CORPORATE FINANCIAL POLICY

WEEK 1: Raising Capital – Equity

-Firm's value is the stream of future CF generated by firm's assets
-Firm can raise money through equity, debt or hybrids

Equity Capital
-Permanent contribution of capital
-Entitled to voting rights
-Shareholders hold residual claim: dividend & liquidation
→ equity is most risky but provides highest expected return

Unlisted firms	Listed firms
• Private Equity ➤ Venture Capital • Start-up/seed financing • Staggered financing • Risk is high • Initial Public Offering (IPO) ➤ Listing shares for first time	• Private placement ➤ To small group of investors • Rights issue ➤ To existing shareholders • Dividend reinvestment plan ➤ Instead of div. get shares

-Method of raising equity depends on: -Cost
-Time to implement
-Transfer of votes/wealth

-Amount of equity raised depends on: -State of the market
-Economics condition
-Yields of alternative investments

-4 ways to raise equity: -Initial Public Offerings (IPOs)
-Private placements
-Right issues
-Dividend reinvestment plans (DRP)

(1) IPO: shares can be issued to public in 3 ways:
-existing shares to new shareholders
-new shares to new shareholders → dilution
-demutualisation and share issuance: members of mutual society become shareholders in a firm

(2) Private placements: issue of new shares to a limited number of investors
→separation of ownership and control → agency issues
→new Value of firm, and new Price of share (before & after) →affect your $
→most popular method now, can eliminate underwriter

	Pre		Post	
Issued Shares:	(m)	(%)	(m)	(%)
. old s'holders	10	100	10	90.9
. new s'holders	0	0	1	9.1
Total	10	100	11	100

Value of Equity:	($m)	($m)
. old s'holders	$100	$99.08
. new s'holders	0	$9.92
Total	$100	$109

(3) Right issues: offer new shares to existing shareholders at *fixed price* and on *pro-rata basis*
→receive new shares in proportion of the number of shares already held
→the % of ownership and wealth will still be the same →doesnt affect your $
→issue price is normally at a discount

Ex-rights price X

$$X = \frac{NM + S}{N + 1}$$

Single Right R (R=X-S)

$$R = \frac{N(M - S)}{N + 1}$$

S: subscription price (price of 1 new share →discounted P)
X: theoretical price of the share (new P)
M: market price of the share (old P)
1/N: pro-rata entitlement (1 more share for every N shares held)

WEEK 1: Raising Capital - Equity (cont)

-Most issues are renounceable (resign, give up)
→ shareholders can: -exercise the right
-do nothing, get cash for right
-sell the rights to a third party
→strategies (1) and (3) are equivalent

1) Exercise right: pay $2.50; get 1 new share	6 shares à $3.33 = $20.00	+ no wealth loss + no voting loss - no cash
2) Do nothing: right expires; keep $2.50	5 shares à $3.33 = $16.67 + $2.50 cash = $19.12	- wealth loss ($0.83) - voting loss (16.67%) + cash
3) Sell the right: Get $0.83; keep $2.50	5 shares à $3.33 = $16.67 + $2.50 cash = $19.12 + $0.83 cash = $20.00	+ no wealth loss - voting loss (16.67%) + cash

(4) DRP: use part or all of a dividend to apply for new shares at minimal transaction cost and usually at a discount
→ just a small right issue
→allows high dividend payout

Regulatory Environment
-Capital raising by companies is regulated by several laws
-Corporations Acts (all companies)
-ASX Listing Rules (listed companies)
-Articles of Association (company specific)
-Trade Practices Act (all companies)
-Special Legislation (some industries only)
→to protect investors

→The Basic Rule (s.1018): all offer of securities of a corporation must be accompanied by a prospectus unless it's an "excluded" offer

-ASX Listing Rule 7.1: cannot issue more than 15% of issued shares within 12 months period (for private placement)
→rights issue is an exception

Underwriting
-Shares not bought before closing date will be bought by underwriters.
→Increasing use of book-building reduces need for underwriting
-Underwriter guarantees success of issue: investment banks, stockbroking
→ underwriting is very expensive →good for large issue only
→issuer has the right but not obligation to sell new shares to the underwriter at the issue price (a put option)
-Sub-underwriter: used by underwriter to lay off risks: banks, insurance, funds

Empirical Findings about IPOs
IPO under-pricing:

$$Underpricing(\%) = \frac{listing\ price - offer\ price}{offer\ price}$$

→ On average, IPOs are under-priced
→if issue P too high: may be unsuccessful
If issue P too low: opportunity for pre-float shareholders

-Explanations of under-pricing:
-Winner's Cruse: information asymmetry
→uninformed investors will withdraw unless IPOs are under-priced
-Market Feedback
→management wants high return the 1st day →under-price
-Bandwagon (cascade hypothesis)
→investors act with the popular actions they perceive
-Investment Banker monopsony power: bankers under-price
-Lawsuit avoidance:
→directors are liable for loss from misrepresentation
-Signalling
-Ownership dispersion: →leads to liquidity