How Do Corporations Raise Money?

- In principle, whenever a company wants to raise new money, say to build a factory, it could issue new shares
- This *dilutes* existing shareholders, since they now own a smaller fraction of the company, but, offsetting that, it creates new earning power for the company
- Shareholders at a meeting could ideally vote on whether they think the prospective profits are worth the dilution, and prospective purchasers of the issue could ponder whether they feel the diluted shares are worth purchasing

Why Do they Call It Equity

- Equity means *equal* share. Term goes back only to 1904, originates in US (OED)

c. (See quot. 1966.) orig. *U.S.*

Thesaurus »
Categories »

1904 E. S. Meade in *Polit. Sci. Q.* Mar. 50 Its preferred stock is quoted at..prices which indicate a general conviction that the equity in the company is worth little.

1928 *New Statesman* 28 July (Finance Suppl.) p. vi, Out of the combined issued capital of £16,629,000 the public put up 93 per cent. of the cash required, but received only 21.8 per cent. of the equity—that is the balance of profits remaining after the fixed dividends have been paid on the Preferred capital.

1930 *Times* 11 Feb. (Financial Rev.) p. iii/2 It was widely imagined that more money was to be made in high pressure equities than in anæmic mortgages.

1966 A. Gilpin *Dict. Econ. Terms* (1967) 72 *Equities*, the ordinary shares of a limited company. They carry the right to the residue of a company's assets after it has paid all its creditors, and share in the distribution of profits, if any, after interest has been paid to preference share-holders and debenture holders each year.

Stuart Myers Pecking Order Theory

- Firms really don't like to issue new shares, because public gives them a bad price, mistrusting management, and it is costly and difficult to issue shares
- Stewart Myers, "The Capital Structure Puzzle, J. Fin. 39:575-92, 1984 proposes "pecking order" theory: firms like to raise money through retained earnings first, through borrowing second, equity only as last resort

Myers Continued

- He says most firms (as of 1984) had not done a single equity offering in the last twenty years, and did not contemplate doing one
- 1973-82 62% of capital expenditures came from retained earnings, only 6% from net equity issuance, rest from net borrowing

Fama & French criticism of Myers JFE 2005

- But Fama and French point out that even 1973-82, 67% of firms issued some equity (Myers referred to net equity at 6%), up to 86% for 1993 to 2002
- Equity issues include issues of stock to employees via options and grants