Issuing equity

Procedures for issuing securities.

Purpose of issuing securities:
Provide a firm with cash to run its operations.
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.

Basics of issuing securities.

All security issues can be classified as either

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

Private Placement

A new issue is purchased and subsequently held by a small group of investors.
Usually relatively small compared to most public issues.
Advantages and disadvantages:

1. Advantage: A private placement avoids the need to register the issue with the regulatory authorities.
   Lower the cost of issuing a private placement.
2. Disadvantage:
   Investors can not easily resell the security.
   Private placements are less liquid than public placements.

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%).

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)

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

The decline of the listed firm

Number of listed companies in the world

Data source: FRED.

Why list a firm on an 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 $\rightarrow$ Lower information cost as a stockholder.
- ...

But this not particularly relevant to the firm and its management.

Why list a firm on an exchange? – ctd

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?

Why list a firm on an exchange? – ctd

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:

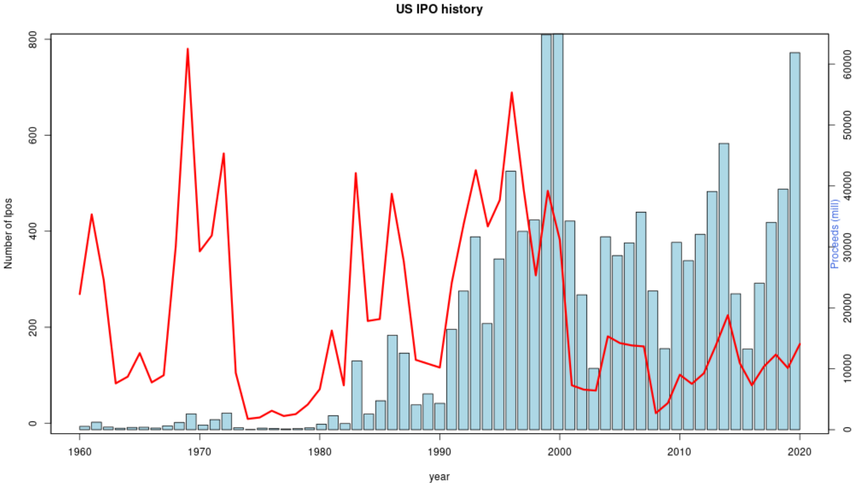
- $-$ Corporate governance framework restricting manager
- $+$ Liquid capital, lower cost of capital

Why list a firm on an exchange? – ctd

Yet 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

US IPO history



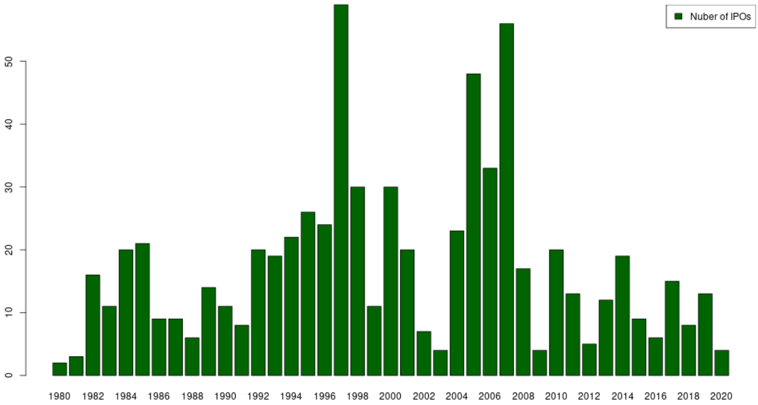
Number of IPO's in a year (red line), and total amount (in million US dollars) raised at the listing. Data from Jay Ritters homepage.

IPOs at the Oslo Stock Exchange

Some observations on IPO's at the Oslo Stock Exchange.

IPOs at the Oslo Stock Exchange

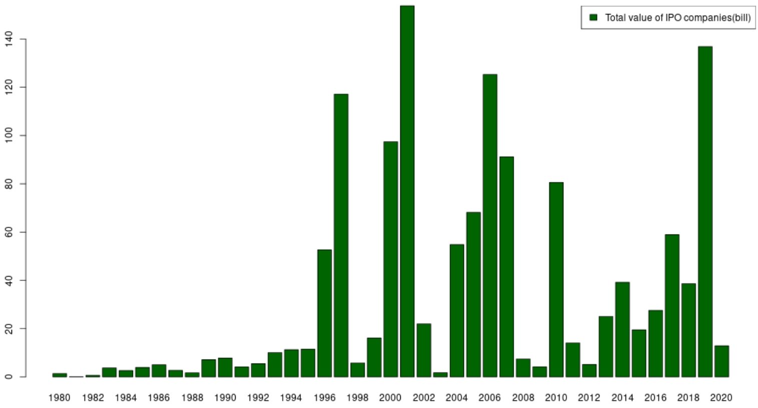
New listings per year



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

IPOs at the Oslo Stock Exchange

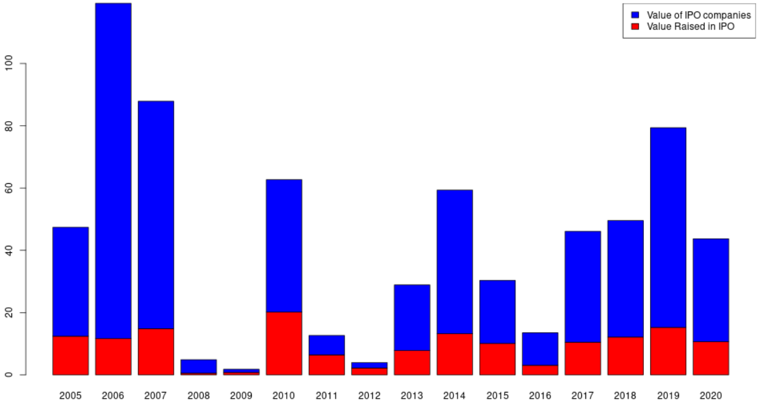
IPO's aggregate values



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

IPOs at the Oslo Stock Exchange

Fraction of company value raised in IPO



Comparing total firm values and amounts raised at IPO date.

Why are IPOs underpriced?

- **Underpricing** = Percent difference between offerprice and closing price on first day of trading.
- **The evidence: Worldwide underpricing**

Country	Period	Average initial return
Norway	1984–1996	12.5%
Canada	1971–1999	6.3%
USA	1960–2001	18.4%

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

Explaining the IPO underpricing

- Look at two selected explanations:
  (i) Winner's curse
  (ii) Costly information acquisition

(i) Winner's curse

- Assume two types of investors: informed and uninformed.
- Informed investors only buy when the issue is underpriced.
- **Uninformed 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)

$\Rightarrow$ 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

- 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.

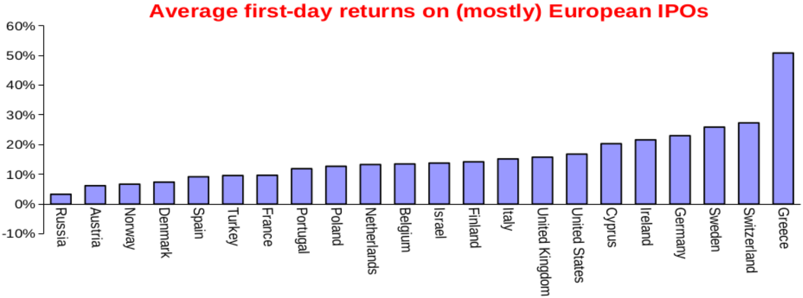
  Note: Otherwise no incentive to reveal their information.
- Allocation rule: Get many shares if they reveal high interest (many shares at a high price), get none or only a few shares if they show low interest.

  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.

IPOs underpricing

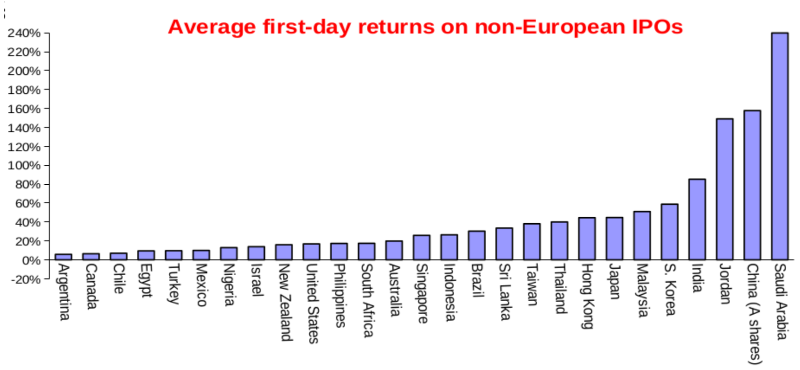
Underpricing – Percent difference between offerprice and closing price on first day of trading.
Major part of the *cost* of listing. To the current owners of equity in the firm: Buyers in the IPO get the stocks for a lower price than their actual value (proxied by the closing price).
The evidence: Worldwide underpricing
Underpricing ranging from 5.4% to 256.9% in 38 other countries.

IPO underpricing - Europe



Source: Jay Ritters homepage

IPO underpricing - Non-Europe



Source: Jay Ritters homepage

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

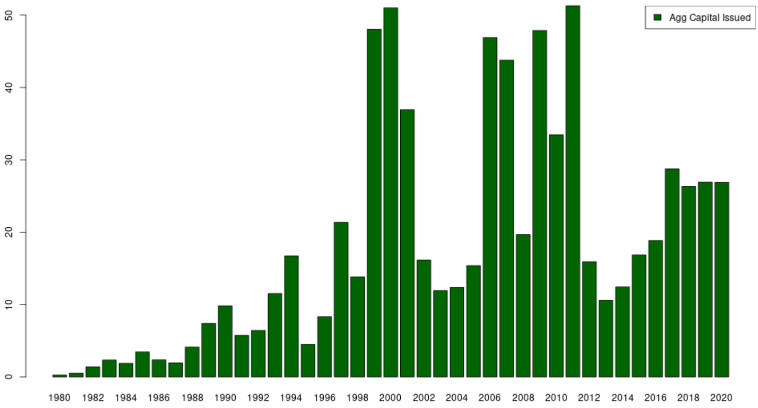
SEO's are similar to IPO's, except that the stock is already traded, and one therefore can observe a price.

SEO's are performed as either

- Private placements, or
- Rights issues

Seasoned Equity Issuance (SEO) at the Oslo Stock Exchange

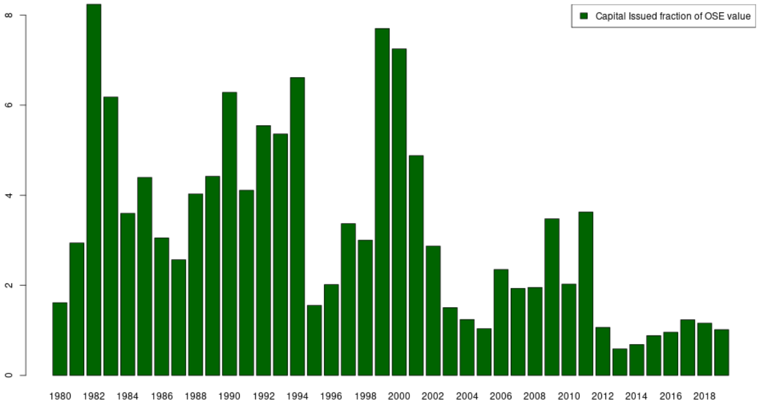
Total capital raised as seasoned equity offers at the OSE



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

Seasoned Equity Issuance (SEO) at the Oslo Stock Exchange

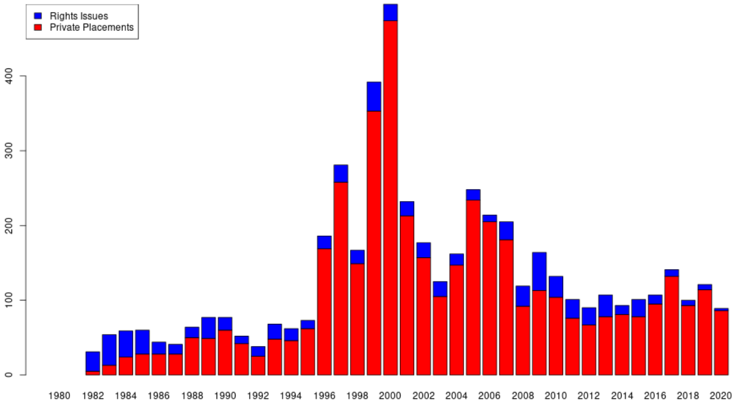
Aggregate capital raised as seasoned equity issues at the OSE, in percent of the exchange value



The figure shows the aggregate amounts raised at the Oslo stock exchange

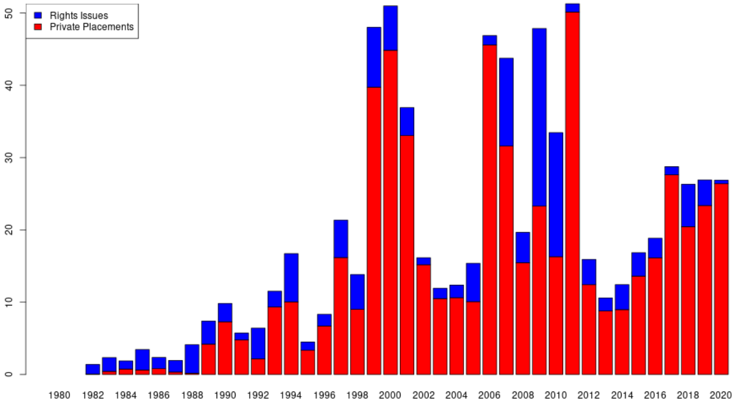
Seasoned Equity Issuance (SEO) at the Oslo Stock Exchange

Seasoned Equity Issues, OSE, split by rights issues and private placements. Number of issues



Seasoned Equity Issuance (SEO) at the Oslo Stock Exchange

Seasoned Equity Issues, OSE, split by rights issues and private placements. Value (in bill NOK) issued



Seasoned Equity issues at the OSE, year by year, split by type of mechanism: Private

Jonathan Berk and Peter DeMarzo. *Corporate Finance*. Pearson, fifth edition, 2020.

Arnoud W A Boot, Radhakrishnan Gopalan, and Anjor Thakor. The entrepeneur's choice between private and public ownership. *Journal of Finance*, April 2006.

James C Brau and Stanley E Fawcett. Initial public offerings: An analysis of theory and practice. *Journal of Finance*, LXI(1):399–436, February 2006.

Erlend Kvaal and Bernt Arne Ødegaard. Egenkapitalutvidelser på Oslo Børs. *Praktisk Økonomi og Finans*, 27(2):111–130, 2011.