

Investment basics — V

Adjusting per share earnings and dividend data for capital changes

INTRODUCTION

Although security investment is essentially concerned with future benefits of income and/or capital appreciation, it is generally conceded that a picture of the past performance of companies is helpful in the formulation of investment decisions. The assumption is that the historical behaviour of companies can serve as some guide as to what their future behaviour might be like in different economic circumstances. For example, different companies tend to perform differently during times of recession, some suffering more than others, some suffering sooner rather than later and still others not suffering at all but deriving particular benefits because of the nature of their business. However, it will not always be clear from a superficial examination of historical data, what exactly the past performance of a company has been. If changes have taken place in the nature of its activities or if its financial structure has altered, historical data relating to its performance may have lost much of their relevance.

This article is concerned with the problem of adjusting historical data so as to properly reflect what, in fact, has happened to earnings and dividends in the past. It is not concerned with the more difficult problem of deciding, on the basis of accurate historical data, what their significance is to future corporate performance. In the final reckoning such significance cannot be objectively determined but must be left to the individual analyst to decide upon subjectively, using what tools of analysis and judgement he can muster.

PER SHARE DATA

Because security transactions relate to quantities of shares, it is customary in South Africa to express both dividends and distributable profits in per share terms. This follows the American practice as opposed to the British of expressing dividends as a percentage of the nominal value of issued equity capital and earnings as a cover factor of dividends declared. Expressing dividends and earnings in per share terms has a clear practical advantage and greatly simplifies the calculations necessary in determining the yield or attributable profit on a particular security investment. Ordinarily, per share figures can be calculated simply by dividing the rand amount of dividends declared or profits earned in respect of ordinary shareholders' interest by the number of ordinary shares in issue, but in certain circumstances this cannot be done and some adjustment, either to the numerator or the denominator of the calculation, must first be made. For example, there may be ordinary shares in issue which for one reason or another do not rank for the dividend concerned. Or it

may be that an interim dividend was declared in respect of one quantity of issued ordinary shares and a final dividend declared in respect of another, usually greater, quantity of such shares. Clearly, two kinds of problem in the calculation of per share data can be identified. The first concerns the calculation of per share data in respect of any single year or period, the second concerns the adjustments which may become necessary to render the per share data of particular years or periods comparable with each other. Only time series data that have been adjusted where necessary and are comparable, can be used for determining accurately what historical corporate performance has been.

TYPES OF CAPITAL CHANGE NECESSITATING ADJUSTMENT

Three types of capital change can be identified which affect the comparability of earnings and dividend per share figures over time. These are capital changes resulting from acquisition issues, capitalisation or scrip issues and rights issues. Each needs to be discussed separately.

Acquisition issues

The effect of acquisition issues, generally, is to increase both the number of ordinary shares outstanding and the amount of profit available for distribution to ordinary shareholders, for acquisitions or takeovers are made for a benefit. However, the ratio of the benefit expected or realised to the amount of new ordinary share capital created may differ from the ratio, *ex ante* the acquisition, of distributable profit and equity funds accumulated.

The point to note here is that no particular adjustment to the yearly per share data may be necessary in the case of acquisition issues, for such data may be rendered comparable automatically through the standard procedure of calculation. However, acquisition issues raise the matter of adjustments designed to render historical data more meaningful to the likely future performance of a merged enterprise. To make no such adjustment at all and merely to show the history of the vehicle concern in terms of its own earnings per share could be quite misleading, giving a false impression of past growth. Such a presentation of historical record was popular with conglomerate companies in the late 1960's but has been abandoned in the U.S. because of changes effected to accounting regulations.

A comparison of the so called pooling method and a weighted average method of presenting historical data in the cases of mergers and take-overs is illustrated by Table 1 opposite.

Table 1 – Pooling and weighted average methods of reflecting historical earnings per share

Year	1	2	3	4	5
Total net earnings – R000's					
Company A	750	550	400	225	100
Company B	100	200	300	400	500
Earnings per share – cents					
Company A*	150,0	110,0	80,0	45,0	20,0
Company B†	10,0	20,0	30,0	40,0	50,0
Pooling method – earnings per share – cents (after merger)					
Company B**	10,0	20,0	30,0	40,0	54,5
Weighted average method – earnings per share – cents (after merger)					
Company B‡	77,3	68,2	63,6	56,8	54,5

*Based on issued capital of 100 000 shares throughout period.

†Based on issued capital of 1 m shares throughout period.

**Based on issued capital of 1 m shares during first 4 years and 1,1 m shares in year 5.

‡Based on issued capital of 1,1 m shares throughout period.

Source: Bethlehem, R. W. *Fundamental Analysis: Its Limitations and Use Portfolio Selection*. Unpublished Unisa MCom dissertation, 1977, p. 66.

As can be seen, the two different methods give a totally different impression of the vehicle company's historical performance. Both cannot be correct!

Obviously the fact that the physical size of a company is increased by acquisition issues does not mean that the company has grown to the benefit of ordinary shareholders. This is made clear by the per share data. But such data, too, may be misleading and considerable care, therefore, needs to be exercised by the analyst.

Capitalisation issues

Capitalisation issues strictly are the effect of a book entry transfer of funds from one equity account to another. They, therefore, change nothing, in themselves, with respect to the fundamental position of a company. The methodology for adjusting per share data for their consequences is, therefore, simple, uncomplicated and widely agreed.

Rights issues

This, however, cannot be said of rights issues which continue to be a subject of dispute even among seasoned analysts. Not to adjust for rights issues may be misleading, but to adjust necessitates the making of arbitrary assumptions and, therefore, leads to controversy. The only point that cannot be contended in the case of rights issues is the fact that the company, ex post, is no longer, strictly, the company it was ex ante and this problem has to be overcome if an accurate picture of record is to be developed.

Methods concerned with adjusting per share data for rights issues may approach the problem either from the viewpoint of the company, as a corporate entity, or from the viewpoint of an investor whose participation as a shareholder in it remains unchanged over a specified period. These will seldom give the same results because maintaining an unchanged position means for the shareholder that he allow his shareholding to decline as a proportion of the total equity of the company. To maintain an unchanged position in terms of his own wealth, a shareholder must sell enough rights arising in terms of an issue to pay for the balance of his entitlement. His view of corporate performance, thus, may begin to diverge from the view of management, concerned as it is or should be with the total enterprise. However, in the final reckoning it must be the shareholder's view which counts for it is in his interest that the company is supposed to function.

Table 2 illustrates the performance of a company from the standpoint of a shareholder who purchased 1 000 shares in it in year 1 and who neither increased nor decreased his investment at any time between year 1 and year 5. It assumes, therefore, that when new shares are offered him in terms of rights issues in years 2 and 4, he follows the procedure referred to above. In the case of the first rights issue, instead of purchasing all the 1 000 shares to which he was entitled at 1 000 cents a share, he purchases an extra 333 shares only, using the proceeds of the sale of 667 letters of allocation (LAs) to provide the necessary money. In the case of the second rights issue his purchase amounts to 363 shares giving him a final total of 1 696 shares at the end of the five year period.

