CHAPTER 11

CONCEPT REVIEW QUESTIONS

1. What are financial intermediaries, and what role do these firms play in providing long-term capital to publicly traded U.S. nonfinancial corporations?

A financial intermediary (FI) is an institution that raises capital by issuing liabilities against itself—for example, in the form of demand or savings deposits. The intermediary then pools the funds raised and uses these to make loans to borrowers or, where allowed, to make equity investments in non-financial firms. Borrowers repay the intermediary and have no direct contact with the individual savers who actually funded the loans. In the United States, commercial banks' corporate financing role has until recently been very limited; in fact, it was effectively restricted by law to making commercial loans and to providing closely related services, such as leasing, until the McFadden Act was repealed in 1994 and the Glass-Steagall Act was repealed in 1999.

2. What patterns are observed in security issues each year?

There is a trend toward securitization, the repackaging of loans and other bank-based credit products into securities that can be re-sold to public investors

3. What does the phrase "bulge bracket" mean?

Bulge bracket firms are the largest IBs providing a wide range of services. Bulge-bracket firms generally occupy the lead or co-lead manager's position in large, new security offerings, meaning that they take primary responsibility for the new offering (even though other banks participate as part of a syndicate), and as a result, they earn higher fees.

4. What patterns have been observed in the types of firms going public in the United States? Why do you think that certain industries become popular with investors at different times?

IPO financing is cyclical. There are "hot" and "cold" markets when IPO activity peaks and then wanes. Industries may for a time be the "hot" industry, for example, tech firms in the late 1990s. Previously, there were clusters of IPO activity in energy, biotechnology, and communications. Industries become popular at certain times because of their high growth rates and high returns. High tech companies had very high returns (but also high risk) in the late 1990s.

5. What are the principal benefits of going public? What are the key drawbacks?

The benefits of going public include: raising new capital for the company, providing publicly traded stocks that can be used in acquiring other companies, having listed stock that can be used to compensate and retain key employees and providing personal wealth and liquidity for entrepreneurs. Key drawbacks include the high financial cost of an IPO (transactions fees for doing the deal), high managerial costs (management time taken up in managing the deal rather than the core business), external pressures to maximize stock price once the firm has gone public, and required, continuing information disclosures.

6. What does the term "underpricing" refer to? If the average IPO is underpriced by about 15 percent, how could an unsophisticated investor, who regularly invests in IPOs, earn an average return less than 15 percent?

Underpricing refers to the fact that IPO shares typically rise on the first day of trading, indicating that they could have been priced higher to begin with. An unsophisticated investor who invests in IPOs is likely to earn lower than average returns. Some IPOs are underpriced, some very underpriced and some just slightly underpriced, while others are overpriced. Sophisticated investors with more information about the IPO will choose to invest only in the best, most underpriced deals. If an unsophisticated investor is able to invest in an IPO, it is probably because there is low demand for that IPO because it is not priced favorably priced for the investor. In other words, if an average investor can buy into the deal, it is probably a below average deal.

7. How does underpricing add to the cost of going public?

Underpricing adds to the cost of going public because the company must issue more shares at a lower price, and ultimately raises less money with the IPO. If issues were correctly valued, the company could either raise more money or it would have less dilution from issuing fewer shares.

8. What happens to a company's stock price when the firm announces plans for a seasoned equity offering? What are the long-term returns to investors, following an SEO?

Price usually drops as it is interpreted as a signal that the firm is over priced.

9. Why do you think that rights offerings have largely disappeared in the United States?

Companies—and their shareholders—found that restricting share sales to existing shareholders severely restricted the potential market for new share sales. By voluntarily allowing public firms to make general cash offers to all investors, shareholders allowed companies to sell equity capital at much higher price than would be possible if these were restricted to existing investors only.

10. In what ways are non-U.S. (private-sector) initial public offerings similar to U.S. IPOs and in what ways are they different?

Less IPO money is raised in non-U.S. countries, and international IPOs are generally smaller than U.S. company IPOs. Like U.S. IPOs, there is often significant first day underpricing, sometimes even larger than U.S. IPO underpricing. U.S. and international IPO companies also earn below average returns in the period following the IPO. Popular non-U.S. IPOs are also oversubscribed, with allocation rules mandated by national law or exchange regulations. Hot issue markets occur internationally as well as in the U.S. Taxation issues, in particular capital gains tax issues, significantly impact how issues are priced. Many international governments impose rules on firms going public, such as requiring them to allocate minimum fractions of the issue to their employees or other targeted groups.

11. What are *Depositary Receipts (DRs)*, and how are these created? Why do you think DRs have proven to be so popular?

American Depository Receipts are dollar denominated claims issued by U.S banks which represent ownership of shares in a foreign company’s stock held on deposit by the U.S. bank in the issuing firm’s home country. U.S. banks create them. They are popular because they allow U.S. investors to easily diversify internationally. ADRs allow U.S. investors to eliminate foreign exchange risk, which would exist without the creation of ADRs. The shares are covered by U.S. securities laws and pay dividends in dollars.

12. In what key ways do *share issue privatizations (SIPs)* differ from private-sector share offerings? Why do you think governments deliberately underprice SIPs?

In a share issue privatization a government sells all or part of its ownership in a state-owned enterprise to private investors via a public share offering. These have done a great deal to develop many national stock markets. SIPs tend to be very large and often dramatically increase the national market’s volume and liquidity.

SIPs are almost always secondary offerings – the proceeds go to the government rather than the firm being privatized. Governments underprice SIPs to create excess demand. The issuing government then allocates shares to ensure maximum political benefit. Governments typically favor employees and small domestic investors, with domestic institutions and foreign investors allocated fewer shares than desired.