Corporate Finance 30002 Notes

Lecture 1 – Raising Capital: Equity

Corporate Finance is about corporate decisions that have financial implications or affect the finances of the business.

Three key decisions of corporate finance
1) Investment (or capital budgeting policy) – which investment projects should the firm undertake?
2) Financing policy – how does the firm obtain funds (debt or equity)?
3) Payout policy – how does the firm return the cash to its owners?

Objective of Corporate Finance is to maximise the long-term value of the firm. A narrower objective is to maximise shareholder wealth (or stock price if firms are public and markets rational and reasonably efficient)

Big Picture of Corporate Finance
• Investors provide capital (Financing policy) – Assets generate cash flow (Investment policy) – Investors get return on their capital (Payout policy)

Financing Policy
Real investment policies imply funding needs

Sources of funding
• Internal funds (retained earnings, cash)
• Debt (borrowing)
• Equity (issuing new shares)
• Hybrids
• Public companies tend to prefer debt to equity

Pecking Order Perspective
Most public firms tend to finance their projects first with retained earnings, then with debt, and only finally with equity as a last resort.
1) Retained Earnings
2) Debt
3) Equity
• Why? Information Asymmetry
• Managers have more information about the firm than outside investors
• Managers prefer to issue equity when equity is overvalued
• Equity issues signal to investors that equity is overvalued
• Stock price declines at equity issue announcement
• Managers avoid issuing equity.

Stock Price reaction to issues:
1) Straight debt – little or no effect
2) Convertible debt (-2%)
3) Equity (-3%)
Debt issue announcement doesn’t lower price. But it’s not easy for private companies to get debt so they need equity.

Raising Equity Capital

- *Public equity* is available to firms with larger needs for capital.
- *Venture Capitalists* provide funding in return for part ownership of the business.
- Firm goes from a sole proprietorship to a privately owned business with multiple shareholders.

Different options to raise equity

- Unlisted Firms
- Private equity financing
  - ‘angel’ financing
  - venture capital
- IPO - listing shares for the first time
- Listed Firms
  - Private Placement – to small group of investors
  - Rights Issue – to existing shareholders
  - Dividend re-investment plan to existing shareholders (offered to reinvest dividend to apply for new shares).

Private Equity

- ‘Angel’ Financing
  - Informal market for direct equity financing provided by a small number of high net worth individuals
- Venture Capital
  - A venture capitalist is an active financial intermediary, providing financing to early-stage and high potential start-up companies mainly in high tech industries
  - It organises and manages funds mostly raised from investors (such as pension funds and endowments/foundations) typically for about 5-7 years.
  - Typically staged financing; significant control over company decisions.

Initial Public Offering (IPO) – The process by which a firm sells equity to the public for the first time.

Primary vs Secondary

Seasoned Equity Offerings (SEOs)

- The sale of shares in an already publicly listed company
- Alternative types of SEOs: general offers, placements, rights issues, dividend reinvestment plans
Motives for Going Public

- better to go public to acquire other companies.
- access to additional capital
- allow venture capitalists to cash out
- current stockholders can diversify
- liquidity is increased
- going public establishes firm value
- makes it more feasible to use stock as employee incentives
- increases customer recognition

Disadvantages of going public

- IPO creates substantial fees
- Greater degree of disclosure and scrutiny
- dilution of control of existing owners
- special ‘deals’ to insiders more difficult to undertake
- managing investor relations is time-consuming

Procedure of IPO

1) Appointment of an underwriter and other advisers
2) undertakes the due diligence process and prepare the preliminary prospectus
3) institutional marketing program commences
4) exposure period: lodge the final prospectus with ASIC and lodge listing application with ASX
5) marketing and offer period
6) offer closes, shares allocated, trading commences

Underwriters

- Investment banks that act as intermediaries between a company selling securities and the investing public
- Underwriters manage the issue of securities on behalf of the issuing firm, performing a range of services, including formulating the method to issue the securities and marketing the issue; pricing the new securities; selling the new securities.

Firm commitment contract vs Best efforts contract

Valuing IPOs – Preliminary Valuation

Two common valuation methods

- DCF – compute PV of CFs over the life of the company
- Comparable firms analysis – compare with publicly traded firms in the same industry that have similar risk and growth prospects (using their PE and PS ratios)
- On the basis of all relevant factors, the investment bank would specify a range in the preliminary prospectus.
Procedures

1) **Fixing Pricing** – traditional method whereby price is set but there is a risk of less shares being demanded.

2) **Book-building** – underwriters ask institutional investors to indicate quantities they would purchase at what price, and record this in a ‘book’. Lower under-subscription risk (reducing price uncertainty) but significant costs & possible investment banking conflicts.

3) **Open Auction** – investors are invited to submit their bids, and the securities are then sold to successful bidders.

Direct Costs of IPOs

- underwriters receive payments in the form of a spread (the difference between the underwriters' buying price and the offering price)
- usually, the underwriting spread on a new issue amounts to 7% of the proceeds to the issuer.
- direct administrative costs to management, lawyers, accountants as well as fees for registering the new securities, etc. can be over 1% of the proceeds.

Indirect Costs

- Under-pricing – issuing a security at an offering price set below the actual market value of the security (captured by first-day closing price)

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\text{Under-pricing} = \frac{(\text{First day closing price} - \text{Offer price})}{\text{Offer price}}
\]

- The economic consequences of under-pricing is significant for the original owners of the firm:

\[
\text{Money left on the table} = (\text{First-day closing price} - \text{Offer price}) \times \text{Number of Shares}
\]

Explanations of Under-pricing

1) **Winner’s curse (information asymmetry)** – as an uninformed investor, you will likely be stuck disproportionately with shares in bad deals (overpriced shares)

- If the expected IPO under-pricing were zero, your expected return would be negative.
- To keep uninformed investors in the IPO market, underwriters must under-price IPO shares on average.
- Evidence: more information freely available about the issuer – less underpricing.

2) **Investment Banking Conflicts**

- Investment banks arrange for underpricing as a way to benefit themselves and their other clients
- Evidence for: higher IPO commissions or higher underwriter’s stake in the IPO – less underpricing
- Evidence against: investment banks also under-price themselves when listing.

3) **Litigation (Implicit) Insurance**
- Liability on the issuer and underwriter for material misstatements and omissions made in connection with the IPO
- So, they intend to underprice the IPO to avoid potential lawsuits if shares subsequently do poorly
- Evidence against: underpricing happens even in other countries with laxer regulatory schemes

(4) Signalling
- Leaving a ‘good-taste’ with investors provides a mechanism to signal the quality of the issue
- Easier to subsequently raise funds at higher prices

Long-run underperformance

Reasons
- ‘clientele effects’ whereby only optimistic investors buy into an IPO but their optimism will as disappear as more information about the firm is released.
- ‘window of opportunity’ whereby management times the issue to take advantage of hot markets.

Seasoned Equity Offerings (SEOs)

Private Placements
- An issue of new shares to a limited number of investors (usually financial institutions)

Advantages
- quicker
- lower issue costs (no need for underwriting usually)
- do not generally require a prospectus

Disadvantages
- shares issued at a discount – transfer of wealth from existing shareholders to new investors
- dilute control of existing shareholders

Rights issue
- A new share issue offered to existing shareholders at a fixed subscription price
- Shareholders receive an entitlement to new shares at a fixed proportion of the number of shares already held (on a proportional basis)
- Shareholders can (1) exercise the rights (2) let the rights expire (3) sell the rights (on the ASX) if the issue is renounceable (in most cases)
- Subscription price usually at 10-30% discount to the share price at the time the issue is announced.

Usually takes 2-3 months to complete