

Corporate Finance

Rising Capital

Chapter 15

Dr Erkan Yalcin

Venture Capital

- Venture Capital (VC): Financing for new, often high-risk, ventures.
 - The broad term private equity is often used to label the rapidly growing area of equity financing for non-public companies.
 - To limit their risk, venture capitalists generally provide financing in stages (first or second).
 - Venture capital firms often specialise in different stages (seed money, or ground floor, financing).
- Business Angels: Individuals who provide funds for early development of new, high-risk ventures.
- Mezzanine-level financing.

Venture Capital Stage Financing

- Funding provided in several stages, contingent upon specified goals at each stage.
 - First Stage
 - 'Ground floor' financing or 'seed money';
 - Fund prototype and manufacturing plan.
 - Second Stage
 - 'Mezzanine' level financing;
 - A debt that in terms of repayment ranks just before equity in liquidation;
 - Begin manufacturing, marketing and distribution.

Some Venture Capital Realities

- Access to venture capital is really very limited.
- Venture capitalists rely heavily on informal networks to help identify potential investments.
- Personal contacts are important in gaining access to the venture capital market.
- Venture capital is incredibly expensive:
 - Typically, the venture capitalist will demand 40% or more of the equity in the company.
 - They frequently hold voting convertible preference shares.
 - They demand several seats on the company's board of directors.

Choosing a Venture Capitalist

- Financial strength;
- Style;
- References;
- Contacts;
- Exit strategy.

Selling Securities to the Public: The Basic Procedure

- Management must obtain approval from the board of directors.
- Management obtains expert opinions on a range of matters
- Appoint an underwriter.
- Prepare a prospectus.
- ASIC examines the prospectus and approves it.
- Securities may not be sold during the registration period.

Crowdfunding

- Crowdfunding is the practice of raising small amounts of capital from a large number of people, typically via the Internet.
- The use of crowdfunding has grown rapidly over the past years.
- The advantage of crowdfunding legislation is that no prospectus is required.

Initial Coin Offerings

- In addition to sales of traditional debt and equity, a company can raise funds by selling tokens.
- Tokens often grant the holder the right to use the company's services in the future.
- Token sales occur on digital currency platforms and can be easily transferred on the platform or converted to US dollars on specialised token exchanges.
- This liquidity has made tokens a popular means of funding since their introduction.

Alternative Issue Methods

- Public Issue: Initial public offering (IPO)
 - General cash offer is offered to general public.
 - Only cash offers.
- Private Issue: Rights Issue
 - Opportunity for existing shareholders to buy more shares;
 - A new issue by a company with shares issued already;
 - Existing shareholders can sell their entitlement if issue is renounceable.

YEAR	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
Initial public offering (IPO)	14.9	23.1	19.7	11.2	1.8	11.5	29.4	10.2	9.9	27.7	38.9
Placements	7.9	8.7	20.0	20.9	38.2	23.1	9.0	12.2	18.7	18.4	14.8
Dividend reinvestment plans	7.3	7.3	9.0	11.6	15.0	10.2	7.8	9.3	6.9	4.6	6.6
Rights issue	3.2	2.1	14.3	12.4	28.5	23.2	7.4	8.1	4.0	7.7	14.2
Other	3.8	7.9	14.9	5.7	6.5	8.5	9.5	2.9	2.9	2.6	3.2
Total equity	37.1	49.1	77.9	61.8	90.0	76.5	63.1	42.7	42.4	61.0	77.7

Source: Australian Financial Markets Reports 2007 to 2015 (AFMR).

Figure 1: Total equity raised, financial years 2005 to 2015

The Methods of Issuing New Securities

METHOD	TYPE	DEFINITION
Public Traditional negotiated cash offer	Standby underwriting	Company negotiates an agreement with an investment banker to underwrite the issue, and the underwriter buys any remaining shares not bought by the public at the close of the issue.
	Best effort underwriting	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.
Privileged subscription	Direct rights offer	Company offers new shares directly to its existing shareholders on a basis proportional to their current holdings.
	Standby rights offer underwriting	Like the direct rights offer, this contains a privileged subscription arrangement with existing shareholders. The net proceeds are guaranteed by the underwriters.
Private	Direct placement	Securities are sold directly to the purchaser.

Underwriters

- Underwriters
 - Investment firms that act as intermediaries between a company selling securities and the investing public.
- Services provided by underwriters:
 - Formulate method used to issue securities.
 - Price securities.
 - Sell securities.
- Syndicate
 - A group of investment bankers (underwriters) that market securities and share the risk associated with selling the issue.
- Types of underwriting involved in a cash offer:
 - Standby;
 - Best efforts.

Standby Underwriting

- The underwriter guarantees to buy any unsold securities at the close of the issue, assuming full financial responsibility for any unsold securities.
- The underwriter charges a fee for this service.
- The underwriter bears the risk of not being able to sell the entire issue to the public

Best Efforts Underwriting

- The underwriter sells as much of the issue as possible, but does not agree to buy any unsold securities at the close of the issue.
- The company bears the risk of the issue not being sold.
- The offer may be pulled if there is not enough interest at the offer price and the company does not get the capital while still incurring substantial flotation costs.

Dutch Auction Underwriting

- It is also called *uniform price auction*.
- The underwriter does not set a fixed price for the shares to be sold.
- Instead, the underwriter conducts an auction in which investors bid for shares.
- The offer price is determined based on the submitted bids.

Underwriting Fees

- It is costly to the issuing firm.
- Factors taken into account:
 - The amount of funds to be raised;
 - The number of shares to be sold to the public;
 - The amount retained by the current owners.

IPOs and Underpricing

- May be difficult to price an IPO because there is not a current market price available.
- Additional asymmetric information associated with companies going public.
- Underwriters want to ensure that their clients earn a good return on IPOs on average.
- Underpricing causes the issuer to 'leave money on the table'.
- Reasons for IPO Underpricing:
 - Underwriters want offerings to sell out;
 - Smaller, riskier IPOs underprice to attract investors.

New Equity Sales and the Value of the Firm

- Private Placement: An exclusive issue of new securities to an investor or group of investors who may or may not be current investors in the firm.
- Share prices tend to decline when new equity is issued.
- Possible explanations for this:
 - Signalling and managerial information;
 - Signalling and debt usage;
 - Issue costs.

The Cost of Issuing Securities

THE COSTS OF ISSUING SECURITIES	DESCRIPTION
1. Underwriting fee/commission	These are direct fees paid by the issuer to the underwriting syndicate.
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 are reported in the prospectus.
3. Indirect expenses	These costs are not reported in the prospectus and include the cost of management time spent working on the new issue.
4. Abnormal returns	In a new issue of shares, the price of the existing shares drops on average by 1% to 3% upon the announcement of the issue. This drop is called the <i>abnormal return</i> .
5. Underpricing	For initial public offerings, losses arise from selling the shares below the true value.

Direct Private Long-term Debt Financing vs Public Issues of Debt

- A direct long-term loan avoids the cost of ASIC registration.
- Direct placement is likely to have more restrictive covenants.
- It is easier to renegotiate a term loan or a private placement in the event of a default.
- Life insurance companies and superannuation funds dominate the private-placement segment of the debt market.
- The costs of distributing bonds or debentures are lower in the private market.