

Chapter 12 Raising Long-Term Financing

Chapter Overview

The *What Companies Do* opening feature discusses the IPO of Financial Engines Inc., which provides financial advice and information to more than one-quarter of the Fortune 500 firms. The financial giant founded by Nobel laureate and finance Professor William Sharpe in 1996 opened at \$12.00 at the beginning of the day and went up by 44% by the end of opening day. It made over \$125 million on the day trading began. This positioned the firm for success in the next few years.

What Companies Do Discussion Questions

1. Who benefited the most from the IPO of Financial Engine Inc.?
2. Was Financial Engines Inc. served well when it appears its shares were underpriced by 44%? Is such underpricing a rarity?

This chapter looks at long-term financing instruments, including:

- 12-1. The Basic Choices in Long-Term Financing
- 12-2. Investment Banking and the Public Sale of Securities
- 12-3. The Market for Initial Public Offerings (IPOs)
- 12-4. Seasoned Equity Offerings in the United States

Technology

1. **Smart Ideas Video** shows Tim Jenkinson of Oxford University talking about ways that a firm can handle an IPO.
2. **Smart Practices Video** features Frank Popoff, retired chairman of the board of Dow Chemical, as he looks at foreign bonds and their role in corporate finance.
3. **Smart Practices Video** features Jay Ritter of the University of Florida as he discusses the long-term underperformance of companies doing an IPO (2 clips).
4. **Smart Practices Video** features Jay Ritter of the University of Florida as he looks at IPO underpricing, which occurs worldwide.
5. **Smart Concepts.** See financing options available to large corporations.

After studying this chapter you should be able to:

- discuss the basic choices that corporations face in raising long-term financing
- describe the costs and benefits of raising long-term funds by issuing securities rather than by borrowing from a financial intermediary
- understand how investment banks help corporations issue securities, and describe the services investment banks provide before, during and after a security issue
- explain the basic issuance and pricing patterns observed in the initial public offering (IPO) market
- describe the basic issuance and pricing patterns observed in the market for seasoned equity offerings (SEOs), and explain why so few large companies issue seasoned ordinary equity
- explain some important aspects of international ordinary equity offerings, including the role of American Depositary Receipts (ADRs).

Lecture Guide

This chapter surveys global financing instruments, going into detail about investment banking and initial public offerings.

Ordinary Shares and Long-term Debt

Most companies finance first through internal financing.

- Student Interaction: Ask students why internal financing is preferred.

Some reasons for this may include:

- There are no restrictions on internal financing. The money is there for management's use
- There are no transactions costs, as there would be in the raising of new debt or equity funds.
- There is no double taxation on internal financing

The choice of debt vs equity is covered in prior chapters, although the instructor can point out that not only are transactions costs generally less for debt issues than equity issues, debt financing provides a tax advantage because of the deductibility of interest payments. The cost of debt financing is therefore always less than the cost of equity financing, making it a preferable choice when feasible.

12-1 The Basic Choices in Long-term Financing

The concepts in this section go back to Chapter 1: that the goal of the firm is to maximise shareholder value. The firm accomplishes this by choosing all possible positive net present value projects. Finance theory says how positive net present value projects are financed shouldn't matter – the positive net present value is added to the value of the firm. In reality, managers are concerned about the financing decision, and sometimes let the lack of available financing reduce their investments, even though the investments are positive net present value.

12-1a The Need to Fund a Financial Deficit

While firms prefer internal financing to external financing, firms may need to enter the financial markets to obtain additional money. Firms want to obtain the *least* cost financing and have a number of choices to make throughout the external financing process. Not only is a firm concerned about the transactions costs involved in obtaining external financing, but it also is concerned with the message sent by issuing the type of security that it chooses.

12-1b The Choice Between Internal and External Financing

The firm's dividend decision and capital structure decisions are part of the financing decision. If a firm pays out a higher percentage of its earnings as dividends, then it may have to raise more funds in the external markets to fund investment projects. A firm may have a particular mix of debt and equity desired in its capital structure that will impact its choice of debt vs equity financing. The firm must look at the costs and benefits of raising money externally vs internally. Are the transactions costs worth the benefits of additional investment?

12-1c Raising Capital from Financial Intermediaries or on Capital Markets

There are global differences in raising capital. In general, banks play a larger role in financing foreign companies than domestic companies.

The banking system has changed substantially since *Glass-Steagall* was essentially repealed.

Glass-Steagall was passed initially because of fears that the Great Depression of the 1930s witnessed severe conflicts of interest when a bank served both as a commercial lender and as an investment bank. A bank could lend a questionable company money as a commercial bank, and then as an investment bank, aid in the issuance of new debt or equity securities, sold to an unsuspecting public. The low-quality, new security proceeds would then be used to pay back the commercial bank loan, protecting the bank at the expense of consumers. In general, recent studies have found that this was not the case in the 1930s. Investors generally were more willing to pay higher prices for securities

underwritten by banks rather than by investment houses. This supports a certification role for banks. In other words, this indicates commercial banks had more information about the company and served to validate their financial statements, making the securities issued more valuable. Banks making loans have information such as internal budget statements. The high cost of collecting and assessing information could keep investment banks from garnering as much information as the commercial banks. In addition, issues underwritten by commercial banks before the Depression had a lower default rate than issues underwritten by investment banks. There is no evidence that commercial banks abused the trust of their clientele by systematically underwriting poor securities.

In markets outside the US, commercial banks typically play a much larger role in corporate finance. The Australian market has a mix of characteristics from the US, UK and European markets.

Figure 12.1 Financial Sector Composition of Australia and the US

Figure 12.2 Global Equity Capital Market (ECM) Activity

12-1d Expanding Role of Securities Markets in Corporate Finance

Figure 12.3 A Decade of Australian Equity Capital Market (ECM) Activity

Annual Global Securities Issuance: Patterns

While there are global differences, there are similarities, for example, the bulk of new financing is debt financing. Foreign firm financing is taking a larger percentage of the overall market, but US firms still dominate.

12-2 Investment Banking and the Public Sale of Securities

Firms generally do not sell new shares directly to the public (although there are exceptions to this – some companies sell their shares directly to the public, without brokers). They choose an investment banking firm, which manages the offering, handling the legal and administrative requirements involved in the process.

Figure 12.4 Prospectus of Financial Engines Common Stock

Note that investment banks are not investors – they are advisers in the issue process. Investment banks (IBs) compete with commercial banks – in some transactions IBs accept credit risk, traditionally a mainstream banking function, by providing short-term loans to firms to help with mergers and acquisitions, called bridge loans because they 'bridge' the gap in financing until the acquiring company can acquire more permanent financing. Investment banks also take on event risk, for example, providing hedging services for client firms that desired this. For example, a company whose revenues were very sensitive to oil costs might want to lock in future oil prices. The investment bank could facilitate this by purchasing oil forward contracts, locking in a price at some time in the future.

While US companies have been expanding abroad, European firms have been picking up more financial services business in the US. From 1998 to 2001, European firms have bought over 80 US financial services companies. The two biggest of these was Switzerland's UBS purchase of Paine Webber and Credit Suisse's purchase of Donaldson, Lufkin and Jenrette.

Many of the mergers between financial services companies and investment banks were not stellar successes. Mergers that seemed not to work as well as planned could include Credit Suisse and First Boston; Kidder, Peabody and GE; and Dillon Read and Travelers. Sometimes the cultures didn't mix – high-flying, glamorous investment banking vs conservative, service-oriented banking. Investment banks and traditional banks tend to have different compensation schemes. Investment banks tend to pay out more of revenues as compensation, providing large bonuses to the executives who generated the revenues. For example, top Wall Street investment bankers could earn yearly salaries of millions of dollars, most of which was a bonus based on performance, rather than base salary.

Underwriting is an important aspect of IB services. This can affect the method chosen to issue and price securities. In Australia, both book building and fixed price offers are common.

Figure 12.5 2011 Australian ECM Bookrunner League Table

12-2a Conflicts of Interest Facing Investment Banks

12-2b Legal Rules Governing Public Security Sales

In Australia, companies choosing to raise funds are regulated by the Australian Securities and Investments Commission (ASIC) and listed on the Australian Securities Exchange (ASX). Once a firm successfully completes its IPO, it becomes subject to all rules and regulations of a publicly traded firm and must follow all ASIC and ASX (or domestic regulator) requirements.

Table 12.1 Key Listing Criteria for the ASX

Table 12.2 The Listing Process in Australia

12-3 The Market for Initial Public Offerings (IPOs)

12-3a Patterns Observed in the US IPO Markets

There are a number of possible explanations for 'hot markets' and for the fact that there tends to be more underpricing of IPOs (higher first day gains) in hot markets.

- Perhaps there are changes in firm risk. If 'everyone' is doing an IPO, then the riskier and harder-to-price companies may be in the market. When there is more risk, and when it is harder to evaluate the risk of a company, there will be more underpricing.
- There may be momentum in hot markets. Investors may be willing to pay more, bidding up the price of a new issue, because they believe the overall market is going up. This can make first day gains a self-fulfilling prophecy.
- There may be 'windows of opportunity,' periods of time when investors are very optimistic about the growth potential of new companies.

The peak of the technology boom saw a record number of IPOs and money raised from IPOs and by venture capitalists. For example, 1999 venture capital investments were larger than the previous three years combined. Internet firms received 2/3 of venture capital money, twice the percentage they received in 1998.

In 1999, IPOs raised over \$75 billion in new equity, which is about equal to the amount raised in new stock issues in the entire decade of the 1980s.

IPOs can raise large amounts of cash. For example, in 1998, DoubleClick, an online advertising network, planned on selling 2.5 million shares at \$12-\$14 per share. Because of the high demand for the offering, DoubleClick increased the number of shares to 3 million and the offer price to \$17 per share, raising \$51 million. Stock can be used as currency in acquisitions. For example, RealNetworks bought its competitor, Vivo for 1.1 million RealNetwork shares valued at \$17 million.

12-3b The Investment Performance of US Initial Public Offerings

At the peak of the IPO boom, many companies,—in particular Internet companies,—had a huge first day 'pop,' in other words a large increase in price on the opening day of trading. The IPO 'boom' began in September 1998 with a 606% first day gain for theglobe.com. One of the highest gains was VA Linux Systems IPO, in which the stock closed at \$239.25, up 700% on the first day of trading from the offer price of \$30. From 1975-1998, 39 IPOs more than doubled in price on the first trading day. In 1999 alone 84 IPOs more than doubled in price on the first trading day. This means that a great deal of money was 'left on the table.' The IPO could have been priced higher, netting the issuing company more money and the investment banker higher fees. In fact, it is estimated that \$29 billion was left on the table in 1999,

compared to \$27 billion left on the table in the previous 9 years combined. (To put this in perspective, note that \$29 billion was more than the GDP of Bolivia.)

A *Wall Street Journal* article on 13 June 2001, 'Analysts' Links to IPOs Mean Losses for Investors' stated that investors lost an average of over 53% when they followed the advice of an analyst working for a Wall Street firm that led or co-managed that stock's IPO. Investors lost only 4.24% when they took the advice of analysts working for firms with no underwriting connection to the IPO.

A *Business Week* article on 5 February 2001, 'Do Top Women Execs = Stronger IPOs?', quoted a University of Michigan study that found having more top managers who are female meant higher stock prices and earnings per share after an IPO. When executive teams were at least 10% female, stock prices were almost 5% higher than for companies with no top women managers. Earnings per share for companies with at least 10% female management were 56% higher than for companies without top female management. When women comprised half of the management team, stock prices were 23% higher and earnings per share 281% higher.

A number of Wall Street investment banking firms are facing charges of improperly splitting IPO profits with favoured clients during the IPO boom. Credit Suisse First Boston agreed in December 2001 to pay \$100 million in SEC-imposed fines to settle charges that it charged substantially higher than normal commissions to some clients or required them to buy higher priced shares in the aftermarket. For example, the prevailing institutional investor commission was 5 to 6 cents a share. Institutional investors paid 50 cents to \$3 a share for some IPO issues. 'Laddering' is the practice of requiring customers who purchased shares at the IPO price to also buy aftermarket shares at much higher prices.

There is a new verb in the English language – to NASDAQ. This verb came into use in 2002, when NASDAQ was off over 60% from its March 2000 high. The verb 'NASDAQ' was first noted in the *New York Times*. When award nominations from a *Times* book review dropped 20%, the paper wrote that nominations nasdaqed. When Denver quarterback Brian Griese had a bad season, a local paper said that his quarterback rating had 'nasdaqed'.

Figure: Average First-Day Returns on IPOs for 43 Countries

12-3c Non-US Initial Public Offerings

Many of the same anomalies of US IPOs are common to international firms:

- Significant first day returns are observed
- Initial international offers yield negative long-term returns

12-3d International Share Issues

There are many similarities between US and international equity issues. Accounting differences can be an issue; however, more foreign firms are adopting GAAP standards. This is required of companies wanting to be listed on US exchanges or wanting to issue American Depositary Receipts (ADRs),

American Depositary Receipts

ADRs are a relatively new investment, increasing in popularity. They provide an easy way for Americans to invest in foreign companies, without having to find a broker in the foreign country, or read a foreign language.

12-3e Share Issue Privatisations

More countries are privatising previously government-owned industries. The most important aspect of privatisation programs is the transforming role they have played in developing many national stock markets in general, and IPO markets in particular.

12-3f Advantages and Disadvantages of an IPO

An IPO or a secondary offering after an IPO can be very profitable for a company's founders. For example, eBay's founder received close to \$130 million from the sale of 790,000 of his 37.6 million shares of stock in eBay's secondary offering in April 1999. (The company did its IPO in September 1998.) In another example, 20-year-old Christopher Klaus founded Internet Services Systems in 1994. The firm went public in 1998, giving Klaus a \$160 million fortune in his remaining 26% ownership of the

company. Not just owners can become rich. Over 2,000 Microsoft employees have become millionaires through exercising employee stock options.

Some of the benefits include:

- New capital available for the company.
- Publicly traded shares for use in acquisitions.
- Listed shares for use as compensation vehicle.
- Personal wealth and liquidity.

Some of the disadvantages include:

- The financial costs of an IPO.
- The managerial costs of an IPO.
- Share Price Emphasis.
- Life in a fishbowl.

Investment bank fees can be very high, particularly relatively speaking. In 1999, a peak US IPO year, in particular a peak technology/internet IPO year, 1/3 of the companies that issued shares that year paid more in investment banking fees than they had in revenues for the previous 12 months.

Table 12.3 Estimated Listing Costs in Australia

12-3g Specialised IPOs, ECOs, Spin-offs, Reverse LBOs and Tracking Stocks

Equity carve-outs (ECOs) do not necessarily increase the share price of the parent company. A 2002 McKinsey analysis of 200 *equity carve-outs* in the US and Europe over the previous 12 years showed that only 10% of the equity carve-outs raised the parents' company share price by more than 12%. The study found that during the two years following the *carve-out*, most parent companies lost value. In contrast the study found that *spun-off* companies outperformed the S&P 500. Note that the evidence on equity carve-outs is mixed. A prior study showed that shareholders of parent companies earn 2% average positive excess returns in the 5 day period around the announcement of an equity carve-out.

The first *tracking stock* was issued by General Motors in the 1980s. Like carve outs and spin offs they are designed to unlock hidden value by separating the parent and subsidiary in order to make valuation easier and more accurate. There is a positive announcement effect when a company issues tracking stock. More analysts follow a stock after tracking stock is issued, indicating that more or better information is available. The parent company and subsidiary tracking stock are more closely related than parent companies and equity carve outs and spun off companies.

12-4 Seasoned Equity Offerings

This is a good place to remind students that new equity issues are relatively rare. Most companies get most of their external financing from debt issues. Net equity issues are negative in most years. This is because:

- When one company purchases another with cash, the shares of the acquired company are removed from the market. The total value of cash-financed takeovers in the US is over a trillion dollars annually.
- US corporations repurchase more than \$150 billion of their own stock annually.
- Only a small percentage of large American companies sell new common stock. Many companies have not issued new stock in decades.
- The share market is more of a key financing source for entrepreneurial, growth firms.

Figure 12.6 Factors That Affect SEO Issuance Decisions – CFO Survey Evidence

12.4a Share Price Reactions to Seasoned Equity Offerings

On average share prices will reflect a 3% decline in value upon the issuance of seasoned equity. This is often a deterrent to the use of these offerings. There is also some news that reflects that SEOs are bad for shareholders for up to 5 years following the SEO.

12-4b Rights Offerings

Pre-emptive rights give ordinary shareholders the right to maintain their proportionate ownership of the corporation. In the US, these rights have been removed by most large publicly traded companies, making rights issues in the US less common than in other jurisdictions.

12-4c Private Placements

Concerning public vs private placements, the instructor can note that private debt placements may have less restrictive covenants and fewer transactions costs than public placements, but may carry a higher coupon interest rate to compensate for the lack of liquidity for investors in a private issue.

Figure 12.7 Australian Secondary Capital Raisings by Offer Structure and Market Capitalisation in 2011

Chapter 12 Resource Articles

'Performance Differences Between IPOs in New Industries versus IPOs in Established Industries,' *Managerial Finance*, 2009. This article reports the results of a study between the IPOs of established industry firms and new industry firms. It finds that, due to uncertainty, the new industry IPOs have higher returns for up to 10 years following the IPO. Since there is little history with which to price and determine IPO list prices, the stocks are more difficult to price and thus can result in much higher returns.

'A Credit Crunch Imperils the Economy,' *Wall Street Journal*, 6 November 2001. This is an op-ed piece saying that cutting interest rates is not necessarily spurring new investment. The money isn't reaching capital-hungry business because Treasury regulators are cracking down on loans. It states that credit rationing, not interest rates is the real problem with the economy.

'The Party's Over,' *The Economist*, 27 January 2001. This article says that after a long corporate-borrowing binge, lenders are wary of taking on more risk.

'Looking for a Low Interest Rate? How about Zero,' *New York Times*, 27 April 2001. This article looks at Calpine Corp., a company that recently issued \$850 in convertible bonds. The bonds carried a 0% interest rate and are convertible into Calpine stock at a 37% premium to Calpine's current price. The article also lists other companies that got low interest rates, although not quite as low as zero.

'Chicago Merc's IPO Hits Market this Week,' *Wall Street Journal*, 1 December 2002. This article looks at the Chicago Mercantile Exchange's IPO, the first major market that has gone public in the US. The timing may be poor, with very few IPOs in 2002, the second straight year that has seen fewer than 100 IPOs.

'Optimism Rises for Resurgence of Tech IPOs,' *Wall Street Journal*, 2 January 2003. This article says there is more hope that 2003 will be a stronger IPO year. The article notes that IPO activity is tied to how well the Nasdaq is performing.

Enrichment Exercises

Activities for students:

1. Download a company prospectus from the ASX website (www.asx.com.au) or the US SEC's Edgar site (www.sec.gov or www.FreeEdgar.com). Choose one of the following sections: risk factors, use of proceeds, dividend policy, dilution, capitalisation, Management's Discussion, business or Management. Summarise what this section says about the company. Does it make you more or less likely to buy the share?

2. Dutch Auctions

One of the hardest parts of an IPO is appropriately pricing the shares. One suggestion for IPOs is a Dutch auction. In a Dutch auction, investors are given a range of prices, and then bid on how many shares they would be willing to buy at a specified price. The company then sorts the offers in descending order. The price that is high enough to get the deal done – sell the required number of shares – is the price that is chosen for the IPO. Try this in class. For a class of 30 students, for example, tell them they each have \$1,000 with which to buy shares. Tell them the company wants to sell 1,500 shares. The price range is \$7 to \$14 a share. Students can use their \$1,000 to bid on shares. In other words, they could offer to buy 142 shares at \$7 a share, or 100 shares at \$10 a share or 71 shares at \$14 a share. Have students submit their bids. Before the next class, sort the bids, and see which students would actually be able to purchase shares. What was the average purchase price?

Dutch auctions are designed to avoid large first day increases in price by more accurately determining investor demand for new shares in advance. Both institutional and individual investors can bid on the same footing – usually there is an advantage for institutional investors because of their large size. A Dutch auction is designed to pull up the initial price, giving the company more of the first day profits. Small investors may also benefit because they have more of an opportunity to purchase shares.

An example of a company that used a Dutch auction successfully is Andover.net, a firm that runs a network of web sites connected to Linux operating systems. The company's offer price jumped to \$24 from the initial offer price of \$18. Fifty per cent of the IPO shares went to individual investors.

4. Equity Carve-Outs

Why can equity carve outs and spin offs potentially create value for shareholders? The discussion can bring out potential reasons such as:

- The carved out firm is more of a 'pure play' company and can be more easily valued by the market. For example, investors may be better able to evaluate the new company's growth opportunities when they are separate from the parent company.
- The new company can tailor executive compensation plans based on the needs of the new company and not the parent company.
- The carve out and spin off provide more information to the market about the new company. The new company now must provide required company reports, with information detailing its cash flows that are separate from those of the parent company.
- The new company may be able to obtain financing that better suits its needs.

5. IPOS – Money on the Table

In spite of the large amounts of money left on the table, neither the companies nor the investment bankers were really unhappy about this situation. Lead students in a discussion of why this might be. This is potentially because:

- The company's stock price often was priced higher than they initially expected, which meant they netted more funds from the IPO than anticipated.
- Firms generally floated only a small per cent of the total shares outstanding, so they could have another secondary offering months after the IPO at a higher price. For example, eBay raised

\$63 million in September 1998 by selling 3.5 million shares at \$18 a share. In April 1999 the company raised \$1.1 billion by selling 6.5 million shares at \$170 a share.

- The publicity generated by a 'hot' IPO was invaluable – the company would be the subject of business press articles touting the company and the high share price. That kind of positive 'buzz' couldn't be purchased at any price.
- The investment bank received an enhanced reputation for doing 'hot' IPO deals, which ultimately generated more in fees from other companies turning to that IB to do their IPOs and other financing.

Another theory states that the market for IPOs is inefficient because short sales aren't allowed at the time of the IPO. Optimistic investors can buy shares; pessimistic ones can't short sell until there is a more established aftermarket. This could result in a short run overvaluation of the shares and greater long-run underperformance. Some of the proxies for uncertainty in IPOs include:

- Bid-ask spread. This reflects dealers' order processing and inventory holding costs. Spreads increase when there is more uncertainty about valuation.
- Time of first trade. Most IPOs do not start trading when the market opens. The lead underwriter makes the decision about when to begin trading. If there is greater uncertainty, the underwriter can delay the time of the first trade to see in which direction the market is moving. IPOs that open late tend to experience more underpricing than those that open earlier.
- Flipping ratio, the proportion of large block sells (sales of 10,000 shares or more). More flipping implies more uncertainty and a greater divergence of opinion about the value of the IPO.
- Not surprisingly, IPOs with greater initial spreads, late opening trades and a high proportion of institutional flipping show poorer long-term returns.

6. Give students a list of companies that went public 2-5 years ago. Ask them to download share price data for those companies, either individually or as a group project. (Yahoo finance is a good source of price data that is easily downloadable into an Excel spreadsheet.) Students can also download market index values for the same period from Yahoo, and compare the IPO share returns to the market returns. What was the average company and share market return in the year (or several years) following the IPO. Did the IPO under perform the market? If so, by how much?

7. Additional discussion questions for students:

1. What is the cost of internal financing? (The cost applied to internal financing is the also the cost of equity for the firm. It is technically slightly less than the cost of new equity financing because of transactions costs associated with new equity issues, although often this differential is ignored because new equity issues are a relatively rare event.
2. Why do firms prefer internal financing in spite of its higher cost? There are a number of possible explanations for this, including the fact that it is easy to use – it's there without having to deal with investment bankers or lenders. It comes with no explicit strings attached, no restrictive covenants, for example. It avoids the double taxation of dividends. If a firm's investment projects cannot be funded internally, the firm will turn to external financing.
3. Would a maximum spread reduce competition among underwriters? If so, how?
4. If compensation is artificially limited, will there be more mispricing of risky issues in order to reduce the risk level of the offering?
5. Could this policy result in having less reputable underwriters handle the riskiest offerings? If so, why?

Answers to Concept Review Questions

1. A financial intermediary (FI) is an institution that raises capital by issuing liabilities against itself – for example, in the form of demand or savings deposits, or by shares in a mutual fund or pension fund. The intermediary then pools the funds raised and uses these to make loans to borrowers or, where allowed, to make equity investments in non-financial firms. Borrowers repay the intermediary and

have no direct contact with the individual savers who actually funded the loans. In the United States, commercial banks' corporate financing role has until recently been very limited; in fact, it was effectively restricted by law to making commercial loans and to providing closely related services, such as leasing, until the McFadden Act was repealed in 1994 and the Glass-Steagall Act was repealed in 1999. While in the US, banks have traditionally been thought of as the main type of financial intermediary, starting in the early 1980s new kinds of financial intermediaries like mutual funds and pension funds arose. These new types of intermediaries are now larger and more powerful than banks as participants in the securities markets.

2. Bulge bracket firms are the largest *Investment Banks* (IBs) providing a wide range of services. Bulge-bracket firms generally occupy the lead or co-lead manager's position in large new security offerings, meaning that they take primary responsibility for the new offering (even though other banks participate as part of a syndicate), and as a result, they earn higher fees.
3. The guiding principle behind legislation is full disclosure – that the firm must disclose all relevant financial, accounting and legal information to potential investors, so that the company and its bankers will not take advantage of investors who do not know as much as firm management or their bankers. Security registration requires that firms disclose information about the company, so investors can be aware of the firm's history, its past performance, and how it intends to use the funds from the securities issued.
4. IPO financing is cyclical. There are 'hot' and 'cold' markets when IPO activity peaks and then wanes. Industries may for a time be the 'hot' industry, for example, tech firms in the late 1990s. Previously, there were clusters of IPO activity in energy, biotechnology, and communications. Industries become popular at certain times because of their high growth rates and high returns. High tech companies had very high returns (but also high risk) in the late 1990s.
5. Less IPO money is raised in non-US countries, and international IPOs are generally smaller than US company IPOs. Like US IPOs, non-US issues often face significant first day underpricing, sometimes even larger than US IPO underpricing. US and international IPO companies also earn below average returns in the period following the IPO. Popular non-US IPOs are also oversubscribed, with allocation rules mandated by national law or exchange regulations. Hot issue markets occur internationally as well as in the US. Taxation issues, in particular capital gains tax issues, significantly affect how issues are priced. Many international governments impose rules on firms going public, such as requiring them to allocate minimum fractions of the issue to their employees or other targeted groups.
6. American Depositary Receipts are dollar-denominated claims issued by US banks that represent ownership of shares in a foreign company's stock held on deposit by the US bank in the issuing firm's home country. US banks create them. They are popular because they allow US investors to easily diversify internationally, even though ADRs do not allow US investors to eliminate foreign exchange risk. The shares are covered by US securities laws and pay dividends in dollars. Australian (and other non-US) companies have used these as a means of accessing larger funding markets and increasing their global profile.
7. In a *share issue privatisation*, a government sells all or part of its ownership in a state-owned enterprise to private investors via a public share offering. These have done a great deal to develop many national stock markets. SIPs tend to be very large and often dramatically increase the national market's volume and liquidity. SIPs are almost always secondary offerings – the proceeds go to the government rather than the firm being privatised. Governments underprice SIPs to create excess demand. The issuing government then allocates shares to ensure maximum political benefit. Governments typically favour employees and small domestic investors, with domestic institutions and foreign investors allocated fewer shares than desired.
8. The benefits of going public include: raising new capital for the company, providing publicly traded stocks that can be used in acquiring other companies, having listed shares that can be used to

compensate and retain key employees and providing personal wealth and liquidity for entrepreneurs. Key drawbacks include the high financial cost of an IPO (transactions fees for doing the deal), high managerial costs (management time taken up in managing the deal rather than the core business), external pressures to maximise share price once the firm has gone public, and required, continuing information disclosures.

9. In an equity carve-out, only part of the company's equity is sold. This is sometimes called a partial IPO. The parent company maintains control of the company typically, but gets the benefit of new capital raised in the external markets. In a spin-off, a part of the company becomes a new, stand-alone company. Wealth may be created because it is easier to value a spun off company, which will have its own set of financial statements. It may also be possible to structure management compensation contracts to more correctly reward managing the spun off business. The spun off business may be better focused than when it was a division of a larger company.
10. Underpricing refers to the fact that IPO shares typically rise on the first day of trading, indicating that they could have been priced higher to begin with. An unsophisticated investor who invests in IPOs is likely to earn lower than average returns. Some IPOs are underpriced, some very underpriced and some just slightly underpriced, while others are overpriced. Sophisticated investors with more information about the IPO will choose to invest only in the best, most underpriced deals. If an unsophisticated investor is able to invest in an IPO, it is probably because that IPO faces low demand because it is not priced favourably for the investor. In other words, if an average investor can buy into the deal, it is probably a below average deal.
11. Underpricing adds to the cost of going public because the company must issue more shares at a lower price, and ultimately raises less money with the IPO. If issues were correctly valued, the company could either raise more money or it would have less share value dilution, because it could issue fewer shares to raise the same amount of money.
12. A firm's share price goes down when it announces a seasoned equity offering. The market knows that the company knows more about the firm than average investors do, and will only issue new equity when the share is overvalued. The issuance of new equity sends a sell signal to investors. Some evidence shows that SEOs are bad news for shareholders over the one to five year period following the SEO – negative risk-adjusted returns have been observed in this time period.
13. Companies – and their shareholders – found that restricting share sales to existing shareholders severely restricted the potential market for new share sales. By voluntarily allowing public firms to make general cash offers to all investors, shareholders allowed companies to sell equity capital at much higher prices than would be possible if these were restricted to existing investors only.
14. Private placements are less costly in terms of time and money than registering with ASC or the SEC. Issuers do not have to reveal confidential information. Since fewer investors are involved, terms may be easier to negotiate. The disadvantages are that the issues don't have a readily available market price, are thus less liquid and the shares face a smaller group of potential investors than in the public market.

Solutions to Self-Test Problems

- ST12-1.** The Bloomington Company needs to raise \$20 million of new equity capital. Its ordinary equity is currently selling for \$42 per share. The investment bankers require an underwriting spread of 7% of the offering price, and the company's legal, accounting, and printing expenses associated with the seasoned offering are estimated to be \$450,000. How many new shares must the company sell to net \$20 million?

- A:** The Bloomington Company needs to raise $\$20,000,000 + \$450,000 = \$20,450,000$
 $7\% \times 42 = \$2.94$
 The shares will net $\$39.06$ a share ($\$42.00 - \2.94)
 $\$20,450,000 / \$39.06 = \underline{\underline{523,554}}$ shares

Answers to End-of-Chapter Questions

- Q12-1.** How should a corporation estimate the amount of financing that must be raised externally during a given year? Once that amount is known, what other decision must be made?
- A12-1.** The amount of financing a corporation needs depends on the capital budgeting projects that it wishes to accept and on its capability to generate financing internally. The rule is to accept all positive net present value projects. A corporation must also cover its additional working capital needs. Once it knows how much financing it requires, then it must decide whether this amount is externally or internally financed. If externally financed, then how much is financed with debt, hybrid securities or equity? If internally financed, how much of the corporation's net income should be retained and how much paid out as dividends?
- Q12-2.** What is the dominant source of capital funding in the United States? Given this result and the fact that most corporations are net borrowers, what decisions must most managers face in order to address this financial deficit?
- A12-2.** The dominant source of funding is internal financing. However, the amounts of internal and external financing are highly variable. A firm will generally borrow to make up its financing deficit if it is not generating enough internally to handle its investment needs.
- Q12-3.** Define the term *financial intermediary*. What role do financial intermediaries play in US corporate finance? How does this compare to the role of non-US financial intermediaries?
- A12-3.** A financial intermediary is an institution, such as a bank, that raises capital by issuing liabilities against itself, or a commercial bank or other entity that lends to corporations. Financial intermediaries play less of a role in financing US corporations than they do for non-US corporations. In many countries, intermediaries play a corporate governance role, for example, helping set the operating and financial policies of the firms they have invested in by serving on corporate boards and monitoring the performance of senior managers. In the US, commercial banks are largely prohibited from exercise a corporate governance role.
- Q12-4.** What are the general trends regarding public security issuance by US corporations? Specifically, which security type is most often sold to the public? What is the split between initial and seasoned equity offerings?
- A12-4.** US corporate issues account for a large proportion of total global securities issued. Companies issue far more debt than equity. Straight (nonconvertible) debt typically accounts for over 90% of total capital raised by US companies. Initial public offerings account for about a third of the total new equity capital raised in the capital markets, while seasoned equity offerings account for the remaining two-thirds.
- Q12-5.** Distinguish between a Eurobond, a foreign bond, and a Yankee bond. Which of these three represents the greatest volume of security issuance?
- A12-5.** A Eurobond is a single currency bond sold in several foreign countries simultaneously and denominated in a single currency. A foreign bond is an issue sold by a non-resident

corporation in a single foreign currency, denominated in the host country's currency. A Yankee bond is sold by a foreign corporation to US investors. Yankee bonds are the single largest category of foreign bond issues.

Q12-6. What do you think are the most important costs and benefits of becoming a publicly traded firm? What questions would you ask before advising whether or not an entrepreneur's firm should go public?

A12-6. The benefits of going public include: raising new capital for the company, providing publicly traded securities that can be used in acquiring other companies, having listed shares that can be used to compensate and retain key employees and providing personal wealth and liquidity for entrepreneurs. Key drawbacks include the high financial cost of an IPO (transactions fees for doing the deal), high managerial costs (management time taken up in managing the deal rather than the core business), external pressures to maximise share price once the firm has gone public, and required, continuing information disclosures. Important questions to ask an entrepreneur are: what are the firm's needs for future financing, how quickly is it growing, how reliable is his/her management team, how sound is the business model, and what are estimated revenues and costs for the company.

Q12-7. If you were an investment banker, how would you determine the offering price of an IPO?

A12-7. An investment banker determines the initial offer price through discounted cash flow analysis – looking at revenue, cost and investment projections for the company, then determining an appropriate discount rate and finally discounting the cash flows, to determine firm value. Debt is subtracted, leaving a value for the firm's equity. An investment banker is also likely to look at comparable firms and find a value for their client, based on multiples of comparable firms, such as price/earnings, price/cash flow, price/revenues, etc.

Q12-8. Are the significantly positive short-run and significantly negative long-run returns earned by IPO shareholders compatible with market efficiency? If not, why not?

A12-8. At first glance, high positive short-term returns on IPOs and negative risk-adjusted long-term returns seem inconsistent with market efficiency. In an efficient market, no investor should be able to follow an investment strategy that yields excess risk-adjusted profits. With regard to IPO returns, two strategies may at first glance appear to violate market efficiency. First, suppose an investor purchased IPO shares at the offer price each time a new IPO came to market, and the investor flipped those shares immediately in the aftermarket. Given that the average one-day IPO return is high, this strategy would appear to earn excess profits. However, several factors make this strategy difficult to implement. First, investment bankers often discourage flipping, so an investor who develops a reputation as a flipper of IPO shares may find that bankers stop offering him shares in new IPOs. Second, the IPOs with the highest first-day returns, so-called hot IPOs, are usually oversubscribed many times. This means that an investor's order for shares will be rationed for hot IPOs, whereas the investor will receive larger allocations in cold IPOs with lower first-day returns. The fact that IPOs seem to underperform in the long run suggests a second investment strategy. One might sell short IPO shares once they begin trading and take a long position in a portfolio of equally risky companies. The problem with this strategy is that many researchers have found that the long-run underperformance of IPOs is a phantom that results from mismeasuring the true risk of these firms. For example, as part of doing an IPO, a firm typically reduces its leverage, which reduces its risk. Lower risk means a lower expected or required rate of return. If one is not careful to take this into account, one might choose a benchmark portfolio which is in fact riskier than a portfolio of IPOs. If the benchmark portfolio earns higher returns than the IPO portfolio, this is hardly evidence against market efficiency.

Q12-9. List and describe briefly the key services investment banks provide to firms before, during, and after a securities offering.

A12-9. In preparing for an equity offering, an IB will file necessary documents with regulators, starting with the registration statement. The bankers must value the IPO shares, typically using discounted cash flow models and market comparables. The firm and its bankers go on a road show, talking about the offering to potential investors and getting an idea about demand and pricing of the shares. The lead underwriter distributes shares among the participating investment banks. Once trading begins, the underwriter may engage in price stabilisation to make sure sales don't falter immediately after their release to the public. After the offering is sold, the investment bank frequently serves as the market maker for trading in the firm's shares, which means it continuously quotes bid and ask prices for the new security.

Q12-10. Explain why the underwriting spread on IPOs averages about 7% of the offering price whereas the spread on a seasoned offering of common stock averages less than 5%?

A12-10. IPOs are riskier than SEOs, and investment bankers require higher compensation for taking more risk. The trading price of an existing company is known and makes pricing the SEO easier. Pricing brand new shares is more difficult and more error-prone.

Q12-11. Discuss the various issues that must be considered in selecting an investment banker for an IPO. Which type of placement is usually preferred by the issuing firm?

A12-11. A firm can choose a negotiated offer, in which the issuing firm negotiates the terms of the offer directly with an investment bank. In a competitive bid offer, the firm announces the terms of its intended equity sale, and investment banks bid for the business. Most equity sales are negotiated, rather than competitive bids. A negotiated bid may be advantageous because the information released in the negotiation raises the probability of a successful outcome for the issuer and this benefit may offset any additional costs that may result from less competition in the banker selection process. The IPO may be a best efforts agreement, in which the IB makes no guarantee about the success of the offering, but promises to sell as much of the issue as possible at the agreed-upon price. These are most common for small, high-risk companies. In a firm-commitment offering, the IB underwrites the issue, which means the investment bank purchases the shares from the firm and then resells the shares. This means the investment banker is taking on the risk of the offering. In selecting an investment banker to underwrite an IPO, firms will consider the banker's overall reputation, the amount of underwriting work they've done in the firm's industry, and whether the underwriter has a reputable analyst that will provide research coverage of the firm after the IPO.

Q12-12. In terms of IPO investing, what does it mean to *flip* a stock? According to the empirical results regarding short- and long-term returns following equity offerings, is flipping a wise investment strategy?

A12-12. Flipping a stock means buying shares at the IPO price and almost immediately selling the shares to realise high first-day returns. This is a wise investment practice – first day gains are positive and long run gains negative. However, investment banks discourage this practice, and may choose to sell to clients who promise not to flip their shares.

Q12-13. What materials are presented in an IPO *prospectus*? In general, what result is documented regarding sales of shares by insiders and venture capitalists?

A12-13. The prospectus provides the following information:

- number of shares offered
- details of the underwriting agreement

- description of the company and its products
- how issue proceeds will be used
- financial summary of operating results for the past few years
- simplified balance sheet
- company history
- company risk factors
- whether insiders will control a majority of the votes after the offering
- how the firm will be governed after the IPO (whether directors will be company insiders)
- compensation of the firm's top managers
- auditors statement

Insiders and VCs rarely sell large fractions of their ownership stakes at the IPO. Investment banks generally prohibit these kinds of sales through lockup agreements. Furthermore, insiders and VCs know that if they sell their shares immediately after the IPO, the market will interpret this in a negative light.

Q12-14. What are *American Depositary Receipts (ADRs)*, and why have they proven so popular with Australian companies and US investors?

A12-14. American Depositary Receipts are dollar denominated claims issued by US banks which represent ownership of shares in a foreign company's shares held on deposit by the US bank in the issuing firm's home country. They are created by US banks. They are popular because they allow US investors to easily diversify internationally. The shares are covered by US securities laws and pay dividends in dollars. They provide Australian companies with the ability to access another, larger funding source – the US market – and increase their global visibility.

Q12-15. How do you explain the highly politicised nature of *share issue privatisation (SIP)* pricing and share allocation policies? Are governments maximising offering proceeds, or are they pursuing primarily political and economic objectives?

A12-15. The higher the growth rate of cash flows, the higher the terminal value of the project. A project where cash flows level off in time will have a much smaller terminal value. Many of these transactions are with respect to assets or projects that generate oligopolistic or monopolistic profits. There is an argument that privatising these makes consumers susceptible to higher prices, since the companies are required to maximise shareholder returns, rather than consumer utility and welfare.

Answers to End-of-Chapter Problems

Investment Banking and the Public Sale of Securities

P12-1. West Coast Manufacturing Company (WCMC) is executing an initial public offering with the following characteristics. The company will sell 10 million shares at an offer price of \$25 per share, the underwriter will charge a 7% underwriting fee, and the shares are expected to sell for \$32 per share by the end of the first day's trading. Assuming this IPO is executed as expected, answer the following:

- a. Calculate the initial return earned by investors who are allocated shares in the IPO.
- b. How much will WCMC receive from this offering?
- c. What is the total cost (underwriting fee and underpricing) of this issue to WCMC?

A12-1. a. Investors who can buy at the \$25 offer price will have realised a 28% gain in one day as the price rises to \$32.

b. WCMC will receive $(\$25) (0.93) (10,000,000) = \232.5 million

c. The total cost of the issue is simply the difference between the market value of the shares sold in the offering and the net proceeds received by the company. At the end of one trading day, the shares are worth \$320 million. Of this, the firm received \$232.5 million, so the total cost of the issue is \$87.5 million.

P12-2. Suppose you purchase shares of Engel Pty. Ltd. (EI), which recently executed an IPO at the post-offering market price of \$32 per share, and you hold the shares for one year. You then sell your shares for \$35 per share. EI does not pay dividends, and you are not subject to capital gains taxation. During this year, the return on the overall market was 11%. What net return did you earn on your EI share investment? Assess this return in light of the overall market return.

A12-2. The EI investment grew from \$32 to \$35 in one year, equivalent to a 9.375% return. In the same period, the stock market returned 11%. You would have made a higher return by investing in the broad market rather than buying shares in the IPO.

P12-3. Norman Internet Service Company (NISC) is interested in selling ordinary equity to raise capital for capacity expansion. The firm has consulted First Tulsa Company, a large underwriting firm, which believes that the stock can be sold for \$50 per share. The underwriter's investigation found that its administrative costs will be 2.5% of the sale price and its selling costs will be 2.0% of the sale price. If the underwriter requires a profit equal to 1% of the sale price, how much spread (in dollars) is necessary to cover the underwriter's costs and profit?

A12-3. $2\% + 2.5\% + 1\% = 5.5\%$

$$5.5\% \times 50 = \$2.75$$

P12-4. The Mitchell Company needs to raise \$50 million of new equity capital. Its common stock is currently selling for \$50 per share. The investment bankers require an underwriting spread of 3% of the offering price. The company's legal, accounting, and printing expenses, associated with the secondary offering, are estimated to be \$750,000. How many new shares must the company sell to net \$50 million?

A12-4. The Mitchell Company needs to raise $\$50,000,000 + \$750,000 = \$50,750,000$

$$3\% \times 50 = \$1.50$$

The shares will net \$48.50 a share ($\$50 - \1.50)

$$\$50,750,000 / \$48.50 = 1,046,392 \text{ shares}$$

P12-5. LaJolla Securities Inc. specialises in the underwriting of small companies. The terms of a recent offering were as follows:

Number of shares	2 million
Offering price	\$25 per share
Net proceeds	\$45 million

LaJolla Securities' expenses associated with the offering were \$500,000. Determine LaJolla Securities' profit on the offering if the secondary market price of the shares immediately after the offering began were as follows:

- \$23 per share
- \$25 per share
- \$28 per share

A12-5. a. The underwriter buys 2 million shares from the firm and pays \$45 million. If the underwriter then sells these shares to the public at \$23 each, then their profit is just \$0.5 million. (2

million shares times \$23, minus \$45 million paid to the firm, minus \$0.5 million in expenses).

- b. If the underwriter can sell 2 million shares at \$25 each, then their profit is \$4.5 million.
- c. If the underwriter sells 2 million shares at \$28 each, then their profit is \$10.5 million.

The Market for Initial Public Offerings (IPOs)

P12-6 Find an Internet site that provides data on recent IPOs, and pick 4 companies that conducted an IPO in recent weeks. Write down the ticker symbols and offer prices for the firms you select; then go to Yahoo! and download daily price quotes since the IPO date. For each firm, calculate the following:

- a. The percentage return measured from the offer price to the closing price the first day
- b. The percentage return measured from the opening price to the closing price the first day

A12-6. Answers will vary.

P12-7. Four companies conducted IPOs last month: Hot.Com, Biotech Pipe Dreams Corp., Sleepy Tyme Pty. Ltd., and Bricks N Mortar International. All four companies went public at an offer price of \$10 per share. The first-day performance of each share (measured as the percentage difference between the IPO offer price and the first-day closing price) was as follows:

Company	First-Day Return
Hot.Com	45%
Biotech Pipe Dreams	30%
Sleepy Tyme	5%
Bricks N Mortar	0%

- a. If you submitted a bid through your broker for 100 shares of each company, if your orders were filled completely, and if you cashed out of each deal after one day, what was your average return on these investments?
- b. Next, suppose your orders were not all filled completely because of excess demand for hot IPOs. Specifically, after ordering 100 shares of each company, you were able to buy only 10 shares of Hot.Com, 20 shares of Biotech Pipe Dreams, 50 shares of Sleepy Tyme, and 100 shares of Bricks N Mortar. Recalculate your average return, taking into account that your orders were only partially filled.

A12-7. a. Because you purchased equal dollar amounts of each company, the weight attached to each investment in the average return calculation is just 25%. Therefore, your average return is 20%:

$$(45\% + 30\% + 5\% + 0\%) / 4 = 20\%$$

- b. Now you have to apply different weights to each IPO's return to calculate your average return: In total, you purchased 180 shares, each of which was priced at \$10. Therefore, the fraction you invested in Hot.Com was 10/180, the fraction invested in Biotech Pipe Dreams was 20/180, and so on. The average return on the portfolio is:

$$(10/180) 45\% + (20/180) 30\% + (50/180) 5\% + (100/180) 0\% = 7.22\%$$

Seasoned Equity Offerings

P12-8. GSM Corporation sold 20 million shares of ordinary equity in a seasoned offering. The market price of the company's shares immediately before the offering was \$14.75. The shares were offered to the public at \$14.50, and the underwriting spread was 4%. The company's expenses associated with the offering were \$7.5 million. How much new cash did the company receive?

- A12-8.** The shares are sold to the public at \$14.50, but with an underwriting spread of 4%, the company only receives 96% of the selling price. Therefore, the net proceeds from the offering are:

$$\$20,000,000(14.50)(0.96) - \$7,500,000 = \$270,900,000.$$

- P12-9.** After a banner year of rising profits and positive stock returns, the managers of Raptor Pharmaceuticals (RP) decided to launch a seasoned equity offering to raise new equity capital. RP currently has 10 million shares outstanding, and yesterday's closing market price was \$75.00 per RP share. The company plans to sell 1 million newly issued shares in its seasoned offering. The investment banking firm Robbum and Blindum (R&B) has agreed to underwrite the new share issue for a 2.5% discount from the offering price, which RP and R&B have agreed should be \$0.75 per share lower than RP's closing price the day before the offering is sold.

- What is likely to happen to RP's stock price when the plan for this seasoned offering is publicly announced?
- Assume that RP's stock price closes at \$72.75 per share the day before the seasoned offering is launched. What net proceeds will RP receive from this offering?
- Calculate the return earned by RP's *existing* stockholders on their shares from the time preceding the announcement of the seasoned offering through the time it was actually sold for \$72.75 per share.
- Calculate the total cost of the seasoned equity offering to RP's existing shareholders as a percentage of the offering proceeds.

- A12-9.**
- Seasoned equity issue announcements usually cause the share price to fall by about 3 per cent, so RP's announcement of its planned offering would cause the stock price to fall from \$75.00/share to \$72.75/share ($\$75 \times 0.97$).
 - If RP shares close at \$72.75 per share immediately before the offering is launched, and the offering will be priced at a \$0.75/share discount to this price, the gross offering price will be set at \$72.00/share. Additionally, R&B's underwriting discount will be 2.5%, so the net proceeds to RP will be only \$70.20/share ($\72.00×0.975), or \$70,200,000 for the entire offering of 1,000,000 newly issued shares.
 - Immediately prior to the offering, an RP shareholder's shares were worth \$75.00 each, but after the offering these shares are worth only \$72.00/share. Existing shareholders thus suffer a loss of 4.0% on their shares [$(\$75 - \$72) \div \$75 = -0.04$].
 - Immediately prior to the offering, the total value of RP's 10 million shares was \$750 million (10,000,000 shares \times \$75.00/share = \$750,000,000). After the offering, the total market value of RP's 11 million shares is \$792 million ($\$72/\text{sh} \times 11,000,000 = \$792,000,000$), but RP's existing shareholders own only ten-elevenths of this amount, or \$720 million ($0.9091 \times \$792,000,000$). So RP's existing shareholders suffered a wealth loss of \$30 million (\$750 million value before – \$720 million value afterward) on this offering. Additionally, RP 'paid' R&B \$1.80/share, or \$1,800,000 total, in the form of the underwriter discount [$1,000,000 \text{ shares} \times (\$72 \text{ offer price} - \$70.20 \text{ net price to RP})$]. Thus RP and its shareholders incurred a total cost of \$31,800,000 (\$30 million wealth loss + \$1.8 million underwriting fee) so that the firm could raise \$70,200,000 in net new funds. For RP's existing shareholders, the net cost of this new issue was thus 45.30% ($\$31,800,000 \div \$70,200,000 = 0.4530$).

Answer to MiniCase

Raising Long-Term Financing

Since graduation from college, you have worked at Precision Manufacturing Pty Ltd, as a financial analyst. You have recently been promoted to the position of senior financial manager, with responsibilities that include capital budgeting decisions and the raising of long-term financing. Therefore, you decide to investigate the various alternatives for raising funds. Your goal is to make sure that the benefits received from undertaking long-term projects are greater than the costs of raising the long-term funds needed to finance those projects. With this goal in mind, you decide to answer the following questions.

Assignment

1. What should managers consider when making the decision whether to finance internally or externally?
2. What services does an investment banker offer to businesses that choose to raise funds in the capital market?
3. What are the benefits to the company of going public?
4. What are the drawbacks to the corporation of going public?
5. What returns can investors in the ordinary equity expect on the first day of trading if they commit to purchase shares through the IPO issue? What factors may affect the relative amount of these first-day returns?
6. Describe the following offers: (a) seasoned equity offer; (b) rights offer, and (c) private placement. In what circumstances would a company use each of these offerings to raise funds?
7. Discuss the differences between international public offerings and domestic (US) public offerings.

Answers

1. The decision of whether to finance internally or externally is based upon the amount of working capital available, the desire to increase or decrease these working capital stocks over time, and the firm's current and future dividend policy. In a general sense the amount of net external financing a firm requires each year is a residual amount, calculated as the difference between the firm's total capital needs and its cash flow from operations (net of dividend payments). Although this residual amount varies by year, managers will try to estimate future needs over multiple years when assessing external funding needs since external funds are typically raised in large sums to minimise transactions costs and informational effects.
2. Investment bankers provide services before, during, and after corporate security offerings. Before the offering the investment bank will assist the firm in filing the necessary documents with regulators, starting with the registration statement. The investment bank must also begin to estimate the value of the securities the firm intends to sell. As part of this process and to solicit demand, the firm and its bankers take a whirlwind tour of major domestic and international cities. This process is referred to as the road show, with the goal being to build a book of orders for shares that is greater (often many times greater) than the amount of shares the firm intends to sell. The lead underwriter is charged with conducting the security offering, ensuring that on the issue date participating investors receive their shares, as well as a copy of the final prospectus. Once a firm's securities begin trading, the underwriter may engage in price stabilisation. In addition, after a share offering is successfully sold, the lead underwriter often serves as the principal market maker for trading in the firm's stock.
3. The benefits to a company of going public include; (a) obtaining new capital for the company, (b) having publicly traded shares for use in acquisitions, (c) having listed shares that can be used as compensation, and (d) enhancing the personal wealth and liquidity of the corporate founders.
4. The drawbacks to a corporation of going public include; (a) the financial costs related with undertaking the offering, (b) managerial costs, (c) the potential overemphasis on share price, and (d) the necessity for an increase in information disclosure.

5. In the United States, the share price in the typical IPO closes roughly 15 per cent above the offer price on the first day of trading. This is referred to as IPO underpricing. In the United States investors' that purchase shares of newly listed shares on the first day of trading and hold these shares for the next five years earn returns that, on average, are over 40 per cent below what they would have earned after five years on alternative equity investments.
6. Seasoned equity offerings (SEOs) are subsequent offers of ordinary equity after the firm has gone public through the IPO. SEOs are relatively rare due to transactions costs and because the announcement of seasoned equity issues conveys negative information to investors. A rights offering is a special type of seasoned equity offering that allows the firm's existing owners to buy new shares at a bargain price or to sell that right to other investors. A private placement involves the sale of securities in a transaction that is exempt from the registration requirements imposed by federal securities law.
7. The international market for equity offerings can be broken down into two parts: (a) each nation's market for domestic stock offerings, and (b) the international market for equity offerings.

For domestic stock offerings in markets outside the United States, the total number of IPOs usually exceeds the number in American by a wide margin each year. However, since these international IPOs are typically much smaller in dollar terms than those in the United States, the total amount of money raised is much smaller outside the US market.

International IPO markets for equity offerings differ in several ways from US markets including the following. The imposition of politically inspired mandates requiring firms going public to allocate minimum fractions of the issue to their employees or to other targeted groups. The prohibition by some governments (including ones as advanced as Japan's) of firms from making IPOs during periods when market conditions are 'unsettled' and/or require explicit permission to be obtained before an IPO can be launched. The requirement that initial offering prices be set far in advance of the issue. The motivation of non-US entrepreneurs for taking firms public is often very different that of the owner/managers of US private companies. For example, whereas many US companies go public to acquire the equity capital needed to finance rapid growth, continental European (specifically, Italian) entrepreneurs go public mainly to rebalance their firms' capital structures and to achieve personal liquidity.