

Chapter 15

Raising Capital

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

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
- Issuing Long-Term Debt
- Shelf Registration

Venture Capital

- Private financing for relatively new businesses in exchange for stock
- Usually entails some hands-on guidance
- The ultimate goal is usually to take the company public; the VC will benefit from the capital raised in the IPO
- Many VC firms are formed from a group of investors who 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
- 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, then the company may amend the registration, and the waiting period will start over
- Securities may not be sold during the waiting period
- The price is determined on the effective date of the registration

Table 15.1

Method	Type	Definition
Public Traditional negotiated cash offer	Firm commitment cash offer	Company negotiates an agreement with an investment banker to underwrite and distribute the new stocks. A specified number of shares are bought by underwriters and sold at a higher price.
	Best efforts cash offer	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. Some best efforts offerings do not use an underwriter.
Privileged subscription	Direct rights offer	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.
Nontraditional cash offer	Shelf cash offer	Qualifying companies can authorize all the shares they expect to sell over a two-year period and sell them when needed.
	Competitive firm cash offer	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 the 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 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; the company does not get the capital and they have still incurred substantial flotation costs
- Not as common as it used to be

Green Shoes and Lockups

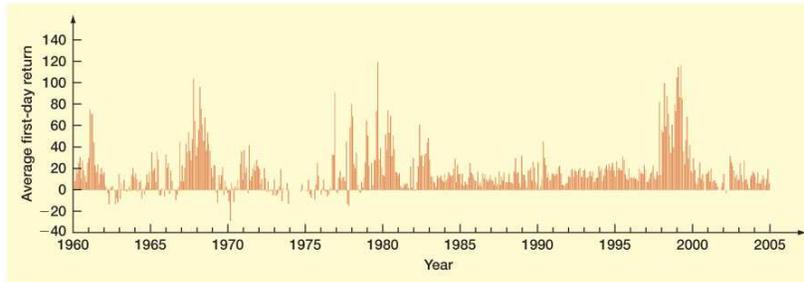
- Green Shoe provision
 - Allows syndicate to purchase an additional 15% of the issue from the issuer
 - Allows the issue to be oversubscribed
 - Provides some protection for the lead underwriter as they perform their price stabilization function
- Lockup agreements
 - Restriction on insiders that prevents 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

- Initial Public Offering – IPO
- May be difficult to price an IPO because there isn't a current market price available
- Additional asymmetric information associated with companies going public
- Underwriters want to ensure that their clients earn a good return on IPOs (on average)
- Underpricing causes the issuer to “leave money on the table”

Figure 15.2

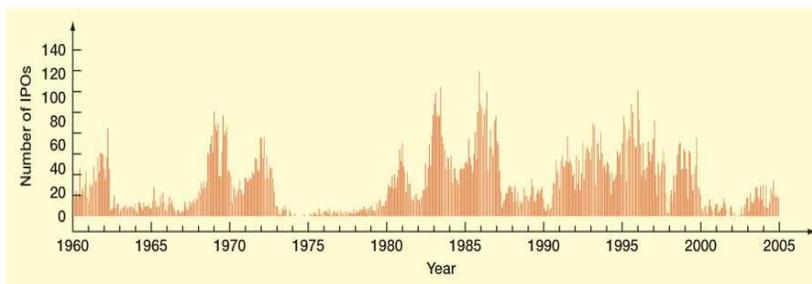
FIGURE 15.2 Average Initial returns by month for SEC-registered initial public offerings: 1960–2005



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: 1960–2005



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.

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

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 the life of the loan
 - Private placements
 - Similar to term loans 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
- 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 preceding 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 are some of the characteristics of private placement debt?
- What is shelf registration?