

# Understanding a Company's Capital Structure

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By Michael Kemp

We know buying shares sees us sharing ownership of a company with lots of other people. But the rights we gain from that shareholding can change even when we maintain our holding at a constant level. The number of shares a company has on issue can and usually does vary through time. Which means our entitlements, both in terms of voting power and profit distribution, can be affected. This article explores why you need to understand your company's capital structure and how changes in it can impact you.

## Debt levels and earnings per share

Let's look firstly at the implications of one simple change in capital structure.

Most companies are financed by a mix of debt and equity (share capital). Which means when debt levels are dialled up the amount shareholders need to contribute is dialled down. And since debt is usually a cheaper form of financing, more debt usually means higher profits to shareholders. Sounds like a great idea. But there is a trade-off. Because debt holders demand to be paid in bad times as well as good, more debt means more risk.

The following example shows how adjusting the capital mix can produce more favourable profit metrics when times are good but expose the company to higher risk should trading conditions deteriorate.

Consider a company with 10 million shares on issue and earnings per share of \$1. Assume it borrows \$10 million at 6% to undertake a share buy-back at \$10 per share so reducing its issued capital to 9 million shares. In the process its after tax interest cost has risen by \$420,000 so reducing its after tax profit. But this profit is now distributed to fewer shareholders. The effect on earnings per share (EPS) is as follows:

Original EPS = \$1

Total Earnings = \$10 million (\$1 X 10 million shares)

Adjusted Earnings = \$9.58 million (\$10 million - \$420,000)

Revised EPS = \$1.064 (9.58/9)

So with no improvement in operating performance, EPS has improved by 6.4%. But as they say in the classics: "There's no free lunch." The gearing ratio has risen. So the trade-off here is risk. And risk demands reward. Informed investors would expect a higher return for the extra risk they have taken on.

Whether you interpret the above example as a prudent use of debt to enhance EPS or a pure trade-off between risk and return also depends upon the reliability of the company's earnings stream. Where earnings are reliable management and shareholders will feel more comfortable in the company's ability to service higher levels of debt. But when earnings are unreliable less debt is

preferable. The bottom line is: don't blindly applaud an improvement in earnings per share without further investigation as to how it was achieved.

The preceding discussion should not be taken as a vote against share buybacks. When well-orchestrated they provide a useful way to fine tune a company's capital structure. And debt is not the only way to finance a buyback. Management might use cash. This is an appropriate use of excess cash when sound investment opportunities are thin on the ground and/or the share price is unreasonably depressed. Remaining shareholders benefit when management repurchases shares below their intrinsic value. But remember – the next time you see a buy back in the offing give thought to the impact it could have on your own shareholding.

## **Impact on financial metrics**

A number of financial ratios are calculated on a per share basis. But, as stated, the number of shares on issue commonly changes from one balance date to the next. Share splits, dividend reinvestment plans, employee share issues, entitlement issues, and the exercise by holders of options, warrants and convertible bonds can cause the number of shares to increase. Reverse share splits (consolidations) and share buybacks (where the company purchases its own shares) can cause the number to fall. To facilitate inter-period comparisons of per share financial ratios companies and analysts adjust for these changes.

## **Using weighted averages**

If the number of shares on issue has changed over the course of the reporting period the obvious question is which number do you use when calculating per share metrics?

For Balance Sheet ratios (such as book value per share) the number of ordinary shares on issue at the end of the reporting period is used. For Income Statement metrics (such as earnings per share) the weighted average number of shares on issue during the period is used. The different methods reflect the static nature of the Balance Sheet and the dynamic nature of the income statement. The Balance Sheet, or Statement of Financial Position, reports on the company's financial status at a point in time. The income statement reflects the activities of the business over the entire reporting period. When the amount of capital financing those activities (as represented by the number of shares on issue) varies then a single figure needs to be derived. This representative figure is referred to as the weighted average.

To calculate the weighted average shares which have been in existence for the entire reporting period (1 year) are awarded a weight of 1. Shares which were or have been in existence for less than the full year are awarded a weight of less than 1. The weight is calculated by dividing the number of days the shares were in existence by the number of days in a year.

## **Dilution**

You may have read the term: "Fully diluted earnings per share". Let's explore what fully diluted means?

The term “share” in earnings per share refers to ordinary shares. Ordinary shares represent part ownership in the company and bestow voting and profit distribution rights. They are subordinate to all other classes of equity instruments. There are several other classes of securities which can convert into ordinary shares at the discretion of either their holders or the issuer (the company). These are sometimes referred to as potential ordinary shares. Conversion will result in a dilution of ownership for existing holders of ordinary shares.

Potential ordinary shares include warrants, options and convertible bonds. The term “fully diluted earnings per share” is a recalculation of earnings per share based on the assumption that these outstanding securities have been converted.

## Calculating the diluted earnings per share

The calculation of EPS and diluted EPS is set out by the Australian Accounting Standards Board in standard AASB133. In complying with this standard companies provide a summary of these calculations towards the end of their annual report in the notes to the financial statements.

Companies include in diluted EPS only those potential ordinary shares which would reduce EPS. For example an “out-of-the money” call option would not be included in the recalculation of EPS. This situation arises when the strike price of the option is higher than the market price of the underlying share. The owner of the option would choose not to exercise the option under these circumstances. Consequently diluted EPS will always be lower than or equal to the undiluted EPS.

To derive the diluted EPS adjusted net profit is divided by the adjusted number of ordinary shares on issue following the assumed conversion. Conversion is deemed to have occurred at the beginning of the accounting period. Potential ordinary shares in existence for only part of the period are weighted for the period they were outstanding.

In calculating diluted earnings per share the net profit figure also needs to be adjusted. Assumed proceeds from conversion are regarded as received and any impact on earnings needs to be allowed for. For example conversion of convertible bonds would mean a reduced interest cost. The interest expense (net of tax) on convertible bonds is added back to net income.

## Banks and the GFC

A practical example of share dilution was seen in the wake of the recent Global Financial Crisis. To boost their flagging balance sheets some banks sought additional capital from shareholders through entitlement issues. The fairest way to undertake an entitlements issue is on a pro rata basis. That is, the number of shares allocated to each shareholder is based on their existing holding. However in these cases each shareholder was offered an equal rather than a pro rata number of shares. Since offers were made at a deep discount to the existing market price shareholders with larger holdings were penalized and owners of small holdings were advantaged.

## Conclusion

In summary it pays to be aware of the potential dilution effect of the changing capital structure of your company. For example this can result from the issue and conversion of options, warrants and

convertible bonds. Also consider the impact of entitlements issues particularly when they are deeply discounted and not being offered on a pro rata basis.

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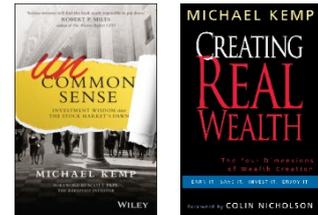
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