Fundamentals of Corporate Finance, 2/e

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Chapter 15: How Firms Raise Capital

Learning Objectives

1. EXPLAIN WHAT IS MEANT BY BOOTSTRAPPING WHEN RAISING SEED FINANCING AND WHY BOOTSTRAPPING IS IMPORTANT.
2. DESCRIBE THE ROLE OF VENTURE CAPITALISTS IN THE ECONOMY AND DISCUSS HOW THEY REDUCE THEIR RISK WHEN INVESTING IN START-UP BUSINESSES.
3. DISCUSS THE ADVANTAGES AND DISADVANTAGES OF GOING PUBLIC AND COMPUTE THE NET PROCEEDS FROM AN IPO.

Learning Objectives

4. EXPLAIN WHY, WHEN UNDERWRITING NEW SECURITY OFFERINGS, INVESTMENT BANKERS PREFER THAT THE SECURITIES BE UNDERPRICED. COMPUTE THE TOTAL COST OF AN IPO.
5. DISCUSS THE COSTS OF BRINGING A GENERAL CASH OFFER TO MARKET.
6. EXPLAIN WHY A FIRM THAT HAS ACCESS TO THE PUBLIC MARKETS MIGHT ELECT TO RAISE MONEY THROUGH A PRIVATE PLACEMENT.

Learning Objectives

7. REVIEW SOME ADVANTAGES OF BORROWING FROM A COMMERCIAL BANK RATHER THAN SELLING SECURITIES IN FINANCIAL MARKETS AND DISCUSS BANK TERM LOANS.

Bootstrapping

- HOW NEW BUSINESSES GET STARTED
  - **Most businesses are started by an entrepreneur who has a vision for a new business or product and a passionate belief in the concept's viability.**
  - **The entrepreneur often fleshes out his or her ideas and makes them operational through informal discussions with people whom the entrepreneur respects and trusts, such as friends and early investors.**

Bootstrapping

- INITIAL FUNDING OF THE FIRM
  - **The process by which many entrepreneurs raise "seed" money and obtain other resources necessary to start their businesses is often called bootstrapping.**
  - **The initial "seed" money usually comes from the entrepreneur or other founders.**

Bootstrapping

- INITIAL FUNDING OF THE FIRM
  - **Other cash may come from personal savings, the sale of assets such as cars and boats, loans from family members and friends, and loans secured from credit cards.**
  - **The seed money, in most cases, is spent on developing a prototype of the product or service and a business plan.**

Venture Capital

- The bootstrapping period usually lasts no more than one or two years.
- At some point, the founders will have developed a prototype of the product and a business plan, which they can “take on the road” to seek venture-capital funding to grow the business.

Venture Capital

- Venture capitalists are individuals or firms that help new businesses get started and provide much of their early-stage financing.
- Individual venture capitalists, angels (or angel investors), are typically wealthy individuals who invest their own money in emerging businesses at very early stages in small deals.
- Exhibit 15.1 shows the primary sources of funds for venture capital firms from 1999 to 2009.

Exhibit 15.1: Source of Venture Capital Funding

EXHIBIT 15.1 **Source of Venture Capital Funding, 1999–2009**

The most important sources of venture capital funds are financial and insurance firms, followed by private and public pension funds, individuals and families, and corporations. Endowments and foundations make up the last significant group of investors.

	Percent of Total Funding
Financial and insurance firms	22.9%
Private and public pension funds	20.5
Individuals and families	17.5
Corporate (non-pension)	16.7
Endowments and foundations	8.8
Other	13.6
Total	100.0%

Venture Capital

- THE VENTURE-CAPITAL INDUSTRY
  - **Emerged in the late 1960s with the formation of the first venture-capital limited partnerships.**
  - **Today, the venture industry consists of several-thousand professionals at about one-thousand venture capital firms, with the biggest concentration of firms in California and Massachusetts.**

Venture Capital

- THE VENTURE-CAPITAL INDUSTRY
  - **Modern venture capital firms tend to specialize in a specific line of business, such as hospitality, food manufacturing, or medical devices.**
  - **A significant number of venture capital firms focus on high-technology investments.**

Venture Capital

- WHY VENTURE CAPITAL FUNDING IS DIFFERENT
  - **Venture capital is important because entrepreneurs have only limited access to traditional sources of funding.**
  - **Three reasons exist as to why traditional sources of funding do not work for new or emerging businesses:**
    - There is high degree of risk involved in starting a new business.

Venture Capital

Types of productive assets - New firms whose primary assets are often intangible (patents or trade secrets) find it difficult to secure financing from traditional lending sources.

Informational asymmetry problems - An entrepreneur knows more about his or her company's prospects than a lender does.

Exhibit 15.2: The Venture-Capital Funding Cycle

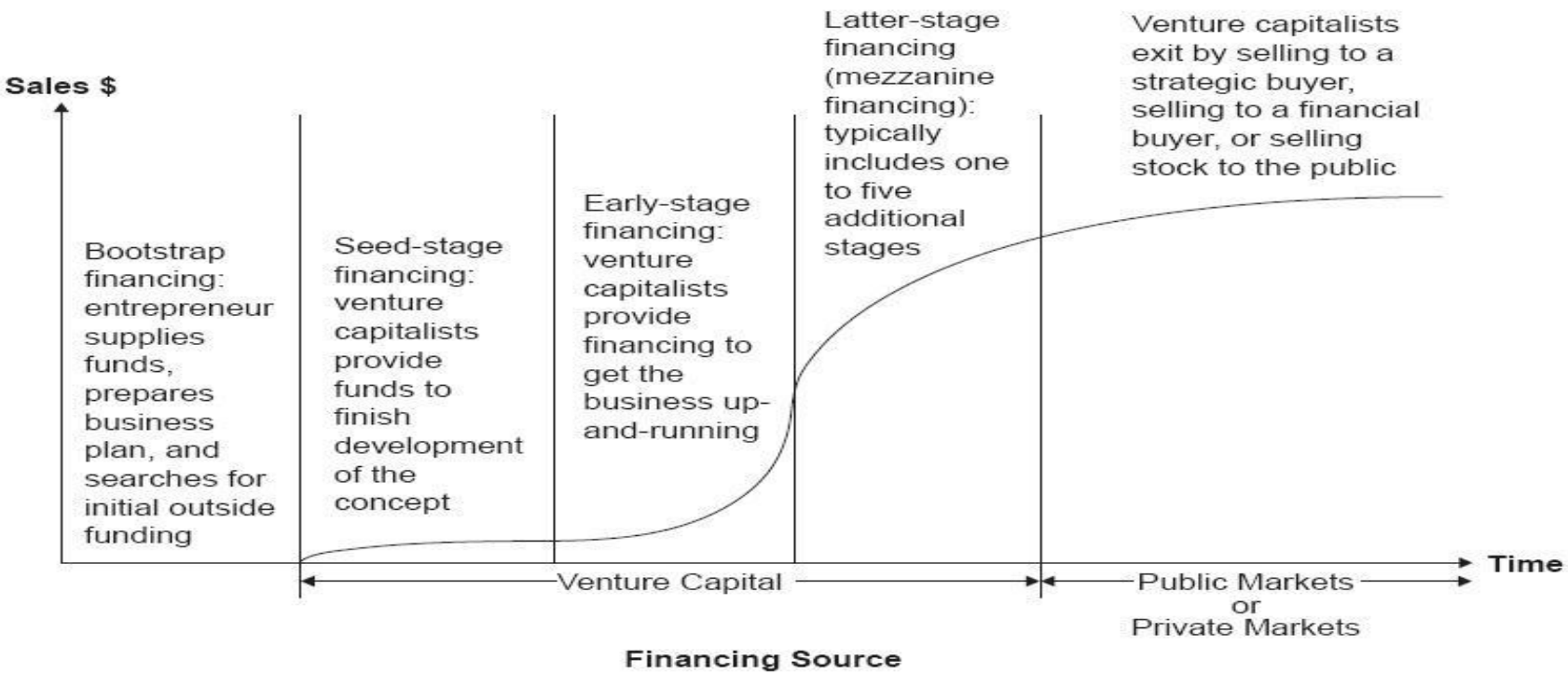

EXHIBIT 15.2
The Venture Capital Funding Cycle

The typical venture capital funding cycle begins when the entrepreneur runs low on bootstrap financing. Venture capitalists then provide equity financing. They will later exit through a private or public sale of their equity. The duration of the cycle is typically three to seven years, and only a small percentage of new ventures make it all the way to the end.

Venture Capital

- THE VENTURE CAPITAL FUNDING CYCLE
  - **Starting A New Business**

    Suppose you have been in the pizza business for several years and have developed a concept for a high-end pizzeria that you believe has the potential to grow into a national chain.
  - **The Business Plan**

    Describes what you want the business to become, why consumers will find your pizzerias attractive (the value proposition), how you are going to accomplish your objectives, and what resources you will need.

Venture Capital

- THE VENTURE CAPITAL FUNDING CYCLE
  - **First-Stage Financing**

    After a number of meetings with you and your management team, the venture capital firm may agree to fund the project—but only in stages, and for less than the full amount being requested.

Venture Capital

- THE VENTURE CAPITAL FUNDING CYCLE
  - **How Venture Capitalists Reduce Their Risk**

    Venture capitalists know that only a handful of new companies will survive to become successful firms.

    They use a number of tactics when they invest in new ventures, including funding the ventures in stages, requiring entrepreneurs to make personal investments, syndicating investments, and maintaining in-depth knowledge about the industry in which they specialize.

Venture Capital

- THE VENTURE CAPITAL FUNDING CYCLE
  - **How Venture Capitalists Reduce Their Risk**

    Staged Funding

    - *The key idea behind staged funding is that each funding stage gives the venture capitalist an opportunity to reassess the management team and the firm's financial performance.*
    - *The venture capitalists' investments give them an equity interest in the company. Typically, this is in the form of preferred stock that is convertible into common stock at the discretion of the venture capitalist.*

Venture Capital

- THE VENTURE CAPITAL FUNDING CYCLE
  - **How Venture Capitalists Reduce Their Risk**

    Personal Investment

    - *Venture capitalists often require an entrepreneur to make a substantial personal investment in the business.*

    Syndication

    - *It is a common practice to syndicate seed and early-stage venture capital investments.*
    - *Occurs when the originating venture capitalist sells a percentage of a deal to other venture capitalists.*

Venture Capital

- THE VENTURE CAPITAL FUNDING CYCLE
  - **How Venture Capitalists Reduce Their Risk**

    Syndication

    - *Syndication reduces risk in two ways:*
      - » First, it increases the diversification of the originating venture capitalist's investment portfolio.
      - » Second, the willingness of other venture capitalists to share in the investment provides independent corroboration that the investment is a reasonable decision.

Venture Capital

- THE VENTURE CAPITAL FUNDING CYCLE
  - **How Venture Capitalists Reduce Their Risk**

    In-depth Knowledge

    - *Another factor that reduces risk is the venture capitalist's in-depth knowledge of the industry and technology.*

Venture Capital

- THE VENTURE CAPITAL FUNDING CYCLE
  - **The Exit Strategy**

    Venture capitalists are not long-term investors in the companies, but usually exit over a period of three to seven years.

    Every venture capital agreement includes provisions identifying who has the authority to make critical decisions concerning the exit process.

    Exit Strategy provisions usually include the following:

    - *Timing (when to exit)*
    - *The method of exit*
    - *What price is acceptable*

Venture Capital

- THE VENTURE CAPITAL FUNDING CYCLE
  - **The Exit Strategy - There are three principal ways in which venture capital firms exit venture-backed companies:**

    Strategic Buyer - selling part of the firm's equity to a strategic buyer in the private market.

    Financial Buyer – a private equity firm buying the new firm with the intention of holding it for a period of time, usually three to five years, and then selling it for a higher price.

    Initial Public Offering - selling common stock in an initial public offering.

Exhibit 15.3: Strategic and Financial Sale and Venture-Backed IPO Exits

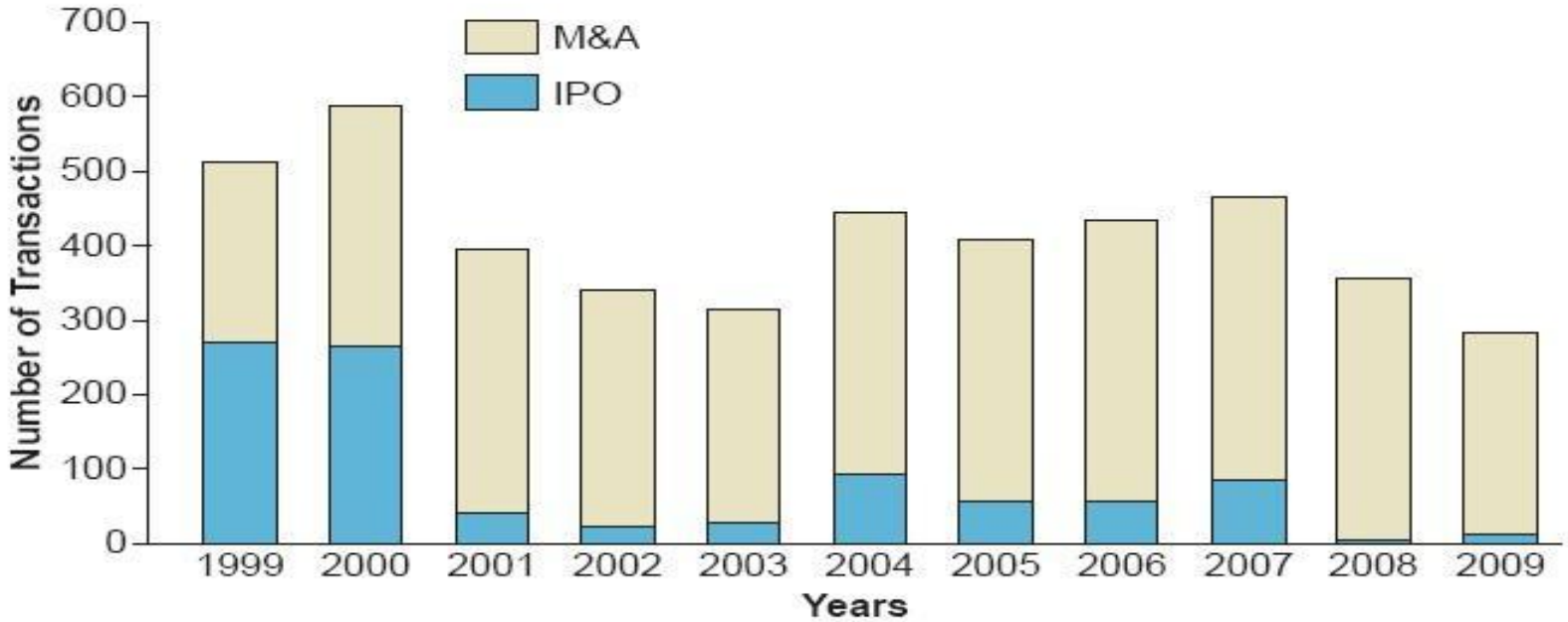

EXHIBIT 15.3

Strategic and Financial Sale and Venture-Backed IPO Exits in the United States, 1999–2009

Comparing the number of strategic and financial (M&A) sales of new businesses with the number of venture-backed IPOs from 1999 through 2009 shows that strategic and financial sales were by far the dominant exit strategy during this period.

Source: National Venture Capital Association 2010 Yearbook.

Venture Capital

- VENTURE CAPITALISTS PROVIDE MORE THAN FINANCING
  - **The extent of the venture capitalists' involvement depends on the experience of the management team.**
  - **One of their most important roles is to provide advice.**
  - **Because of their industry and general knowledge about what it takes for a business to succeed, they provide counsel for entrepreneurs when a business is being started and during early stages of operation.**

Venture Capital

- THE COST OF VENTURE-CAPITAL FUNDING
  - **The cost of venture-capital funding is very high, but the high rates of return earned by venture capitalists are not unreasonable.**
  - **A typical venture-capital fund may generate annual returns of 15 to 25 percent on the money that it invests, compared with an average annual return for the S&P 500 of about 12 percent.**

Initial Public Offering

- One way to raise larger sums of cash or to facilitate the exit of a venture capitalist is through an initial public offering, or IPO, of the company's common stock.
  - **First-time stock issues are given a special name because the marketing and pricing of these issues are distinctly different from those of seasoned offerings.**

Initial Public Offering

- ADVANTAGES OF GOING PUBLIC
  - **The amount of equity capital that can be raised in the public equity markets is typically larger than the amount that can be raised through private sources.**
  - **Once an IPO has been completed, additional equity capital can usually be raised through follow-on seasoned public offerings at a lower cost.**

Initial Public Offering

- ADVANTAGES OF GOING PUBLIC
  - **Can enable an entrepreneur to fund a growing business without giving up control.**
  - **After the IPO, there is an active secondary market in which stockholders can buy and sell its shares.**
  - **Publicly traded firms find it easier to attract top management talent and to better motivate current managers if a firm's stock is publicly traded.**

Initial Public Offering

- DISADVANTAGES OF GOING PUBLIC
  - **High cost of the IPO.**
  - **The costs of complying with ongoing SEC disclosure requirements also represent a disadvantage of going public.**

Initial Public Offering

- DISADVANTAGES OF GOING PUBLIC
  - **The transparency that results from these SEC compliances can be costly for some firms.**
  - **Finally, some investors argue that the SEC's requirement of quarterly earnings forecasts and quarterly financial statements encourages managers to focus on short-term profits rather than long-term wealth maximization.**

Initial Public Offering

- INVESTMENT-BANKING SERVICES
  - **To complete an IPO, a firm will need the services of investment bankers, who are experts in bringing new securities to the market.**
  - **Investment bankers provide three basic services when bringing securities to market–origination, underwriting, and distribution.**

Initial Public Offering

- INVESTMENT-BANKING SERVICES
  - **Identifying the investment-banking firm that will manage the IPO process is an important task for the management of a firm because not all investment banks are equal.**
  - **Securing the services of an investment-banking firm with a reputation for quality and honesty will improve the market's receptivity and help ensure a successful IPO.**

Initial Public Offering

- ORIGINATION
  - **Includes giving the firm financial advice and getting the issue ready to sell.**
  - **The investment banker helps the firm determine whether it is ready for an IPO.**
  - **Once the decision to sell stock is made, the firm's management must obtain a number of approvals.**
  - **Since securities sold to the public must be registered in advance with the SEC, the first step in this process is to file a registration statement with the SEC.**

Initial Public Offering

- UNDERWRITING
  - **Underwriting is the risk-bearing part of investment banking.**
  - **The securities can be underwritten in two ways:**
    - On a firm-commitment basis
    - On a best-efforts basis

Initial Public Offering

- UNDERWRITING
  - **Firm-Commitment Underwriting**

    Is more typical; the investment banker guarantees the issuer a fixed amount of money from the stock sale.

    The investment banker actually buys the stock from the firm at a fixed price and then resells it to the public.

    The underwriter bears the risk that the resale price might be lower than the price the underwriter pays—this is called price risk.

Initial Public Offering

- UNDERWRITING
  - **Firm-Commitment Underwriting**

    The investment banker's compensation is called the underwriter's spread. In a firm-commitment offering, the spread is the difference between the investment banker's purchase price and the offer price.

    The underwriter's spread in the vast majority of initial public stock offerings in the United States is 7%.

Initial Public Offering

- UNDERWRITING
  - **Best-Effort Underwriting**

    With a best-effort underwriting, the investment banking firm makes no guarantee to sell the securities at a particular price.

    In best-effort offerings, the investment banker does not bear the price risk associated with underwriting the issue, and compensation is based on the number of shares sold.

Initial Public Offering

- UNDERWRITING
  - **Underwriting Syndicates**

    To share the underwriting risk and to sell a new security issue more efficiently, underwriters may combine to form a group called an underwriting syndicate.

    Participating in the syndicate entitles each underwriter to receive a portion of the underwriting fee as well as an allocation of the securities to sell to its own customers.

Initial Public Offering

- UNDERWRITING
  - **Determining the Offer Price**

    One of the investment banker's most difficult tasks is to determine the highest price at which the bankers will be able to quickly sell all of the shares being offered and that will result in a stable secondary market for the shares.

Initial Public Offering

- UNDERWRITING
  - **Due Diligence Meeting**

    Before the shares are sold, representatives from the underwriting syndicate hold a due-diligence meeting with representatives of the issuer.

    Investment bankers hold due-diligence meetings to protect their reputations and to reduce the risk of investors' lawsuits in the event the investment goes sour later on.

Initial Public Offering

- DISTRIBUTION
  - **Once the due-diligence process is complete, the underwriters and the issuer determine the final offer price in a pricing call.**
  - **The pricing call typically takes place after the market has closed for the day.**
  - **By either accepting or rejecting the investment banker's recommendation, management ultimately makes the pricing decision.**

Initial Public Offering

- DISTRIBUTION
  - **The First Day of Trading**

    Underwriter sells the shares to investors in the market, after registration with the SEC.

    Speed of sale is important because the offer price reflects market conditions at the end of the previous day and these conditions can change quickly.

Initial Public Offering

- DISTRIBUTION
  - **The Closing**

    At the closing of a firm-commitment offering, the issuing firm delivers the security certificates to the underwriter and the underwriter delivers the payment for the securities, net of the underwriting fee, to the issuer.

    The closing usually takes place on the third business day after trading has started.

Initial Public Offering

- THE PROCEEDS - Consider the following questions:
  - **What are the total expected proceeds from the common-stock sale?**
  - **How much money does the issuer expect to get from the offering?**
  - **What is the investment bank's expected compensation from the offering?**
- The best approach to calculating these amounts is to first work through the funding allocations on a per-share basis and then compute the total dollar amounts.

IPO Pricing and Cost

- THE UNDERPRICING DEBATE
  - **The issuer prefers the stock price to be as high as realistically possible while the underwriters prefer some degree of underpricing.**
  - **Underpricing is defined as offering new securities for sale at a price below their true value.**
  - **In a firm-commitment offering, the underwriters will suffer a financial loss if the offer price is set too high; under a best-effort agreement, the issuing firm will lose.**

IPO Pricing and Cost

- THE UNDERPRICING DEBATE
  - **If the underpricing is significant, the investment banking firm will suffer a loss of reputation for failing to price the new issue correctly and raising less money for its client than it could have.**

IPO Pricing and Cost

- IPOs ARE CONSISTENTLY UNDERPRICED
  - **Data from the marketplace show that the shares sold in an IPO are typically priced between 10 and 15 percent below the price at which they close at the end of first day of trading.**
  - **The average first-day return is a measure of the amount of underpricing.**

Exhibit 15.4: Initial Public Offerings

EXHIBIT 15.4 **Initial Public Offerings, Gross Proceeds, and Returns, 1995–2009**

This exhibit summarizes the number of IPOs per year, the average first-day returns to investors, and the gross proceeds from all IPOs for the period 1995–2009. The average first-day return represents the amount of underpricing. The exhibit illustrates the substantial variation in IPO activity and underpricing in the U.S. public equity markets during this period.

Year	Number of IPOs	Avg First Day Return (%)[a]	Gross Proceeds (Billions)
1995	458	14.50%	$ 30.16
1996	675	16.10%	$ 42.25
1997	473	14.40%	$ 31.58
1998	284	15.50%	$ 33.80
1999	477	57.00%	$ 64.79
2000	381	45.60%	$ 65.07
2001	79	8.70%	$ 34.24
2002	66	5.10%	$ 22.03
2003	62	10.50%	$ 9.53
2004	174	12.20%	$ 31.53
2005	160	9.30%	$ 28.27
2006	157	13.00%	$ 30.48
2007	160	13.90%	$ 35.69
2008	21	24.80%	$ 22.76
2009	41	11.10%	$ 13.17
1995–2009	3668	18.11%	$495.35

IPO Pricing and Cost

- THE COST OF AN IPO
  - **Three basic costs are associated with issuing stock in an IPO:**

    Underwriting spread - is the difference between the proceeds the issuer receives and the total amount raised in the offering.

    Out-of-pocket expenses - include other investment banking fees, legal fees, accounting expenses, printing costs, travel expenses, SEC filing fees, consultant fees, and taxes.

    Underpricing - typically defined as the difference between the offering price and the closing price at the end of the first day of the IPO.

Exhibit 15.5: Costs of Issuing an IPO

EXHIBIT 15.5 Costs of Issuing an IPO, 2001–2009

This exhibit shows IPO costs in the U.S. for the period from 2001 to 2009, by the total value of the shares issued. IPO costs include the direct costs associated with the underwriter's spread and out-of-pocket expenses plus the costs of underpricing (represented by the average first-day return). As you can see, underpricing costs tend to be higher in larger issues, while direct costs decline as the size of the issue increases.

Value of Issue ($ millions)	Number of IPOs	Direct Costs[a] (%)	Average First-Day Return[b] (%)
$2–9.99	16	17.05%	−0.32%
$10–19.99	37	11.76	8.81
$20–39.99	83	9.55	5.72
$40–59.99	121	8.76	8.67
$60–79.99	102	8.50	10.26
$80–99.99	97	8.42	17.44
$100–199.99	255	7.83	16.07
$200–499.99	147	7.32	11.29
$500 and over	67	5.76	10.42
All issues	925	8.33%	11.93%

General Cash Offer by a Public Company

- If a public firm has a high credit rating, the lowest-cost source of external funds is often a general cash offer, also referred to as a registered public offering.
- A general cash offer is a sale of debt or equity, open to all investors, by a registered public company that has previously sold stock to the public.

General Cash Offer by a Public Company

- Similarities in procedures between *general cash offer* and those involved in an *IPO*.
  - **Management decides type of security and amount to be raised.**
  - **Approval is obtained from the board of directors to issue securities.**
  - **The issuer files a registration statement and satisfies all of the securities laws enforced by the SEC.**

General Cash Offer by a Public Company

- Similarities in procedures between *general cash offer* and those involved in an *IPO*.
  - **After assessing demand, the underwriter and the issuer agree on an offer price.**
  - **At the closing of a firm-commitment offering, the issuer delivers the securities to the underwriter, and the underwriter pays for them, net of its fees.**

General Cash Offer by a Public Company

- COMPETITIVE VERSUS NEGOTIATED SALE
  - **In a general cash offer, management must decide whether to sell the securities on a competitive or a negotiated basis.**
  - **In a competitive sale, the firm specifies the type and amount of securities it wants to sell and hires an investment banking firm to do the origination work.**

General Cash Offer by a Public Company

- COMPETITIVE VERSUS NEGOTIATED SALE
  - **Once the origination is completed, the firm invites underwriters to bid competitively to buy the issue.**
  - **In a negotiated sale, the issuer selects the underwriter at the beginning of the origination process.**
  - **At that time, the scope of the work is defined, and the issuer negotiates the origination and underwriter's fees to be charged.**

General Cash Offer by a Public Company

- COMPETITIVE VERSUS NEGOTIATED SALE
  - **Lowest-Cost Method of Sale**

    Which method of sale—competitive or negotiated—results in the lowest possible funding cost for the issuing firm?

    Competitive Bidding keeps everyone honest. Greater the number of bidders, the greater the competition for the security issue, and the lower the cost to the issuer.

    Negotiated sales lack competition and therefore should be the more costly method of sale.

General Cash Offer by a Public Company

- COMPETITIVE VERSUS NEGOTIATED SALE
  - **Selecting the Best Method**

    For debt issues, most experts believe that competitive sales are the least-costly method of selling so-called vanilla bonds when market conditions are stable.

    For equity securities, negotiated sales provide the lowest-cost method of sale.

General Cash Offer by a Public Company

- COMPETITIVE VERSUS NEGOTIATED SALE
  - **Shelf Registration**

    Since November 1983, the SEC has allowed some two-thousand large corporations the option of using shelf registration.

    Allows a firm to register an inventory of securities for a two-year period.

    During that time, the firm can take the securities “off the shelf” and sell them as needed.

General Cash Offer by a Public Company

- COMPETITIVE VERSUS NEGOTIATED SALE
  - **Shelf Registration**

    Costs associated with selling the securities are reduced because only a single registration statement is required.

    A shelf registration statement can cover multiple securities, and there is no penalty if authorized securities are not issued.

General Cash Offer by a Public Company

- COMPETITIVE VERSUS NEGOTIATED SALE
  - **Shelf Registration (Benefits)**

    Greater flexibility in bringing securities to market. Securities can be taken off the shelf and sold within minutes.

    Allows firms to periodically sell small amounts of securities, raising money as it is actually needed, rather than banking a large amount of money from a single security sale and spending it over time.

Exhibit 15.6: Average Gross Underwriting Spread

EXHIBIT 15.6 Average Gross Underwriting Spread and Out-of-Pocket Expenses as a Percentage of Amount Raised for Public Offerings, 1977 to 2001

You can see from this exhibit that issuing common stock is the most expensive method of obtaining funds, while issuing corporate bonds (debt) is the least expensive. The higher cost for the stock issues reflects the greater underwriting risk (higher sales commissions) and the higher out-of-pocket expenses required to bring equity securities to market. For all three types of securities shown—common stock, preferred stock, and bonds—there are economies of scale; as issue size increases, total issue cost, as a percent of the amount raised, declines.

	Common Stock			Preferred Stock			Bonds		
Principal Amount ($ millions)	Gross Underwriting Spread (%)	Out-of-Pocket Expenses (%)	Total (%)	Gross Underwriting Spread (%)	Out-of-Pocket Expenses (%)	Total (%)	Gross Underwriting Spread (%)	Out-of-Pocket Expenses (%)	Total (%)
$0.0–$9.9	7.69%	5.94%	13.63%	4.69%	3.65%	8.34%	2.04%	1.91%	3.95%
$10.0–$24.9	5.99	2.70	8.69	3.05	1.24	4.29	1.29	1.11	2.40
$25.0–$49.9	5.52	1.57	7.09	2.33	0.57	2.90	0.95	0.68	1.63
$50.0–$99.9	5.13	0.89	6.02	2.06	0.28	2.34	0.96	0.43	1.39
$100.0–$199.9	4.68	0.59	5.27	2.76	0.28	3.04	0.90	0.30	1.20
$200.0–$499.9	4.16	0.41	4.57	2.63	0.17	2.80	0.84	0.16	1.00
$500.0 and over	3.49	0.14	3.63	2.62	0.10	2.72	0.57	0.08	0.65

General Cash Offer by a Public Company

- THE COST OF A GENERAL CASH OFFER
  - **Exhibit 15.6 shows the average underwriting spread, out-of-pocket expenses, and total cost for common stock, preferred stock, and corporate bond issues of various sizes.**
  - **Total cost includes only underwriting spread and out-of-pocket expenses.**
  - **Issuing common stock is the most costly alternative, and issuing corporate bonds (nonconvertible) is the least costly.**

Private Markets and Bank Loans

- PRIVATE VERSUS PUBLIC MARKETS
  - **Because many smaller firms and firms of lower credit standing have limited access, or no access, to the public markets, the cheapest source of external funding is often the private markets.**
  - **When market conditions are unstable, some smaller firms that were previously able to sell securities in the public markets no longer can.**

Private Markets and Bank Loans

- PRIVATE VERSUS PUBLIC MARKETS
  - **Bootstrapping and venture capital financing are part of the private market as well.**
  - **Many private companies that are owned by entrepreneurs, families, or family foundations, and are sizable companies of high credit quality, prefer to sell their securities in the private markets even though they can access public markets.**

Private Markets and Bank Loans

- PRIVATE VERSUS PUBLIC MARKETS
  - **Choice of markets is a function of:**

    Desire to avoid the regulatory costs and transparency requirements

    Preference for working with a small group of sophisticated investors rather than the public at large

Private Markets and Bank Loans

- PRIVATE PLACEMENTS
  - **Occur when a firm sells unregistered securities directly to investors such as insurance companies, commercial banks, or wealthy individuals.**
  - **About half of all corporate debt is sold through the private placement market.**
  - **Investment banks and money center banks often assist firms with private placements.**

Private Markets and Bank Loans

- PRIVATE PLACEMENTS
  - **Help the issuer locate potential buyers for their securities, put the deal together, and do the necessary origination work, but they do not underwrite the issue.**
  - **In a traditional private placement, the issuer sells the securities directly to investors.**
  - **Have a number of advantages, relative to public offerings, for certain issuers.**

Private Markets and Bank Loans

- PRIVATE PLACEMENTS

  The cost of funds, net of transaction costs, may be lower with private placements.

  Private lenders are more willing to negotiate changes to a bond contract.

  If a firm suffers financial distress, the problems are more likely to be resolved without going to a bankruptcy court.

  Other advantages include the speed of private placement deals and flexibility in issue size.

Private Markets and Bank Loans

- PRIVATE PLACEMENTS
  - **The biggest drawback of private placements involves restrictions on the resale of the securities.**
  - **The SEC limits the sale of private placements to several dozen "knowledgeable" investors who have the capacity to evaluate the securities' investment potential and risk.**
  - **To compensate for the lack of marketability, investors in private placements require a higher yield relative to a comparable public offering.**

Private Markets and Bank Loans

- PRIVATE EQUITY FIRMS
  - **Like venture capitalists, private equity firms pool money from wealthy investors, pension funds, insurance companies, and other sources to make investments.**
  - **Invest in more mature companies, and they often purchase 100 percent of a business.**
  - **Private equity firm managers look to increase the value of the firms they acquire by closely monitoring their performance and providing better management.**

Private Markets and Bank Loans

- PRIVATE EQUITY FIRMS
  - **Once value is increased, they sell the firms for a profit. Private equity firms generally hold investments for three to five years.**
  - **Large public firms often sell businesses when they no longer fit the firms' strategies or when they are offered a price they cannot refuse.**
  - **Establishes private equity funds to make investments. These funds are usually organized as limited partnerships or limited liability companies.**

Private Markets and Bank Loans

- PRIVATE EQUITY FIRMS
  - **Focus on firms that have stable cash flows because they use a lot of debt to finance their acquisitions.**
  - **When a large amount of debt is used to take over a company, the transaction is called a leveraged buyout.**
  - **Improve the performance of firms in which they invest by:**

    Making sure that the firms have the best possible management teams.

Private Markets and Bank Loans

- PRIVATE EQUITY FIRMS

  Closely monitoring each firm's performance and providing advice and counsel to the firm's management team.

  Facilitating mergers and acquisitions that help improve the competitive positions of the companies in which they invest.

  - **Carry a much smaller regulatory burden and fewer financial reporting requirements than do public firms.**
  - **Are able to avoid most of the SEC's registration and compliance costs and other regulatory burdens, such as compliance with the Sarbanes-Oxley Act.**

Private Markets and Bank Loans

- PRIVATE INVESTMENTS IN PUBLIC EQUITY
  - **Private Investments In Public Equity (PIPE) transactions are transactions in which a public company sells unregistered stock to an investor—often a hedge fund or some other institutional investor.**
  - **Have been around for a long time, but the number of these transactions has increased greatly since the late 1990s.**

Private Markets and Bank Loans

- PRIVATE INVESTMENTS IN PUBLIC EQUITY
  - **Investors purchase securities (equity or debt) directly from a publicly traded company in a private placement.**
  - **The securities are virtually always sold to the investors at a discount to the price at which they would sell in the public markets to compensate the buyer for limits on the liquidity associated with these securities and, often, for being able to provide capital quickly.**

Private Markets and Bank Loans

- PRIVATE INVESTMENTS IN PUBLIC EQUITY
  - **Transaction are not registered with the SEC, they are "restricted securities".**
  - **Under federal securities law, they cannot be resold to investors in the public markets for a year or two unless the company registers them.**
  - **The company often agrees to register the restricted securities with the SEC, usually within 90 days of the PIPE closing.**

Private Markets and Bank Loans

- PRIVATE INVESTMENTS IN PUBLIC EQUITY
  - **PIPE transactions involving a healthy firm can also be executed without the use of an investment bank, resulting in a cost saving of 7 to 8 percent of the proceeds.**
  - **A PIPE transaction can be the only way for a small financially distressed company to raise equity capital.**

Commercial Bank Lending

- PRIME-RATE LOANS
  - **The common types of bank loans are prime-rate loans and bank term loans.**
  - **Prime rate loans are loans in which the borrowing rate is based on the prime rate of interest.**
  - **The prime rate charged by a bank may be higher that other market borrowing rates because banks provide a range of services with these loans.**

Commercial Bank Lending

- BANK TERM LOANS
  - **Are business loans with maturities greater than one year.**
  - **May be secured or unsecured, and the funds can be used to buy inventory or to finance plant and equipment.**

Commercial Bank Lending

- THE LOAN PRICING MODEL
  - **In determining the interest rate to charge on a loan, the banks takes the prime rate (PR) plus an adjustment for default risk above the prime rate (DRP), and an adjustment for the yield curve for term loans (MAT) into account.**

$$k_l = PR + DRP + MAT \qquad (15.1)$$

Commercial Bank Lending

- THE LOAN PRICING MODEL
  - **Loan Pricing Example**

    A bank has two customers. Firm A has the bank's highest credit standing and Firm B's credit standing is prime+3. The bank prime rate is 4.25 percent. What is the appropriate loan rate for each customer, assuming the loan is a term loan?

Firm A: 4.25%.

Firm B: 4.25% + 3.00% = 7.25%