# Study Plan

# Chapter 11

**Learning Objectives**

After studying this chapter you should be able to:

- Discuss the basic choices that corporations face in raising long-term financing;
- Describe the costs and benefits of raising long-term funds by issuing securities on capital markets rather than by borrowing from a financial intermediary;
- Understand how investment banks help corporations issue securities, and describe the services investment banks provide before, during, and after a security issue;
- Explain the basic issuance and pricing patterns observed in the initial public offering (IPO) and Seasoned Equity Offerince (SEO) market in the major financial centres;
- Explain what American Depositary Receipts (ADRs) are and discuss why these have proven to be so popular with U.S. investors.

**Summary and Conclusions**

- In almost all market economies, internally generated funds (primarily retained earnings) are the dominant source of funding for corporate investment. External financing is used only when needed, and then debt is almost always preferred to equity financing. The difference between a firm's total funding needs and its internally generated cash flow is referred to as its financial deficit.
- Financial intermediaries are institutions that raise funds by selling claims on themselves (often in the form of demand deposits or checking accounts) and then use those funds to purchase the debt-and-equity claims of corporate borrowers. They thus break—or intermediate—the direct link between final savers and borrowers that exists when companies fund their investment needs by selling securities directly to investors.
- The total volume of security issues has surged but U.S. corporate issuers routinely account for two thirds of the worldwide total.
- Companies wanting to raise capital externally must make a series of decisions, beginning with whether to issue debt or equity, and whether to employ an investment bank to assist with the securities' sale. This chapter focuses on common-stock offerings, but the decisions and issuing procedures are very similar for preference shares and debt securities.
- Firms wanting to raise new common-stock equity must decide whether to sell stock to public investors through a general cash offering, or to rely on sales to existing stockholders in a rights offering. Rights issues are now fairly rare in the United States, though they remain common in other developed countries.

- In the United States, shares can be sold through private placements to accredited investors, or it can be sold to the public if the securities are registered with the SEC. A company's first public offering of shares is known as its initial public offering, or IPO. The typical American IPO is underpriced, on average, by about 15 percent, and this has held true for several decades. International IPOs are also underpriced. It is unclear whether IPOs are poor long-term investments.
- Subsequent offerings of shares are known as seasoned equity offerings, or SEOs. The announcement of a seasoned equity issue tends to decrease a company's stock price. There is strong evidence that firms issuing seasoned equity underperform over the long term.
- Investment banks assist companies in selling new securities by underwriting security offerings. Underwriting a security offering involves three tasks: (1) managing the offering, which includes advising companies about the type and amount of securities to sell, (2) underwriting the offering, by purchasing the securities from the issuer at a fixed price to shift the price risk from the issuer to the investment bank, and (3) selling the securities to investors.
- The largest share offerings in world history have all been share issue privatizations, or SIPs. Since 1981, governments have raised over $850 billion through these share offerings, and they have transformed stock market capitalization, trading volume, and the number of citizens who own shares in many countries.