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Investment Banking

4. Seasoned Equity Offering

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SEO

Introduction
Private Placement
Cash Offer
Rights Offer

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Introduction

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- New shares issues by listed companies [seasoned equity issues] may take three forms:
  - Private Placement
  - Cash Offer
  - Rights Offer

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Private Placement

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- Shares are sold directly to one or a small number of investors;
- The terms of the offer (number and price of shares) are negotiated between the parties;
- Usually strategic investors (financial investors only in case of financial distress)

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Private Placement

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- Advantages
  - Lower intermediation costs, since there is no need to place the shares and guarantee their placement by an Investment Banking, and issuing costs (legal and administrative);
  - Terms of offer may be change to comply with specific requirements of investors;

- Disadvantages
  - Lower number of potential investors
  - New investors normally take a higher stake and will want some intervention in the management of the company

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Cash Offer

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- As is the case for IPOs, shares are offered to the general public and the issue can be organized by an Investment Bank on a Firm Commitment basis or a Best Effort basis

- However, in this case, a reference price already exists (the current market stock price).
  - New shares are offered to the general public, for a price slightly lower than the current market price

- Widely used in United States but not internationally;

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Cash Offer

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- Announcement leads, on average, to a price decline
  - Value destroyed can be a significant fraction of the money raised
  - Consistent with adverse selection/asymmetric information
- When shares are over-valued ($P > V$) the issue of new shares benefits present shareholders at the expense of new shareholders;
- When shares are under-valued ($P < V$) there is a wealth transfer from old to new shareholders;
- Larger role for investment banks as they can credibly certify the issue's quality

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Rights Offer

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- The current shareholders of the company have the right to buy new issued shares proportionally to the shares currently held
- The option to buy new shares can be exercised or sold
- Current shareholders may keep the same amount of control and economic interest in the company by buying their allotted shares for the new issue at the subscription price
- Since the current shareholders have the right to buy the new shares the subscription price can be much lower than the market value of the shares (stock price) without the current shareholders being affected
- This type of offer is highly popular in Europe and Asia, but strangely no that much used in the USA (*puzzle*)

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Rights Offer

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- The existence of these underwriting rights and, above all, the possibility to trade them, separately from the original shares, guarantee that present shareholders are not financially compromised, whatever the price established for the new shares;
- Shareholders may then opt for one of the following paths:
  - Exercise the rights and buy the new shares;
  - Sell the rights and being compensated for the decrease in the market price of their shares, as a consequence of the dilution effect.
- The market price reduction is a rational adjustment, due to the dilution effect as the price of the new shares is set lower than the present market price of current shares.

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Rights Offer

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- How it works?
  - A right for each current share is attributed to the shareholders before the capital increase
  - An investor that has x rights (x = #old shares/#new shares), is able to buy a new share at the subscription price, generally at discount to the market price
  - The rights can be traded (bought and sold), so any rational shareholder will either exercise or sell them
  - If the shareholder does not exercise its rights and does not sell them, he will experience a reduction in its net worth since after the rights issue the price of the shares will fall due to the dilution effect

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Rights Offer

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Valuation of rights

- P_0 – Share Price before rights issue (price Rights-On or Cum-rights). The holder of this share has the right to subscribe new shares;
- P_E – Equilibrium Share Price after the rights issue (ex-rights price)
- R – Value of the subscription rights
- S – Subscription price for the new shares
- $N_{0(1)}$ – Number of shares before (after) the equity increase
- n – Number of new shares
- m – Number of rights to subscribe one new share, set as N_0/n

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Valuation of rights

- $N_1 = N_0 + n$
- $P_E = (N_0 * P_0 + n * S) / N_1$
- $S + m*R = PE \rightarrow R = (PE - S) / m$ (from the buyer side)
- $R = P_0 - P_E$ (from the seller side)

Assumption: there is no change to the intrinsic value of the company during the period for rights transaction

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What can a shareholder with x shares do?

- Sell X subscription rights
  - Wealth before rights issue – $X*P_0$
  - Wealth after rights issue – $X*P_E$ (shares) + $X*R$ (cash)
  - $= X*(P_E + R) = X*P_0$
- Exercise X subscription rights
  - Wealth before rights issue – $X*P_0$
  - Wealth after rights issue – $(X+X/m)*P_E = (X+X/m)*(P_0-R) =$

$= X*P_0+X/m*(P_0-R) - X*R = X*P_0 + X/m*P_E - X*R =$

$= X*P_0+X/m*[P_E - m*R] = X*P_0 + X/m*S$

[X/m*S = additional investment to buy new shares]

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What can a shareholder with x shares do?

- Do nothing
  - Value before rights issue – $X*P_0$
  - Value after rights issue – $X*P_E$ (shares)
  - Loss = $X*P_0 - X*P_E = X*(P_0-P_E) = X*R$

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- When the offer of new shares is restricted to shareholders, the definition of the subscription rights is irrelevant for the shareholders' wealth
  - The lower the subscription price, the higher will be the value of the subscription right
- Defining a price much lower that the share price is a way of ensuring the success of the capital raise
  - It does not harm (theoretically) the current shareholders if these exercise or sell their subscription rights
  - The shareholders have a higher loss if they let the right expire without doing anything
- If the subscription price >= stock price, the value of the rights will be zero and no one will subscribe the capital increase (no one will buy the shares)

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Rights Offer

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Example

- The capital of company ABC is represented by 4.500.000 shares, with a market price of €9. The company announced that it will issue 800.000 new shares in order to increase its capital (equity), reserved to shareholders, by €6.72 million that are necessary for new investments.
  - What should the share price of company ABC be after the share issue? [€8.91]
  - How many rights will it be necessary to subscribe one new share? [5.625]
  - What is the value of each subscription right? [~€0.091]
  - Assuming that you own 45.000 shares of company ABC, but you did not exercise your subscription rights. Quantify your loss?[~€4050/~4095]