EQUITYPANDIT KNOWLEDGE SERIES

Tutorial-2

Why does Companies List their shares on Stock Market and how does the share trades?

Companies need financing for their projects and businesses or to carry out the operations or expansion. **They have two different options:**

1. **Borrow money from financial institutions like banks**
2. **Listing on Stock Market**

Since the borrowing money from banks or other financial institution, would put pressure on business as they have to pay the higher interests as well as the principal amount, hence the companies chooses the second way to list on Stock Market and generate finances.

Primary Market

Companies list their shares on Stock Market in the form of IPO (Initial Public Offerings). Investors or traders subscribe to that IPO and shares are transferred by the company to the investors at the subscription price. In this way company gets the zero interest finances by releasing their shares in Primary market.

Secondary Market

Companies get their finances against the shares issued by them. Now these previously issued shares are traded in Secondary market among investors and traders without the involvement of the issuing companies.

How Stock trades and how does the price movement takes place?

Stock trades on Stock market with the basic fundamental of Supply and Demand. If Supply is higher than Demand then the stock price moves down and if the Demand is higher than supply then the stock prices moves up. Supply and Demand are investors and traders psychology and it depends on what an investor or a trader thinks for the company. Mainly the stock prices are directly dependent on following attributes:

a. **Earnings:** Company's worth depends on what does it earns? What are it's revenues and profits? What's on their balance sheets? A company having higher revenues and earnings would definitely see more demand and hence supply would go short, which would result in share price hike.

b. **External factors:** External factors like dollar prices, gold prices, oil prices, raw material prices, etc. plays an important role on company stock prices. For eg. IT companies share prices would increase by increase in Dollar prices, if they are involved in exports. Higher the dollar prices, higher would be their earnings in local currency and hence higher demand and hike in its share prices. Same way, decrease in Dollar prices would decrease their earnings and hence lower earnings. Same way the companies, which are involved in imports, would be dependent on dollar prices in opposite way i.e. by increase in Dollar prices, cost of their raw material increases and hence their profit margin decreases, which would decrease their demand.

c. **Interest Rates:** Interest rate is an important factor in economy. Decrease in interest rates may provide liquidity in market and hence banking sector, automobile sector and real estate sector's share prices would increase and vice versa.

There are thousands of attributes that affects the psychology of investors or traders towards a company and hence share prices would be dependent on all those attributes. So, in short, Share prices depend on Psychology of the investors and traders.

Which company is bigger? Does it depend on Company's share prices?

No, two different companies can't be compared on share prices. Company with share price of Rs.50 can be much bigger than another company with share price of Rs.200. It depends on Market capitalization.

Market Capitalization of a company = Company's Share price X No. of shares allotted.

Hence, Company A with share price of just Rs.50 but with 10 million shares (Market Capitalization: 50X10 Million= Rs.500 Million) is much bigger than a company B with share price of Rs.200 with only 1 million shares allotted (Market Capitalization: 200X1 Million = Rs.200 Million). So any companies can be compared only based on Market capitalization and not on Share prices.

Why do companies care about their stock prices in secondary market, when they are not involved?

The original company that issues the stock does not participate in any profits or losses resulting from trading and investment in secondary market, because this company has no vested monetary interest. This is what confuses many people. Why then does a company, or more specifically its management, care about a stock's performance in the secondary market when this company has already received its money in the IPO?

There are few reasons behind this:

1. **Company Management are also shareholders:** Company's management or directors are big shareholders of the company and hold big number of shares of their company and hence increase or decrease in share prices would directly affect their networth.

2. **Interest of Shareholders:** Company's Management has to produce gains for shareholders and since these shareholders are part company owners. Over a long run, poor performance can be attributed as company's mismanagement and shareholders can look for change.

3. **Financing:** Another role of stock market is to act as a barometer of financial health. Share prices increases if company performs better and see strong earnings. Strong earnings are good indication that the company would be able to meet its debt requirements. As a result, the company would get cheaper finances from banks and other financial institutions at lower rates.

4. **Avoid takeovers:** Companies that trades on stock market are vulnerable to takeovers by other company, if they allow share prices to fall sharply.

5. **Brand:** The last obvious reason for increasing the share price and increasing the shares is to build the brand and prestige by increasing the market capitalization. Higher market capitalization shows bigger company or brand, which may attract more customers and human resource and also to bargain from their venders.

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