FNCE 20005 CORPORATE FINANCIAL DECISION MAKING

TUTORIAL 2: EQUITY CAPITAL - SOLUTIONS

SECTION A

QUESTION 1

(a) 9 million shares @ $1.00 = $9 million
(b) Bryan must hold 8 shares to get 1 new share
(c) $X = \frac{8*10+1}{8+1} = \$9$
(d) Option value of the right is not considered in the formula;
There may be transaction costs/taxes related to exercising the right;
New information about the company may arrive on the ex-rights date or the whole stock market may have moved on that day.
(e) $R = X - S = 9 - 1 = \$8$
(f) If accepts, total shares = 90 consisting of 80 existing + 10 new
The issue has no impact on his wealth as follows:

Pre Issue Wealth	
80 shares @ $10.00	$800
Cash	$10
	$810
Post Issue Wealth	
90 shares @ $9.00	$810

(g) 1) Private placement; 2) Dividend Reinvestment Plan (DRP)
Given the need for speed, private placement would be best suited. Disadvantage: Transfer of wealth and control from old to new shareholders.
(h) Since the subscription price is so low, one would expect that most shareholders will exercise their option to buy the new shares. Risk: If the price of Demons' shares keeps on dropping, the incentive for investors to buy the new shares decreases. Demons may not be able to sell all its shares to raise all the capital it needs.

QUESTION 2

ASX Listing Rule 7.1 restricts the amount of equity capital that an Australian listed company may raise by way of a private placement to 15% of its issued capital within a given 12 month period unless the company first obtains approval from its shareholders to place a larger amount.

The rule addresses a problem in Agency Theory. Specifically it seeks to protect existing shareholders against a substantial loss in wealth which would be suffered in the event that management placed a large block of shares to a small group of new investors at a substantial discount to the current share price.

QUESTION 3

The statement means that ordinary shareholders are paid last. In other words, ordinary shareholders are entitled to the profit (if any) that remains after all other claimants such as suppliers, employees, lenders and government bodies have been paid. Its significance is that ordinary shareholders are exposed to greater risk than all other claimants.

QUESTION 4

In comparison to fixed-price offers, book-building for an IPO generally results in an issue price that is closer to the market price when trading commences. The main advantages are that information provided by informed (institutional) investors can be used in setting the issue price, the risk of under-subscription is virtually eliminated, and the issue price is likely to be higher than with a fixed-price offer. Book-building also has some disadvantages. Book-building involves significant costs so it is usually viable only for large issues. Also, there are possible investment banking conflicts, that is, investment bankers may allocate hot IPO shares to their favoured clients.