SPROTT
SCHOOL OF BUSINESS

BUSI 2505e - Business Finance

Monday, February 8, 2010

8:45-9:15 quiz #2

§15 raising capital

outline

- 15.1
- 15.2
- 15.3
- 15.4
- 15.5
- 15.6
- 15.7
- 15.8
- 15.9
- 15.10

- group assignment #1 to be posted this week on course website and webct

- §15.1 - The Financing Life Cycle of a Firm: Early-Stage Financing and Venture Capital
- §15.2 - The Public Issue
- §15.3 - The Basic Procedure for a New Issue
- §15.4 - The Cash Offer
- §15.5 - IPOs and Under pricing
- §15.6 - New Equity Sales and the Value of the Firm
- §15.7 - The Cost of Issuing Securities
- §15.8 - Rights
- §15.9 - Dilution
- §15.10 - Issuing Long-Term Debt

15.1: venture capital (vc)

- 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 and the VC will benefit from the capital raised in the 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

- **Financial strength** - you want to have the option to obtain additional financing
- **Style** - do you want a hands-on or hands-off VC?
- **Contacts** - will the VC provide you with additional business contacts that can help your business succeed
- **Exit strategy** - VCs are not long term investors, what are the provisions for the VC getting out of the business?

- **Public issue** - the creation and sale of securities that are intended to be traded on the public markets
- All companies on the TSE come under the Ontario Securities Commission's jurisdiction

- Management must obtain permission from the Board of Directors
- Firm must prepare and distribute copies of a preliminary prospectus (red herring) to the OSC and to potential investors
- OSC studies the preliminary prospectus and notifies the company of required changes (usually takes 2 weeks)
- When the prospectus is approved, the price is determined and security dealers can begin selling the new issue

- For equity sales, there are two kinds of public issues:
  - **General Cash Offer** - New securities offered for sale to the general public on a cash basis
  - **Rights Offer** - New securities are first offered to existing shareholders. These are more common outside North America

- Public (traditional negotiated cash offer)
  - **Firm commitment cash offer** - 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** - 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** - Company has investment bankers auction shares to determine the highest offer price obtainable for a given number of shares to be sold.

- Public (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.

- Public (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** - 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 4 months.

- **IPO** - Initial Public Offering (or unseasoned new issue)
  - A company's first equity issue made available to the public.
- **SEO** - Seasoned Equity Offering
  - A new issue for a company that has previously issued securities to the public.

15.4: 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 underwriters 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

The BB Drum Co. recently raised several million dollars in an initial public offering. BB received $22 per share from the underwriter, the offering price was $25 per share, and the market price rose to $28 on the first day of trading. What was the spread paid by BB?

answer: 13.6%

15.4: firm commitment underwriting

- Also called a “bought deal”
- 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 Canada

You decide to take your company public by offering a total of 50,000 shares of common stock to the public in an initial public offering (IPO). You hire an underwriter who arranges a firm commitment underwriting and suggests an initial selling price of $28 a share with an 8% spread. As it turns out, the underwriters only sell 48,500 shares. How much cash will you receive from your IPO?

answer: $1,288,000

15.4: 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 situation, the company does not get the capital and they have still incurred substantial flotation costs

Wexford Industries offers 60,000 shares of common stock to the public in an initial public offering (IPO). The underwriters agree to pay $35 a share and to provide their services in a best efforts underwriting. The offer price is set at $39. After completing their sales efforts the underwriters determine that they were able to sell a total of 48,250 shares. How much cash did Wexford Industries receive from their IPO?

answer: $1,688,750

- Underwriter conducts an auction and investors bid for shares
- Offer price is determined based on the submitted bids
- More commonly used in bond markets
- Also called **uniform price auction**

You decide to sell an additional 1,500 shares of stock in your firm through a Dutch auction. The bids that you receive are:

Bidder	Quantity	Price
A	1,000	$42
B	200	$41
C	100	$40
D	1,000	$39
E	1,500	$19

How much will you receive in total from selling the additional 1,500 shares? Ignore all transaction and flotation costs.

answer: $58,500

- **Over Allotment Option**
  - 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** - Specify how long insiders must wait after an IPO before they can sell stock, usually 180 days
- **Quiet Period** - For 40 days following an IPO, the OSC requires that all communications with the public are limited to ordinary announcements

- 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 might cause the issuer to "leave money on the table"

The BangBang Drum Company recently raised several million dollars in an initial public offering. BangBang received $22 per share from the underwriter, the offering price was $25 per share, and the market price rose to $28 on the first day of trading. What initial return did investors earn on the stock?

answer: 12.0%

- Stock prices tend to decline when new equity is issued
- Possible explanations for this phenomenon
  - **Signaling and managerial information** - managers may choose to sell new shares of stock when they believe the current stock price is high (they can issue fewer shares at a higher price)
  - **Signaling and debt usage** - issuing equity may send signal that management believes the company currently has too much debt
  - **Issue costs** - issuing securities is very expensive and the decrease in price may be partial compensation for the cost of the issue

- **Spread** - difference between the offer price and money received by issuer
- **Other direct expenses** - legal fees, filing fees, etc.
- **Indirect expenses** - opportunity costs, ie. management time spent working on issue
- **Abnormal returns** - price drop on existing stock
- **Underpricing** - below market issue price on IPOs
- **Over allotment option** - cost of additional shares that the syndicate can purchase after the issue has gone to market

- 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 usually trade on the same exchange as the company’s stock

- 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

15.8: 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 have to be issued?

$$\frac{\text{Funds to be raised}}{\text{subscription price}} = \frac{10,000,000}{20} = 500,000$$

- How many rights will it take to purchase one share?

$$\frac{\text{old shares}}{\text{new shares}} = \frac{5,000,000}{500,000} = 10$$

- What is the value of a right?

$$\frac{M_0 - S}{N + 1} = \frac{25 - 20}{10 + 1} = \$0.45$$

A firm has 800,000 shares outstanding at a market price of $120 a share. It wants to raise $16 million via a rights offering. The subscription price is $100 per share. How many rights are required to purchase one of the new shares?

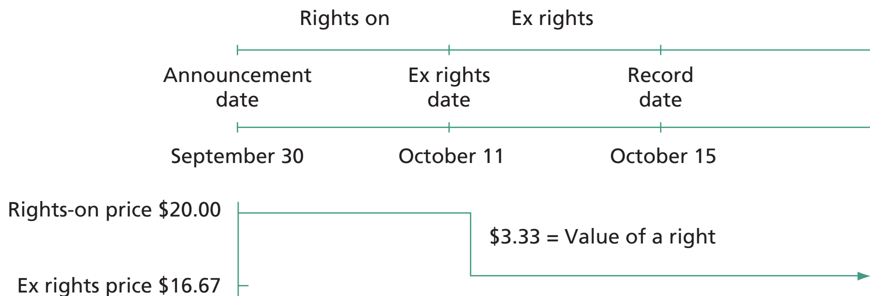
answer: 5.0 rights

A firm has 800,000 shares outstanding at a market price of $120 a share. It wants to raise $16 million via a rights offering. The subscription price is $100 per share. What is the value of a right?

answer: $3.33

- **Ex-rights** - the price of the stock will drop by the value of the right on the day that the stock no longer carries the “right”
- **Standby underwriting** - underwriter agrees to buy any shares that are not purchased through the rights offering
- Stockholders can either exercise their rights or sell them, they are not hurt by the rights offering either way

- Rights offerings are generally cheaper
- Until the early 1980's, rights offerings were the most popular method of raising new equity in Canada
- Bought deals have replaced rights offers as the prevalent form of equity issue



In a rights offering, there is a date of record, which is the last day that a shareholder can establish legal ownership. However, stocks are sold ex rights two business days before the record date. Before the ex rights day, the stock sells rights on, which means the purchaser receives the rights.

A firm has 800,000 shares outstanding at a market price of $120 a share. It wants to raise $16 million via a rights offering. The subscription price is $100 per share. What is the ex-rights price?

answer: $116.67

A firm has 800,000 shares outstanding at a market price of $120 a share. It wants to raise $16 million via a rights offering. The subscription price is $100 per share. What will the firm be worth after the offering?

answer: $112.0 million

- 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

The Big Burger Co. has 225,000 shares of stock outstanding at a market price of $45. If the firm issues another 25,000 shares at a price of $40, what will happen to the market price of the stock?

answer: Decrease by 1.1%

- **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 issues (Private placements)
  - Similar to term loans with longer maturity
  - Easier to renegotiate than public issues
  - Lower costs than public issues