

# Key Concepts and Skills

- Understand the venture capital market and its role in financing new businesses
- Understand how securities are sold to the public and the role of investment bankers
- Understand initial public offerings and the costs of going public
- Understand how rights are issued to existing shareholders and how the rights are valued

# Chapter Outline

- The Financing Life Cycle of a Firm: Early-Stage Financing and Venture Capital
- Selling Securities to the Public: The Basic Procedure
- Alternative Issue Methods
- Underwriters
- IPOs and Underpricing
- New Equity Sales and the Value of the Firm
- The Cost of Issuing Securities
- Rights
- Dilution
- Issuing Long-Term Debt
- Shelf Registration

# Venture Capital

- Private financing for relatively new businesses in exchange for equity
- Usually entails some hands-on guidance
- The company should have an “exit” strategy
  - Sell the company – VC benefits from proceeds from sale
  - Take the company public – VC benefits from IPO
- Many VC firms are formed from a group of investors that pool capital and then have partners in the firm decide which companies will receive financing
- Some large corporations have a VC division



# Choosing a Venture Capitalist

- Look for financial strength
- Choose a VC that has a management style that is compatible with your own
- Obtain and check references
- What contacts does the VC have?
- What is the exit strategy?



# Selling Securities to the Public

- Management must obtain permission from the Board of Directors
- Firm must file a registration statement with the SEC
- The SEC examines the registration during a 20-day waiting period
  - A preliminary prospectus, called a red herring, is distributed during the waiting period
  - If there are problems, the company is allowed to amend the registration and the waiting period starts over
- Securities may not be sold during the waiting period
- The price is determined on the effective date of the registration

# Table 15.2 - I

Method	Type	Definition
Public Traditional negotiated cash offer	Firm commitment cash offer	The company negotiates an agreement with an investment banker to underwrite and distribute the new shares. A specified number of shares are bought by underwriters and sold at a higher price.
	Best efforts cash offer	The company has investment bankers sell as many of the new shares as possible at the agreed-upon price. There is no guarantee concerning how much cash will be raised.
	Dutch auction cash offer	The company has investment bankers auction shares to determine the highest offer price obtainable for a given number of shares to be sold.
Privileged subscription	Direct rights offer	The company offers the new stock directly to its existing shareholders.
	Standby rights offer	Like the direct rights offer, this contains a privileged subscription arrangement with existing shareholders. The net proceeds are guaranteed by the underwriters.

# Table 15.2 - II

Nontraditional cash offer	Shelf cash offer	Qualifying companies can authorize all shares they expect to sell over a two-year period and sell them when needed.
	Competitive firm cash offer	The company can elect to award the underwriting contract through a public auction instead of negotiation.
Private	Direct placement	Securities are sold directly to the purchaser, who, at least until recently, generally could not resell securities for at least two years.

# Underwriters

- Services provided by underwriters
  - Formulate method used to issue securities
  - Price the securities
  - Sell the securities
  - Price stabilization by lead underwriter
- Syndicate – group of investment bankers that market the securities and share the risk associated with selling the issue
- Spread – difference between what the syndicate pays the company and what the security sells for initially in the market

# Firm Commitment Underwriting

- Issuer sells entire issue to underwriting syndicate
- The syndicate then resells the issue to the public
- The underwriter makes money on the spread between the price paid to the issuer and the price received from investors when the stock is sold
- The syndicate bears the risk of not being able to sell the entire issue for more than the cost
- Most common type of underwriting in the United States

# Best Efforts Underwriting

- Underwriter must make their “best effort” to sell the securities at an agreed-upon offering price
- The company bears the risk of the issue not being sold
- The offer may be pulled if there is not enough interest at the offer price. In this case, the company does not get the capital, and they have still incurred substantial flotation costs
- Not as common as it previously was

# Dutch Auction Underwriting

- Underwriter accepts a series of bids that include number of shares and price per share
- The price that everyone pays is the highest price that will result in all shares being sold
- There is an incentive to bid high to make sure you get in on the auction but knowing that you will probably pay a lower price than you bid
- The Treasury has used Dutch auctions for years
- Google was the first large Dutch auction IPO

# Green Shoes and Lockups

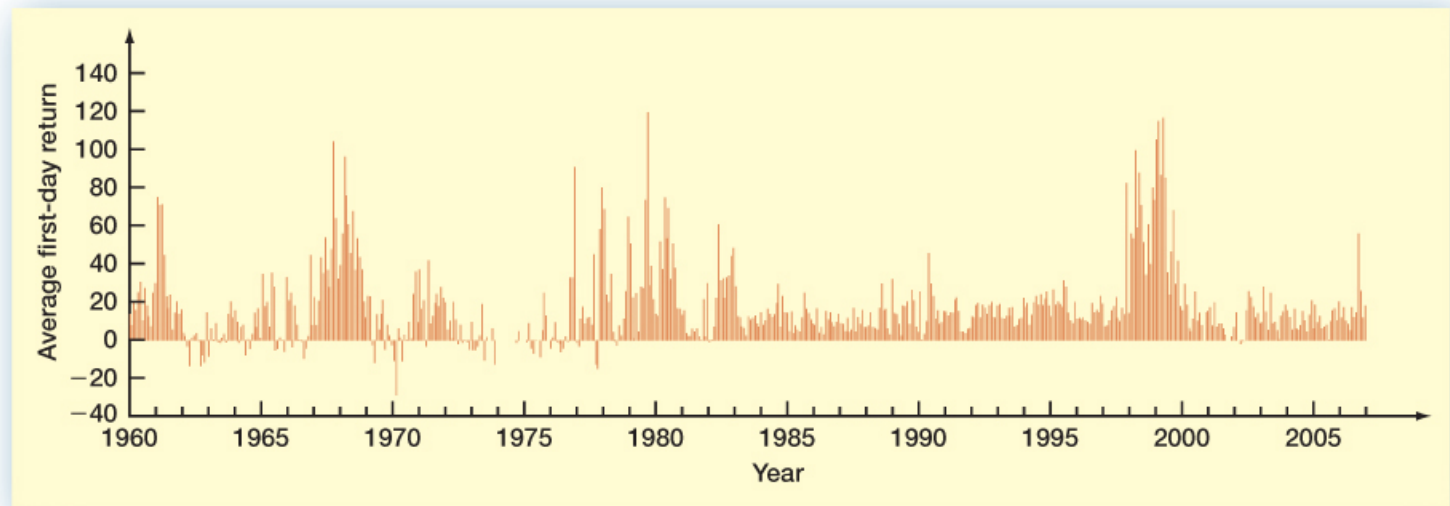
- Green Shoe provision
  - Allows the syndicate to purchase an additional 15% of the issue from the issuer
  - Allows the issue to be oversubscribed
  - Provides some protection for the underwriters as they perform their price stabilization function
- Lockup agreements
  - Restriction on insiders that prevents them from selling their shares of an IPO for a specified time period
  - The lockup period is commonly 180 days
  - The stock price tends to drop when the lockup period expires due to market anticipation of additional shares hitting the street

# IPO Underpricing

- May be difficult to price an IPO because there isn't a current market price available
- Private companies tend to have more asymmetric information than companies that are already publicly traded
- Underwriters want to ensure that, on average, their clients earn a good return on IPOs
- Underpricing causes the issuer to “leave money on the table”

# Figure 15.2

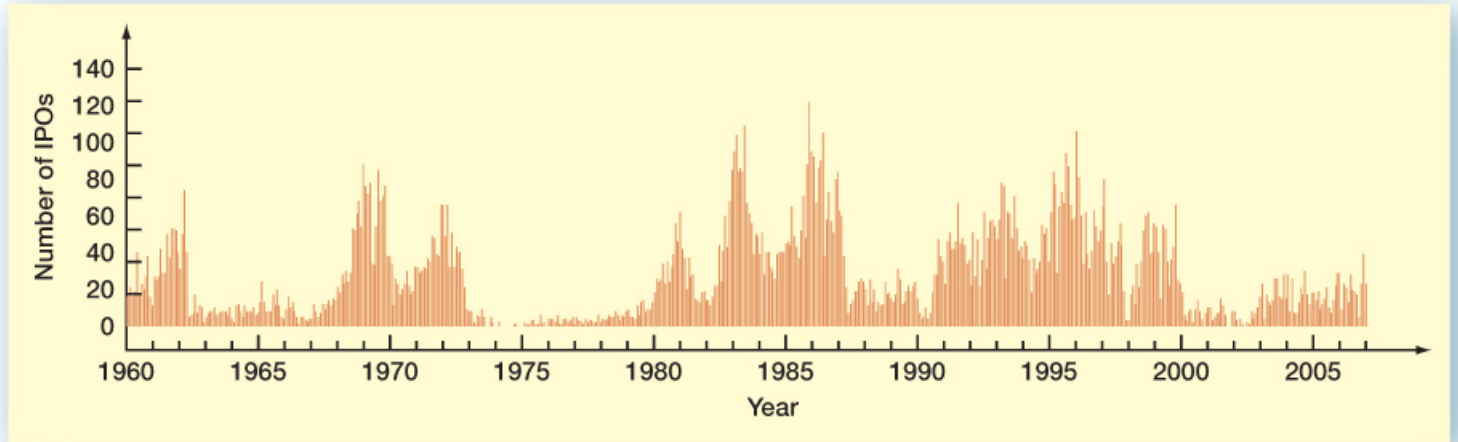
**FIGURE 15.2** Average Initial Returns by Month for SEC-Registered Initial Public Offerings: 1960–2007



SOURCE: R.G. Ibbotson, J.L. Sindelar, and J.R. Ritter, "The Market's Problems with the Pricing of Initial Public Offerings," *Journal of Applied Corporate Finance* 7 (Spring 1994), as updated by the authors.

# Figure 15.3

**FIGURE 15.3** Number of Offerings by Month for SEC-Registered Initial Public Offerings: 1960–2007



SOURCE: R.G. Ibbotson, J.L. Sindelar, and J.R. Ritter, "The Market's Problems with the Pricing of Initial Public Offerings," *Journal of Applied Corporate Finance* 7 (Spring 1994), as updated by the authors.

# Work the Web Example

- How have recent IPOs done?
- Click on the web surfer to go to Hoovers and follow the “IPO Central” link
  - Look at the IPO Scorecard and Money Left on the Table to see how much underpricing there has been in recent issues
  - What other information can you find on IPOs at this site?




# New Equity Issues and Price

- Stock prices tend to decline when new equity is issued
- Possible explanations for this phenomenon
  - Signaling and managerial information
  - Signaling and debt usage
  - Issue costs
- Since the drop in price can be significant and much of the drop may be attributable to negative signals, it is important for management to understand the signals that are being sent and try to reduce the effect when possible

# Issuance Costs

- Spread
- Other direct expenses – legal fees, filing fees, etc.
- Indirect expenses – opportunity costs, i.e., management time spent working on issue
- Abnormal returns – price drop on existing stock
- Underpricing – below market issue price on IPOs
- Green Shoe option – cost of additional shares that the syndicate can purchase after the issue has gone to market

# Rights Offerings: Basic Concepts

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- Issue of common stock offered to existing shareholders
  - Allows current shareholders to avoid the dilution that can occur with a new stock issue
  - “Rights” are given to the shareholders
    - Specify number of shares that can be purchased
    - Specify purchase price
    - Specify time frame
  - Rights may be traded OTC or on an exchange

# The Value of a Right

- The price specified in a rights offering is generally less than the current market price
- The share price will adjust based on the number of new shares issued
- The value of the right is the difference between the old share price and the “new” share price

# Rights Offering Example

- Suppose a company wants to raise \$10 million. The subscription price is \$20, and the current stock price is \$25. The firm currently has 5,000,000 shares outstanding.
  - How many shares must be issued?
  - How many rights will it take to purchase one share?
  - What is the value of a right?

# Dilution

- Dilution is a loss in value for existing shareholders
  - Percentage ownership – shares sold to the general public without a rights offering
  - Market value – firm accepts negative NPV projects
  - Book value and EPS – occurs when market-to-book value is less than one

# Types of Long-Term Debt

- Bonds – public issue of long-term debt
- Private issues
  - Term loans
    - Direct business loans from commercial banks, insurance companies, etc.
    - Maturities 1 – 5 years
    - Repayable during life of the loan
  - Private placements
    - Similar to term loans but with longer maturity
  - Easier to renegotiate than public issues
  - Lower costs than public issues

# Shelf Registration

- Permits a corporation to register a large issue with the SEC and sell it in small portions over a two-year period
- Reduces the flotation costs of registration
- Allows the company more flexibility to raise money quickly
- Requirements
  - Company must be rated investment grade
  - Cannot have defaulted on debt within last three years
  - Market value of stock must be greater than \$150 million
  - No violations of the Securities Act of 1934 in the last three years

# Quick Quiz

- What is venture capital, and what types of firms receive it?
- What are some of the important services provided by underwriters?
- What type of underwriting is the most common in the United States, and how does it work?
- What is IPO underpricing, and why might it persist?
- What are some of the costs associated with issuing securities?
- What is a rights offering, and how do you value a right?
- What are some of the characteristics of private placement debt?
- What is shelf registration?

# Ethics Issues

- Brokers have been known to sell securities based on sales scripts that have little to do with the information provided in the prospectus. Also, investors often make investment decisions before receiving (or reading) the prospectus. Who is at greater fault in this case?
- Traditionally, IPO share allocations have been reserved for the underwriting syndicates' best customers. What ethical implications exist.

# Comprehensive Problem

- A company wants to raise \$20 million. The subscription price is \$40, and the current stock price is \$50. The firm currently has 5,000,000 shares outstanding.
  - How many shares must be issued?
  - How many rights will it take to purchase one share?
  - What is the value of a right?



End of Chapter