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- Stock Broker & Client
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- Investment Banker

Raising Long-Term Finance

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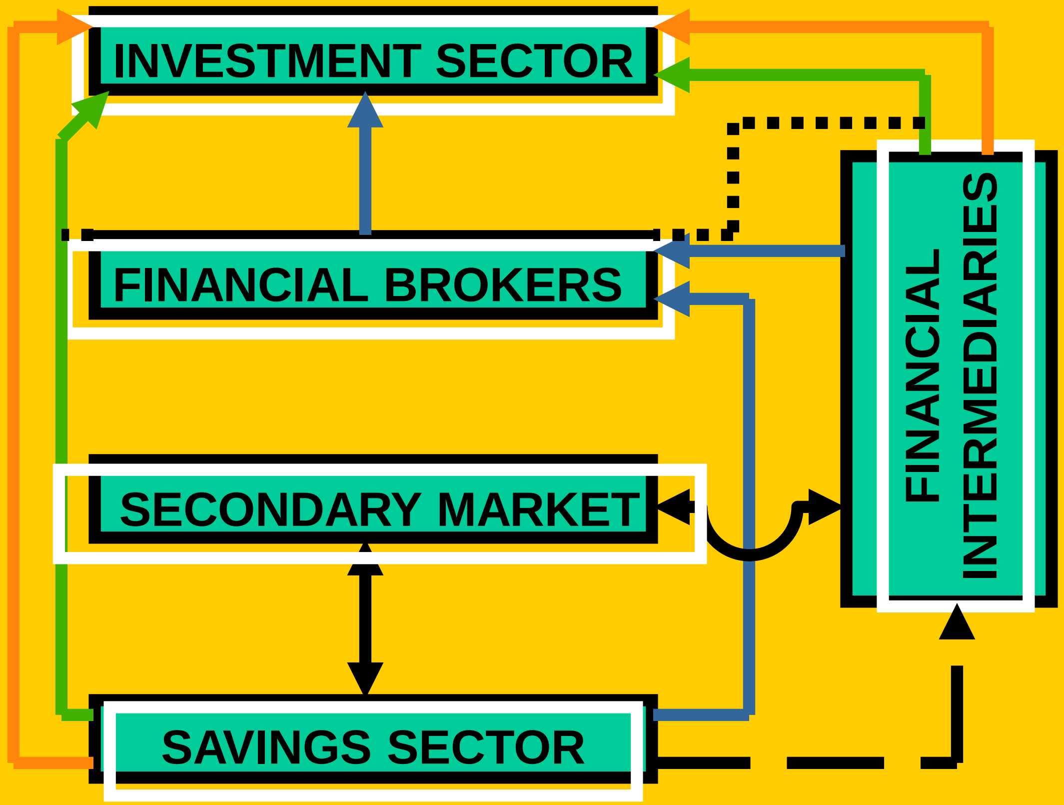
Venture Capital

- Venture Capital is money invested to finance a new firm (start-ups). These are high-risk, unproven businesses that need financing.
- Example: Aurobindo Pharma, Indiabulls.com, classteacher.com, egurucool.com, etc.
- Since success of a new firm is highly dependent on the effort of the managers, restrictions are placed on management by the venture capital company and funds are usually dispersed in stages, after a certain level of success is achieved.

Venture Capital

- So, venture capital is provided in stages after ensuring the progress of the firm.
- Typically, firms require large amounts of capital to grow rapidly.
- Usually, the instruments include large amounts of convertibles, warrants, etc.



- Public issue
- Privileged subscription
- Private placement
- Indicates the possible presence of a "standby arrangement"
- Indicates the financial intermediaries' own securities flow to the savings sector

Public Issue

- Public Issue is sale of bonds or stocks to the general public (example – ASPET's IPO/FCD issue totalling Rs. 75 crore issue)
- Securities are sold to hundreds, and often thousands, of investors under a formal contract overseen by regulatory authorities especially SEBI (prospectus filling, etc.)
- Prospectus is a formal summary that provides information on an issue of securities

Public Issue

- When a company issues securities to the general public, it usually uses the services of an investment banker (ASPET had IDBI, SBI Caps, JM Morgan, and UTI Bank).
- Investment Banker/Underwriter is a firm that buys an issue of securities from a company and resells it to the public
- Investment banker receives an underwriting spread when acting as a middleman in bringing together providers and consumers of investment capital.

Investment Banker

- Underwriting spread -- the difference between the price the investment bankers pay for the security and the price at which the security is resold to the public.
- Underpricing – Issuing securities at an offering price set below the true value of the security
- Total costs of IPOs are high for smaller issues (approx Rs. 1 to 30 crores).
- Large issues are generally handled by several underwriters to spread the risk among them.

Investment Banker

- Investment bankers have expertise, contacts, and the sales organization to efficiently market securities to investors.
- Thus, the services can be provided at a lower cost to the firm than the firm can perform the same services internally.
- Three primary means companies use to offer securities to the general public:
  - Traditional (firm commitment) underwriting
  - Best efforts offering
  - Shelf registration

Traditional Underwriting

Underwriting -- Bearing the risk of not being able to sell a security at the established price by virtue of purchasing the security for resale to the public; also known as ***firm commitment underwriting***.

- If the security issue does not sell well, either because of an adverse turn in the market or because it is overpriced, the underwriter, not the company, takes the loss.

Traditional Underwriting

Underwriting Syndicate -- A temporary combination of investment banking firms formed to sell a new security issue.

A. Competitive-bid

- The issuing company specifies the date that sealed bids will be received.
- Competing syndicates submit bids.
- The syndicate with the highest bid wins the security issue.

Traditional Underwriting

B. Negotiated Offering

- The issuing company selects an investment banking firm and works directly with the firm to determine the essential features of the issue.
- Together they discuss and negotiate a price for the security and the timing of the issue.
- Depending on the size of the issue, the investment banker may invite other firms to join in sharing the risk and selling the issue.
- Generally used in most corporate bond issues.

Underwriting ... Other Ways

Best Efforts Offering -- A offering in which the bankers agree to use only their best efforts to sell the issuer's securities. The bankers do not commit to purchase any unsold securities.

Shelf Registration -- A procedure whereby a company is permitted to register securities it plans to sell over the next two years. These can then be sold whenever the company chooses.

Other Offers

- Seasoned Offering – Sale of securities by a firm that is already publicly traded
- General Cash Offer – Sale of securities open to all investors by an already public company
- Rights Issue – Issue of securities offered only to a current stockholders
- Private Placement – Sale of securities to a limited number of investors without a public offering (start-ups and venture caps generally opt for this route)

Rights Offerings

- SPL currently has 11 crore shares outstanding. The market price is Rs. 24 per share. SPL decides to raise additional funds via a 1 for 11 rights offer at Rs. 22 per share. If we assume 100% subscription, what is the value of each right?
- Current market value = 264 crores, total shares (after rights) = 12 crores; amount of new funds = Rs. 22 crores; new share price = Rs. 23.83 per share; value of right = market price – ex-rights price

Private Placement

- Private (or Direct) Placement -- The sale of an entire issue of unregistered securities (usually bonds) directly to one purchaser or a group of purchasers (usually financial intermediaries). Eliminates the underwriting function of the investment banker.
- The dominant private placement lender in this group is the mutual funds (even insurance companies and FIs are very active as well).

Private Placement Features

- Allows the firm to raise funds more quickly.
- Eliminates risks with respect to timing.
- Eliminates SEBI regulation of the security.
- Terms can be tailored to meet the needs of the borrower.
- Flexibility in borrowing smaller amounts more frequently rather than a single large amount.

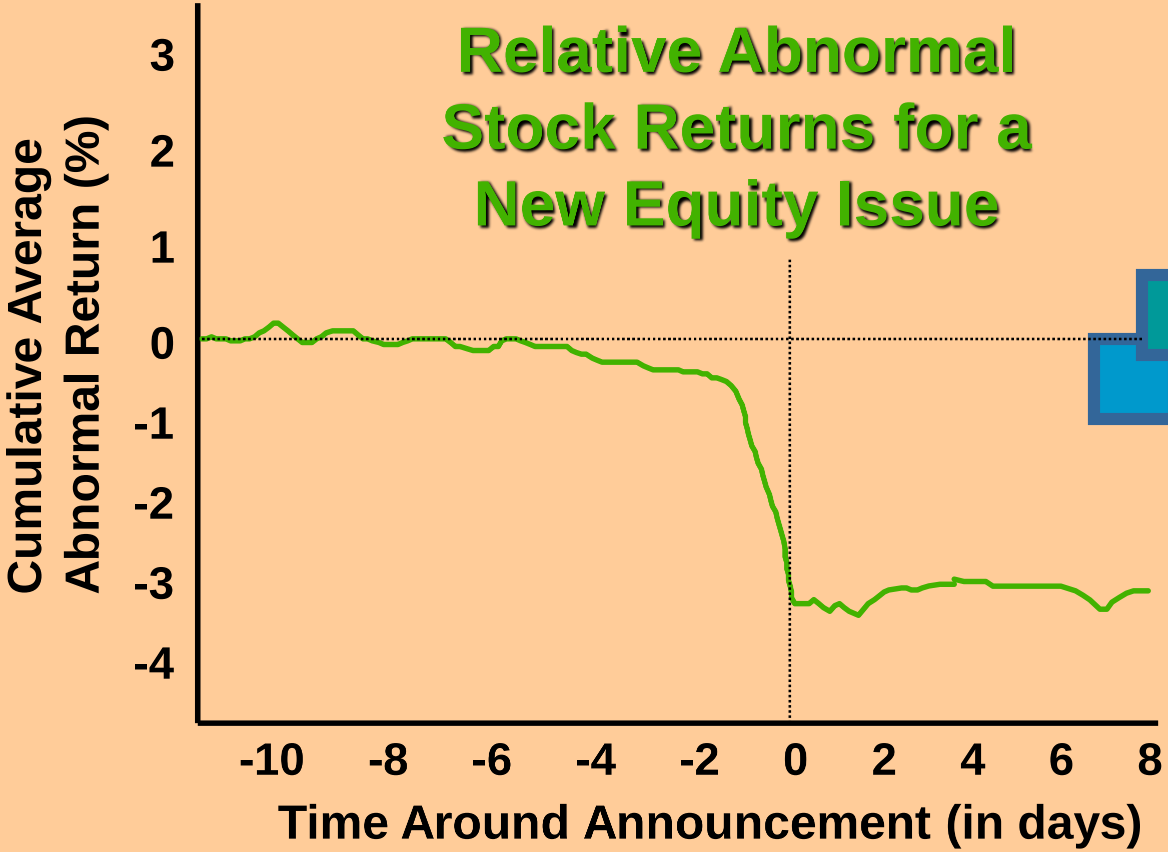
Private Placement and Other Developments

- Event Risk -- The risk that existing debt will suffer a decline in creditworthiness because of the issuance of additional debt securities.

- Private Placement with Registration Rights – It combines a standard private placement with a contract requiring the issuer to register the securities with the SEBI for possible resale in the public market.

Signaling Effects

- Negative stock price reaction to common stock or convertible issues.
- Straight debt and preferred stock do not tend to show statistically significant effects.



Possible Explanations for Price Reactions

<u>Asymmetric (Unequal) Information</u>

- Potential investors have less information than management (particularly for common stock).
- Exchanges of different types of securities show that increases (decreases) in financial leverage are associated with positive (negative) abnormal returns. (questionable in India)

Terms of Offering

Right – A short-term option to buy a certain number (or fraction) of securities from the issuing corporation; also called a **subscription right**.

Terms specify:

- the number of rights required to subscribe for an additional share of stock
- the subscription price per share
- the expiration date of the offering

Subscription Rights

<u>Options available to the holder of rights</u>:

- Exercise the rights and subscribe for additional shares
- Sell the rights (they are transferable)
- Do nothing and let the rights expire

Generally, the subscription period is four weeks or less.

Subscription Rights

A shareholder who owns 77 shares and just received 77 rights would like to purchase 8 new shares. It takes 10 rights for each new share. What action should the shareholder take?

The shareholder can then purchase 7 shares (use 70 rights) and still retain the 7 remaining rights. Thus, the shareholder needs to purchase an additional 3 rights.

Value of Rights

What gives a right its value?

A right allows you to buy new stock at a discount that typically ranges between 10 to 20 percent from the current market price.

The market value of a right is a function of:

- the market price of the stock
- the subscription price
- the number of rights required to purchase an additional share of stock

How is the Value of a Right Determined?

P_0 - R_0 = [(R_0)(N) + S], therefore

$$\boxed{R_0 = P_0 - [\,(R_0)(N) + S\,]}$$

R_0 = the market price of one right when the stock is selling "rights-on"

P_0 = the market price of a share of stock selling "rights-on"

S = the subscription price per share

N = the number of rights required to purchase one share of stock

How is the Value of a Right Determined?

Solving for R_0.

$$R_0 = \frac{P_0 - S}{N + 1}$$

$$P_X = P_0 - R_0 = [\ (R_0)(N) + S\ ]$$

By substitution for R_0, we can solve the "ex-rights" value of one share of stock, P_X.

$$P_X = \frac{(P_0)(N) + S}{N + 1}$$

Theoretical versus Actual Value of Rights

Why might the actual value of a right differ from its theoretical value?

- Transaction costs
- Speculation
- Irregular exercise and sale of rights over the subscription period

Arbitrage acts to limit the deviation of the actual right value from the theoretical value.

Standby Arrangement

Standby Arrangement -- A measure taken to ensure the complete success of a rights offering in which an investment banker or group of investment bankers agrees to "stand by" to underwrite any unsubscribed (unsold) portion of the issue.

Oversubscription Privilege

Oversubscription Privilege -- The right to purchase, on a pro rata basis, any unsubscribed shares in a rights offering.

Privileged Subscription versus Underwritten Issue

- Investors are familiar with the firm's operations when using a rights offering.
- The principal sales tool is a discounted price (rights offering) and the investment banking organization (underwriting).
- There is a wider distribution of shares with a public offering.

Regulation of Security Offerings

Registration Statement -- The disclosure document filed with the SEBI in order to register a new securities issue.

Part 1: Prospectus -- Discloses information about the issuing company and its new offering and is distributed to investors.

Part 2: Additional information required by the SEBI that is not part of the printed prospectus.

Red Herring

Red Herring -- The preliminary prospectus. It includes a legend in red ink on the cover stating that the registration statement has not yet become effective.

- SEBI reviews the registration statement to see that all the required information is presented and that it is not misleading.
- Deficiencies are communicated in a *comment letter*.
- Once satisfied, SEBI approves the registration. If not, it issues a *stop order*.

Regulation of Security Offerings

Tombstone Advertisement -- An announcement placed in newspapers and magazines giving just the most basic details of a security offering.

- The term reflects the stark, black-bordered look of the ad
- Includes the company's name, a brief description of the security, the offering price, and the names of the investment bankers in the underwriting syndicate.

Book Building Process

- Bharti Tele and Idea Tele undertook a process by which demand for its proposed IPO shares was elicited (and built up).
- The IPO price was assessed for determination of the quantum of shares to be issued by means of an advertisement/offer document.
  - SEBI defines Book Building as a process undertaken by which a demand for the securities proposed to be issued by a body corporate is elicited and built up and the price for such securities is assessed for the determination of the quantum of such securities to be issued by means of a notice, circular, advertisement, document or information memoranda or offer document.

Book Building Process

- Trading Member – These are entities who can participate in the book building process. They can bid on their own account or on behalf of their clients.
- Floor Price - The minimum offer price below which bids can't be entered.
- Merchant Banker - An entity registered under SEBI Regulations.
- Syndicate Members - Intermediaries registered with the Board and permitted to carry on activity as an underwriter. They are appointed by the Book Runner(s) to the issue.

Example - when an IPO fails

3/1/2002, Delhi, ICICIDirect.com: The IPO worth Rs 70 crore issued by ASPET got a lukewarm response from investors. Sources say that the issue could garner only 15-20 per cent of the target (it closed on 29/12/2001). The lead managers to the issue J M Morgan Stanley declined to comment. The other members to the issue were IDBI, SBI Caps and UTI Bank.

The company issued 50 lakh equity shares at a par rate of Rs 10 per share and had also issued 69.5 lakh 14 per cent FCDs of Rs 100 each aggregating Rs 69.50 crore. CRISIL and CARE had assigned a AAAr and AAA (SO) rating to FCDs.

The issue was totally underwritten and the remaining issue will be subscribed by underwriters, unless the promoters of the company Khaithan group has other plans. Sources said that the number of applications were very less.

Next … Terms Used in Capital Markets