

Chapter 15

Raising Capital

Chapter Organization

- 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 New Equity Sales and the Value of the Firm
- 15.6 The Cost of Issuing Securities
- 15.7 Rights
- 15.8 Dilution
- 15.9 Issuing Long-Term Debt
- 15.10 Summary and Conclusions

T15.2 Evaluation Activities Carried Out By Venture Capitalists

“Prior to funding an investment as lead investor, how often do you engage in the following activities?”

Interview management team/tour facilities	100%
Tour facilities	100%
Contact former business associates/outside investors	96%
Contact current customers	93%
Have informal discussions with experts about the product	84%
Conduct in-depth review of pro forma financials	84%
Contact competitors	71%
Contact banker	62%
Contact suppliers	53%
Secure formal technical study of product	36%
Secure formal market research study	31%

Source: “Toward a Model of Venture Capital Investment Decision-Making” by Fried and Hirsch, 1994.

T15.3 Choosing a Venture Capitalist

Key Considerations in Choosing a Venture Capitalist

- Financial Strength - the ability to supply additional resources
- Management Style - level of involvement in decision-making
- References - the results of previous ventures
- Contacts - ability to provide introductions
- Exit Strategy - how and under what circumstances does the venture capitalist plan to “cash out”?

T15.4 The Basic Procedure for a New Issue

- 1. Obtain Approval from the Board of Directors
 - ◆ If increasing the number of shares outstanding, must submit to a vote of the shareholders
- 2. File preliminary prospectus (**red herring**) with OSC
 - ◆ Approx. 2 week waiting period for OSC approval
 - ◆ Tombstone ads placed
- 3. Revise prospectus to meet OSC approval, determine price.
- 4. Sell Securities to the Public

T 15.5 Streamlining Securities Filings

The Prompt Offering Prospectus

- Reduces repetitive filing requirements for large companies.
- Accessible only by large companies
- File annual and interim financial statement regardless of issuing securities.
- To qualify
 - ◆ Must have reported for at least 36 months
 - ◆ Must comply with continuous disclosure requirements
- Allows a short prospectus to issue securities

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- Large issuers only required to satisfy home country filings

T15.6 The Cash Offer - Terminology

■ Underwriter

- ◆ The Underwriter syndicate buys the securities and sells to the public.
- ◆ Underwriter bears risk in the offering, and must be compensated

■ Spread - the difference between what the Underwriter pays and the offering price of the securities.

■ Bought Deal - issuer sells entire issue to a single investment dealer or group

■ Selling period - Underwriting group agrees not to sell securities for less than the offering price until the syndicate dissolves.

■ Overallotment option - (aka *Green Shoe provision*) allows underwriting group to purchase additional shares at the offering price net of fees and commissions.

T15.7 A Red Herring

Subject to Completion, Dated December 19, 1989



25,000,000 Shares

The Reader's Digest Association, Inc.

Class A Nonvoting Common Stock
(par value \$0.01 per share)

Of the 25,000,000 shares of Class A Nonvoting Common Stock offered, 21,000,000 are being offered hereby in the United States and 4,000,000 are being offered in a concurrent international offering outside the United States. The initial public offering price and the aggregate underwriting discount per share will be identical for both Offerings. The closing of the U.S. Offering is a condition to the closing of the International Offering, but the closing of the International Offering is not a condition to the closing of the U.S. Offering. See "Underwriting".

All of the shares of Class A Nonvoting Common Stock offered are being sold by the Selling Stockholders. See "Selling Stockholders". The Company will not receive any of the proceeds from the sale of shares by the Selling Stockholders. (continued)

T15.7 A Red Herring (continued)

Prior to the Offerings, there has been no public market for shares of Class A Nonvoting Common Stock. It is currently anticipated that the initial public offering price will be in the range of \$18 to \$22 per share. For the factors to be considered in determining the public offering price, see “Underwriting”.

Application will be made to list the shares of Class A Nonvoting Common Stock on the New York Stock Exchange.

These securities have not been approved or disapproved by the securities and exchange commission nor has the commission passed upon the accuracy or adequacy of this prospectus. Any representation to the contrary is a criminal offense.

(continued)

T15.7 A Red Herring (continued)

	<u>Initial Public Offering Price</u>	<u>Underwriting Discount (1)</u>	<u>Proceeds to Selling Stockholders (2)</u>
Per Share.....	\$	\$	\$
Total (3).....	\$	\$	\$

(1) The Company and the Selling Stockholders have agreed to indemnify the Underwriters against certain liabilities, including liabilities under the Securities Act of 1933.

(2) Before deducting expenses, estimated to be \$ _____, of which \$ _____ will be payable by the Company and \$ _____ will be payable by the Selling Stockholders.

(3) The Selling Stockholders have granted the U.S. Underwriters an option for 30 days to purchase up to an additional 3,150,000 shares at the initial public offering price per share, less the underwriting discount, solely to cover over-allotments. Additionally, the Selling Stockholders have granted an over-allotment option with respect to an additional 600,000 shares as part of the International Offering. If such options are exercised in full, the total initial public offering price, underwriting discount and proceeds to Selling Stockholders will be \$ _____ and \$ _____, respectively. See "Underwriting". (continued)

T15.7 A Red Herring (concluded)

The shares offered hereby are offered severally by the U.S. Underwriters, as specified herein, subject to receipt and acceptance by them and subject to their right to reject any order in whole or in part. It is expected that the certificates for the Shares will be ready for delivery at the offices of Goldman, Sachs & Co., New York, New York on or about _____, 1990.

Goldman, Sachs & Co. _____ Lazard Frères & Co.

The date of this Prospectus is _____, 1990.

Information contained herein is subject to completion or amendment. A registration statement relating to these securities has been filed with the Securities and Exchange Commission. These securities may not be sold nor may offers to buy be accepted prior to the time the registration statement becomes effective. This prospectus shall not constitute an offer to sell or the solicitation of an offer to buy nor shall there be any sale of these securities in any State in which such offer, solicitation or sale would be unlawful prior to registration or qualification under the securities laws of any such State.

T15.8 A Tombstone Ad

58,750,000 Shares

Consolidated Rail Corporation

Common Stock
(par value \$1.00 per share)

Price \$28 Per Share

The shares are being sold to the United States Government pursuant to the Central Privatization Act. The Company will not receive any proceeds from the sale of the shares.

Users request a copy of the Prospectus describing these securities and the business of the Company may be obtained without any State from any Underwriter who may legally distribute it within each State. The securities are offered only by means of the Prospectus and this announcement is neither an offer or offer to sell nor a solicitation of any offer to buy.

52,000,000 Shares

This portion of the offering is being offered in the United States and Canada by the undersigned:

Goldman, Sachs & Co.
The First Boston Corporation
Merrill Lynch Capital Markets
Morgan Stanley & Co.
Salomon Brothers Inc.
Shearson Lehman Brothers Inc.

Also shown & Sons, Dillon, Read & Co. Inc., Credit Suisse, Luffin & Jernette, Credit Suisse Lambert, Hambrecht & Gust, G. F. Hutton & Company Inc., Kuhn, Loeb & Co., Laden Thorne & Co., Montgomery Securities, Prudential-Bache Capital Funding, Robinson, Cohen & Stephens, L. S. Rothschild, Shearson, Thurgood, T. Smith, Inc., South Realty, Swiss Lyman & Co., Northern Securities & Co., Dean Witter Reynolds Inc., Simon, Ross & Company, J. C. Weinman & Co., East Mountain & Co., Edwards & Sons, Inc., McClellan & Company, Oppenheimer & Co., Inc., Piper, Jaffray & Hopwood, Prudential, Bell & Turpin, Inc., Thomas McKelless Securities Inc., United First Securities, Inc., Advent, Inc., American Securities Corporation, Anschutz and S. Westwood, Inc., Robert W. Baird & Co., Salomon Field, W. Richards, Robert C. Rosenfeld Co., Inc., Ward Ellis & Lowell, Washburn & Company, Inc., Burns Prudential, Thomas H. Butler & Singer Inc., Green & Company, Drexel Securities Corporation, Eberstadt Fleming Inc., Egan, Oshinsky & Taylor, Inc., First of Michigan Corporation, First Securities Company, Furman Bell, Mayer, Shale & Birney, Grout & Co., Incorporated, Hoke, Noel, Lohrman, Friedlich, Investment Securities Corporation, Jersey Management Svcs. Inc., Johnson, Lane, Smith & Co., Inc., Johnson, Lorton & Co., Josephthal & Co., Lazard, Threlwell & Co. Inc., Conyn J. Lawrence, Legg Mason Wood Walker, Morgan Keegan & Company, Inc., Moseley Securities Corporation, Neuberger & Company, Inc., Neuberger & Berenson, The Ohio Company, Founders Finance Refiners, Inc., The Robinson-Humphrey Company, Inc., Rutledge Inc., Stephens Inc., ERM, Neuhaus & Company, Etkin & Co., Tucker, Anthony & R. S. Day, Inc., Underwood, Neuhaus & Co., Wood Grundy Corp.

This special bracket of newly issued and controlled firm assumed for Co Lead Advisors in the United States offering pursuant to the Central Privatization Act.

ABC Investment Services Corporation
ABC Lead Securities Corporation
Citic Securities, Inc.
Walter Smith & Co., Inc.

6,750,000 Shares

This portion of the offering is being offered outside the United States and Canada by the undersigned:

Goldman Sachs International Corp.
First Boston International Limited
Merrill Lynch Capital Markets
Morgan Stanley International
Salomon Brothers International Limited
Shearson Lehman Brothers International

Algemeen Bank Nederland N.V., Banque d'Alsace Lambert S.A., Banque Nationale de Paris, Citibank & Co., The Nikko Securities Co., Export Ltd, Fomento Operacional, N.M. Rothschild & Sons, J. Henry Seligman Wegg & Co., Societe Generale, G. G. Waring Securities, ABC International Ltd, Banque Paribas Capital Markets Limited, Caixa Mattema de Credit Agricole, Compagnie de Banque et d'Investissements, CIB, Credit Lyonnais, Swiss Leasing, IMI Capital Markets (UK) Ltd., Jett Seligmanberg, Getulio & Co., Law Securities Limited, Morgan Grenfell & Co., Paribasbank, van Campenot & Co SCS, Swiss, Volkbank, Yessing and Wulfsberg, J. Vanhel & Co Ltd, M. M. W. Seligman-Brockmann, Stern & Co., Waandhouwer Londenbank, Yamaichi International (London)

March 27, 1992

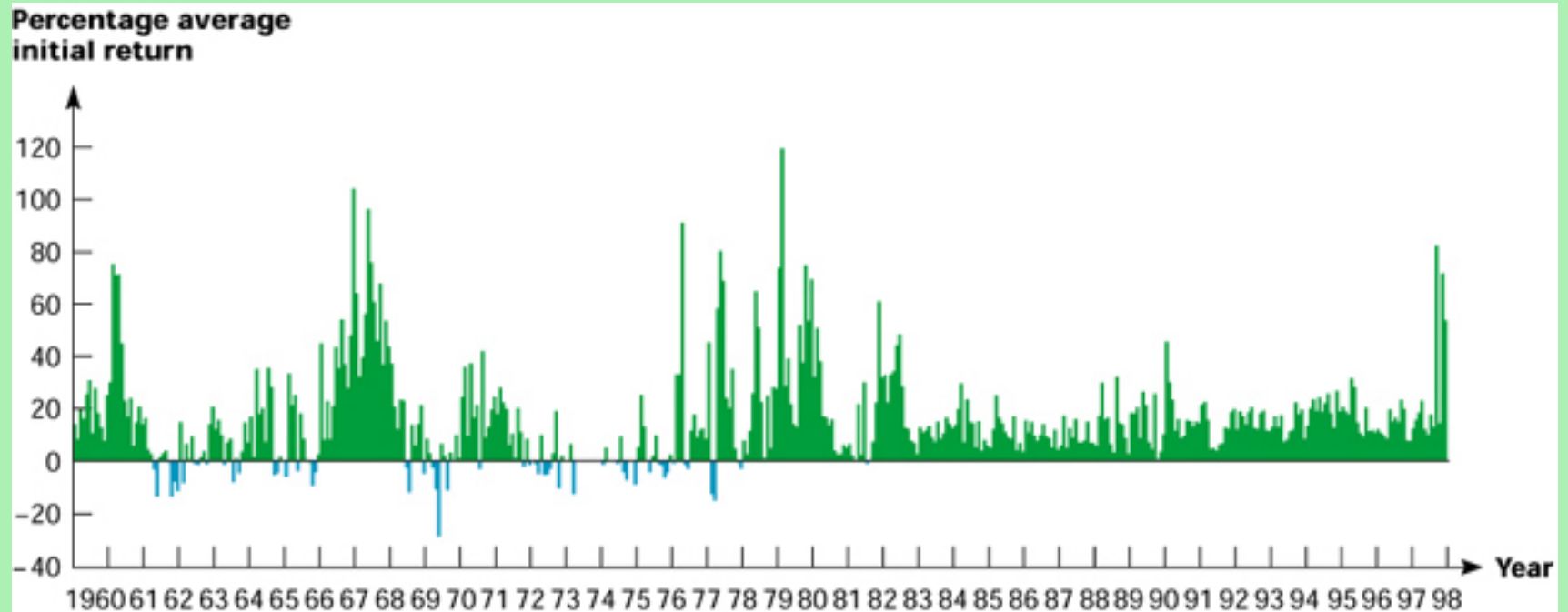
T15.9 Empirical Studies of Underpricing (Table 15.4)

Sample	Sample Period	Average Underpricing
120 US IPOs, selected monthly	1960-69	11.4%
5,000 US IPOs	1960-82	18.8
1026 US IPOs	01/1980 - 03/1982 (hot market)	48.4
	Remainder 1977-1982	16.3
	Subset of established firms	10.0
1188 US IPOs	1983-1987	
	74 reverse LBO	2.0
	1,114 IPO control sample	7.8
1,078 US IPOs	1981-1985	6.2
1,526 US IPOs	1975-1984	14.3
100 Canadian IPOs	1971-1983	9.0-11.5
116 Canadian IPOs	1984-1987	4.3
299 Canadian IPOs	1984-1995	7.8

T15.10 Empirical Studies of Underpricing (Table 15.3)

Variable	Empirical Evidence
Direct Disclosures	
Sales and earning from existing operations	+ or 0
Book value of existing assets	+
Information intermediation	
High quality (good reputation) services	+
Signals of inside information	
Entrepreneurial ownership retention	+ or 0
Use of proceeds for risky investments	+
Stated dividend policy	0

T15.11 Average Initial Returns by Month for SEC-Registered IPOs: 1960-1998 (Fig. 15.1)



T15.12 New equity sales and the value of the firm

- Why should stock price decrease with the announcement of an equity issue?
 - 1. Managerial Information
 - ◆ New issue is a 'signal' that managers, who are thought to be better informed about the firm's prospects, think that the stock is currently trading at a higher price.
 - 2. Debt usage
 - ◆ Investors ask why managers choose to issue stock when funds could be raised by a debt issue. Is the firm over-leveraged? Are there liquidity concerns?
 - 3. Issue costs
 - ◆ Stock prices may fall because it is expensive to sell securities.

T15.13 Costs of issuing securities

- **Spread** - difference between investor price and proceeds to firm
- **Direct expenses** - fees of the offering (legal, filing) and taxes
- **Indirect expenses** - the time managers spend on the offering where they might otherwise be pursuing projects
- **Abnormal returns** - For established firms, stock price drops an average of 3% on announcement of new issue.
- **Underpricing** - For IPOs, the stock is offered to the market at a price below where it soon trades
- **Overallotment** - Special price to the underwriter.

T15.14 Direct and Indirect Costs, in Percentages, of Equity IPOs: 1990-94 (Table 15.5)

Proceeds (\$ millions) issues	Number of spread	Gross expense	Other	Total	Underpricing
			direct	direct	
2 - 9.99	337	9.05%	7.91%	16.96%	16.36%
10 - 19.99	389	7.24	4.39	11.63	9.65
20 - 39.99	533	7.01	2.69	9.70	12.48
40 - 59.99	215	6.96	1.76	8.72	13.65
60 - 79.99	79	6.74	1.46	8.20	11.31
80 - 99.99	51	6.47	1.44	7.91	8.91
100 - 199.99	106	6.03	1.03	7.06	7.16
200 - 499.99	47	5.67	0.86	6.53	5.70
500 - up	10	5.21	0.51	5.72	7.53
Total	1767	7.31%	3.69%	11.00%	12.05%

Source: Inmoo Lee, Scott Lochhead, Jay Ritter, and Quanshi Zhao, "The Costs of Raising Capital" *Journal of Financial Research* 19 (Spring 1996).

T15.15 Rights Offerings: Basic Concepts

- Rights offering

Issue of common stock to existing shareholders

- Subscription price

The dollar cost of one of the shares to be issued.

- Ex-rights date

Beginning of the period when stock is sold without a recently declared right, normally two trading days before the holder-of-record date.

- Holder-of-record date

Date on which existing shareholders are designated as the recipients of stock rights.

T15.16 The Value of a Right

The **value** of a right equals the difference in the price of the issuer's outstanding shares before and after the rights offering, and is determined by three factors:

- the total amount of money to be raised,
- the subscription price of the new shares, and
- the number of existing shares.

The number of new shares to be issued equals

Funds to be raised/Subscription price

T15.16 The Value of a Right (concluded)

The number of rights needed to buy one share equals

$$\frac{\text{Number of old shares}}{\text{Number of new shares}}$$

After the offering, the new value of the firm is

$$\text{Pre-offering firm value} + \text{funds raised},$$

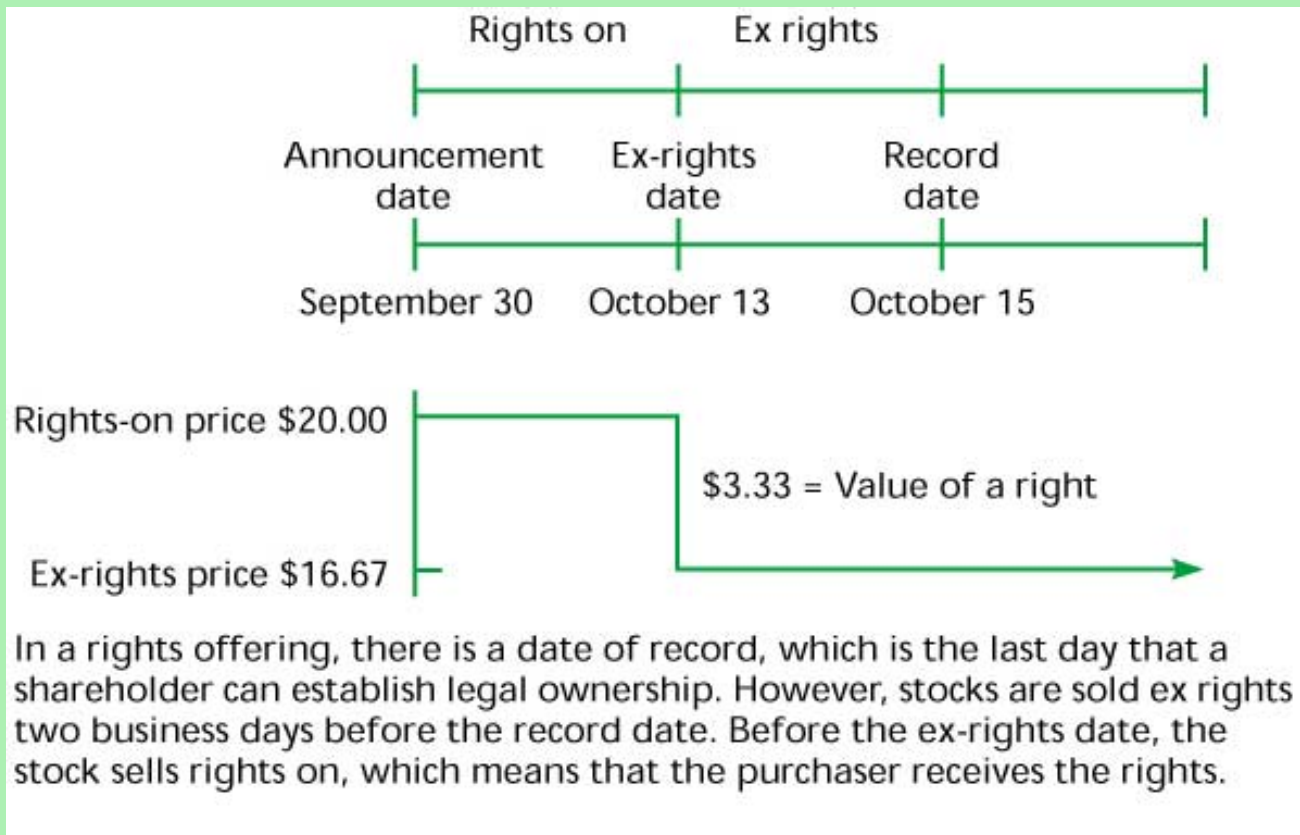
and the new share price must be

$$\frac{\text{New firm value}}{\text{Total number of shares outstanding}}.$$

The value of the right must equal

$$\text{Old share price} - \text{new share price}.$$

T15.17 Ex Rights Stock Prices (Figure 15.4)



T15.18 Rights Offerings: Issues

- Standby fees

Amount paid to underwriter participating in a standby underwriting agreement.

- Standby underwriting

The type of underwriting in which the underwriter agrees to purchase the unsubscribed portion of the issue.

- Oversubscription privilege

A privilege that allows shareholders to purchase unsubscribed shares in a rights offering at the subscription price.

- Effects on shareholders

Shareholders don't gain or lose, as long as they either exercise or sell their rights.

T15.19 New Issues and Dilution

■ Dilution

Loss in existing shareholders' value in terms of either ownership, market value, book value, or EPS

Which is most important? What matters most to investors?

■ Types of dilution

◆ Dilution of proportionate ownership

A shareholder's reduction in proportionate ownership due to less-than-proportionate purchase of new shares

◆ Dilution of market value

Loss in share value due to use of proceeds to invest in negative NPV projects.

◆ Dilution of book value and earnings per share (EPS)

Reduction in EPS due to sale of additional shares

T15.20 Issuing Long-Term Debt

- Generally, use the same procedures as for equity.
 - ◆ Register security with securities regulator, issue prospectus, etc.
- Direct private long-term financing
 - ◆ Term loans - direct business loans
 - Lenders are regulated by the OSFI
 - Regulate the capital requirements of financial institutions
 - CDIC insures deposits, and is therefore interested in bank policy
 - ◆ Private placements
 - Investment dealer* rather than an underwriter
 - Offering memorandum* rather than a prospectus
 - Sold to *exempt purchasers*

T15.21 Issuing Long-Term Debt: comparisons

Compare the costs for term loans, private placements and publicly issued debt for each of the following cost classifications:

- Registration costs
- Restrictive covenants
- Renegotiation
- Suppliers of funds
- Transaction costs

T15.22 Chapter 15 Quick Quiz

1. What factors should an entrepreneur consider when choosing a venture capitalist?

Financial strength, references, exit strategy, management style, contacts

2. What is a “red herring”? More important, what purpose does it serve in the issuance process?

It is a preliminary prospectus used to generate interest in the upcoming security sale

3. What is the difference between a “firm commitment” underwriting and a “best efforts” underwriting? When would each be used?

In the former, the underwriter buys the entire issue and assumes financial responsibility for the sale; in the latter the underwriter simply sells as much of the offering as possible, and is used for smaller, riskier offerings.

T15.23 Solution to Problem 15.1

Bajor Mining Co. is proposing a rights offering. Presently there are 250,000 shares outstanding at \$60 each. There will be 50,000 new shares offered at \$40 each.

- a. What is the new market value of the company?
- b. How many rights are associated with one new share?
- c. What is the ex-rights price?
- d. What is the value of a right?
- e. Why might a company have a rights offering rather than a general cash offer?

T15.23 Solution to Problem 15.1 (concluded)

- a. New value = $(250,000 \times \$60) + (50,000 \times \$40) = \$17$ million
- b. There will be $(250,000 / \underline{\hspace{2cm}}) = \underline{\hspace{1cm}}$ rights associated with each new share.
- c. The ex-rights price is $\$17 \text{ million} / \underline{\hspace{2cm}} = \56.67 .
- d. The value of one right equals $\$ \underline{\hspace{1cm}} - 56.67 = \$ \underline{\hspace{1cm}}$.

T15.23 Solution to Problem 15.1 (concluded)

- a. New value = $(250,000 \times \$60) + (50,000 \times \$40) = \$17$ million

- b. There will be $(250,000/50,000) = 5$ rights associated with each new share.

- c. The ex-rights price is $\$17 \text{ million}/300,000 = \56.67 .

- d. The value of one right equals $\$60 - 56.67 = \3.33 .