Chapter 3: Equity

There are a few differences between debt and equity:

- debt holder are senior to equity holders
- equity holders have the control over the organization
- dividends are not tax-deductible while interest is

There are two sources of equity: retaining profits within the firm and issuing new equity securities. Three different kinds of equity exist:

Common stock; this is a share of ownership in an organization. The holders are normally allowed to vote. These kind of stockholders are seen as the owners of an organization. *Dual-class common stock* have two classes of common stock, which differ in terms of their votes per share. This type of stock is usually used in firms where the majority of the control is in the hands of some people or a group.

Preferred stock; Shareholders with preferred stock have a claim on a firms earnings. This means that they get paid before the dividends on the common stock are paid out. Preferred shares are almost always *cumulative*: if no dividends are paid out, they mount up and must be paid in full before any dividends can be paid to common shareholders.

Convertible preferred stock can be converted into common stock. One of the biggest advantages of preferred stock is that it allows corporations to issue a debt like security without lowering the ratings on their existing debt. A disadvantage is that dividends are not tax-deductible.

Warrants; Warrants are the rights to buy shares of the firm at a preset price for a preset period. We can call this right a *Call option.* Warrants are longterm call options. Warrants are often offered in a package with some other securities.

Secondary equity markets can be arranged as an *exchange* (a physical location where buyers and sellers meet) *market* or an over-the-counter market (no physical place).

Private equity

Private equity cannot be traded in public because it is not registered on a public exchange.

We know 3 types of private equity:

1. *Strategic investors*: Companies with potential growth for the future are bought and restructured.
2. *Venture Capital*: Finances starting firms with enormous potential for growth in the future.
3. *Mezzanine financing*: Finances firms with potential to permit them to be ready for listing in capital markets.

A disadvantage of private equity is its illiquidity, which is caused by the fact that private equity is not allowed to be traded on public stock markets.

The initial public offering (IPO) market is extremely cyclical; there are both demand-side and supply-side explanations. On the demand side, there are periods when an especially large number of new firms have investment projects that need to be funded. On the supply side, there might be periods when investors and institutions that traditionally invest in IPOs have huge amounts of money to invest. IPOs are observed frequently in some years and not in other years.

The available evidence suggests that the hot issue periods are characterized by a large supply of available capital. Given this, firms are better off going public during a hot issue period.

Firms have a number of reasons to go public. First, firms can attract capital at more favorable terms from the public markets. Furthermore, stock prices in the public markets supply a important source of information for managers of the firm. Finally, going public can be good publicity.

However, going public costs a lot of money. The largest expenditure is the underwriting fee. Another important cost of going public is the difference between the price at which the investment banker sells the issue and the price at which the stock trades in the secondary market short thereafter. The price of the investment banker is generally 10 to 15 percent lower than the price on the secondary market. Public firms also have costs that private firms do not have, like the shareholder meetings and the financial analysis and statements.

Overview

Advantages of going public:

- entree to capital markets is easier
- shareholders gain liquidity
- original owners can diversify
- monitoring and information
- raises the firm's credibility with customers, employees, and suppliers.

Disadvantages:

- Going public is pricy
- costs of dealing with shareholders
- competitors acquire information about the public firm
- public pressure

The process of going public

The registration statement

After choosing the underwriter, the firm collects the data needed for the registration statement. The underwriters are accountable for ensuring that it discloses all information about the firm.

Marketing the issue

This is also the responsibility of the underwriter. It involves marketing the stock and try to sell the IPO to institutional investors. This is nonbinding, but can influence the offer price, number of shares and allocations to particular investors.

Pricing the issue

This is the final stage, determining the number of shares to be sold, and distributing the shares to investors. An *oversubscribed offering* means that investors want to buy more shares than the underwriter wants to sell.

Book building vs. Fixed-price method

The above described method is the book building method. The fixed-price method provides a prospectus with the number of shares and the offer price. The important distinction between the two methods is that with the book building method, the investment bank is less able to gauge investor demand.

In addition, investors in fixed-price offerings are generally allocated shares in oversubscribed offerings using some fixed formula.

Most of the IPOs are underpriced. This is very important to know because the underpricing of IPOs increases the cost of going public.

It is important to consider why underwriters underprice new issues. There is a possibility that the shares will not be sold and because the cost of having unsold shares is borne by the underwriter, it may have a considerable influence on the pricing choice and even lead the underwriter to underprice the issue.