

Chapter 10

Stock Offerings and Investor Monitoring

Outline

Private Equity

- Financing by Venture Capital Funds
- Financing by Private Equity Funds

Public Equity

- Ownership and Voting Rights
- Preferred Stock
- Participation in Stock Markets

Initial Public Offerings

- Process of Going Public
- Underwriter Efforts to Ensure Price Stability
- Timing of IPOs
- Initial Returns of IPOs
- Google's IPO
- Facebook's IPO
- Abuses in the IPO Market
- Long-Term Performance Following IPOs

Stock Offerings and Repurchases

- Secondary Stock Offerings
- Stock Repurchases

Stock Exchanges

- Organized Exchanges
- Over-the-Counter Market
- Extended Trading Sessions
- Stock Quotations Provided by Exchanges
- Stock Index Quotations
- Private Stock Exchanges

Monitoring Publicly Traded Companies

- Role of Analysts
- Accounting Irregularities
- Sarbanes-Oxley Act
- Shareholder Activism
- Limited Power of Governance

Market for Corporate Control

Use of LBOs to Achieve Corporate Control
Barriers to the Market for Corporate Control

Globalization of Stock Markets

Privatization
Emerging Stock Markets
Variation in Characteristics Among Stock Markets
Methods Used to Invest in Foreign Stocks

Key Concepts

1. Explain the role of venture capital funds and private equity funds provide equity financing to firms.
2. Describe the process of an engaging in an initial public offering.
3. Describe the process of engaging in a secondary offering.
4. Explain how firms are monitored within the stock market.

POINT/COUNTER-POINT:

Should a Stock Exchange Enforce Some Governance Standards on the Firms Listed on the Exchange?

POINT: No. Governance is the responsibility of the firms, not the stock exchange. The stock exchange should simply ensure that the trading rules of the exchange are enforced and should not intervene in the firms' governance issues.

COUNTER-POINT: Yes. By enforcing governance standards such as requiring a listed firm to have a majority of outside members on its board of directors, a stock exchange can enhance its own credibility.

WHO IS CORRECT? Use the Internet to learn more about this issue and then formulate your own opinion.

ANSWER: An exchange and the listed firms can be viewed as more credible if there are governance standards. However, the credibility of an exchange is questionable if it cannot properly monitor itself properly (as was the case for the NYSE when the board allowed some excessive compensation to executives who managed the exchange).

Questions

1. **Shareholder Rights.** Explain the rights of common stockholders that are not available to other individuals.

ANSWER: Common stockholders are permitted to vote on key matters concerning the firm such as the election of the board of directors, authorization to issue new shares of common stock, approval of amendments to the corporate charter, and adoption of by-laws.

2. **Stock Offerings.** What is the danger of issuing too much stock? What is the role of the securities firm that serves as the underwriter, and how can it ensure that the firm does not issue too much stock?

ANSWER: The issuance of too much stock can cause dilution of ownership, and can depress stock prices because the supply of stock may now exceed demand.

Securities firms distribute or place stock for corporations. They serve as intermediaries since corporations issuing stock typically do not have the expertise to place their own stock. They have experience to know how much stock can be digested by the market.

3. **IPOs.** Why do firms engage in IPOs? What is the amount of fees that the lead underwriter and its syndicate charge a firm that is going public? Why are there many IPOs in some periods and few IPOs in other periods?

ANSWER: Firms engage in IPOs when they have feasible expansion plans but are already near their debt capacity.

The transaction cost (fees) is normally about 7 percent of the gross proceeds received by the issuing firm.

Firms prefer to engage in IPOs when business conditions and market conditions are favorable. They avoid IPOs if business conditions are poor, because they do not need funds to expand if the business outlook is poor. Also, when business conditions are poor, the market conditions are weak, meaning that they would have to sell their shares at a low price.

4. **Venture Capital.** Explain the difference between obtaining funds from a venture capital firm and engaging in an IPO. Explain how the IPO may serve as a means by which the venture capital firm can cash out.

ANSWER: Before a firm engages in an IPO, it may obtain equity funding from a venture capital firm for a period of two to five years. An IPO allows other shareholders to invest in the equity of the firm.

Venture capital firms tend to sell off their shares shortly after the firm engages in an IPO. After the shares are publicly traded, the venture capital firm may sell its shares in the secondary market.

5. **Prospectus and Road Show.** Explain the use of a prospectus developed before an IPO. Why does a firm do a road show before its IPO? What factors influence the offer price of stock at the time of the IPO?

ANSWER: A prospectus specifies how the proceeds of the offering are to be used, the past performance of the issuing firm, the risk involved in the firm's business, and the price range in which the shares will be offered.

The firm does a road show to promote its offering. That is, it explains to various institutional investors how it will use the funds to support its expansion. The goal of the road show is to convince some large investors to invest in the shares of the firm.

The offer price is influenced by market conditions, industry conditions, and the prevailing market multiples (such as price/earnings ratio). Firms prefer to engage in an IPO when market conditions allow for a high offer price.

6. **Bookbuilding.** Describe the process of bookbuilding. Why is bookbuilding sometimes criticized as a means of setting the offer price?

ANSWER: The lead underwriter engages in bookbuilding by soliciting indications of interest in the IPO by institutional investors, so as to determine demand. The bookbuilding process used in the United States is sometimes criticized because it dictates an offer price that is lower than what some institutional investors would pay.

7. **Lockups.** Describe a lockup provision and explain why it is required by the lead underwriter.

ANSWER: Describe the pressure of the share price at the lockup expiration date. The lockup provision restricts insiders and venture capital firms from selling their shares until a specified period (usually 6 months) after the IPO. Once the lockup provision expires, the insiders and venture capital firms can sell the shares that they own, which sometimes places downward pressure on the price of the stock at that time.

8. **Initial Return.** What is the meaning of an initial return for an IPO? Were initial returns of Internet IPOs in the late 1990s higher or lower than normal? Why?

ANSWER: The initial return is the return from the offer price until the end of the first day of trading. The initial returns of Internet IPOs in the late 1990s were high, because many investors wanted to invest in them.

9. **Flipping.** What does it mean to “flip” shares? Why would investors want to flip shares?

ANSWER: Flipping shares refers to selling shares shortly after (such as a day or two) obtaining them at the IPO. Some institutional investors attempt to flip shares to take advantage of an initial return over the first day. IPO performance tends to be unusually high on the first day, followed by a downward drift. Some investors want to earn the initial return and then sell out. They may earn a very high return without tying their funds up for a long period of time.

10. **Performance of IPOs.** How do IPOs perform over the long run?

ANSWER: IPOs perform poorly on average when compared to other firms over the long-term period.

11. **Asymmetric Information.** Discuss the concept of asymmetric information. Explain why it may motivate firms to repurchase some of their stock.

ANSWER: Asymmetric information may allow a firm’s managers to realize when its stock is undervalued, and they may repurchase shares at that time.

12. **Stock Repurchases.** Explain why the stock price of a firm may rise when the firm announces that it is repurchasing its shares.

ANSWER: Stock repurchases may signal that the firm’s managers believe the stock is undervalued, so the investors may purchase the stock based on this signal, and that places upward pressure on the stock price.

13. **Corporate Control.** Describe how the interaction between buyers and sellers affects the market value

of a firm, and explain how that value can subject a firm to the market for corporate control.

ANSWER: If a firm's business performance is weak, investor demand for shares will typically be weak, and the firm's stock price will be weak. Another firm's managers may consider purchasing the weak firm at its prevailing weak price, and then improving that firm's performance by replacing managers and reorganizing that firm. Managers of the weak firm have an incentive to improve their firm to prevent the firm from being acquired.

- 14. ADRs.** Explain how ADRs enable U.S. investors to become part owners of foreign companies.

ANSWER: American depository receipts (ADRs) are certificates that represent ownership of a foreign stock. They are traded in the United States. U.S. investors can purchase ADRs as a method of investing in foreign securities.

- 15. NYSE.** Explain why stocks traded on the NYSE generally exhibit less risk than stocks that are traded on other exchanges.

ANSWER: Stocks traded on the NYSE tend to represent larger firms. These stocks also have a large trading volume, which enhances their liquidity.

- 16. Role of Organized Exchanges.** Are organized stock exchanges used to place newly issued stock? Explain.

ANSWER: Organized exchanges are used to facilitate secondary market transactions. They are not used to place newly issued stock.

Advanced Questions

- 17. Role of IMFs.** How have international mutual funds (IMFs) increased the international integration of capital markets among countries?

ANSWER: International mutual funds (IMFs) have allowed investors easy access to foreign securities, since the firm sponsoring the IMFs makes the portfolio decisions and executes the transactions. Even small investors can easily invest in foreign securities by purchasing shares of IMFs. Consequently, international capital markets have become more integrated.

- 18. Spinning and Laddering.** Describe spinning and laddering in the IPO market. How do you think these actions influence the price of a newly issued stock? Who is adversely affected as a result of these actions?

ANSWER: Spinning is the process in which an investment bank allocates shares from an IPO to corporate executives who may be considering an IPO or other business that would require the help of an investment bank. Laddering involves investors placing bids for IPO shares on the first day that are above the offer price.

Laddering ultimately results in upward price momentum, which may or may not accurately reflect the fair value of the underlying stock. If spinning occurs at favorable stock prices, this may keep the stock price from achieving its fair value.

The initial owners of the firm may be adversely affected because the firm may not receive as much proceeds from the IPO due to spinning and laddering. Spinning may result in shares sold at a lower than market price. Laddering might only occur if there is an unusually strong demand for the shares. If there is such a strong demand, the IPO price must be too low.

- 19. Impact of Accounting Irregularities.** How do you think accounting irregularities affect the pricing of corporate stock in general? From an investor's viewpoint, how do you think the information used to price stocks changes in response to accounting irregularities?

ANSWER: Generally speaking, accounting irregularities introduce additional uncertainty and risk. Consequently, investors would require a higher rate of return, which would result in a lower stock price.

The existence of accounting irregularities probably results in closer scrutiny of financial statements for investors. Furthermore, investors will probably seek additional sources of information and opinions in addition to the firm's financial statements as part of their decision-making process.

- 20. Impact of Sarbanes-Oxley Act.** Briefly describe the provisions of the Sarbanes-Oxley Act. Discuss how this act affects the monitoring by shareholders.

ANSWER: The Sarbanes-Oxley Act:

- 1) Prevents a public accounting firm from auditing a client firm whose employees were employed by the client firm within one year prior to the audit.
- 2) Requires that only outside board members of a firm be on the firm's audit committee.
- 3) Prevents the members of a firm's audit committee from receiving consulting or advising fees or other compensation from the firm beyond that earned from serving on the board.
- 4) Requires that the CEO and CFO of firms that are of at least a specified size level to certify that the audited financial statements are accurate.
- 5) Specified major fines or imprisonment for employees who mislead investors or hide evidence.
- 6) Prevents public accounting firms from offering non-audit services to an audit client if the client's audit committee pre-approves the non-audit services to be rendered before the audit begins.

The Act prevents accounting irregularities by firms and should improve the ability of shareholders to monitor firms.

- 21. IPO Dilemma.** Denton Co. plans to engage in an IPO and will issue 4 million shares of stock. It is hoping to sell the shares for an offer price of \$14. It hires a securities firm, which suggests that the offer price for the stock be \$12 per share to ensure that all the shares can be easily sold. Explain the dilemma here for Denton Co. What is the advantage of following the advice of the securities firm? What is the disadvantage? Is the securities firm's incentive to place the shares aligned with that of Denton Co.?

ANSWER: The advantage is that Denton Co. wants to have a successful offering in which it can sell all of its shares, and it wants investors to believe that they made a good investment. This could help Denton engage in a secondary offering at some point in the future when it needs to raise more funds.

The disadvantage of using an offer price of \$12 instead of \$14 is that Denton gives up \$2 per share, and therefore may receive \$8 million less in proceeds from selling the stock.

The securities firm wants to place all the shares for Denton. However, it does not suffer the loss in proceeds when it lowers the offer price, although its fees from performing the underwriting function

may be reduced slightly. In addition, the underwriter can benefit when institutional investors invest in shares at a low price and earn high returns, because they may subscribe to future offerings by the investment bank. Denton understands that the securities firm needs to set the offer price low enough to attract enough investors to sell the entire amount of shares, but any discount beyond that point may be perceived as “leaving money on the table.” When investors buy a stock at an IPO for less than its fundamental value, they gain at the expense of the firm that issued the stock.

- 22. Variation in Investor Protection among Countries.** Explain how shareholder protection varies among countries. Explain how enforcement of securities laws varies among countries. Why do these characteristics affect the valuations of stocks?

ANSWER: Shareholders in some countries have more voting power and can have a stronger influence on management of corporations. The legal protection of shareholders also varies substantially among countries. Shareholders in some countries can more effectively sue publicly-traded firms if their executives or directors commit financial fraud. In general, common law countries such as the U.S., Canada, and the United Kingdom allow for more legal protection than civil law countries such as France or Italy. If a country has securities laws but no enforcement, the laws are useless.

Investors have more power to ensure that management serves their interests if they have more protection, and therefore can ensure that managers make decisions that are intended to maximize the firm's value.

- 23. International ETFs.** Describe international ETFs, and explain how ETFs are exposed to exchange rate risk. How do you think an investor decides whether to purchase an ETF representing Japan, Spain, or some other country?

ANSWER: Exchange-traded funds are passive funds that track a specific index. By investing in an international exchange-traded fund, investors can invest in a specific index representing a foreign country's stock market. The ETFs are denominated in dollars. However, the net asset value of an international ETF is determined by translating the foreign currency value of the foreign securities into dollars. Thus, a weaker foreign currency will reduce the net asset value in dollars.

The decision to purchase a specific ETF for a specific country is based on expected return and risk, which may be determined based on an assessment of the country's economic and political conditions, and the expectations about whether its local currency will weaken (which reduces the net asset value of the ETF).

- 24. VC Fund Participation and Exit Strategy.** Explain how venture capital (VC) funds finance private businesses, as well as how they exit from the participation.

ANSWER: VC funds review proposals by private businesses that need funding. If they provide the business with an equity investment, they may attempt to exit about 4 or 7 years later by selling its equity stake to the public after the business engages in a public stock offering. Many VC funds sell their shares of the businesses in which they invest during the first 6 to 24 months after the business goes public. Alternatively, the VC fund may cash out if the company is acquired by another firm, as the acquirer will purchase the shares owned by the VC fund.

- 25. Dilemma of Stock Analysts.** Explain the dilemma of stock analysts that work for securities firms and assign ratings to large corporations. Why might they prefer not to assign low ratings to weak but large corporations?

ANSWER: Although analysts can provide useful information for investors, they have historically been very generous when rating stocks. In the past, the bonuses paid to analysts were sometimes based on how much business they generated for their employer and not on the accuracy of their stock ratings. Stock exchange rules prevent such forms of compensation to analysts now. Yet, analysts are in an awkward situation when assigning low ratings to a corporation. If the corporation wants to hire a securities firm to help it place new shares of stock or merge with another firm, it is unlikely to hire the securities firm whose analyst assigned it a low rating.

- 26. Limitations of an IPO.** Businesses valued at less than \$50 million or so rarely go public. Explain the limitations to such businesses if they did go public.

ANSWER: A public offering of stock may be feasible only if the firm will have a large enough shareholder base to support an active secondary market. With an inactive secondary market, the shares would be illiquid. Investors who own shares and want to sell them would be forced to sell at a discount from the fundamental value, almost as if the firm were not publicly traded. This defeats the purpose of being public.

- 27. Private Equity Funds.** Explain the incentive for private equity funds to invest in a firm and improve its operations.

ANSWER: Managers of a private equity fund typically take a percentage of the profits they earn from their investments in return for managing the fund. They also charge an annual fee for managing the fund. If they were able to improve the business substantially while they managed it, they should be able to sell their stake to another firm for a much higher price than they paid for it. Alternatively, they may be able to take the business public through an initial public offering (IPO) and cash out at that time.

- 28. VCs and Lockup Expiration Following IPOs.** Venture capital firms commonly attempt to cash out as soon as is possible following IPOs. Describe the likely effect that would have on the stock price at the time of lockup expiration. Would the effect be different for a firm that relied more heavily on VC firms than other investors for its funds?

ANSWER: If many VC firms are selling their shares at lockup expiration, there is downward pressure on the stock price. The downward pressure might be especially pronounced for firms that received a proportionately large amount of funding from VC firms before they went public.

- 29. Impact of SOX on Going Private.** Explain why some public firms decided to go private in response to the passage of the Sarbanes-Oxley (SOX) Act.

ANSWER: For many firms, the cost of adhering to the guidelines of the act exceeds \$1 million per year. Many small, publicly traded firms decided to revert back to private ownership as a result of the act. These firms perceived that they would have a higher value if they were private, rather than publicly held, because they could eliminate the substantial reporting costs required of publicly traded firms.

- 30. Pricing Facebook's IPO Stock Price.** Describe the dilemma of securities firms that serve as underwriters for Facebook's IPOs, when attempting to satisfy Facebook and the institutional investors that invest in Facebook's stock. Do you think that the securities firms that served as underwriters for Facebook's IPO satisfied Facebook or its investors in the IPO? Explain.

ANSWER: Based on the stock price movements over the first few months after the IPO, one may argue that Facebook benefitted to a greater degree than its institutional investors. The stock price declined by about 50% within a few months after the IPO. These results suggest that the stock price was set too high at the time of the IPO. The investors paid that price, while Facebook received that price, so Facebook gained while investors lost.

- 31. Private Stock Market.** What are some possible disadvantages to investors who invest in stocks listed on a private stock market?

ANSWER: Investors need to register with the private stock exchange, and prove that they have sufficient income (such as about \$200,000 per year) and sufficient net worth (such as at least \$1 million). Second, there is limited transparency because the required disclosure of information by private firms listed on private stock exchanges may be less than what is required when firms go public. Firms are required to have their financial statements audited when their shares are publicly-traded. Third, the trading volume in a private stock market is very limited. With such limited participation by investors, it is difficult to determine the appropriate market price.

Interpreting Financial News

Interpret the following statements made by Wall Street analysts and portfolio managers:

- a. “The recent wave of IPOs is an attempt by many small firms to capitalize on the recent run-up in stock prices.”

Firms prefer to go public when stock market conditions are favorable so that they can benefit from high valuations in the market. Their stock will sell for a higher price if the prices of other similar publicly traded firms are high.

- b. “IPOs transfer wealth from unsophisticated investors to large institutional investors who get in at the offer price and get out quickly.”
Some institutional investors invest in IPOs at the offer price, and then quickly sell (flip) their shares to individual investors who were not able to buy shares at the offer price. The individual investors pay a much higher price and the long-term performance of IPOs is poor, especially for individual investors who pay the price that exists a day or two after the IPO. Thus, the institutional investors gain while the individual investors lose.

- c. “Firms must be more accountable to the market when making decisions because they are subject to indirect control by institutional investors.”

If a firm performs poorly, the institutional investors with a large stake in that firm may engage in shareholder activism to improve the firm’s performance.

Managing in Financial Markets

As a portfolio manager of a financial institution, you are invited to numerous road shows at which firms that are going public promote themselves, and the lead underwriter invites you to invest in the IPO. Beyond any specific information about the firm, what other information would you need to decide

whether to invest in the upcoming IPO?

Market conditions should be assessed. As stock market conditions change, valuations change. In addition, industry conditions change over time, which affect valuations of firms within a particular industry.

Problem

1. **Dividend Yield.** Over the last year, Calzone Corporation paid a quarterly dividend of \$0.10 in each of the four quarters. The current stock price of Calzone Corporation is \$39.78. What is the dividend yield for Calzone stock?

ANSWER:

$$\text{Dividend yield} = \frac{4 \times \$0.10}{\$39.78} = 1.01\%$$

Flow of Funds Exercise

Contemplating an Initial Public Offering (IPO)

Recall that if the economy continues to be strong, Carson Company may need to increase its production capacity by about 50 percent over the next few years to satisfy demand. It would need financing to expand and accommodate the increase in production. Recall that the yield curve is currently upward sloping. Also recall that Carson is concerned about a possible slowing of the economy because of potential Fed actions to reduce inflation. It is also considering the issuance of stock or bonds to raise funds in the next year.

- a. If Carson issued stock now, it would have the flexibility to obtain more debt and would also be able to reduce its cost of financing with debt. Why?
If Carson supports some of its growth with stock, it changes its capital structure to include more equity that does not require a cash outflow (no interest payments). Thus, it can more easily cover its debt payments. In addition, financial institutions would be more willing to provide more credit because Carson has more equity to support its business and is less likely to default on debt.
- b. Why would an IPO result in heightened concerns in financial markets about Carson Company's potential agency problems?

When the firm is publicly owned, management is at least partially separated from ownership. Managers are agents who are supposed to be serving shareholder interests. Yet, the managers may be tempted to make decisions that are in their own best interests rather than maximize shareholder wealth. If there are agency problems, the firm's performance may suffer, and its stock price would be reduced. Shareholders who own stock are adversely affected by agency problems.

- c. Explain why institutional investors such as mutual funds and pension funds that invest in stock for long-term periods (at least a year or two) may prefer to invest in IPOs rather than to purchase other stocks that have been publicly traded for several years?

Institutional investors may believe that the market does not properly price newly issued stock, and they can capitalize on this discrepancy by investing in IPOs.

- d. Given that institutional investors such as insurance companies, pension funds, and mutual funds are the major investors in IPOs, explain the flow of funds that results from an IPO. That is, what is the original source of the money that is channeled through the institutional investors and provided to the firm going public?

The money invested by insurance companies comes from insurance premiums paid by policyholders. The money invested by pension funds comes from retirement accounts of employees and their respective employers. The money invested by mutual funds comes from shareholders who want the mutual fund to invest their money.