Chapter 14: Equity Capital

Private companies

A private company can decide to raise outside equity capital. When this is the case it can seek funding from several potential sources namely:

- Angel investors: Individual investors who buy equity in small private firms. Usually this is the first source where a firm seeks funding.
- Venture capital firm: a limited partnership that specializes in raising money to invest in the private equity of young firms. The institutional investors are known as the limited partners in a venture capital firm. The venture capitalists are the general partners who work for and run a venture capital firm.
- Institutional investors, such as pension funds and insurance companies. They are also active investors in private companies. Institutional investors may be limited partners in a venture capital firm, or may invest directly in private firms.
- Corporate investors are corporations that invest in private companies. Also known as corporate partners, strategic partners or strategic investors.

If a company sells equity to outside investors for the first time, they prefer to issue preferred stock rather than common stock.

Preferred stock issued by mature companies such as banks, usually has a preferential dividend and seniority in any liquidation and sometimes special voting rights. Preferred stock issued by young companies has seniority in any liquidation but typically does not pay cash dividend.

Convertible preferred stock: a preferred stock that gives the owner an option to convert it into common stock on some future date.

The pre-money valuation is the value of a firm’s prior shares outstanding at the price in the funding round.

The post-money valuation is the value of the whole firm (old + new shares) at the price at which the new equity is sold.

The relation between firm and its investors is subjected to changes as needs and resources develop. The exit strategy is an important consideration for investors in private companies. It details how they eventually will realize the return from their investment. There are two ways in which investors exit: through an acquisition or through a public offering.

The IPO

The initial public offering (IPO) is the process of selling stock to the public for the first time.

Going public has some advantages: it provides companies with greater liquidity and better access to capital. When companies go public their private equity investors have the ability to diversify.

Public companies often have access to very large amounts of capital through the public markets in the IPO and in their subsequent offerings.

The major disadvantage of going public is a consequence of the major advantage: when investors sell their stake and thereby diversify their holdings, the equity holders of the corporation become more widely dispersed. This means a loss of control.

Another disadvantage is that when a company goes public, it must satisfy all of the requirements of public companies.

Last century new standards were adopted, which were set by the Securities and Exchange Commission for example. Compliance with these standards is costly and time-consuming for public companies. An underwriter is an investment banking firm that manages a security issuance and designs its structure. An underwriter helps a company after it decides to go public.

There are two IPO possibilities:

1. Primary offering: new shares available in a public offering that raise new capital.
2. Secondary offering: an equity offering of shares sold by existing shareholders (as part of their exit strategy).

A standardized form of a traditional IPO process; the steps underwriters go through during an IPO:

Underwriters and the syndicate

The large and complex IPOs are managed by a group of underwriters. The lead underwriter is the primary banking firm responsible for managing a security issuance. It provides most of the advice on the sale and arranges for a group of other underwriters called the syndicate. The syndicate is a group of underwriters who jointly underwrite and distribute a security issuance. This group helps the market sell the issue.

SEC fillings

A requirement of the SEC is for companies to prepare a registration statement: a legal document that provides financial and other information about a company to investors prior to a security issuance. Managers work closely with their underwriters to prepare this statement.

The preliminary prospectus or red herring is a part of the registration statement prepared by a company prior to an IPO that is circulated to investors before the stock is offered. The SEC requires companies to make a registration statement to make sure the company has disclosed all of the information for investors to decide whether to purchase the stock.

Before the IPO, the company prepares the final registration statement. The final prospectus is part of this final registration statement that contains all the details of the offering, including the numbers of shares offered and the offer price.

Valuation

The underwriters and the company come up with a price range that they think is a reasonable valuation for the firm. There are two ways to value a company.

1. The first one is to estimate the future cash flows and to compute the present value.
2. The second option is to estimate the value by examining comparable companies.

After the price range is set, the underwriters explore what the market thinks of the valuation. They arrange a road show: during an IPO, when a company's senior management and its lead underwriters travel to promote the company and explain their rationale for an offer price to institutional investors such as mutual funds and pension funds.

After the road show, the underwriters get the information of the customers about their interest. The customers tell how many shares they may want to purchase. After that, the book building follows: this is a process used by underwriters for coming up with an offer price based on customers' expressions of interest.

Pricing the deal and managing the risk

The most common agreement is a firm commitment: an agreement between an underwriter and an issuing firm in which the underwriter guarantees that it will sell all of the stock at the offer price. The underwriter purchases the entire issue and if the shares are not sold the underwriter must offer the shares at a lower price and the loss is for the underwriter.

Sometimes the company pays a spread: a fee a company pays to its underwriters that is a percentage of the issue price of a share of stock.

Underwriters appear to use information they acquire during the book-building stage to intentionally under price the IPO. Underwriters can use a mechanism that allows them to sell extra shares of more successful offerings called over-allotment allocation or greenshoe provision. This allows the underwriter to issue more stock, usually amounting to 15% of the original offer size, at the IPO offer price.

When the IPO process is complete, the company's shares trade publicly on an exchange. Issuers have continuous access to the equity markets. Often existing shareholders are subject to a lockup, a restriction that prevents them from selling their shares for some period (usually 180 days) after the IPO.

Besides the traditional method discussed before, there also other ways to sell shares during an IPO:

- Best-efforts: for smaller IPOs, a situation in which the underwriter does not guarantee that the stock will be sold, but instead tries to sell the stock for the best possible price.
- Auction IPO: an online method for selling new issues directly to the public that lets the market determine the price through bids from potential investors. Such mechanisms are called OpenIPO.

IPO puzzles

Four characteristics of IPOs that are relevant to the financial manager:

1. IPOs appear to be under priced, on average: the price at the end of trading on the first day is often substantially higher than the IPO price.
2. Amount of IPOs is cyclical: the market is full with IPOs when times are good, but when times are bad, the number of IPOs declines; "Hot" and "Cold" IPO markets.
3. The transaction costs of issuing an IPO are very high.
4. On average, the long-run performance after a newly public company is poor.

The seasoned equity offering

When a public company returns to the equity markets and offers new shares for sale, this is called a seasoning equity offering (SEO). The processes of an IPO and a SEO are almost the same. A difference is that in a SEO the market prices for the stock already exists, so there is no price-setting process.

Primary shares are new shares issued by a company in an equity offering.

Secondary shares are shares sold by existing shareholders in an equity offering.

Tombstones are newspaper advertisements in which underwriters advertise a security issuance. By reading the tombstones investors know who to call to buy the stock.

There are two types of seasoning equity offering:

1. A cash offer: a type of seasoned equity offering in which a firm offers the new shares to investors at large.
2. A rights offer: a type of seasoned equity offering in which a firm offers the new shares only to existing shareholders. These offers protect existing shareholders from under pricing.

The stock price reaction to a SEO is negative in most cases; usually the market reacts on the news of an SEO with a price decline.

Adverse selection reflects the lemons principle or the idea that when quality is hard to judge, the average quality of goods being offered for sale will be low. This problem especially arises when financial managers are selling new equity.

Seasoned offerings are, as well as IPOs, expensive. A firm has to pay direct costs, in addition to the price drop.