Chapter 1: Capital

Finance is the study of tradeoffs between the future and the present. When investing in the debt or equity market, it is all about giving up something today to gain something in the future.

Firms which require funds are coming together in the so called *Capital markets* with other institutions that are willing to invest their money. A capital market is a place where parties that want to invest capital meet parties that want to raise capital.

Financial intermediaries are institutions, like banks, funnels the savings of corporations and individuals to firms that require money to finance their investments. Financing firms through financial intermediaries is indirectly. Buying and holding stocks and bonds finance a firm in a direct way.

Internal capital. This is the capital inside the firm. This capital is raised by retaining the earnings and by obtaining external funds from the capital markets.

External capital. Debt and equity are the two basic sources of outside financing. Debt holders are senior to equity holders. This means that the claims of the debt holders must be completely paid before the firm can make payments to its equity holders. Another important difference is that payments to debt holders are generally tax-deductible to the firm and the dividends to equity holders are payouts of profits and are not tax-deductible.

Firms can raise capital from two sources, public and private. Public capital can be traded on public secondary markets. An example of a public secondary market is the New York Stock Exchanges. Private capital comes in a few different forms. As bank loans or as *private placements*. Private placements are limited to a small group of investors and these placements cannot be sold on the public markets.

Another difference between Public markets and private markets, is the anonymity of the public markets. In private markets, everyone knows each others identity, but in public markets buyers and sellers do not know each other. Because of this, the private markets are often less liquid. With this we mean that the transaction costs of buying and selling are higher than in public markets.

Regulations increase the costs of issuing public securities, but they also provide protection for investors which raises the value of the securities.

Three important pieces of legislation

1. *The Securities Acts of 1933 and 1934*

   Require that companies file a registration statement with the SEC. This contains: general information about the firm, detailed financial data, a description of the security, the agreement between the underwriter and the issuing firm and the composition of the underwriting syndicate.

2. A *prospectus*, a printed document that includes information about the security and the firm, must be available to investors. This is part of the registration statement.

   After approval of the registration statement by the SEC, the primary offering starts. *Due diligence* means investigating and disclosing any information that is relevant and providing an audit of the accounting numbers by a certified public accounting firm.

3. *The Glass-Steagall Act*

   Also called the Banking Act of 1933. Requires banks to divorce their commercial banking activities from their investment banking activities. This gave rise to many investment banks. Firms that stayed in the underwriting business were forced to build *Chinese walls*. This involves structuring a company's procedures to prevent certain types of communication between underwriting parts and the sales and trading sectors.

Congress and the regulatory agencies have started relaxing these constraints, because U.S. financial institutions are very constrained. Commercial and investment banks have been drawing closer to *universal banking*; that is, they are beginning to offer a whole arrange of services. Interstate banking was legalized in 1994. Because of the fierce competition, the surviving banks will tend to be bigger, better capitalized, and better prepared to serve business firms in creative ways.

Modern investment banks are made up of two parts: the corporate business and the sales and trading business.

- the corporate side is a fee-for-service business; the firm sells its expertise. The main one is underwriting securities.
- investment banks sell securities on the sales and trading end of their business to the bank's institutional investors.

Market making requires that the investment bank act as a *dealer* in securities, at wholesale (*bid*) and (*ask*) prices. The bank makes money on the bid-ask spread. They can also trade securities using their own funds(*proprietary trading*).

The underwriter of a security issue performs four functions:

- *origination*; this involves giving advice to the issuing firm about the type of security to issue, the timing and the pricing.
- *distribution*; this contains the selling of the issue.
- *risk bearing*; in most cases, the underwriter has agreed to buy the securities the firm is selling and to resell them to its clients. If the issue does poorly, the underwriter may be stuck with securities that must be sold at bargain prices.
- *certification*; certifying the quality of an issue, which requires that the bank maintain a sound reputation in capital markets.

The *underwriting agreement* between the firm and the investment bank is the document that specifies what is being sold, the amount being sold, and the selling price. The *underwriting spread* is the difference between the total proceeds of the offering and the net proceeds that accrue to the issuing firm, and the existence and extent of the *overallotment option* (*Greenshoe-option*). This option permits the investment banker to request that more shares be issued on the same terms as those already sold.

It is called an *initial public offering (IPO)* when an equity is issued by a firm for the first time. At the contrary, if a firm is already publicly traded, it is making *seasoned offering (SEO)*. IPO and SEO can include both primary and secondary issues. *Primary issue*: raising capital by selling stock to the public. *Secondary issue*: selling a number of shares which a shareholder currently owns.

Debt and equity

Some characteristics of the cost of debt and equity issues:

- Debt fees are lower than equity fees.
- There are economies of scale in issuing.
- Initial public offerings are much more expensive than seasoned offerings because the initial are far riskier and much more difficult to price.

Offerings

There are a few different types of offerings:

- A *firm commitment offering*: the underwriter agrees to buy the whole offering from the firm at a set price and to offer it to the public at a slightly higher price.
- A *best-efforts offering*: the underwriter and the firm fix a price and the minimum and maximum number of shares to be sold. The underwriter then makes 'the best effort' to sell the issue.

The more well-known firms tend to use firm commitment offerings, but the less established firms tend to go public with best-efforts offerings.

Negotiated offering: the firm negotiates the underwriting agreement with the underwriter.

Competitive offering: the firm specifies the underwriting agreement and puts it out to bid.

Shelf offering: a firm registers all the securities it plans to issue within two years.

Rights offering on a standby basis: an agreement by the investment bank to take up any unexercised rights and exercise them. While making rights offering, one can use investment bankers on a standby basis (making rights offering can also be done without investment bankers). A *standby basis* includes an agreement by the investment bank to take up any unexercised right and exercise them, paying the subscription price to the firm. The *subscription price* is the price that the right holders must pay for the stock.

Euromarkets are a collection of large international banks that help firms issue bonds and make loans outside the country in which the firm is located.

Direct issuance is selling directly in the foreign market.

Differences between the U.S. and Germany, the U.K. and Japan

Germany has universal banking (its banks can take on in both commercial and investment banking). In Germany, public equity has not been an important source of funds for firms, most is privately financed. But this is about to change, since Germany attempts to develop an equity culture. Furthermore, by law, listed German firms have two-tiered boards of directors. The management board is composed of company executives who manage the firm on a day-to-day basis. The supervisory board consists of 10 to 20 members, half of which must be worker representatives. The other half is elected by shareholders.

In Japan, the city banks are the primary suppliers of funds to Japanese firms. The banks have significant powers to seize collateral, both as a direct lender and as a trustee for secured bond issues. Japanese banks can hold common stock, and when combined with insurance companies, the ownership percentage of financial institutions rises to 40 percent.

These shareholders frequently meet to exchange information about the financial condition of the firm, and representatives of the main bank do not hesitate to step in when the firm experiences difficulties. These cross-holdings of firms are a significant feature of the Japanese financial system. A keiretsu is a group of firms in different industries bound together by cross-ownership of their common stock and by customer-supplier relationships. The substantial cross-holdings of customers and suppliers means that firms are less subject to contractual problems. From 1980 Japan's bond and stock markets became more deregulated.

London is the leading market for international transactions in stocks, bonds and foreign exchange. Fixed brokerage commissions were causing large institutional investors to take their trade elsewhere than London. In response to competitive pressures, the London Stock Exchange instituted a wide-ranging series of changes in October 1986 that have come to be known as the 'Big Bang'.

Four major changes were produced:

1. The elimination of fixed commissions.
2. The granting of permission to foreign banks and securities firms to enter the British market on their own or to buy domestic firms.
3. The elimination of the system of wholesale traders and retail traders in favor of a system where members were free to act as both brokers and dealers.
4. The introduction of a computerized trading system.

With increased competition, lower costs, and the increase in stock prices, trading in London quadrupled in two years following the Big Bang.

The current trends are more efficient trading technology and *securitization,* which is the combining of financial instruments that are not securities, registering them as securities and selling them directly to the public.