University of Essex

Department of

Accounting, Finance and Management

AC302 Corporate Finance

"Describe and compare the alternative methods that companies can use to raise capital in the various capital markets. Include in your discussion the advantages and disadvantages for the companies and investors and the role of intermediaries".

1) Describe and compare methods of capital raising in various capital markets
2) For each of the methods evaluate the advantages and the disadvantages to:

- Companies
- Investors
- The role played by intermediaries in raising capital

Word count:

BA Accounting and Management

1. Introduction

Bodies, Kane and Marcus (2002) suggest that "Financial markets are traditionally segmented into money markets and capital markets"
Sources of finance from money markets are described as short-term, cash equivalents usually marketable, liquid meaning easily transferable to cash, low risk debt securities. These include treasury bills, commercial papers, bankers acceptance and alike. In our discussion however we will be focusing on capital markets which are in contrast to the former in that they are longer-term more risky securities. Capital market instruments can be further divided into four categories, debt markets, equity markets and derivative markets which constitute options and futures contracts the latter we will only be discussing in short since derivatives are risky speculative income, far more suited for risk hedging.

2. Debt markets

Debt markets provide a means of long term borrowing for a number of parties including corporations, government agencies, municipalities and special trusts. Debt instruments can be classified as secured, unsecured, tax exempt, convertible debt, publicly issued or privately held. The classification of debt instruments depends on the intrinsic nature of the debt the "market they are issued, currency they are payable in, protective features and their legal status"[1]. Some debt instruments include bonds which is a long term contract under which a borrower agrees to make interest and principal payments at a specified date, debentures are unsecured bond with no lien against property for security but this depends on the creditworthiness and the strength of the firm, otherwise debentures require some collateral. Thus under a mortgage bond or mortgage debenture a corporation pledges real assets as security for the long term debt, similarly a floating charge debenture has a claim on companies operational asset(s) once the firm defaults. Further, bonds, mortgages, debentures can be fixed or floating rate, these characteristics raise or lower the value of the asset. We also have debt instruments coupled with option features such as convertibility and redeemability, thus a discussion on all of the diverse instrument is beyond the scope of our discussion therefore we discuss only some of the advantages and the problems with these instruments to companies and investors.

2.1 Advantages to company

the advantages of issuing corporate bonds is that it "allow[s] private firms to borrow money directly from the public"[2], this gives companies the incentive to shift borrowing form banks to public investors at lower rates than bank loans. With fixed coupon rate payments corporations can benefit by hedging from term structure of interest rate and enjoy better financial planning and budgetary control. Further "the cost of debt is typically lower than that of common stock when corporate taxes are considered." (Brigham and Gapenski, 1990:520) as interest is tax deductible.

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[1] http://www.finpipe.com
[2] Bodie et al (2002) p40

2.2 Disadvantages to company

When firm raises capital by long term debt, financial leverage increases, this increases the cost of future debt or equity financing as investment becomes risky as a result of higher levels of fixed interest debt to equity, thus default risk is a real concern because of debt interest obligation, in some cases the lender may impose protective covenants designed to limit additional debt, dividend, and further liens so that bondholders , debentures are protected this fundamentally makes further borrowing difficult. Thus greater monitoring and control takes place with public issue of debt such as debentures and bonds then term loans from banks. Also when bonds securities are issued corporations have to incur certain costs, investment banking institutions usually charge a fee in relation to the amounts issued, legal fees, registration and other expenses.

2.3 Advantages to investors to buy corporate

Some of the several common features of long term debt is that investors usually receive a stream of coupon payments over a period of time with the final principle payment at maturity. As with corporate bonds the higher risk of debt in comparison to government bonds, offers higher, more attractive yields to accompany the trade off. Further, including corporate bonds in investors portfolio provides investors with a steady dependable income over a period of time with increased diversity as corporate bonds can be chosen from a variety of sectors of the industry, minimizing unsystematic risk.

2.4 Disadvantages to investors

In comparison to common stocks, bonds and other fixed income securities do not give the investor ownership interest in corporate governance, thus no voting rights in change of directors if they are underperforming. Also some bond holder's i.e. unsecured debentures have no collateral backing when the company goes onto insolvency, therefore when the company is in financial difficulty unsecured creditors have no guarantee to regaining their investment. The market risk is also important to bond holders as this influences the value of the bond, in that a bond value rises as interest rate falls as a result of new bond issued at lower yields, conversely bonds value falls as interest rate rises, this feature raises the value of redeemable bonds from a company position as high coupon payments as a result of high interest rate can be redeemed and reissued at the lower market rate.

Role of intermediaries

Banks, securities firms, insurance companies play a role in intermediation.

Bonds and private placements see page 65 bodie
+/- of private placement in Douglas et al pg738 and public placement
http://www.finpipe.com/pubpriv.htm

3. Equity markets

Equity markets are alternatively referred to as stock markets, stocks "represent ownership shares in a corporation" (Bodie et al (2002:44), where shareholders are entitled to vote in Annual General Meetings (AGM) in relation to corporate governance. Stocks are listed on the stock exchange (i.e. NYSE, NASDAQ, LSE, MSE (Milan Stock Exchange)) this secondary market allows private and public investors to trade stocks freely. Note that NYSE is physical in that there is a floor whilst NASDAQ is virtual, thus "Stocks that do not trade on a centralized exchange are traded "over the counter" (OTC) through trading organizations such as the National Association of Security Dealers Automatic Quotations (NASDAQ)"[3].

There are a number of varieties of shares, they can be categorised as preference shares, ordinary shares and deferred shares. Preference shares are like perpetual bonds (hybrid securities i.e. somewhere between debt and equity, some contractual obligations but not in all) in comparison to fixed income securities that we have discussed above, thus preferred stock such as cumulative, redeemable, participating and convertible usually have some contractual obligation to pay dividends weather in this period or rolled over to the next, priority of claims and have no voting rights, the difference between preference shares depends on the level of risk the investor is willing to bear in terms of claims on asset, ability to transfer to ordinary shares and the ability to redeem shares at a specified date. Deferred shares are the most risky this is because they come after dividend payment of preference and ordinary equity holders. Common stocks are perpetual securities, they are not redeemable by the issuing firms although they are re-purchasable by the issuer, ordinary stockholders have the right to receive dividends that the directors declare, although directors are not obliged to declare any. For a company to issue equity securities it has to be listed on the stock markets, the Initial Public offering (IPO) enables the corporation to raise capital from global investors that have a diversity of interest. We discuss some of the advantages and the disadvantages in going public to both companies and investors.

3.1 Advantages to company. See Brigham and Gapenski (1985:471)

Going public raises further capital, in relation to private placements shares are usually priced higher on a public market. By going public it "makes common stock negotiable and creates a visible market"[4] this further creates value to stocks because of enhanced liquidity, also by being public, corporation become more flexible in gaining further equity capital "more quickly and more cheaply"[5]. The image of the firm is further enhanced as the firm goes public as it represent a new development of the organizations life, going public also increases visibility to global investors who wish to invest in a well diversified portfolio.

It is not uncommon for firms to grow by acquisition as a result of share considerations, thus going public allows merging of interest and integration.

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[3] http://www.finpipe.com

[4] Douglas R. and John D. (1997) Corporate Finance and Management, Prentice-Hall pg 748

[5] Douglas R. and John D. (1997) pg 748

Furthermore going public increases liquidity, compared to privately held securities that are not exchanged on a global market or over-the-counter markets which are said to be “illiquid”[6] were potential buyers don’t always exist.

3.2 Disadvantages to companies

There are a number of disadvantages to going public, firstly a public firm is subject to disclosure requirements that govern the reporting to shareholders, thus reports must be filed with SEC (Securities and Exchange Commission) in US and London Stock exchange in UK, management are likely to be reluctant to make such information public since it would be available to competitors and predators. Management are usually faced with the pressures to pay dividend to shareholders this may not always be the best option as reinvestment in healthy projects may be a lot more profitable in the long term. Also by issuing shares nationally and globally there is a dilution of ownership interest, in some cases existing shareholders can lose voting control as shares become highly diluted.

Costs of public issue is “often 5-10 percent of the finance raised”[7] thus going public is a highly costly transition that does not happen often although firms do offer seasonal offering.
Douglas et al pg 542 suggests that floatation costs and commission charges depends inversely on the size of the offering but usually 4% - 5% of public offering,
Douglas et al pg 744 costs of offering

Marketing and initial floating costs are of most significance as companies go public, thus most companies choose to use leading underwriters, and these companies however charge a gross underwriting spread which is usually a percentage of the issuing price.

Role on intermediaries

Carter and Manaster (1990)[8], “IPO is the first effort by private firms to raise capital in a public equity market” they further show that IPO subscription price and the first market price is greater then a reasonable risk premium, thus firms and underwriters are deliberately under pricing their IPOs

Firm commitment contract, this is where underwriter purchases the entire IPO issue from the firem with the intention of selling it to investors.
Primary market is characterized by asymmetric information (thus underpricing of IPO compensates uninformed investors for the risk of trading against superior information: underwriters to investors) the secondary market can be charterized as perfect information, shares of IPO are sold in secondary market (price here usually reflects full informational value)

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[6] http://www.amerigopartners.com/initial_public_offering.htm
[7] Pike R and Neale B (1996) Corporate Finance and Management: Decisions and Strategies Second Edition, Prentice Hall pg 478
[8] Carter, R and Manaster, S ‘Initial public Offering and the Underwriter Reputation’ Journal of Finance September 1990

‘Hot issue’ this is the period were IPO were “grossly underpriced”(Seha, (1988) this period is 1950, 1951, 1961, 1968 were return were unusually large.

3.3 Advantages to investors

Firms that wish to invest in preferred stocks have tax benefits, in that a high proportion of dividends received from local corporations are not form part of the taxable income.
Shareholders have limited liability in case of company failure, and thus their initial investment would be the only loss in liquidation.
Existing shareholders usually sell some of their shares for IPO, this intern allows portfolio diversification.

3.4 Disadvantages to investors

Firstly investors have only residual claims, this means that ordinary shareholders are usually last in line over the claims of the company’s assets in liquidation.
Equity investment has greater uncertainties regarding the rate of return on investment and payments in a given period for this reason the higher risk is tolerated by higher return. Furthermore in comparison to debt capital, equity capital has more risk to investors then debt capital because debt subscribers have priority of claims in liquidation, whilst equity subscriber has residual claims this is why equity capital is sometimes referred to as risk capital.
Dividends are not tax deductible, thus it makes them relatively more expensive then loans

Role of intermediaries

The agency costs in a primary offering can be quite high thus some government agencies chose to market securities them selves rather than use investment bankers or syndicates. “Investment banker serves as an intermediary between the issuer and the purchasers”[9], investment bankers are chosen because of there global experience and expertise.
See page 65 bodie

Role of intermediaries/ syndicate/ investment bankers/ compensation charges in Douglas et al pg 732-734

Bodie pg 104 gives some information on functions of investment companies who are said to be financial intermediaries

“You always need intermediation” (from web lecture)

4. Derivative markets

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[9] Douglas R. and John D. (1997) pg 734

"derivatine instruments can be used for speculative purposes as wellas for accomplishing a specific financial or investment objectives" (Fabozzi and Modigliani ,1996:15) but a number of financial fiascos has reduced the credibility for the use of derivatives, this is usually do to lack of understanding of risk and return that derivatives hold.

Derivative markets are the most recent development in financial markets, it provides firms to minimise risk by hedging, derivatives "are instrument whose value depends on the prices of other, more basic variables"[10]. Derivatives are dependent upon an underlying asset or a variable, thus it is referred to as derivative asset or contingent claim in that "their value derive from or are contingent on the value of other assets"[11], also there are a number of innovations in derivatives, as mentioned earlier a convertible bond has an embedded derivative i.e. an option to convert the debt security into equity (call option).
Typically there are four types of derivatives: forward, futures, swaps and options. Our discussion would be reflecting on some of the benefits that derive from using these instruments.

The real question is that are derivatives an alternative method that companies can use to raise capital? Certainly "Derivatives provide a cost effective vehicle to hedge financial market risk. At the same time, they are also used to raise capital, reduce taxes, smooth accounting earnings, and provide a valuation method for financial assets"[12]

4.1 Advantages to companies

Smaller firms issuing convertible bonds "often include warrants as a 'sweetener' to a new issue of common stock or a privately placed debt issue"[13]this is because these securities are less costly than debt securities as they reduce agency costs. Swaps are advantageous as they can transform fixed rate debt to floating rate debt also futures allows firms to hedge from particular risks in the future, thus by entering a future contract it enables the parties to hedge price risk, foreign exchange risk, interest rate risk and commodities.
Callable bonds are also advantageous because of the term structure of interest rates, thus as interest rates falls bond value rises the issuer then utilise the option to recall the bond because the bond was issued when interest rates were high, consequently the new bond issue would have a lower interest rate.

4.2 Disadvantages to companies

Pike et al (1996:351) and Hull (1998:13) suggest that a number of companies including Proctor and Gamble, Bearing Bank and Kodak have suffered because they have engaged in derivative transactions. The reason behind the loss is that derivatives

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[10] Hull (1998) pg 12
[11] Bodie et al (2002) p55
[12] Hodgson A. (1999) Derivatives and their Application to Insurance: A Retrospective And Prospective Overview, The Changing Risk Landscape: Implications for Insurance Risk Management, AON
[13] Douglas et al (1997) pg 843

"can be used for either hedging or speculation: that is they can be used either to reduce risk or take risks"[14]

4.3 Advantages to investors

Derivatives "allow an investor to benefit from an increase in the price of an asset at a fraction of the cost of buying the asset itself"[15].

4.4 Disadvantages to investors

Using options and other strategies investors are placing all or some of the capital at risk, this is in exchange for extraordinary capital gain. Thus such strategies are inappropriate for risk-averse investors.

Conclusion

Our discussion has factated a number of areas of corporate fianace specifically upon the the benefits and deficiencies beared by companies when making long term fianancial decisoions, investors are also significant since they have a perfect choice to where and whom they invest in thus companies when making financial decisions should take into consideation the investors choice and needs.

Companies that wish to raise long term finance can do so by access to efficient capital market, they can choose to sell additional debt, sell equity or sell the assets of the company, the latter we have not discussed.

[14] Hull J.C (1998) pg 13
[15] http://www.institutdesderives.com/guide_suite_en.php. 4 April 2003