The Capital Allocation Process

The Capital Allocation Process

Otherwise known as:

…How money goes from those that have it to those that need it...

$$$

The Capital Allocation Process

But what exactly is "Capital"?

"Wealth in the form of money or other assets owned by a person or organization available for a purpose such as starting a company or investing."

Oxford Dictionary

The Capital Allocation Process

Other kinds of "Capital"…

Human Capital

"…the economic value of a worker's experience and skills. Human capital includes assets like education, training, intelligence, skills, health, and other things employers value such as loyalty and punctuality."

Investopedia

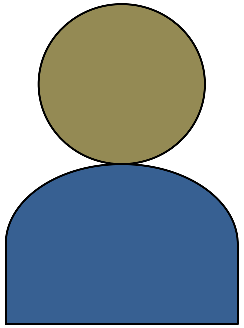
Natural Capital

"…the world's stock of natural resources, which includes geology, soils, air, water and all living organisms. Some natural capital assets provide people with free goods and services, often called ecosystem services."

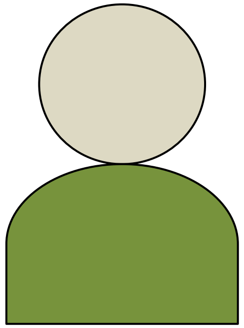
Wikipedia

The Capital Allocation Process

A Simple Example We All Understand…



Some people have more money than they need to meet daily expenses.



Some people need more money than they have for a expense (house, car, college).

The Capital Allocation Process

A Simple Example We All Understand…

These folks put their excess funds (surplus) into an account with the bank.

These folks ask the bank for a loan to buy a house, car, or fund college education.

The Capital Allocation Process

A Simple Example We All Understand…

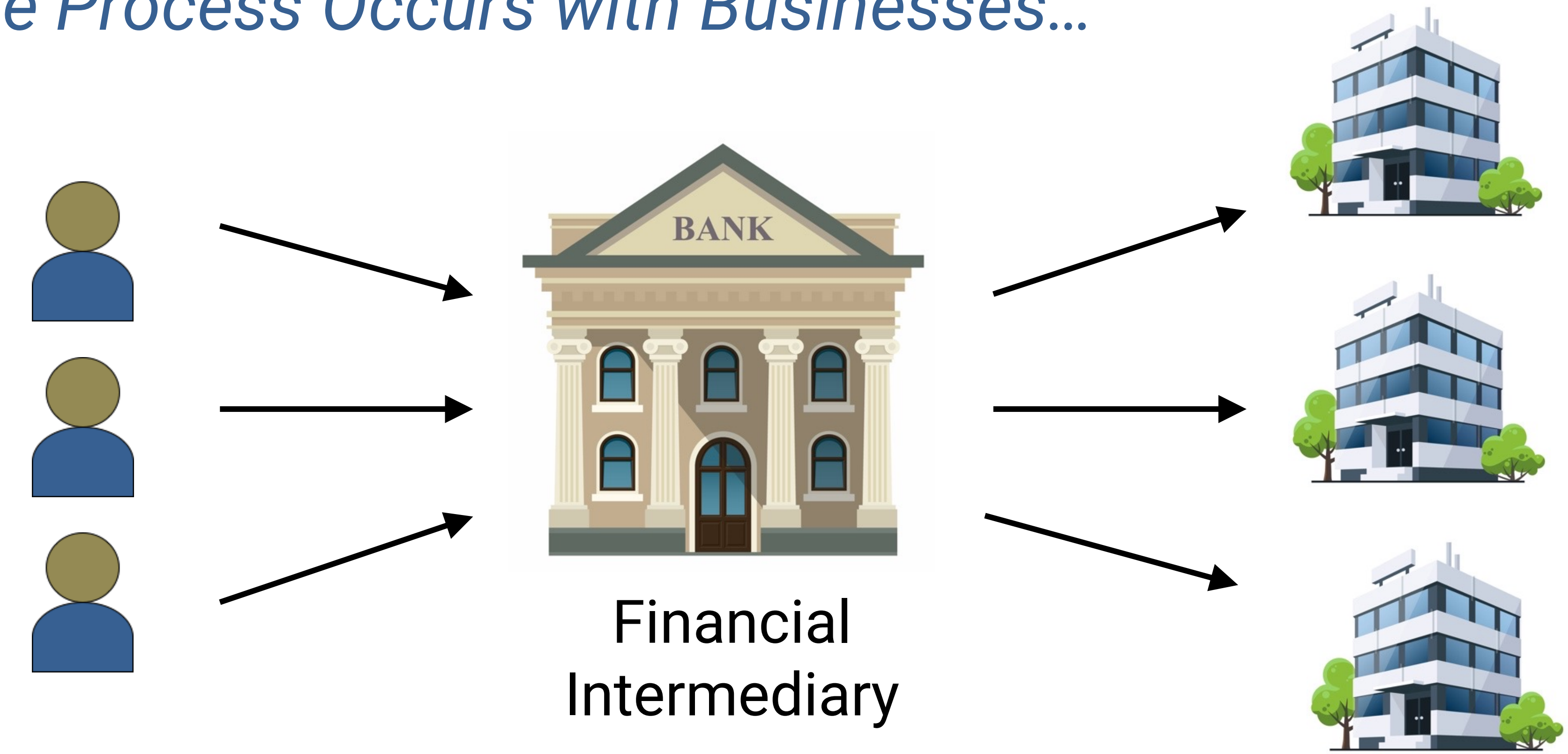
The bank pays these people interest to use their money.

These people pay back their loan over time, with interest.

The bank makes money by charging more interest for the loan than it pays to the folks with a bank account.

The Capital Allocation Process

The Same Process Occurs with Businesses…



“Indirect” Transfer Through a Financial Intermediary

The Capital Allocation Process

The process of funding a company through loans (e.g., from a bank or by issuing bonds) is known as “Debt Financing”.

The process of funding a company through selling shares of the company’s stock is known as “Equity Financing”.

Financial managers (i.e., the CFO) aim to find the right balance between debt and equity financing.

It’s the work of the CFO to figure out the right balance – so we won’t worry about these details…

Equity Financing

Scenario 1 - Selling Shares Directly to Investors

Individuals

Groups of Individuals

Venture Capitalists

Small companies (not yet public) commonly sell shares to private investors to raise funds.

"Private Placement"

"Direct" Transfer Process

Equity Financing

Scenario 2 – Going Public

"We need $ to…"

- Keep up with fast growth
- Acquire a competitor
- Build an international company
- Payoff the Venture Capitalists!

Companies that require considerable amounts of money can sell shares to the public in its "Initial Public Offering", or IPO.

Equity Financing

Indirect Transfer through an Investment Bank

How an IPO Works…

1. The Company works with an Investment Bank to determine the share price.
2. The Investment Bank buys the available shares from the company at that price (less a fee) in a process known as "*underwriting*".
3. The Investment Bank then sells the shares to large investor groups, which ultimately sell to the public via one of the exchanges (NYSE, NASDAQ).

Equity Financing

A Few of the More Well-Known Investment Banks…

- Morgan Stanley
- BNP PARIBAS
- J.P.Morgan
- Bank of America
- BARCLAYS
- UBS
- BLACKROCK
- citigroup
- CREDIT SUISSE
- Deutsche Bank
- TD Securities
- LAZARD
- HSBC
- DBS
- Goldman Sachs
- RBC Royal Bank

Equity Financing

What happens after the IPO?

The Company

The company sold its available shares and received its money.

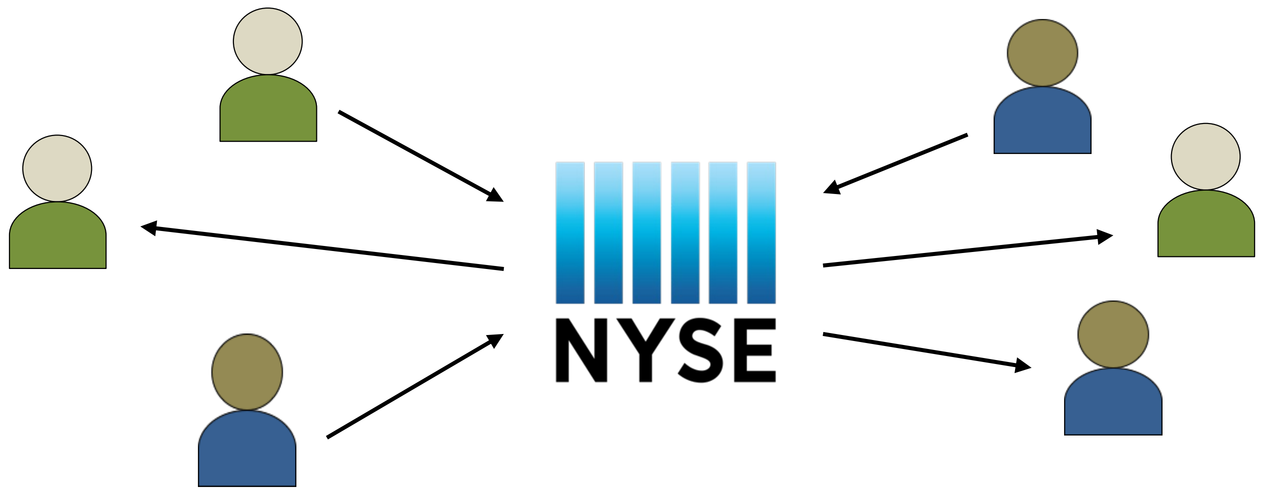
Investment Bank

The Investment Bank sold its shares and received its money.

For all practical purposes, the Company and the Investment Bank are now done. They have their money and are happy.

Equity Financing

What happens after the IPO?



The company's shares now trade (are bought and sold) in the public domain, through "exchanges" like NYSE (New York Stock Exchange).

Note that the Company doesn't see any money from these transactions.

Equity Financing

Primary Markets: when a company sells stock to raise money (capital). Money goes directly to the company.

Secondary Markets: when the company's stock is traded among investors. Money goes between the investors, and not the company.

So does a company care what happens to its stock price after the IPO?

Sure!

- The Founders & Employees often own stock, and want to benefit from it.
- The Shareholders (and company owners) want to maximize their wealth!
- If the stock price gets too low, the company becomes a target for acquisition!

Main Takeaways…

- Debt Financing: Banks connect people with money to companies that need it through the loan process.

- Equity Financing: Company’s in need of cash sell shares of their stock to investors who want to own a piece of the business.

- The IPO process enables companies to acquire a large sum of money, in exchange for allowing many investors to own a portion of the company.

- Even though a public company is not financially involved in the secondary markets, management still considers the stock price as an important measure of success.

It is the role of the CFO to determine the balance between debt and equity financing.

We need to know this because it impacts how we fund product development projects!

Next Time…

Access to Capital = Growth and Prosperity

Credits & References

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Slide 2: Couple sitting in a private jet drinking cocktails, by peopleimages.com, Adobe Stock (492639536.jpeg). Young couple managing family budget by Africa Studio, Adobe Stock (187508350.jpeg).

Slide 3: Capital definition source: Yahoo.com, https://search.yahoo.com/search?p=capital+definition&fr=yfp-t&fr2=p%3Afp%2Cm%3Asb&ei=UTF-8&fp=1 (accessed April 7, 2022). Businessman's hand & steel grocery cart full of money stacks by Romario Ien, Adobe Stock (54127527.jpeg)

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Slide 6: Bank building façade by nazarkru, Adobe Stock (235548047.jpeg). Several hundred dollar bills on a white background by nosorogua, Adobe Stock (96847794.jpeg).

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