Equity Issuance

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1 Introduction

2 Procedures for issuing securities.

There is a large number of different types of securities that a firm can use to get capital. They all fulfill the purpose of providing a firm with cash to run its operations.

Here are some of the more common financing options.

- Equity investment by owner.
- Bank borrowing.
- Venture capital (equity investment)
- Private placement of Bonds.
- Private placement of Equity.
- Public bond issue.
- Public equity issue.

This list you can think of as sorted by size, the latter types of financing here will only be used by larger corporations, because of the large (out-of-pocket) costs involved.

Small corporations will usually start by financing with equity and bank borrowing, and progress up this list as they grow.

3 Basics of issuing securities.

All security issues can be classified as either

1. a *direct private placement* or
2. a *public offering*.

4 Private Placement

A *private placement* of securities issue simply refer to a situation in which the new issue is purchased and subsequently held, by a small group of investors (usually a bank, insurance company or pension fund). Typically, private issues are relatively small compared to most public issues. Private issues have the following advantages and disadvantages to the issuing firm and to the private buyers.

1. When a company makes a private placement, it avoids the need to register the issue with the SEC (Securities and Exchange commission), thus lowering the cost of issuing a private placement.
2. A disadvantage of a private placement is that the investor can not easily resell the security. Private placements are less liquid than public placements.
3. A potential advantage to both the issuer and investor of a private placement is that the debt contract can be tailor made. This may make it easier for the issuing firm to get special terms or conditions accepted by the investor since their relationship is much more intimate.
4. Private placements allow small and medium-sized firms to obtain financing without paying the high issue costs of a public issue and who may need highly specialized, flexible loan arrangements.
5. Typically the interest rate on private placements is higher than on comparable public issues. This higher interest rate reflects the higher risks and illiquidity of private placements.

5 Public offering

A *public offering* is exactly what it sounds like it is: a security issue to the public. Public offerings are generally of two types:

1. a *general cash offering* or
2. a *rights offering*.

Before looking at the special characteristics of these two types of public offerings, we will first take a look at the features that are common to all public issues.

5.1 Steps involved in a public offer.

1. The first step in making a public offering is to get the *approval of the board of directors*. Although the final details of the issue will not be known at this time, the firms should have a pretty good idea of the type of security it will issue and the approximate amount of funds to be raised.
2. The second step is to prepare a *registration statement* with the aid of the company's investment bankers. The registration statement is a detailed document which presents information about the proposed financing and the firms history, existing business and plans for the future. After close examination by the SEC, and possible revisions, the SEC will either accept or reject the issue as satisfying its guidelines for a public offering. If accepted, the firm has a 20 day waiting period before it can actually issue the securities.
3. The first part of the registration statement that is sent to the SEC is usually distributed by the company to potential investors in the form of a *preliminary prospectus*. It is generally known as a *red herring* because of the red print denying that the company is attempting to sell the securities before the registration becomes effective.
4. After registration, a *final prospectus* is issued which usually differs from the preliminary only by the addition of the final offer price and a few other minor changes that are required by the SEC. At the same time, the company publishes a *"tombstone"* advertisement which lists the names of the underwriters (investment bankers) from whom a prospectus can be obtained.
5. The issue is finally sold by the investment banking group (called a *syndicate*). The issue can be sold either on an underwritten basis or on a best efforts basis. In the case of an underwritten basis the investment bankers actually purchase the issue from the firm, then takes the risks of selling the securities to investors. On a best efforts basis, the investment bankers do not guarantee the sale of the issue, they merely agree to use their best efforts to help the corporation sell its securities.

5.2 Cost of public issues.

A public issue can generate substantial administrative costs. The single largest cost of a public issue is underwriting. Underwriters provide advice to the company, buy the issue, and resell it to the public.

Table 1 show estimates of the percentage costs for public stock issues.

Table 1 Estimated Issue costs for public common stock offerings. Source: (Weston and Copeland, 1992, pg 898)

	Seasoned issues.	
	Large issues	Small issues
Underwriter fees	2–3%	8–10%
Other direct expenses	0.5	4–6
Indirect expenses	1–2	2–4
Event adjustments	1–2	1–2
Underpricing	?	?
Options to underwriters	?	?

1. Stock issues, in general, are more expensive than debt issues. This higher cost is mainly due to the larger costs of underwriting a stock issue.

2. Many of the costs of issuing securities are fixed. Therefore, there are large economies of scale in issuing securities.

Note that a hidden cost of issuing securities is in "underpricing", that is, setting an offer price which is substantially below the true value of the securities.

5.3 General cash offers.

Earlier we said that public offerings could be classified as either a *general cash offer* or as a *rights offer*. We first consider the important characteristics of a general cash offer. We will later discuss rights offers in more detail.

General cash offers are sold to investors at large, whereas rights offers are sold to the firms existing security holders. Virtually all debt issues are sold by general cash offers. Equity securities may or may not be.

The first public issue by a company is known as an *unseasoned issue*. Since an unseasoned issue is, by definition, a company's first public offering, it is necessarily a general cash offer.

Most general cash offers are *underwritten*, although if the investment bankers perceive the issue to be unusually risky it may be sold on a *best efforts* basis.

Setting the offer price can be a difficult task for the company and its investment bankers, especially for unseasoned issues where there is no existing market for the securities. Researchers have found that, in general, new issues tend to be substantially underpriced. A study by Roger Ibbotson of 120 new unseasoned issues, for example, found that an abnormal return of 13% in the first month, and 8% in the second month could have been earned by an investor who bought at the issue price. Thus it appears as if underwriters consistently price new issues below their true market value.

6 Initial Public Offering (IPO)

Initial Public Offering (IPO): A privately held company issues new stocks, register the stocks for public trading on a stock exchange, and sell the stocks to investors.

Examples:

Big: May 1999 Goldman Sachs raised $3.7 billion.

Famous: August 9, 1995 Netscape raised $140 million. Stock offered at $25 and closed at $58.25 on the first day of trading (+108%).

6.1 IPO mechanics

Classical IPO

- Engage underwriter, syndicate (investment banks)
- File with regulator (SEC, Finanstilsynet,...)
- Initial valuation range
- Road show, book building
- Set offer price,
- IPO day, under/over-subscribed?
- Trading at IPO day - What is the market valuation?

Alternatives to IPO:

- Price set through auction (Google)
- Pure listing, no new shares (Spotify)

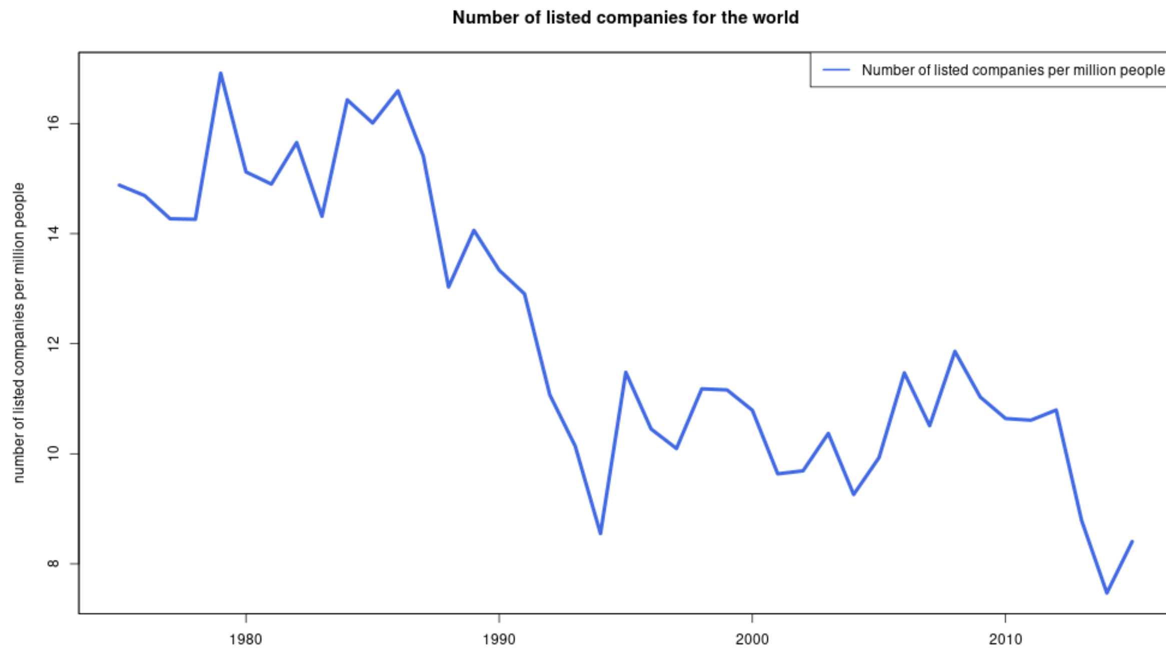
6.2 Advantages and disadvantages of an IPO

- Advantages
  - Access to more capital later
  - Liquidity for the stock: Enables initial investors to cash out
  - Provides visibility
  - Facilitate mergers
- Disadvantages
  - Expensive, gross spread is 7%
  - Ongoing need to provide financial reports
  - Subjected to (hostile) takeovers
  - Legal liability (liable for information in prospectus)
  - IPO process diverts attention from business
  - Loss of confidentiality

7 Why do firms list on exchanges?

It seems that the numbers of companies that choose to list is declining over time. Figure 1 shows the world decline in number of exchange listed corporations.[1]

Figure 1 Number of listed companies in the world



Data source: FRED.

Industry is thinking about why one keep firms on the exchange.
With more capital available (private equity), why list?
Key question: What is the value *to the firm* of being on an exchange?
All else equal, the firms owners (stockholders) would prefer listed stocks:

- Easier to buy/sell (liquidity)
- Being able to observe stock price (value) a public good
- Higher requirement for the firm to provide information to the market → Lower information cost as a stockholder.
- ...

But this not particularly relevant to the firm and its management.
Finance 101: The value of the firm:
Present value of future cashflows.
Hence: Management should focus on making investment (and financing) decisions that maximizes this.
How can being listed affect the PV(future cashflows)?
Which firms list, and which remains private?

[1] See also *The Economist* may 2012: The death of the public corporation?

One possible framing:
Theoretical model of Boot, Gopalan, and Thakor (2006)
The Public/Private decision a result of a tradeoff.
Private:

- + Maximal freedom of decisions for entrepreneur/manager
- − Potentially complicated contractual relationship to providers of capital (e.g. venture financiers)
- − Illiquid capital - higher cost of capital

Public:

- − Corporate governance framework restricting manager
- + Liquid capital, lower cost of capital

Another way of framing: Interview evidence of Brau and Fawcett (2006).
What is important for CFO's in the listing decision?

- Merger/takeover positioning
- Strategic moves (enhancing firm reputation)
- Cashing out by insiders
- Lower Cost of capital

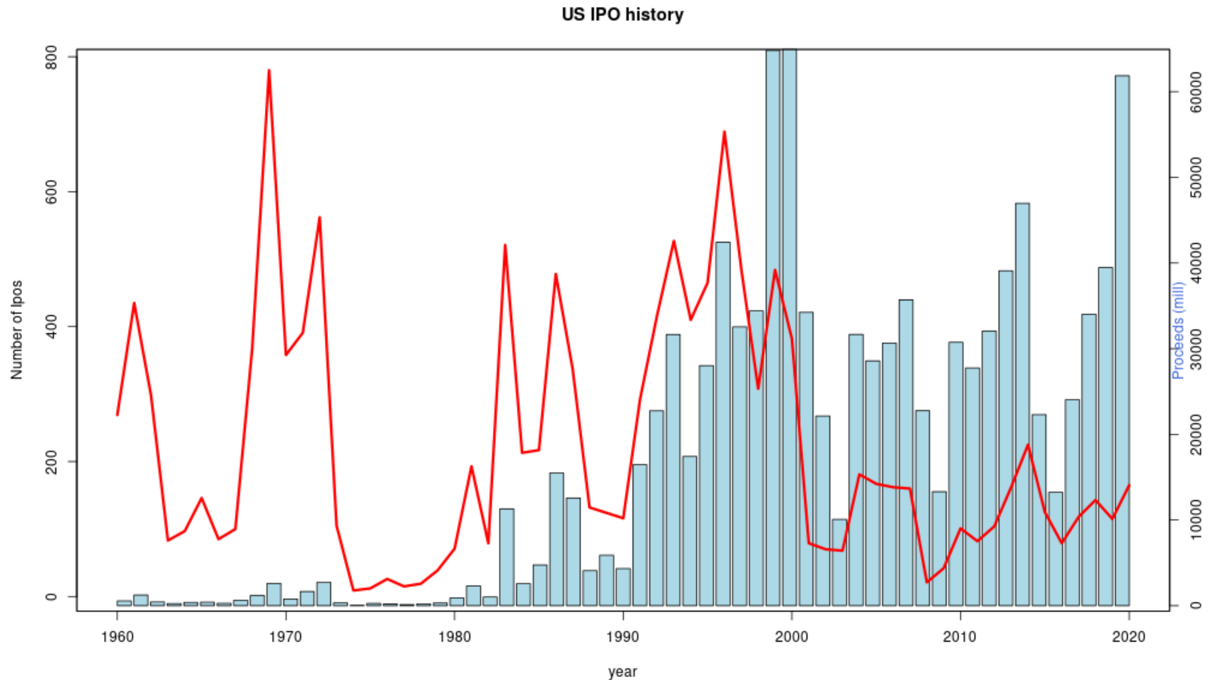
Problem: While this is what the CFO *say* is most important, economic link still not obvious for many of these:

e.g.: Takeover positioning - does this work through the expected increase in cash flows as a result of a (value-increasing) merger?

7.1 IPO's - some aggregates

Figure 2 Show some aggregate data for the US, number of IPO's and amounts raised.

Figure 2 US IPO history



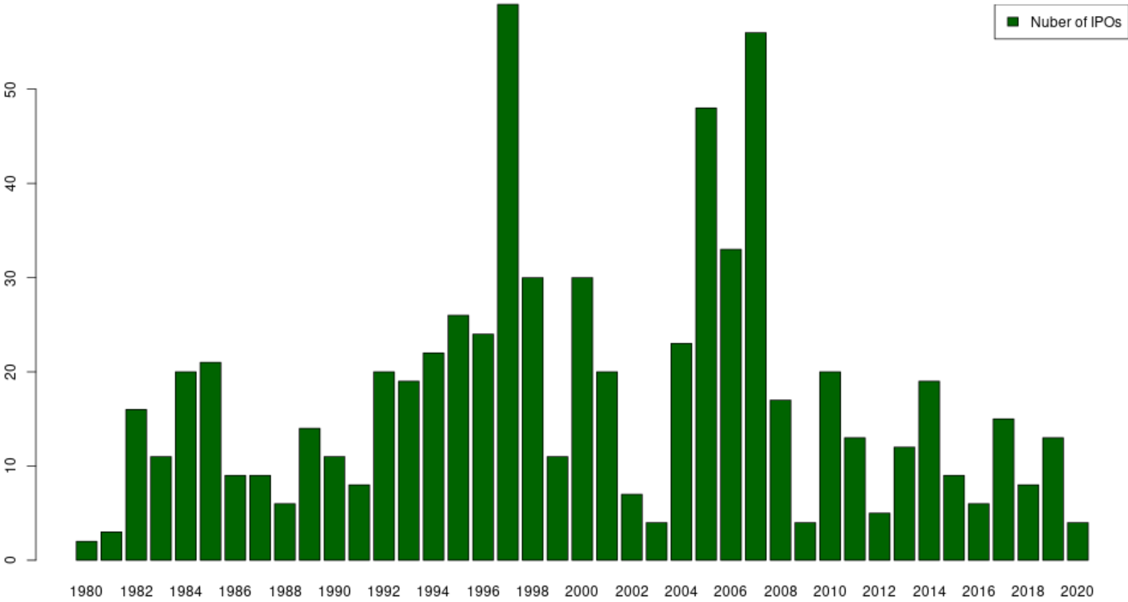
Number of IPO's in a year (red line), and total amount (in million US dollars) raised at the listing. Data from Jay Ritters homepage.

7.2 IPOs at the Oslo Stock Exchange

Let us look at some number for new firms listing at the Oslo Stock Exchange. Figure 3 shows the number of new firms entering the Oslo Stock Exchange.

Figure 4 gives some information about the importance of the stock market for the Norwegian economy, by showing the value (in bill NOK) of the new firms. Note, though, that the amount raised in the IPO is substantially less than the value of the new firms.

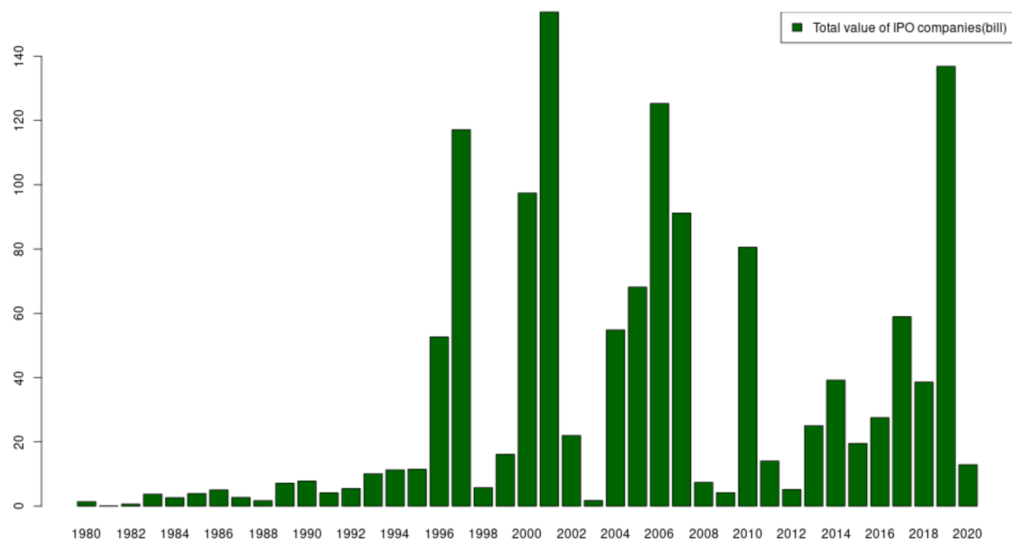
Figure 3 New listings per year



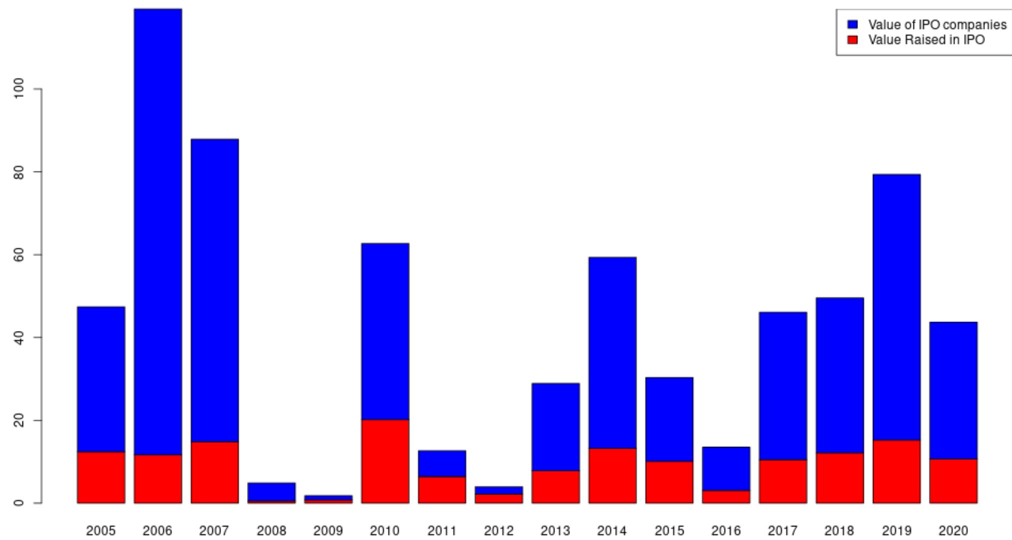
Each year we count the number of new equities in the OSE stock price data.

Figure 4 IPO's aggregate values

Panel A: Total value of all new companies at yearend.



Panel B: Comparing total firm values and amounts raised at IPO date.



In the figure in panel A we sum the firm values at yearend for all stocks newly listed on OSE during the year. In the figure in panel B we show the same aggregate values, calculated at the IPO date. We also show the aggregate amounts raised during the IPO.

7.3 IPOs underpricing

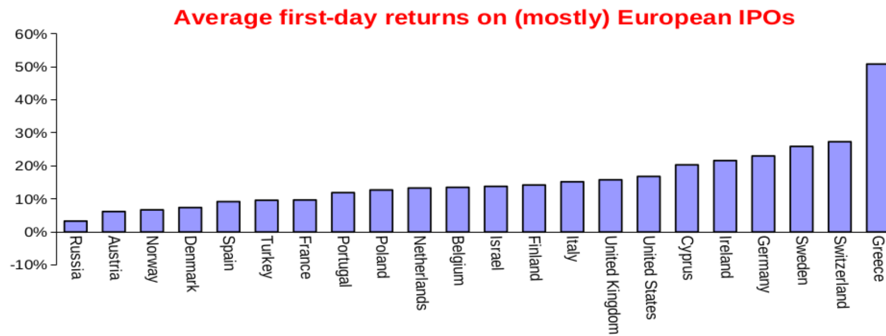
Underpricing – Percent difference between offerprice and closing price on first day of trading.

Major part of the *cost* of listing. To the current owners of equity in the firm: Buyers in the IPO get the stocks for a lower price than their actual value (proxied by the closing price).

The evidence: Worldwide underpricing

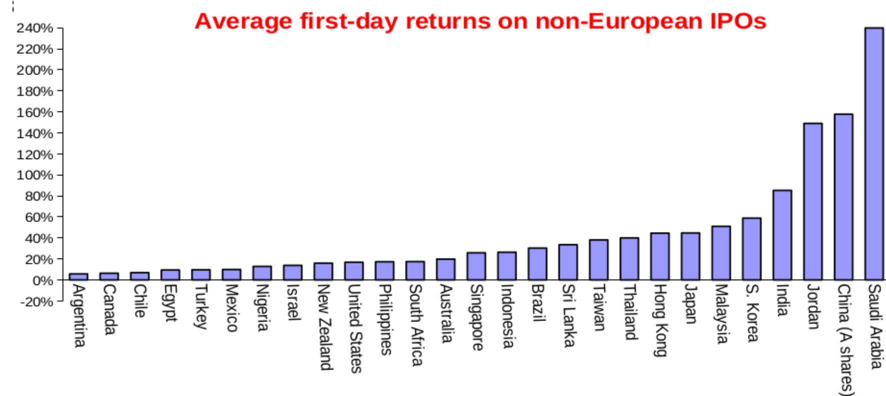
Underpricing ranging from 5.4% to 256.9% in 38 other countries.

Figure 5 IPO underpricing - Europe



Source: Jay Ritters homepage

Figure 6 IPO underpricing - Non-Europe



Source: Jay Ritters homepage

7.4 Explaining the IPO underpricing

Look at som selected explanations:

(i) Winner's curse

(ii) Costly information acquisition

(i) Winner's curse
(Rock, 1986).

- Assume two types of investors: informed and uninformed.
- Informed investors only buy when the issue is underpriced.
- **Uniformed investors face the winner's curse:**
  - If they are allocated shares, it is because the informed investors did not want to buy (the issue is overpriced)
  - If they are not allocated shares, it is because the informed investors want to buy (the issue is underpriced)

  ⇒ If they get shares, they regret, if they do not get shares, they regret!

- Winners curse problem reinforced by:
- **Pre-rationing of big (institutional) investors:**
  - Underwriters need to nurture their relationship with big institutional investors. Makes their selling job easier.
  - One way to do this is to pre-ration shares when they have a good offering (one with large underpricing) on their hands.
  - This further reduces the probability that small investors are allocated shares if the offering is really good.

(ii) Costly information acquisition (Benveniste and Spindt, 1989),

- Informed investors have knowledge that would help firm/underwriter to price the issue.
- Must compensate investors through underpricing in order to induce information sharing, and use **greater underpricing** when favorable information is revealed than when unfavorable information is revealed.

  Note: Otherwise no incentive to reveal their information.

- Allocation rule: Get many shares if they reveal high interest (many shares at a high price), get none or only a few shares if they show low interest.

  Note: If an investor that know the offering is good, tries to make huge profit by pretending that he is only interested at a low price, he wont be allocated shares.

- Truthful revelation incentive strengthened by awarding extra shares to regulars.

8 Issuing new equities after an IPO: Seasoned Equity Issuance (SEO)

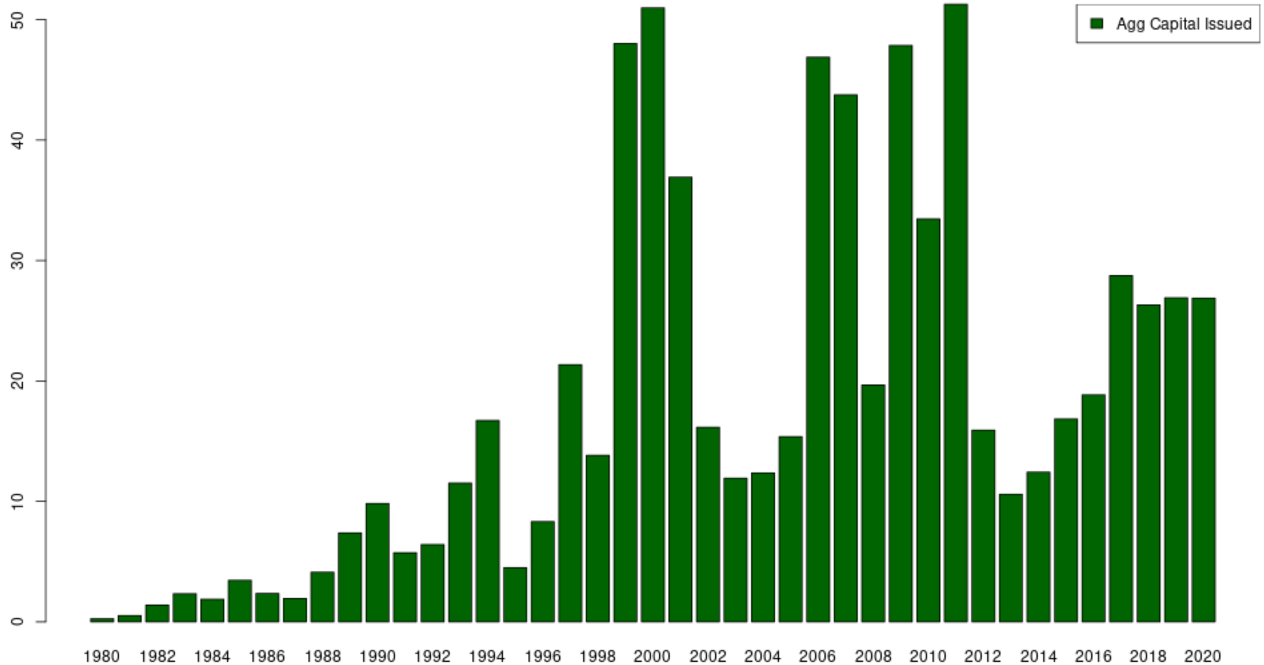
SEO's are similar to IPO's, except that the stock is already traded, and one therefore can observe a price.
SEO's are performed as either

- Private placements, or
- Rights issues

8.1 Seaoned Equity Issuance at the Oslo Stock Exchange

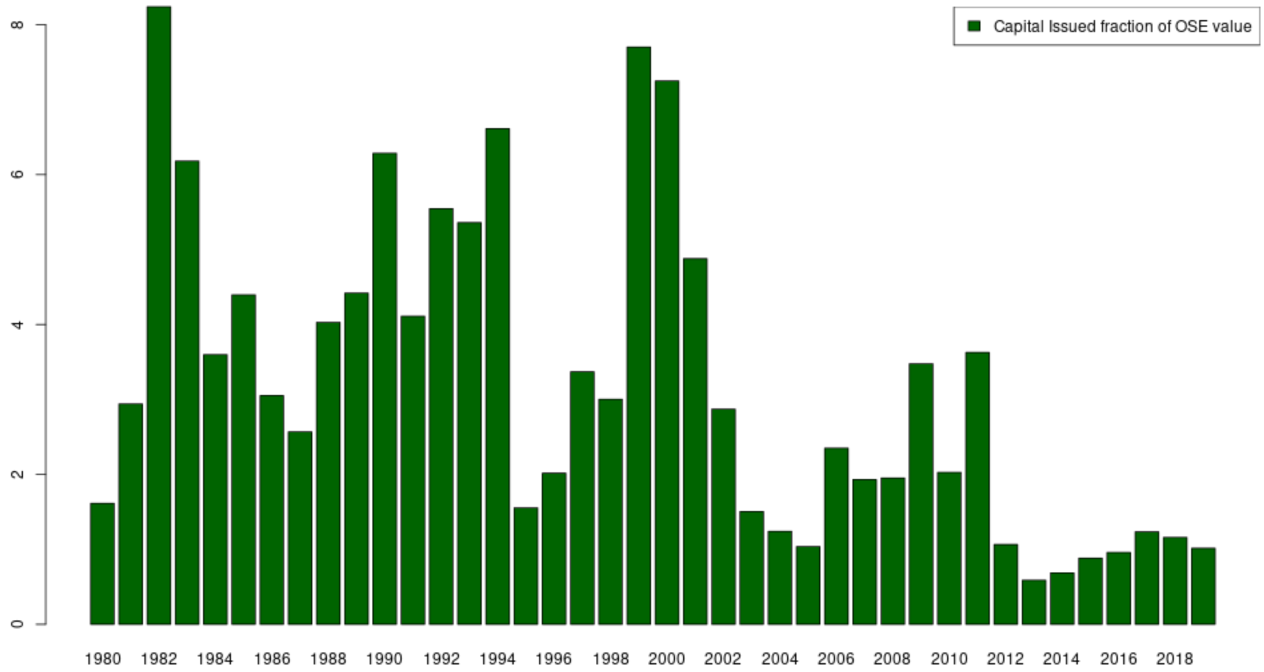
In this section we look empirically at seasoned equity issues the OSE. Figures 7 and 8 show some aggregates.

Figure 7 Total capital raised as seasoned equity offers at the OSE



The figure shows the aggregate amounts raised at the Oslo stock exchange through seasoned equity issues.

Figure 8 Aggregate capital raised as seasoned equity offers at the OSE, in percent of the exchange value



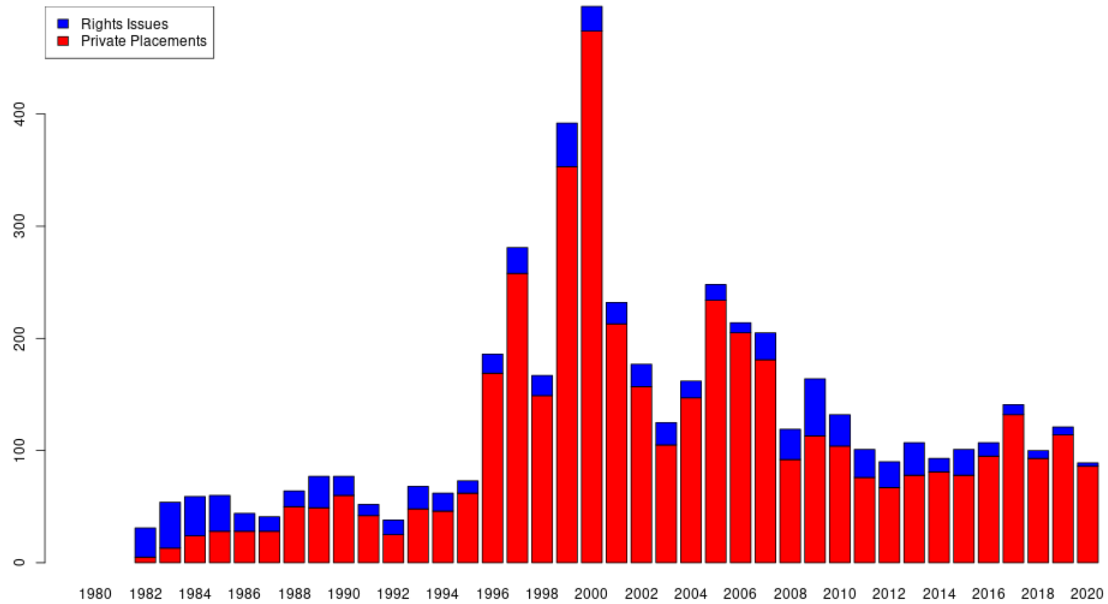
The figure shows the aggregate amounts raised at the Oslo stock exchange through seasoned equity issues, in percent of the total value of firms listed at the OSE.

The issuance is done through two types of mechanism, rights issues, and private placement. In figure 9 we look at the importance of these two types.

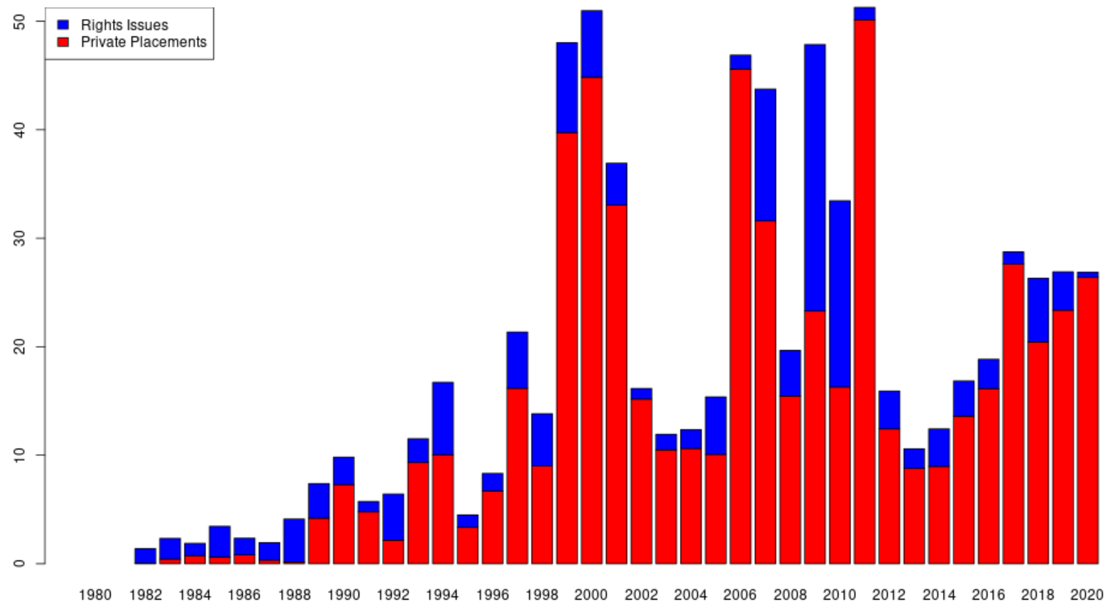
The results here are updates of Kvaal and Ødegaard (2011). See that paper for more detail (in Norwegian).

Figure 9 Seasoned Equity Issues, OSE, split by rights issues and private placements

Panel A: Number of issues



Panel B: Value (in mill NOK) issued



Seasoned Equity issues at the OSE, year by year, split by type of mechanism: Private placement and Rights Issue. In panel A we show the number of SEO's of each type. In Panel B we show the total amounts raised through SEO's of each type.

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