value of the company.

2/ ANTICIPATION MECHANISM

Take the example of a highly profitable company, entirely equity-financed, that now has investments of 100. With these investments, the company is on track to be worth 400 in 4 years, which corresponds to an annual rate of return on equity of 41.4%. Suppose that this company can invest an additional 100 at a rate of return similar to that on its current investments. To finance this additional capital requirement, it must sell new shares. Suppose also that the shareholder-required rate of return is 10%.

Before the company announces the capital increase and before the market anticipates it, the value of its equity capital 4 years hence is going to be 400 which, discounted at 10%, is 273 today.

If, upon the announcement of the capital increase, management succeeds in convincing the market that the company will indeed be worth 800 in 4 years, which is 546 today, the value accruing to current shareholders is $546 - 100 = 446$. There is thus instantaneous value creation of 173 ($446 - 273$) for the old shareholders.

The anticipation mechanism operates in such a way that new shareholders will not receive a excess rate of return. They will get only the return they require, which is 10%. If the intended use of funds is clearly indicated when the capital increase is announced, the share price *before* the capital increase will reflect the investment opportunities, and only the old shareholders will benefit from the value creation arising from them.

Some share prices that show very high P/E ratios are merely reflecting anticipation of exceptional investment opportunities. The 400 of added value in this example is already priced in. The reader will himself be able to observe companies whose share prices are at times so high that they cannot correspond to growth opportunities financed in the traditional way by operating cash flow and borrowing. The shareholders of these companies have placed a bet on the internal and external growth opportunities the company may be able to seize, as it may have done in the past, financed in part by issuing new shares.

Section 39.4

CAPITAL INCREASES AND FINANCIAL CRITERIA

In this section, we reckon only in terms of adjusted figures. The reader is referred to Chapter 27 for the calculation of the share price adjusted for a capital increase with subscription rights. The example we use is the capital increase by Carlsberg in June 2008.

CARLSBERG CAPITAL INCREASE	
Pre-increase data	
Number of shares:	76.3m
Share price:	DKK674
Market capitalisation:	DKK51.4bn
Book value of equity:	DKK18.6bn
Earnings per share, 2007:	DKK25.3
Post-increase data	
Number of new shares issued:	76.3m
Issue price:	DKK400
Proceeds of the issue:	DKK30.5bn
Pre-emptive subscription right:	one for every old share held
Eligibility date of new shares:	1 January 2008
For information:	€1 = DKK7.5

NB The reader must not confuse the amount of the capital increase in the financial sense – that is, the amount of funds raised, which is DKK30.5bn for Carlsberg – with the legal and accounting sense of the term.

Accountants and lawyers are accustomed to apportioning the proceeds of a capital increase between the increase in authorised capital (the number of new shares issued multiplied by the par value of the share; for Carlsberg, the par value is DKK20, and

the increase in authorised capital is therefore DKK1.5bn) and the increase in the share premium account (the remainder). Since the reader knows how to distinguish between the DKK1.5bn and the DKK30.5m, we are confident he will know how to distinguish between the two meanings of “capital increase”.

1/CAPITAL INCREASE AND EARNINGS PER SHARE

A capital increase will change earnings per share instantaneously. If EPS decreases, there is said to be **dilution** of earnings; if it increases, there is said to be **accretion** (or the operation is said to be “earnings-enhancing”, which may sound better). This dilution has nothing in common with the dilution of Section 39.1 but the name and is calculated differently. The one has to do with a shareholder’s percentage of ownership, the other with earnings per share.

Consider Carlsberg, whose shares carry a midrange P/E (26.6) warranted by the company’s moderate risk and reasonable growth prospects, and Company A, whose very weak prospects of EPS growth justify a low P/E (10). For both companies, shareholders require an after-tax rate of return on equity of 8%, and we will assume that both Carlsberg and Company A invest the funds raised by a capital increase at 8%; there is neither creation nor destruction of value on this occasion. For both, the value of equity capital therefore increases by the amount of the capital increase.

Carlsberg and Company A each increase the number of shares by 100% and raise DKK30.5bn which, invested at 8%, will increase their net earnings by DKK2.75bn. The impact of the capital increase will be as shown in the table below.

(in DKK)	Before capital increase					After capital increase			
	Market value of equity	P/E	Earnings	Number of shares	EPS	Market value of equity	Earnings	Number of shares	EPS
Carlsberg	51.4bn	26.6	1.9bn	76.3m	25.3	81.9bn	4.65bn	152.6m	30.5 (+ 20%)
Company A	51.4bn	10	5.14bn	76.3m	67.4	81.9bn	7.89bn	152.6m	51.7 (−23%)

Carlsberg’s EPS increases by 20% but the operation does not create value. Similarly, Company A’s EPS decreases by 23% but the operation does not destroy value. This demonstrates once again that earnings per share are not a reliable indicator of value creation or destruction. These changes are merely mechanical and depend fundamentally on:

- the company’s P/E ratio; and
- the rate of return on the investments made with the proceeds of the capital increase.

More generally, the rule the reader will want to retain is that any capital increase will:

- **dilute** EPS whenever the reciprocal of P/E is greater than the rate of return on the investments financed by the capital increase;
- **be neutral** whenever the reciprocal of P/E is equal to this incremental ROCE; and
- **increase or “enhance”** EPS whenever the reciprocal of P/E is less than incremental ROCE.

It can easily be demonstrated that the earnings dilution occasioned by a capital increase at the market price is equal to:

$$\text{Change in } EPS = P/E \times \frac{\text{Capital raised}}{\text{Market capitalisation after capital increase}} \times \left(\text{After-tax rate of return} - \frac{E}{P} \right)$$

For Carlsberg, any investment that generates a return per year greater than 3.8% (the reciprocal of P/E of 26.6) will increase earnings per share, whereas for Company A the bar is set higher at 10% (reciprocal of 10). Hence the appeal of issuing new shares when P/Es are high, even though no value is created.

In the short term, it is rare for funds raised by a capital increase to earn the required rate of return immediately, either because they are sitting in the bank waiting for the investments to be made or because some period of time must elapse before the achieved rate of return reaches the required level. Consequently, it is not rare for EPS to decrease following a capital increase – but this does not necessarily mean that value is being destroyed.

Three measures of EPS dilution might be distinguished here:

- 1 Instantaneous dilution with no reinvestment of the funds raised. This is seldom calculated because it holds no interest.
- 2 Dilution assuming investment of the funds at the risk-free rate of interest. This is the measure that financial analysts generally calculate.
- 3 Dilution with reinvestment of the funds. This is obviously the measure of most interest, but it is difficult to get hold of because it requires forecasting the rate of return on future investments.

In the long term, EPS dilution should normally be offset by the earnings generated by the investment financed by the capital increase. It is therefore necessary to study the expected rate of return on that investment, for it will determine the future course of the company's value.

With the wisdom that derives from experience, and notwithstanding what any theory might indicate, we could almost say that whenever P/Es are high, it is a crime for a company not to issue new shares!

2/ CAPITAL INCREASE AND VALUE OF EQUITY CAPITAL

To say that the book value of a company's equity increases after a capital increase is to state the obvious, since the proceeds of the share issue are included in that book value.

It is of more interest to compare the percentage increase in book value with the ratio of the proceeds of the capital increase to the market value of equity and to calculate the growth in value per share.

Let us go back to the example of Carlsberg and make several different assumptions about market value (only the last of which is true). In all cases, we set the proceeds of the capital increase at the actual percentage level, which is 60% of the group's market capitalisation before the operation.

(in DKKbn)	Case 1	Case 2	Case 3 (real)
Book value of equity	18.6	18.6	18.6
Market value of equity	30	40	51.4
Capital increase	18	24	30.5
Dilution	37% ²	37%	37%
Increase in book value	+ 97%	+129%	+ 164%

² $18/(18 + 30)$.

At constant capital structure, the increase in equity allows a parallel increase in debt and thus in the company's overall financial resources. This phenomenon is all the more important when the company is profitable and its market value is greater than its book value. Here we link up again to the PBR (price-to-book ratio) notion that we examined in Chapter 27.

A capital increase may increase a company's financial power considerably, with relatively little dilution of control.

- If market value of equity coincides with book value, the dilution of control will be accompanied by a similar increase in the company's overall financial resources.
- If market value is greater than book value, the dilution of control will be countered by a greater increase in financial resources.
- If market value is less than book value, the dilution of control will be accompanied by a lesser increase in financial resources.

3/ BOOK VALUE PER SHARE

Let us continue with the example of Carlsberg, this time changing the issue price of the new shares but keeping the size of the issue at 76.3m shares.

Issue price	100	244	400
Book value per share before capital increase	243.8	243.8	243.8
Book value per share after capital increase	171.9 (−30%)	243.9 (0%)	321.89 (+32%)

At the time of a capital increase, book value per share increases if the share price is greater, and decreases if the share price is less, than book value before the capital increase. This is self-evident since in the one case the issue price is higher than book value per share and in the other it is lower.

This increase or decrease also applies to the rights of the old shareholders in respect of the book value of equity.

Consider a fast-growing company worth €40m whose book value is €1m. If it carries out a €40m capital increase that doubles its market value, the old shareholders' equity rights are multiplied by 20.5 (from €1m to €20.5m)! For them, the capital increase locks in what was previously just a potential. If the company were to be wound up right after the capital increase, the old shareholders would have a right to €20.5m when they had put in only €1m, whereas the new shareholders would have a right to €20.5m when they had put in €40m. In a way, this imbalance is the "price of admission" when investing in such a profitable company – but also one entailing high risk, as shown, for example, by the Internet companies.

Book value per share is diluted for old shareholders if the market value of the company's shares is less than the book value ($PBR < 1$). It is increased if market value is greater than book value ($PBR > 1$).

SUMMARY

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A capital increase is a sale of shares, the proceeds of which go to the company and thus indirectly to all shareholders who will therefore share future cash flows.

In the theory of markets in equilibrium, the cost of a capital increase is equal to the cost of equity given the valuation of the shares. This is neither the dividend yield nor, except very rarely, the earnings yield (reciprocal of P/E). It is a forward-looking cost and one to which there is no firm commitment on the company's part. (*Ex post*, it may be quite different: exorbitantly high or actually negative.) Value is created for old shareholders if the capital increase captures the value creation stemming from the new funds.

Other theoretical approaches provide a wealth of insights. A capital increase tends to benefit lenders to the detriment of shareholders in so far as the market rerates the company's debt to reflect the reduced risk of its capital structure. A capital increase tends to favour old shareholders over new, via a transfer of value, if the rate of return on new investments is correctly anticipated. The *a priori* negative signal that any capital increase sends – namely, that the shares are overvalued – has to be countered (signalling theory). A capital increase is a subject of acrimonious discussions between managers and shareholders. It entails a temporary reduction in informational asymmetry (agency theory).

The reduction in equity rights of a shareholder that neither puts in nor takes out funds on the occasion of a capital increase is called real dilution. In the case of a capital increase with subscription rights, real dilution is different from apparent or overall dilution.

This dilution of power and control is to be distinguished from the dilution (or its opposite) in the company's financial parameters in the short term. Any capital increase increases EPS when the reciprocal of P/E is less than the after-tax rate of return on reinvested funds. Book value per share is diluted for old shareholders if the company's market capitalisation is less than its book value.

QUESTIONS

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- 1/What is important in a capital increase where each shareholder takes his proportionate share of the issue?
- 2/What is dilution of control?
- 3/When are there three different measures of dilution of control? What are they?
- 4/What is the purpose of subscription rights? What is their theoretical value?
- 5/At what price is a capital increase effected when made with an issue of subscription rights? When made without?
- 6/How can a company be sold by means of a capital increase?
- 7/What is the consequence of a capital increase on EPS in the short term? In the long term?
- 8/Should there be an issue of new shares whenever the share price is overvalued?
- 9/Why are the most profitable companies the ones that gain the most by issuing new shares?
- 10/When an investment bank underwrites an issue of new shares, it charges the issuing company a commission. How is this commission analysed using options theory?
- 11/Does a capital increase with pre-emptive subscription rights signal overvaluation of the shares more strongly than one without?

EXERCISES

- 1/ (a) A company has a market value of €100m divided into 1 million shares. It proposes to raise funds equivalent to 25% of its value by issuing new shares at €75. Calculate the value of the subscription right, the apparent, technical and real dilutions, the adjustment coefficient and the subscription ratio.
- (b) A shareholder holds 90 shares of the company above. Show the bonus share aspect inherent in a capital increase of this kind.
- (c) If the shareholder does not subscribe to the new issue, what is his new ownership percentage? Calculate it in two different ways.
- (d) Show that if all shareholders subscribe to the capital increase, the issue price does not matter.
- (e) What is EPS after the capital increase if previously it was €10?
- (f) If the book value of equity was €80m before the capital increase, what is the percentage increase in it? What is the book value per share before the operation? What is it after the operation?
- (g) Answer questions (a) through (f) again assuming that, after a sharp run-up in share prices, the market value of the company has doubled. The amount of the capital increase is still €25m, but the issue price rises to €150. What conclusions do you draw?
- 2/ Case study: Ixo capital increase
Issue of 760m new shares, or 7 new for every 20 old, with pre-emptive subscription rights

- Number of shares before the capital increase: 2172m
 Issue price: SF21
 Eligibility date of new shares: 1 January 2008
 Subscription period: from 25 May 2008 to 10 June 2008
 Six-month high/low: SF60/SF22
 Latest price: SF30.64
- The company will pay 2007 dividends in shares not in cash.
 Issue proceeds (gross): SF16bn. Stated purpose: restore financial balance after huge losses due to the subprime crisis.
 The capital increase has been guaranteed by BNP Paribas, Goldman Sachs, JP Morgan and Morgan Stanley.
- What do you think of UBS capital increase?
 - Compare consolidated shareholders' equity (SF35.6bn) with the amount of the capital increase, the amount of the latter to market capitalisation before the operation. What do you conclude?
 - Calculate the real dilution entailed by the capital increase.
 - Calculate the value of the pre-emptive subscription right.
 - What do you think of the guaranty granted by the four banks?

ANSWERS

Questions

- 1/Not much.
- 2/Reduction in the equity rights of shareholders that do not subscribe to the capital increase in proportion to their current shareholding.
- 3/When there is a capital increase along with an issue of pre-emptive subscription rights. Apparent dilution (ignoring the value of the rights), real dilution (the one that matters) and technical dilution (solely attributable to the rights).
- 4/Subscription rights ensure that the old shareholders can take part in the capital increase if they wish.
- 5/At market value. At the price guaranteed by the bank underwriting the share issue.
- 6/By having a very large capital increase with a very small issue premium.
- 7/Generally, dilution. It depends on the returns generated by the projects that are financed.
- 8/In theory, yes. In practice, this is quite difficult to do.
- 9/Because this is the virtuous circle of the capital increase.
- 10/The commission represents the price of the put option that the company buys from the bank. In effect, the company is buying the right to sell the newly issued shares to the bank at the guaranteed price.
- 11/Yes, because the substantial discount provides a cushion against a sharp drop in the market price and because the banks were unwilling to get caught up in a process that would have led to them guaranteeing a price close to the market price.

Exercises

- 1/ (a) Subscription right = 6.25, apparent dilution = 25, real dilution = 20, technical dilution = 5, adjustment coefficient = 0.9375, subscription ratio = 1 new for 3 old.

- (b) The shareholder has 90 subscription rights. If he sells 72 of them and keeps 18, he will be able to buy 6 new shares without expending any cash. This is equivalent to receiving 6 bonus shares.
- (c) $(90 + 6) / (1,000,000 + 333,333) = 0.0072 = (90/1,000,000) \times (1 - 20)$.
- (d) Since the control percentages are unchanged and the amount of the increase is fixed, the price has no effect.
- (e) Before the funds raised are invested, EPS falls to 7.5.
- (f) Book value of equity increases by 31.25%. Book value per share drops from €80 before to €78.75 after.
- (g) Subscription right = 7.14, apparent dilution = 14.3, real dilution = 11.1, adjustment coefficient = 0.9643, subscription ratio = 1 new for 6 old. Book value per share after: €90.

2/UBS case study

- (a) UBS had no choice but to massively increase its capital to compensate its huge losses due to the subprime crisis.
- (b) Book value of equity before capital increase = SF35.6bn. Amount of capital increase = SF16bn. Market capitalisation before capital increase = SF66bn. UBS is valued more than its book value so dilution will be low compared to the amount of new capital.
- (c) Real dilution is 19%.
- (d) It's a rather positive signal as UBS' competitors are confident the share price will not plummet: after detaching the subscription, the issue discount is only 25% under the market value while price is highly volatile.

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