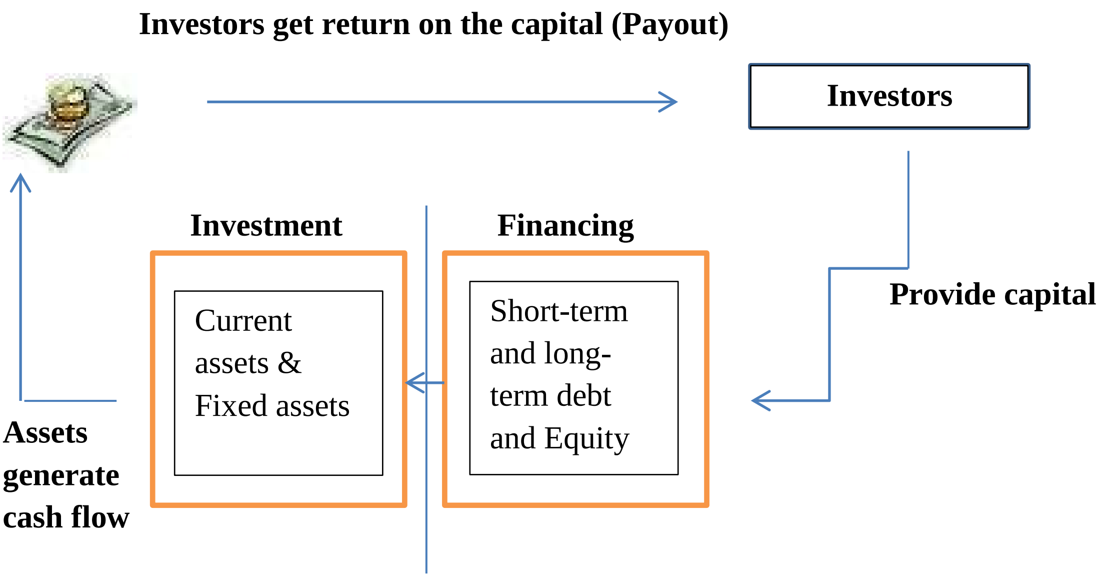
Week 1 – Raising capital: Equity

What is corporate finance?

It is corporate decisions that have financial implications or affect the finances of a company. The 3 key decision areas of this topic are investment, financing and payout policies – i.e. spend-raise-return policies. The broad objective of corporate finance is to maximise the firm's value and at a narrower level, it is to maximise shareholders' wealth or stock price (if market is rational and reasonable efficient). The 3 policies determine the optimal structure of the company. The balance sheet representation of the 3 policies:



What are the sources of the funds needed for the investment decisions?

- Internal funds, i.e., retained earnings and cash
- External funds, i.e., debt, equity and hybrids

Debt	**Equity**
Fixed claim	Residual Claim
Tax deductible	No tax deductible
High priority in financial trouble	Low priority in financial trouble
Fixed maturity	Infinite
No management control	Management control

What is the "pecking order" perspective?

This theory postulates that the cost of financing increases due to asymmetric information. Most public firms tend to finance their projects by retained earnings first, then debt and then equity, as a last resort. Why is this so? This is due to information asymmetry. Investors assume that managers have more information than outside investors and hence they would prefer to issue equity when it is overvalued (occurs when company will not be able to deliver – except by pure luck – performance to justify its value) and consequently, at equity price announcement they will place a lower value. This is why managers prefer to avoid issuing equity.

How to raise equity?

Unlisted private firms raise capital through private equity financing, i.e., angel finance (informal angel high net worth individuals/investors) and venture capital (capitalist fund start-up companies for a portion of equity and they usually have a say in the business) or through IPOs whereby they list their shares on the share market for the first time.

Listed public firms raise capital through private placement (to small group of investors), rights issue (to existing shareholders) or dividend reinvestment plan (to existing shareholders – offered to reinvest their dividend to apply for new shares).

Angel finance and venture capital are private equity. Public equity is available to firms with larger needs for capital and those are IPOs (Primary v/s secondary offerings) and SEOs (general offers to the public, placements to financial institutions, rights issue and DRPs to existing shareholders).

Initial public offerings (IPOs)

Why do companies go public?
- To create public shares for use in future acquisitions.
- To establish a market price/value for the firm.
- To enhance the reputation of the company.
- To broaden the base of ownership.
- To allow one or more principals to diversify personal holdings.
- To minimise the cost of capital
- To allow venture capitalists to cash out
- To attract analysts' attention
- The firm has run out of private equity
- Debt is becoming too expensive.

Advantages of going public
- Access to additional capital
- Allow venture capitalists to cash out
- Current stockholders can diversify
- Liquidity is increased (shares can be rapidly sold with little impact on the stock price)
- Going public establishes firm value

- Makes it more feasible to use stock as employee incentives (performance measure)
- Increases customer recognition

Disadvantages of going public
- IPO creates substantial fees (legal, accounting and investment banking fees…)
- Greater degree of disclosure and scrutiny
- Dilution of control of existing owners
- Special "deals" to insiders will be more difficult to undertake
- Managing investor relations is time-consuming

Procedures for an IPO:

1. Appoint an underwriter and other advisers
2. Undertake due diligence process and prepare preliminary prospectus
3. Institutional marketing program begins (incl. IPO road shows)
4. Exposure period: Lodge final prospectus with ASIC and listing application with ASX
5. Marketing and offer period
6. Offer closes, shares allocated and trading commences.

Underwriter

An underwriter is a company or another entity like an investment bank that acts as an intermediary between the company selling securities and the investing public to administer the public issuance and distribution of securities. Sometimes they form a syndicate which is an underwriting group. They are the key of success for an IPO. They perform a wide range of services on behalf of the issuing firm such as:
- formulating the method used to issue and market the securities;
- price and sell the new securities.
They can make 2 types of contracts: Firm commitment (in cases of under-subscription, they buy the unsold shares, basically they are responsible for the unsold inventory) and best efforts contract (in cases of under-subscription, the underwriter has no obligation to buy the unsold ones and thus the offer is withdrawn if the minimum limit is not achieved). The higher the demand for an issue, the more likely is the contract to be a firm commitment one and vice-versa.

Valuing IPOs – Preliminary valuation

Since the firm is going public for the first time, there is no established price. There are 2 common valuation methods:
- Discounted cash flow analysis (PV of CFs over the life of the firm).
- Comparable firms analysis (compare with publicly traded firms in the same industry facing the same risk and growth prospects). E.g. using their price earnings ratio.
On the basis of all relevant factors, the underwriter will specify a range.

Procedures:
1. Fixed pricing – traditional method
The price is set by the issuing company, prospectus is sent and offers are received. This

method is subject to market movement and high risks of under-subscription.
2. Book-building
An underwriter "builds a book" based on the indications given by institutional investors about how much shares they would buy and at what price. There is a lower risk of under-subscription but it has significant costs and possible investment banking conflicts.
3. Open auction
Investors are invited to submit their bids and then the securities are sold to successful bidders.

Direct costs of IPOs

Underwriters' fees in the form of a spread (difference between the underwriters' buying price and the offer price – usually 7%) and direct administrative costs such as management, legal, accounting and registration fees – usually 1% of the proceeds.

Indirect costs of IPOs

- Under-pricing

This means that the pricing of the IPO (offer price) is below is market value. This is done to encourage investors to participate in the IPO and reduce concerns and uncertainty concerning liquidity issues of the issuing company.
Under-pricing (%) = (1st day closing price – offer price) / offer price
The economic consequence of this cost is significant to the original owners.
Money left on the table = (1st day closing price – offer price) X Number of shares

Why do we have under-pricing?
Winner's curse (IA) – The winning bidder will tend to overpay compared to the intrinsic value of the security. To keep uninformed investors in the market, under-pricing is necessary.
Investment banking conflicts – The banks arrange for under-pricing to benefit themselves and their clients.
Litigation insurance – The liability of material misstatements and omissions made in connection to the IPO is born by the issuer and underwriter. Hence, they under-price the securities just in case the shares perform poorly, to avoid potential lawsuits.
Signalling – This leaves a "good-taste" with investors and signals the quality of the issue which subsequently facilitates the raising of funds at a higher price.

Reasons for long-run underperformance of IPOs

- Clientele effects
  This assumes that only optimistic investors buy into an IPO and their optimism will disappear as more information about the firm is released or when policies change, they will adjust their stock holdings accordingly.
- Window of opportunity
  This is a short period of time during which an otherwise unattainable opportunity exists. Management takes advantage of high demand (hot market) and times the issue during that period. A decline in demand for IPOs (cold market) after hot markets is generally correlated with a reduction in equity prices after IPOs.

Seasoned equity offerings (SEOs)

The method to raise equity depends on costs, time to implement the method and the transfer of voters' wealth (from old to new shareholders).

- **Private placements**
  The sale of new securities to a relatively small number of investors. Investors are usually financial institutions such as mutual funds, large banks, insurance companies and pension funds. This is the opposite of a public issue.
  Advantages: Quicker to complete; lower issue costs (no need for underwriting normally); do not generally require a prospectus.
  Disadvantages: Share are issued at a discount and there is a transfer of wealth from old to new shareholders and this dilutes the control/voting power of existing shareholders.
- **Rights issue**
  A new share issue offered to existing shareholders at a fixed subscription price during a fixed period of time. Shareholders receive an entitlement to new shares at a fixed proportion of the number of shares already held (on a pro-rata basis). Shareholders can exercise the rights (no wealth or voting power loss); let the rights expire (wealth and voting power loss); sell the rights on the ASX if the issue is renounceable (no wealth or voting power loss). Subscription price is usually at a discount to the current market value. When a stock with rights is trading on an exchange, it has what is called "cum-rights" or "with rights." As you know a rights offering is short-term, so there is a deadline to buy the stock and receive the rights. From the time of the announcement of the rights offering to the ex-rights date, the rights are attached to the stock (cum rights). On the ex-rights date, XYZ stock trades "ex-rights" or "without rights," and the market price drops accordingly. "M" = market price of share cum-rights; "X" = theoretical price of share ex-rights and "R" is the value of the right, i.e. how much would the market pay for the right to purchase one additional share at the subscription price.
  X = total cash value / total number of shares or
  X = (N/N+1) M + (1/N+1) S
  R = X – S or
  R = N(M-S)/N+1
  Comparison of RI with PP:
  - Constraints on PP
  - Convenient source of funds
  - Preserves voting patterns but takes longer than PP
  - Can be costly due to prospectus requirements, underwriting and admin. fees.

  Share price will not necessarily fall to X on the ex-rights date due to:
  - New information may affect the stock price on ex-rights date
  - General movement in share price
  - Transaction costs/taxes related to exercising the right
  - R ignores the option characteristic of the right