FNCE30002: CORPORATE FINANCE

LECTURE 1: RAISING CAPITAL: EQUITY

Examinable Content is the lecture notes – what is said in the lectures.

The Nature of Capital:
Equity characterisitcs:

- Permenant contribution
- ordinary shareholders have full voting rights
- shareholders hole a residual claim (after payment to debtholders – generally paid out of profit)
    - Last to be paid during liquidation
- it is the most risky form of investment
    - High risk = high *required* return
    - E.g.: Expected (Promising) 10%; Required 15% -> Do not invest
        - -> Prices fall
        - Expected return increases
        - Expected = required return

Differentiating forms of capital:

- Voting rights
- Return on the investment
- Risk exposure
    - Debtholders don't vote, but they get to say I will only lend money if you sustain a profit of __, otherwise you must return me my money -> without the voting rights, they still hold a lot of power.

Reasons for IPO 0 Initial Public Offerings ("float"):

- Create public shares for use in future acquisitions: If we are listed, we can offer shares for merge. E.g. 1 share of A's is 1.3 share of B's
- Establish market price/value
- Boarden base of ownership
- Allow one or more principals to diversify personal holdings, etc…
    - Reduce diversificable risks

The Process of IPO:

1. Engage an Investment Banker
    a. Prepare prospectus: legal document
    b. Providing underwriting (guarantee success – promise to buy shares leftover for a fee)
    c. **Setting the Price**
    d. Fixed Pricing – traditional
        i. Set price, prospectus sent out and offers are received
        ii. Danger: high price – no sell, low price – opportunitiy costs
    e. Bookbuilding
        i. Competitive bidding by instrituitional investors (big investors)
            1. **Open pricing**: Bids are taken from the market and the fnal price is which clears the market

            a. 4 shares, 6 institutions, bid 15-20 -> sell 4 at 17
        2. **Constrained open pricing**: indicative range is provided and investor bids within that range are invited.
2. The Roadshow:
    a. Hit the streets and attempt to gauge investor interest
    b. Help determining what an appropriate subscription price is for shares
3. Set the price and list
    a. Shares are issued in the primary market
    b. Shares are trading on the secondary market
    c. "Left on the table" if the subscription price is lower than price these shares will be traded subsequentially.
        i. Underpriced = (First day closing price – Subcription price)/ Subscription price

- IPOs can make a 20% on the first day, but also can get 0 or negative returns (28%)

IPO: Underpricing

- Information assymetry and the Winner's Curse
    - Uninformed Investors is not able to judge whether the IPO is under or over priced -> hence usually only able to invest in overpriced because informed investor will take up all places of underpriced IPO
    - Informed Investors is able to judge and only invest in underpriced IPO
    - This leads to crowding out effect of uninformed investors, and hence **on average IPO are underpriced to keep these uninformed investors** as informed investors do not have enough fund for all IPOs
- Market Feedback Hypothesis:
    - Give underprice price for institutional investors during book building as compensation for them to gain info on true price of the shares for the market general offer.
- Market Bandwagon (a.k.a cascades hypothesis)
    - Induce the first wave of populatity among the investors by issuing underpriced
    - Resulted in positively-slpoed demand curves
    - Relies on multi-selling stages process
- Investment banker monopsony power
    - IPO spinning: reducing the investment banker own costs, and to develope relationships with other potential clients of the banker
    - Agency's problem
- Lawsuit Avoidance and implicit insurance:
    - Prospectus is partly a marketing document so some forecases might by inaccurate, and underpricing ensures that subscribers enjoy a gain from investment
- Signalling as part of a longer term strategy:
    - Underprice this time, so next time going to the market, we can leave it with more profit.
- Ownership Dispersion:
    - Greater liquidity
    - The harder it is for shareholders to remove the boardseat from their position

IPO: Long-run performance of IPOs

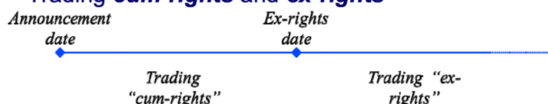
- Divergence of opinion hypothesis
  - IPO investors are both optimistic and perssimsitic, successful IPO are naturally optimisitc, over time this optimism adjusts resulting in a fall in share price
- Impresario hypothesis
  - Intial effort to create appearance of excess demand (by intitial underpricing), but this effort tends to decrease and price then follow to fall
- Windows of opportunity hypothesis
  - A decline in demand for IPOs will be correlated with a reduction in equity prices generally
  - IPOs are strategically releases when demand are high, hence when demand fall, prices follow

Seasoned Equity Offerings (SEOs):
Unseasoned Equity Offerings are IPOs: never available before
Seasoned Equity Offerings are offerings of shares already on the market subsequent to the IPO

1. Rights Issues (to exisiting shareholders)
   a. Offer by a company of new shares to exisitng shareholders at a fixed proportion (pro-rata basis)
   b. Usually 10-30% discount
   c. Takes at least 19 days to complete

Rights Issues – continued

- Subscription price (*S*)
- Pro-rata entitlement (*1:N*)
- Trading ***cum-rights*** and ***ex-rights***



- Valuation
  - A *1:N* rights issue gives the holder an entitlement to purchase 1 additional share for every *N* shares currently held at a price of *$S*
  - *R* is the value of the right
  - *X* is the theoretical price of the share *ex-rights*
  - *M* is the market price of the share *cum-rights*

Rights Issues – continued

Value of the right

- How much would the market pay for the right to purchase one additional share at the discounted price?

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

Theoretical ex-rights price

- What should the value of the share be once it begins trading ex-rights?

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

Ex-price usually fall less than the amount of the right, because the right is a group of shares and we need to acount for that.

- Renounceability: most issues are renounceable,
    - Exercise right
        - Maintain wealth and ownership
    - Allow to lapse
        - Wealth and ownership loss
    - Sell the rights to a third party (trading of rights occurs on the ASX)
        - Maintain wealth but reduce ownership
- Rights are prefered over private placements could be b/c of
    - Constraints on private placements: limit on amount issued
    - Convenient source of fund (alternative source)
    - Preserves voting patterns
    - But costly in terms of time (Min 19 business days)

*Alternative to rights issues, hybrid of rights issues and placement, three main types are not examiable

Accelerated Entitlement Offers

- Different shareholders subject to different conditions
- Two Stages:
  Stage One: Accelerated offer to <u>institutional</u> shareholders
  Stage Two: Offer to <u>retail</u> shareholders
- Three main types
  1. Accelerated Non-renounceable Entitlement Offer (JUMBO)
  2. Accelerated Renounceable Entitlement Offer (AREO)
  3. Simultaneous Accelerated Renounceable Entitlement Offer (SAREO)
- Advantages are that these allow funds to be raised quickly (like a placement) whilst allowing retail investors the chance to participate (like a traditional rights issue)

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2. General Offers (to the public)
3. Placement (to financial instituition)

Placements

Example

- Daffy Limited has 10 million shares on issue with a current share price of $10 each. Daffy then raises $9 million by placing 1 million shares at $9 each to a group of financial institutions. The pre-and post-placement capital structure of the company is set out below:

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

Share price$_{before}$ = $100m/10m = $10 per share

Value of Equity:	($m)	($m)
. old s'holders	$100	$99.09
. new s'holders	0	$9.91
	$100	$109

Share price$_{after}$ = $109m/11m = $9.91 per share

- Diluting effect – transfer of wealth
- Advantages: relatively quick and low transaction costs
- Disadvantages: potential dilution in voting power and value (due to discount)

Underprice: when the first day closing price is higher than the subscription price
Usually underperform, even with increase in capital, still underperforming compare to market

Dividend Reinvestment Plans (DRP):

- Use part/all dividends and reinvest into the company usually at a discount
- Virtually accepts the dividends but have to pay tax – which is offset by the imputation credits
- Allow high dividend payout while lessening impact of cash outflows

Underwriting:

- Fixed Basis: purchase shares that wasn't purchase
- Best Efforts Basis: will try their best but doesn't buy up the leftovers
- Underwriter is required to act only if the issue is not fully subscribe
- The issuers has the right but not obligation to sell to the underwriter
    - Put options on the new shares
- Sub-underwriting
    - Used to lay off risks

LECTURE 2: RAISING CAPITAL: DEBT AND LEASING

The nature of Debt:

- Temporary contribution of capital by investors for specified time
- Usually no voting rights, fixed and prior ranking contractual right to return on capital and of capital, debt is the least risky type (but also lowest IR)
    - Secured debt (over asset), unsecured debt (riskier and higher IR)

Debt Covenants:

- Designed to protect interests of lenders
- Negative covenants:
    - Limit access to further debt
    - Restrict holding of certain investments
    - Restrict dividend paid
- Positive covenents
    - Maintain presence in certain market
    - Maintaining assets
- Resrtiction on new debt issues or dividend payments prevents wealth transfer from debt to shareholders

Issued vs bank debt:

- Monitoring and contractual debt restrictions imposed by banks
    - Constrain managers from actions that reduce firm value
- Conterargument:
    - Prevent managers from investing in +ve NPV projects (taking risks that could increase value)
    - Gives monopoly power to the bank in further bowwoing negotiations with the firm