Raising Equity Capital

Advanced Financial Management

Julio Crego

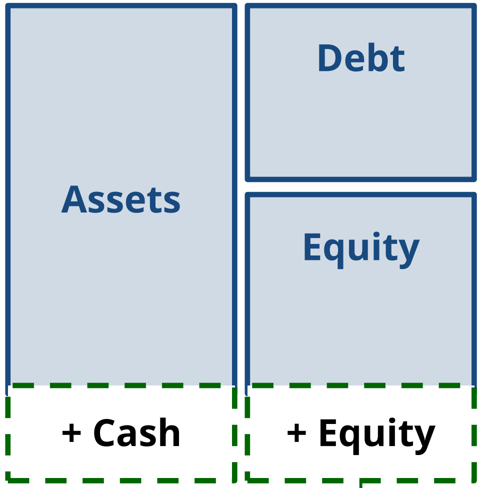
Key takeaways

01 **Equity is the basic form of capital in any company and although its main characteristics are common across all companies, each company's shares might have its own specific rights and characteristics**

02 **Raising Equity is a key component of Financial Management since its an available capital source at any stage of the company's maturity**

03 **There are many options to raise equity, from Venture Capital in the early stages of the company to access to the general financial markets through Initial Public Offerings in later stages**

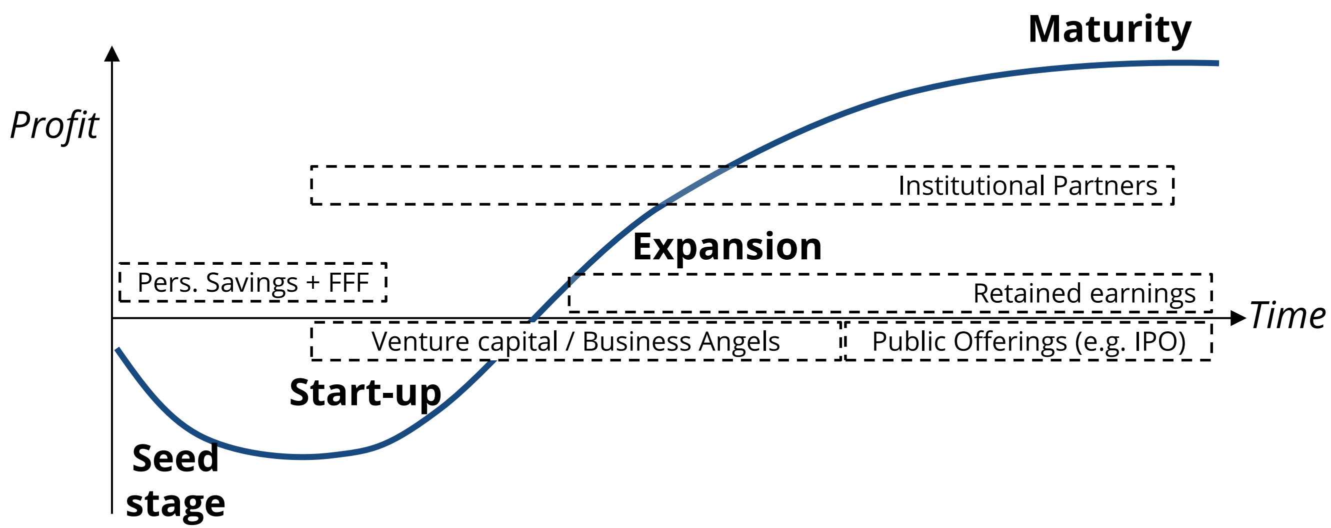
Raising Equity



- **Retained earnings**
- **Private**
  - **Personal savings**
  - **FFF: family, friends and "fools"**
  - **Business angels**
  - **Venture capital**
  - **Institutional partners**
  - **(...) other**
- **Public**
  - **Initial Public Offering (IPO)**
  - **Secondary Offering**

→ Choice depends on several factors, mainly: sector, maturity stage, total amount needed and control

Typical equity financing timeline



IPOs costs

Direct Costs

The underwriting spread:

- The underwriting spread is the fee paid by the firm to the underwriters.
- Typically this about 7% of the issue price.

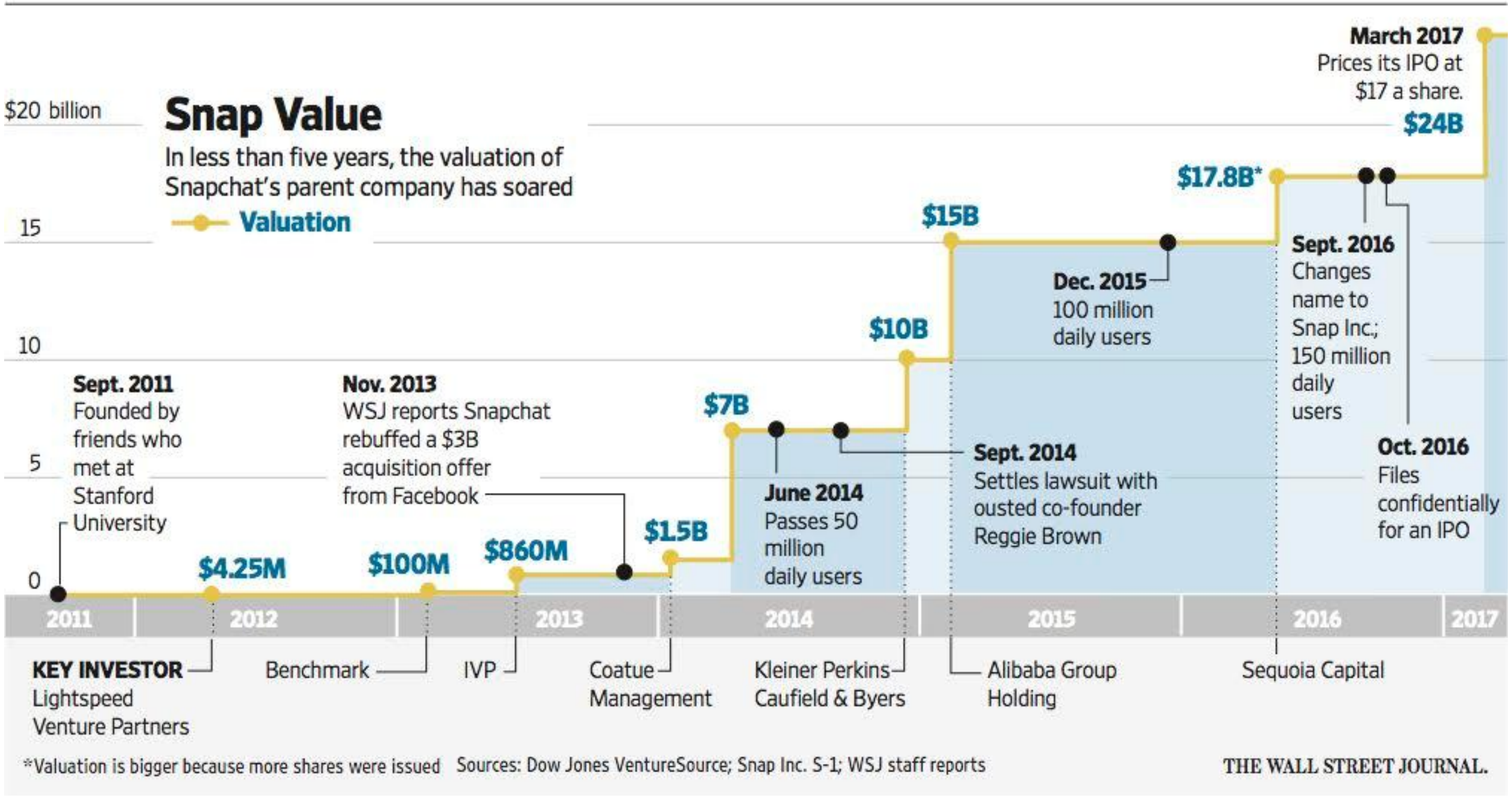
Costs due to IPO underpricing

- IPOs issue prices tend to be below the closing price on that day.
- The difference between closing price and issue price is lost by issuers.

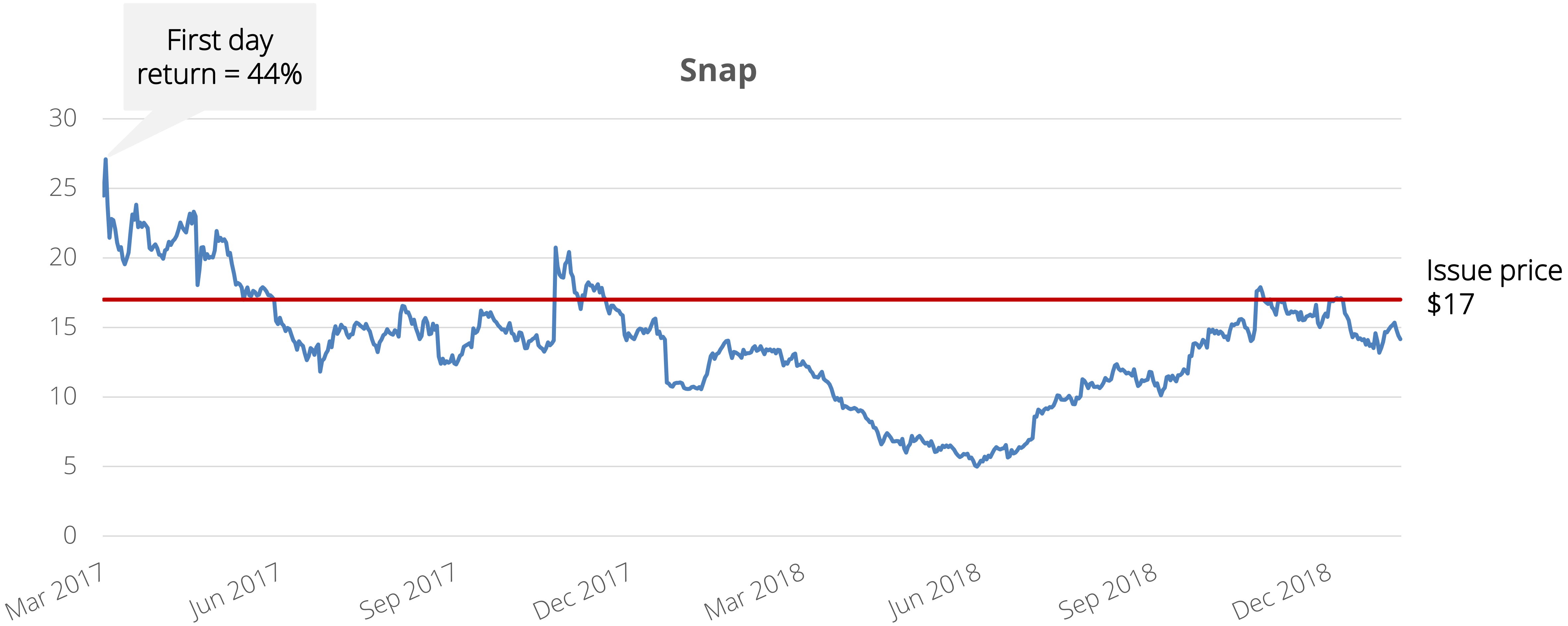
Why are IPOs underpriced?

- Underwriter price supports
  - Underwriters can support the price of an IPO by buying shares at IPO price or lower
- Benefit the underwriter
  - Favors for the clients of the underwriters
- Risk averse owners
  - Once-in-a-lifetime very positive NPV project
- Information asymmetry (Winner's curse)
  - Form of adverse selection: an auction's winner (i.e. the highest bidder) may have overestimated the object's value
  - You win (get all the shares you requested) when demand for the shares by others is low and the IPO is more likely to perform poorly.
  - We need all types of investors to buy the shares of an IPO, otherwise there may not be enough demand for the issues.

Example: Snap funding rounds



Example: Snap stock price over time



News discussion

FT Article: “Why Deliveroo's IPO might not be the dud it seemed”

1. Do you think the main reason Deliveroo’s IPO was a flop was the lack of profits?

2. Does the article suggest there is a risk for IPO overpricing?

“It is supply chain shortages, soaring inflation and spooked central banks that are ending the IPO party.”

3. Why do you think the quoted factors may affect IPO activity trends?

Exercise

Three years ago, you founded Outdoor Recreation, Inc., a retailer specializing in the sale of equipment and clothing for recreational activities such as camping, skiing, and hiking. So far, your company has gone through three funding rounds:

Round	Date	Investor	Shares Issued	Share Price ($)
Series A	Feb 2007	You	500,000	1
Series B	Aug 2008	Angels	1,000,000	2
Series C	Sept 2009	Venture Capital	2,000,000	3.5

It is currently 2011 and you need to raise additional capital to expand your business. You have decided to take your firm public through an IPO. You would like to issue an additional 6.5 million shares through this IPO. Assuming that your firm successfully completes its IPO, you forecast that 2011 net income will be $7.5 million.

a. Your investment banker advises you that the prices of other recent IPOs have been set such that the P/E ratios based on 2011 forecasted earnings average 20. Assuming that your IPO is set at a price that implies a similar multiple, what will your IPO price per share be?

b. What percentage of the firm will you own after the IPO?

Exercise

Firm G will become public. After the issuance, the debt-to-value ratio of the firm will be 30%. Currently Firm H, which has similar operations is trading at $5 and has a debt-to-value ratio of 60%. Firm G has 10M shares and firm H has 3M shares. Firm G reported earnings of 10 while Firm H reported earnings of 15. Using market value over earnings as the multiple, what is the IPO price of Firm G?

Exercise

Consider you want to bid in an auction IPO. You know that the firm might be worth 1 million dollars or 10 million dollars. Several investors know the actual value, but you do not. Nonetheless, you know they are equally likely. What would be your maximum bid if the risk-free is 0?

A. 10 million dollars
B. 0 million dollars
C. 5.5 million dollars
D. 1 million dollars

Exercise

Mark established his firm using 500,000 from his own capital and creating 1 million shares. Two years later, an angel investor invested 1.5 million in exchange for 2 million of new shares. Nowadays, Mark is considering raising even more capital from venture capital. The venture capital firm offers 2 million in exchange for 1 million shares. If Mark decides to raise the extra capital on these terms, what percentage of the firm will Mark end up owning?

A. 50%
B. 12.5%
C. 9%
D. 25%