FINA 3070 Notes 4B

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1 When A (Listed) Company Needs New Capital

- Increase in "retained earnings": without printing new bonds/shares, a company can keep dividend constant when net income increases, or even reduce dividend.
- Raise new capital
  - New borrowing
    - Private loans: not to be traded (e.g. bank loans)
    - Public bonds: tradeable (straight/simple bonds, convertible bonds)
  - New shares
    - Seasoned equity offering: already listed company
    - P.s. unseasoned equity offering: IPO, i.e. private company becomes public (listed) company

2 Debt Raising (Bond Issuing) By Listed Company

2.1 Private Placement (not our focus)

- "Small" amount of borrowing from small number of "selected lenders".
- Raise loans from "commercial banks", or "rich individuals / institutional investors".
  - Common in both HK and US.
- Issue small number of bonds to investment banks to be resold to their clients.
  - Common in US, less common in HK.

2.2 GCO (General Cash Offer)

- Issue "many" new bonds to the public.
- Common in US, less common in HK.
- Investment banks serve as "underwriters" (receive spread/compensation from company).
- Public announcement (optional: approval by special meeting of shareholders).
- Book-building (demand book) by i-bank underwriters
  - Invite many investors (small investors might not be invited).
  - Road shows: presentation explaining characteristics of new bond (share), e.g. coupon rate, YTM etc.
  - Collect "individual demand curves of each investor" $\rightarrow$ get aggregate demand curve.
  - Decide offering price (i.e. printing price, issue price).
- Issuing new bonds have lower GCO costs than issuing new shares.

3 Book-Building: Slope of Individual and Aggregate Demand Curves

3.1 Individual Demand Curve Slope

- Information asymmetry and difficulty of valuing the common stock: the more severe info asymmtery, the steeper the slope.
- Investors that are more risk-aversed (or with more capital constraint) have steeper slope. (Even if you lower the price, I'm still only willing to buy a small quantity.)
- Short sales contraints also steepen the slope.

3.2 Aggregate Demand Curve Slope

- Horizontal summation of different investors' slopes. (see Notes4B pp.6)

4 Bond Rating

4.1 Seniority Declining

- Bonds issued earlier (senior bonds) have less default risk than junior bonds, which are issued more recently. Reason: Suppose for a specific the cash flow of a company is low, the senior bond-holders will receive their payments first.
- Senior bonds have higher bond rating (e.g. AAA) than junior bonds (e.g. A).
- Subscribers (investors) of the latest batch are 'indifferent'. Because they pay a fair price (AA-grade price for AA-grade price bond).
- Seniority declining is more common, as early investors will demand this as a protection (to avoid being hurt later). Therefore, the outstanding bonds' price usually doesn't change even if new bonds are issued.
- However, the market price of the original batch (senior bonds) might still change (not because of the new bond issues, but because of the company's future performance).

4.2 If No Seniority Declining (Notes4B pp.12)

- The company is 'happy' (more borrowing value with AA-grade price; calculate rectangle area).
- The earlier shareholders are 'unhappy' (suffer capital loss).
- Subscribers (investors) of the latest batch are 'indifferent'. Because they pay a fair price (AA-grade price for AA-grade price bond).

4.3 Misc.

- If a firm issues more 'straight' bonds, the stock price usually doesn't change.
- Thus, raising new capital is considered 'neutral news'.

5 Equity Raising (Stock Issuing) By Listed Company

5.1 Placing / Private Placement

- A small number of new shares to a small number of big investors.
- Common in HK, less common in US.

5.2 GCO

- Lots of new shares to the public, through i-banks.
- Common only in US.

5.3 Rights Offering

- Lots of new shares issued on a 'pro rata (proportional) basis' to 'current' stockholders. (E.g. a current stockholder holding 1% of existing shares will subscribe to 1% of the newly shares to be issued.)
  - Current stockholders can also choose to 'give up' such right.
- The percentage ownership won't be affected by the newly issued stocks: important for closesly-held companies (e.g. in HK, UK, Europe).
- No book-building necessary (the demand is fixed proportionally anyways.)