Corporate Finance

Week 1 Raising capital: Equity

1. Equity characteristics
    a. Permanent contribution of capital
        - Primary equity market: first issuing shares to the market to obtain capitals, cash flow going into the company
        - Secondary equity market: traded among investors, change of ownership between investors, capital not going to the company

    b. Ordinary shareholders have full voting rights
        - Debtholder and Preference shareholders has no voting rights

    c. Shareholders hold a residual claim
        - Dividends are paid only after all other obligation (interests to debtors) are paid (subordinated right to a return on capital)
        - Shareholders are the last in line after debtor claim of assets (Subordinated right to a return of capital on liquidation)

    d. Therefore, equity is the riskiest form of investment
        - high return? Not necessary true
        - accurately saying, higher required return
        - for any promised high risk investment, we require high expected return on the project (=required return) → liquid/competitive market adjust quickly to equate expected and required return

2. Differentiating forms of capital
    a. Voting
        - Debtholders don't vote but they still have power in turns of <u>requiring a sufficient level of interest coverage ratio</u>. E.g. if violated, you need to <u>repay immediately</u>
        - <u>Have significant influence on the management</u> of the firm even with no voting rights
    b. Return
    c. Risk

3. Why 'float' your company (not maintain a private ownership)
   (reasons in most popular order)
    a. To create public shares for use in future acquisition
    - Once 'float' we can use shares as currency to acquire other firms
    b. To establish a market price/value for our firm
    c. To enhance the reputation of our company
    - Profile building → possible for future fund
    d. To broaden the base of ownership (more liquid in selling the shares)
    e. To allow one or more principals to diversify personal holdings
    f. To minimize our cost of capital
    g. To allow VCs to cash out
    h. To attract analyst's attention
    i. Our company has run out of private equity
    j. Debt is becoming too expensive

4. **Initial Public Offerings (IPO)** – unseasoned equity offering (new)

   a. Process

      - Step 1: Engage an investment Banker

        ✓ Prepare prospectus detailing IPO

        ✓ Underwriter that guarantees all issued shares will be sold and is liable to purchase left-over at the conclusion of the float

        ✓ Determine subscription/issue price

- ①**Fixed pricing** (traditional method)

   I. price is set, prospectus sent out and offers are received

   II. dangers to issuer? Too high, no one invests no getting enough capital; too low, opportunity cost (can raise even more capital)

   → Risky, quicker and cheaper

- ②**Bookbuilding** (Lower price uncertainty but higher costs – info provided to the investors so need to give some discount)

   I. competitive bidding by institutional investors

   II. 2 broad approaches

      i. Open pricing (bids taken from market and price is that which clears the market)

   ➔ Receive price from diff. institutions

   ➔ Dutch auction (from high to low until all being sold)

      ii. Constrained open pricing (an indicative range is provided and investors bids within that range are invited)

   ➔ E.g. tell me your bid at least $68

➔ Possibly getting higher price for the share

- Step 2: the roadshow
  - ✓ Marketing the float by bankers to engage investor's interest
  - ✓ Book-building: determine an appropriate subscription price

- *Too high:* no one will buy and float will be a failure
- *Too low*: original owners of the firm have suffered an opportunity cost in that the shares could have been sold for a higher price

- Step 3: Set the price and list
  - ✓ Primary market: funds received by issuing firm
  - ✓ Secondary market: funds paid by buyers of shares go into share seller

b. Underpricing

- Subscription price for an IPO below the 'true' value of the shares
- $Underpricing = \frac{First\ day\ closing\ price - subscription\ price}{subscription\ price}$
- even many IPO are underpriced in average, does not mean investor can capture the positive returns by investing in all IPOs