Market Capitalisation

Market capitalisation simply means the total value that the market is placing on a company, based on the current market price of its shares. To calculate it, we simply take the number of shares which a company has issued and multiply it by the price at which those shares last traded on the stock market.

If we accept that the price of a company's shares represent the agreed value of one share by the last buyer and seller, then the market capitalisation is simply the extension of that to the total value of all of the shares issued by the company as assessed by the last buyer and seller. This is not an objectively-based valuation of the company, but simply the agreed view, rational or irrational, of both the last buyer and seller on the market.

It is important to understand, however, that market capitalisation is not the price we would have to pay to buy the whole company. That would involve a takeover and the price would generally be higher than the simple measure of market capitalisation for many reasons.

Market capitalisation is generally seen as useful as a rough indication of:

1. The size of the company. Clearly, company with a market capitalisation of $50 billion is much larger than a company with a market capitalisation of $10 billion.
2. The liquidity of the market in the company's shares. The more shares a company has issued, and therefore the more shareholders it is likely to have, the more buyers and sellers and the more shares available for purchase or sale at any time. The bid-ask spread is also likely to be smaller, the larger the market capitalisation.

The formula for the calculation of market capitalisation is:

Market Capitalisation = Number of shares issue × market price per share

Therefore, if a company has issued 20 million shares that last sold for $2.50:

Market capitalisation = 20 million × 2.50 = $50 million

There are two variables in the calculation:

- Number of shares issued
- Price of the last sale

Both of these will change over time.

The price will change on the market constantly. Each time the price changes, so will the market capitalisation change. So, market capitalisation is a value that is ever changing while a market is trading.

The number of shares issued by a company may also change. Some ways the number of shares issued may change are:

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Placements

Rights issues

Share Purchase Plan issues

Bonus issues (rare these days)

As consideration for acquisitions, takeovers or mergers

Share splits

Share consolidations

Exercise of options over shares issued by the company to directors, management or shareholders

Issues of shares as part of a management incentive program

Buy-backs of shares by the company (reduces the number of shares issued)

Payment of calls on contributing shares

Conversion of convertible hybrid securities issued by the company

The issue of additional shares will generally increase the market capitalisation of a company except in a share split, where any change in capitalisation is likely to be minor.

The buyback of shares will tend to reduce the market capitalisation of the company – fewer shares issued, but that may be modified in some cases by an increase in the price of the remaining shares.

An additional technical point in the calculation of market capitalisation is that where a company has issued two or more types of share, the total market capitalisation of the company is the sum of the market capitalisation for each type of share.

A final consideration to be aware of is that market capitalisation reflects only the market's perceived **equity value** of a company. It is important to note that a company's choice of capital structure has a significant impact on how the total value of a company is allocated between equity and debt. A more comprehensive measure of the total value of a company is enterprise value (EV), which also considers debt, preferred stock, and other factors. Market capitalisation is only one of the inputs to the calculation of enterprise value.

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