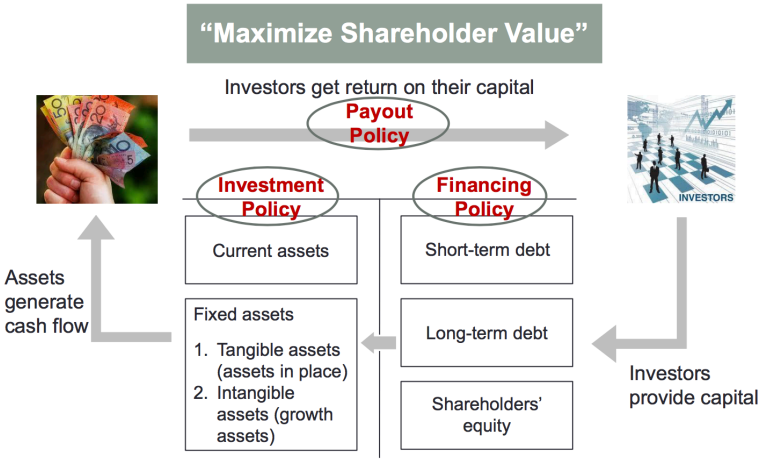
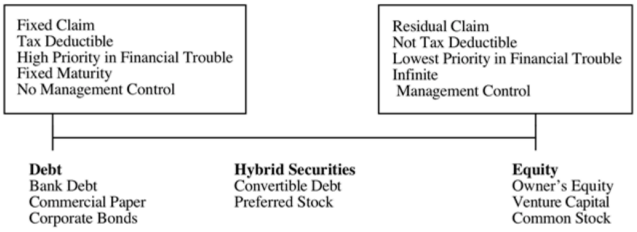
[Topic 1] Raising Capital: Equity



1. **Raising Capital** through (i) internal funds (ii) Debt (iii) Equity (iv) Hybrid

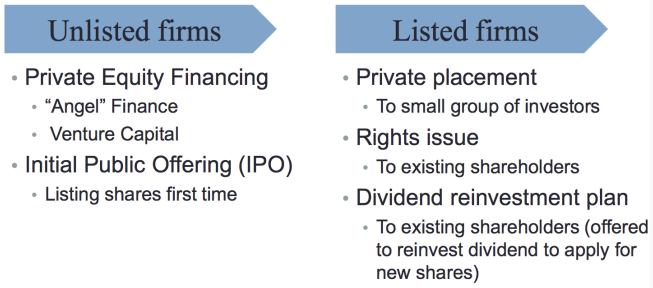
2. **Pecking Order Perspective**: Public firms prefers to finance in this order.

   Retained Earnings - > Debt -> Equity



Why? "**Information Asymmetry**": Equity issues signal to investors that equity is overvalued. Stock prices decline at announcement.

3. Different Options **Raising Equity**:



4. **Private Equity**:

(i) <u>"Angel" Finance</u>

Small number of high net worth individuals

(ii) <u>Venture Capital</u>

Active financial intermediary, providing financing to early-stage and high-potential start-up companies mainly in high tech industries. Funds mostly raised from investors (such as pension funds and endowments foundations). Typically staged financing; significant control over company decisions.

<u>Exit Strategies</u> - Trade Sale or IPO

5. **Underwriter**: 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 (i) formulating the method used to issue the securities and marketing the issue (ii) pricing the new securities (iii) selling the new securities.

Firm Commitment contract (promise to buy unsold shares) vs. **Best efforts contract** (risk of undersubscription).

6. **Public Equity:**

Initial Public Offering (IPOs)	Seasoned Equity Offerings (SEOs)
Sells equity for the first time. **Motives and Advantages?** (i) create public shares for use in future acquisition (ii) establish market price (iii) enchant reputation (iv) minimize cost of capital (v) current stockholders can diversify **Disadvantages?** (i) Costly (substantial fees: legal, accounting, investment banking fees 10%) (ii) Dilution of control for existing owners (iii) Greater degree of disclosure **Procedure** Step1. Appointment of an underwriter and other advisers Step2. Undertakes the due diligence process and prepare the preliminary prospectus Step3. Institutional marketing program commences (including IPO road shows) Step 4. Exposure period: lodge the final prospectus with the Australian Securities and Investment Commission (ASIC) and lodge listing application with ASX Step 5. Marketing and offer period Step 6. Offer closes, shares allocated, trading commences	**Private Placement** An issue of new shares to a limited number of investors. Advantages: (i) low cost (ii) quick (iii) no prospectus Disadvantages: (i) dilute control of existing shareholders (ii) transfer of wealth from old to new **ASX Listing Rule 7.1** prohibits a company from issuing more than 15% of its issued capital within a given 12 month period without first obtaining the approval of its shareholders **Rights Issues (continue below No. 10)** New share issue offered to existing shareholders at a fixed subscription price. Pro-rate basis. Usually at a discount (10-30%). Advantages: (i) Preserves voting patterns Disadvantages: (i) Costly [Prospectus, underwriting fees] (ii) takes longer than PP **Dividend Reinvestment Plans** Use part or all of dividend to apply for new shares without transaction costs and usually at a discount (5-10%) to the current market price. Rationale: allows high dividend payout while lessening impact on cash outflows. 1:9 issue: 9 shares give you 1 additional share

7. **Valuing IPOs**: establishing price

Common valuation methods help to build range:

(i) Discounted cash flow (DCF) analysis – compute the present value of cash flows over the life of the company

(ii) Comparable firms analysis – compare with publicly traded firms in the same industry that have similar risk and growth prospects (using their Price/Earnings ratios, Price/Sales ratios, etc.)

Determining the Real Price:

(i) Fixed Pricing – traditional method (common in Australia). Price is set, prospectus sent out and offers are received. Subject to market movement - high risk of under-subscription.

(ii) Book-building – Underwriters ask institutional investors to indicate quantities they would purchase at what price, and records this in a "book". Lower under-subscription risk (reducing price uncertainty), but significant costs & possible investment banking conflicts

(iii) Open auction (a Dutch auction) - Investors are invited to submit their bids, and the securities are then sold to successful bidders (e.g., Google's IPO in 2004).

8. Cost of IPOs

(i) Direct Costs:

Underwriters receive payment in the form of a spread (the difference between the underwriters' buying price and the offering price) [Usually, 7%] . Direct administrative costs to management, lawyers, accountants as well as fees for registering the new securities, etc. can be over 1% of the proceeds

(ii) Indirect Costs (Underpricing)

Issuing securities at an offering price set below the actual market value of the security (captured by first-day closing. price)

$$Underpricing\ (\%) = \frac{First\ day\ closing\ price - Offer\ price}{Offer\ price}$$

Why?

(i) Winner's curse (information asymmetry)

As an uninformed investor, you will likely be stuck disproportionately with shares in bad deals (overpriced shares). To keep uninformed investors in the IPO market, underwriters must underprice IPO shares on average. Evidence: more information freely available about the issuer → less underpricing

$$\underbrace{50\%}_{\%\ \text{Underpriced Offerings}} \cdot \overbrace{0.5}^{\text{Expected Share Allocation}} \cdot \underbrace{(+10\%)}_{\text{Underpricing}} + \underbrace{50\%}_{\%\ \text{Overpriced Offerings}} \cdot \overbrace{1.0}^{\text{Expected Share Allocation}} \cdot \underbrace{(-10\%)}_{\text{Overpricing}} = -2.5\%$$

(ii) Investment Conflicts

Investment banks underprice to benefit themselves and their other clients. Evidence for: Higher IPO commissions or higher underwriter's stake in the IPO → less underpricing.

(iii) Litigation Insurance

underprice the IPO to avoid potential lawsuits if shares subsequently do poorly.

(iv) Signaling

Leaving a good taste with investors. Easier to subsequently raise funds at higher prices.

9. Long-run Underperformance

Why?

(i) Clientele Effects

Only optimistic investors buy into an IPO, but their optimism will disappear as more information about the firm is released

(ii) Window of Opportunity

Management times the issue (taking advantage of high demand for IPOs by the market – hot markets). A decline in demand for IPOs (cold markets) after hot markets are generally correlated with a reduction in equity prices after IPOs.

10. Rights Issue

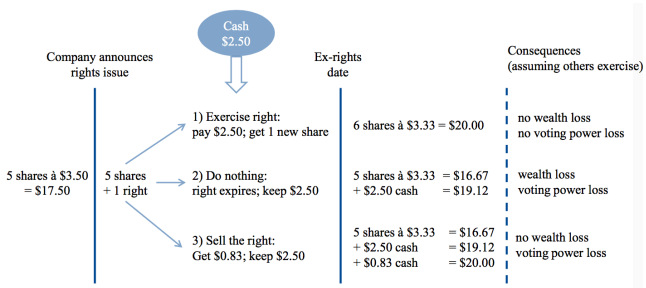
Share price drops after Ex-rights date.

$$X = \frac{N}{N+1}M + \frac{1}{N+1}S = \frac{5}{6}\times\$3.50 + \frac{1}{6}\times\$2.50 = \$3.33$$

Value of the right: New price - Subscription Price

Shareholders Strategies:

Share price will not necessarily fall to theoretical ex-rights price (X) on the ex-rights date (rights drop-off) due to:



(i) New information may affect the stock price on ex-rights date.

(ii) General movement in share prices.

(iii) Transaction costs/taxes related to exercising the right.

(iv) The theoretical value R ignores the option characteristic of the right. Not everybody would exercise. Therefore, price might not drop as much.

11. **Regulatory Environment**: to protect investors and require "full" information disclosure.