Chapter 15 Lecture – Raising Capital

Learning Objectives

After studying this chapter, you should be able to:

LO1 Explain the venture capital market and its role in the financing of new, high-risk ventures.

LO2 Describe how securities are sold to the public and the role of investment banks in the process.

LO3 Explain initial public offerings and identify some of the costs of going public.

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Venture Capital "Private Equity"

- **Private financing for new, high risk businesses in exchange for stock**
  - **Individual investors**
  - **Venture capital firms**
- **Usually involves active participation by VC**
- **Ultimate goal: take company public; the VC will benefit from the capital raised in the IPO**
- **Hard to find**
- **Expensive**

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Venture Capital Stage Financing

- **Funding provided in several stages**
- **Contingent upon specified goals at each stage**
- **First stage**
  - **"Ground floor" or "Seed money"**
  - **Fund prototype and manufacturing plan**
- **Second Stage**
  - **"Mezzanine" financing**
  - **Begin manufacturing, marketing & distribution**

Choosing a Venture Capitalist

- **Financial strength**
- **Compatible management style**
- **Obtain and check references**
- **Contacts**
- **Exit strategy**

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Selling Securities to the Public

1. Management obtains permission from the Board of Directors
2. Firm files a registration statement with the SEC
3. SEC examines the registration during a 20-day waiting period
4. Securities may not be sold during the waiting period
5. A preliminary prospectus, called a *red herring*, is distributed during the waiting period
   - If problems, the company amends the registration, and the waiting period starts over
6. Price per share determined on the effective date of the registration and the selling effort begins

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Issue Methods

- Public Issue
  - Registration with SEC required
  - General cash offer = offered to general public
  - Rights offer = offered only to current shareholders
  - IPO = Initial Public Offering = Unseasoned new issue
  - SEO = Seasoned Equity Offering
- Private Issue
  - Sold to fewer than 35 investors
  - SEC registration not required

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Methods of Issuing New Securities

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 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. Some best efforts offerings do not use an underwriter.
	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.
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.

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Underwriters

- Underwriting services:
  - Formulate method to issue securities
  - Price the securities
  - Sell the securities
  - Price stabilization by lead underwriter in the aftermarket
- 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

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Dutch or Uniform Price Auction

Buyers:
- •Bid a price and number of shares

Seller:
- •Work down the list of bidders
- •Determine the highest price at which they can sell the desired number of shares

•All successful bidders pay the same price per share.
•Encourages aggressive bidding

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Dutch or Uniform Price Auction Example

The company wants to sell 1,500 shares of stock.

Bidder	Quantity	Bid
A	500	$20
B	400	18
C	250	16
D	350	15
E	200	12

The firm will sell 1,500 shares at $15 per share.
Bidders A, B, C, and D will get shares.

Bidder	Quantity	Bid	Σ Qty
A	500	$20	500
B	400	18	900
C	250	16	1,150
D	350	15	1,500
E	200	12	1,700

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Green Shoe Provision

- *"Overallotment 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
- In all IPO and SEO offerings but not in ordinary debt offerings

Lockup Agreements

- Not legally required but common
- Restricts insiders from selling IPO shares for a specified time period
  - Common lockup period = 180 days
- Stock price tends to drop when the lockup period expires due to market anticipation of additional shares hitting the Street

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Seasoned Equity Offerings

- Stock prices tend to decline when new equity is issued
- Signaling explanations:
  - Equity overvalued: If management believes equity is overvalued, they would choose to issue stock shares
  - Debt usage: Issuing stock may indicate firm has too much debt and can not issue more debt
- Issue costs
  - Issue costs for equity – direct and indirect - are significantly more than for debt

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The Cost of Issuing Securities

The Costs of Issuing Securities	
1. Spread	The spread consists of direct fees paid by the issuer to the underwriting syndicate—the difference between the price the issuer receives and the offer price.
2. Other direct expenses	These are direct costs incurred by the issuer that are not part of the compensation to underwriters. These costs include filing fees, legal fees, and taxes—all reported on the prospectus.
3. Indirect expenses	These costs are not reported on the prospectus and include the cost of management time spent working on the new issue.
4. Abnormal returns	In a seasoned issue of stock, the price of the existing stock drops on average by 3 percent upon the announcement of the issue. This drop is called the abnormal return.
5. Underpricing	For initial public offerings, losses arise from selling the stock below the true value.
6. Green Shoe option	The Green Shoe option gives the underwriters the right to buy additional shares at the offer price to cover overallotments.

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How are Start-up Firms Unusually Financed?

- Founder's resources
- Angels
- Venture capital funds
  - Most capital in fund is provided by institutional investors
  - Managers of fund are called venture capitalists
  - Venture capitalists (VCs) sit on boards of companies they fund

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Why Would a Company Consider Going Public?

- Advantages of going public
  - Current stockholders can diversify.
  - Liquidity is increased.
  - Easier to raise capital in the future.
  - Going public establishes firm value.
  - Makes it more feasible to use stock as employee incentives.
  - Increases customer recognition.

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Disadvantages of Going Public

- Must file numerous reports.
- Operating data must be disclosed.
- Officers must disclose holdings.
- Special "deals" to insiders will be more difficult to undertake.
- A small new issue may not be actively traded, so market-determined price may not reflect true value.
- Managing investor relations is time-consuming.

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What are Equity Carve-Outs?

- A special IPO in which a parent company creates a new public company by selling stock in a subsidiary to outside investors.
- Parent usually retains controlling interest in new public company.

What is a Rights Offering?

- A rights offering occurs when current shareholders get the first right to buy new shares.
- Shareholders can either exercise the right and buy new shares, or sell the right to someone else.
- Wealth of shareholders doesn't change whether they exercise right or sell it.

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What is Meant by Going Private?

- Going private is the reverse of going public.
- Typically, the firm's managers team up with a small group of outside investors and purchase all of the publicly held shares of the firm.
- The new equity holders usually use a large amount of debt financing, so such transactions are called leveraged buyouts (LBOs).

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Advantages of Going Private

- Gives managers greater incentives and more flexibility in running the company.
- Removes pressure to report high earnings in the short run.
- After several years as a private firm, owners typically go public again. Firm is presumably operating more efficiently and sells for more.

Disadvantages of going private

- Firms that have recently gone private are normally leveraged to the hilt, so it's difficult to raise new capital.
- A difficult period that normally could be weathered might bankrupt the company.

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More on Angel Investors (vs. private investors)

- Invest money in seed, startup and early stage companies
- Invest time in entrepreneurs and their companies
  - Business acumen
  - Mentoring and coaching
  - Serve on boards
  - Make business introductions

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Who are these Angel Investors

- **Often successful, exited entrepreneurs or retired business persons – active investors**
  - **Invest both time and money in companies**
- **Accredited Investors - SEC definition**
- **Angels invest their own money (not money managers)**
- **Investing in local companies**

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Motivation: Why Become an Angel Investor?

- **Helping entrepreneurs**
- **Stay engaged – using skills and experiences to help build a business**
- **Giving back to community or university**
- **An active form of investing – not just watching markets**
- **Return on Investment is the metric**

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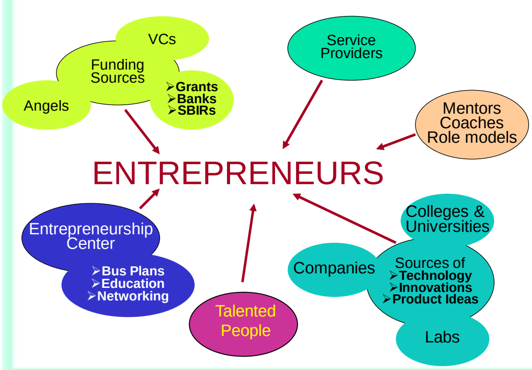
Entrepreneur-Friendly Communities



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