Raising Equity Capital

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Learning Objectives

By the end of this module, students will be able to:

- list the various sources of private equity funding
- calculate pre- and post-money valuations
- list the pros and cons of going public
- describe the process of going public
- explain the mechanics of an SEO
- calculate a rights theoretical value

1 Private companies financing

Sources of funding

- Angel investors Individual investors who buy equity in small private firms.
- Crowdfunding Small amount investors through internet/social networks Warning: not all of them allow real equity funding (indiegogo, kickstarter) Example with equity funding: https://www.seedrs.com
- Venture capital firms Ltd partnership specialized in raising money to invest in private equity of young firms (start-ups). Partners are typically institutional investors.
- Private equity firms Similar to venture capitalists firms, but invest in privately held firms rather than start-up companies.
- Institutional investors May invest directly or through venture capital firms.
- Corporate investors Strategic investment. e.g. https://en.wikipedia.org/wiki/List_of_mergers_and_acquisitions_by_Alphabet

Selling stocks to outside investors

- Often *preferred stocks*
  - No regular cash dividends
  - Success: might be convertible in common stocks
  - Failure: senior claim on assets
- Pre-money valuation: value of shares outstanding at funding price
- Post-money valuation: value of whole firm at funding price
- **Important**: exit strategy if success
  - Acquisition by large corporation
  - Public offering

Example: RealNetworks

Example

RealNetworks Inc (NASDAQ:RNWK) was founded by Robert Glaser in 1993 (He is still Chairman of the Board and interim CEO in 2019).
In April 1995, Glaser's initial investment in the company was $1 million represented by 13,713,439 shares of Series A.

Calculate the initial share price

Example

At that time, the company had its first round of outside equity funding, selling 2,686,567 new shares (series B) at $0.67 per share.

What was the pre-money valuation? What was the post-money valuation? What was the ownership percentage of R. Glaser after this round?

Example

In the following few years, RealNetworks raised three more rounds of outside equity:

Series	Date	# of shares	Share Price	Investors
B	04-1995	2,686,567	0.67	Angel investors
C	10-1995	2,904,305	1.96	Venture capitalists
D	11-1996	2,381,010	7.53	Venture capitalists
E	07-1997	3,338,374	8.99	Microsoft Corp.

Complete the table, showing the pre- and post-money valuation for each round What was the ownership percentage of R. Glaser in the end of July 1997?

2 Going public : the IPO

Going public: pros and cons

Pros

- greater liquidity
- better access to capital

Cons

- costly
- more regulation requirements
- original shareholders ”diluted”

Types of offerings

- Which shares are sold?
  - New shares: Primary offering
  - Existing shares: Secondary offering

- Choose contract with underwriter
  - Best effort No guarantee, find best selling price, often all-or-none clause.
  - Firm commitment Underwriter purchases the entire issue.
  - Auction IPO Stocks sold through an auction, not very common, example: Google, Inc.

The mechanics of an IPO

- Choose underwriter and build syndicate
- SEC (market authority) filings: registration statement
- Red herring, final prospectus
- Valuation: book building, auction, DCF, comparables

Greenshoe provision

- Over-allotment allocation (max. 15%)
- Used by underwriter to manage risk: the underwriter "short sells" the greenshoe allotment (i.e. it markets a total number of shares which includes the greenshoe).
  - Success: exercise greenshoe option (earn more)
  - Failure: repurchase greenshoe allotment on market (support price)

Cost of an IPO

- Reported on prospectus
  - Underwriter gross spread
  - Direct expenses: filing fees, legal fees, taxes
- Other costs
  - Indirect expenses (management time, ...)
  - Costs incurred by existing shareholders (underpricing)

Example: RealNetworks

Example

RealNetworks went public in November 1997, a few months after Series E round.
3,000,000 shares were offered to the public, at $12.50 per share, for a total of $37.5 million of gross proceeds.
Costs The underwriting fee was $0.875 per share, and the direct expenses estimated to $950,000.
Greenshoe provision RealNetworks granted the underwriter the right to purchase up to 450,000 additional shares at the IPO price.

Estimate the net proceeds to the company (the greenshoe option was raised)

3 The Seasoned Equity Offering

Mechanics of SEO

- Which shares (mix possible)
  - New shares: Primary shares
  - Existing shares: Secondary shares
- Kind of SEO
  - Cash offer (most frequent in the USA)
  - Rights offer (widely used in France, for an example)

Example: RealNetworks

> **Example**
>
> RealNetworks went through several SEO after 1997 IPO.
> The first one was in June 1999, 4 million shares were offered:
> - 3,525,000 primary shares
> - 475,000 secondary shares,
>   (including 310,000 sold by R. Glaser)
>
> The shares were offered at $58 per share.

What were the gross proceeds of this SEO to the company?

Rights offers: rationale

Price offered for new shares < Current market price The right to buy a new share at this (lower) price has a value.

- Mechanics
  - 1 right per existing share before SEO
  - A given number of rights is needed to buy a new share
- Value of a right
  - Theoretical value: should offset stock price fall (due to issue at price lower than market price)
  - Rights are listed on the same market as underlying shares
- Shareholder strategy
  - Use the rights to participate in the SEO, get new shares at lower price, keep same share of overall equity
  - Do not participate in SEO, sell the rights as compensation

Rights offers: calculation (1)

> **Definition**
>
> Equilibrium price after SEO
>
> $$PA = \frac{(SB \times PB) + (SN \times PN)}{SB + SN}$$

SB # of outstanding shares before
SN # of new shares
PB Market price of outstanding shares
PN Price of new shares
PA Equilibrium price right after SEO

Rights offers: calculation (2)

Definition

The rights theoretical value offsets the difference between the market price of oustanding shares and the equilibrium price after SEO.

$$RV = PB - PA = PB - \frac{(SB \times PB) + (SN \times PN)}{SB + SN}$$

RV Rights theoretical value

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