Chapter 30
SELLING SECURITIES

Get 'em while they' re hot!

Now that we have studied the properties of the various financial securities, let's see how companies sell them to investors. Bank finance was beautiful in its simplicity – whenever a company needed funds, it turned to its bank. Now that direct financing has become more common, companies can raise funds from a great many investors whom it does not necessarily know. That means they have to market their financing!

Section 30.1
GENERAL PRINCIPLES IN THE SALE OF SECURITIES

1/ THE PURPOSE OF OFFERINGS

The company's main goal in selling its securities to investors is to obtain the highest possible price.

For the sale to be successful, the company must offer investors a return or a potential capital gain. Otherwise, it will be harder to gain access to the market in the future.

The offering must be in line with this objective. The price of a security is equal to its present value, as long as all publicly available information has been priced in. This is the very basis of market efficiency. Conversely, asymmetric information is the main factor that can keep a company from selling an asset at its fair value.

Investors must therefore be given the information they need to make an investment decision. The company issuing securities and the bank(s) handling the offerings must provide investors with information. Depending on the type of offering, this can be in the form of:

- a mandatory legal written documentation called a prospectus;
- presentations by management via meetings/conference calls with investors or electronic road shows;
- valuations and comments by financial professionals on the deal and the issuer via notes by financial analysts and presentations to the bank's sales teams, for example.

A firm underwriting commitment by the bank(s) handling the transaction can provide additional reassurance to investors, because if the bank is willing to arrange and

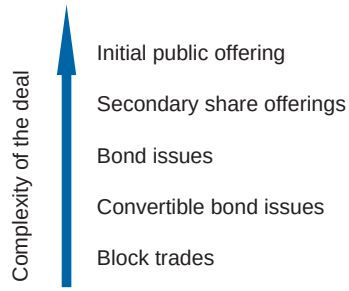
underwrite the offering, it must believe that the offering will succeed and that the price is "fair". After all, investors are also clients to whom the bank regularly offers shares.

In any offering the bank's exact positioning is always ambiguous. In theory it is mandated by the company that is issuing the securities and must therefore defend that company's interests to the fullest. But to do so, it must persuade the investors, who are its regular customers, to subscribe. It cannot afford to lead its clients astray. Ultimately, it defends the interests of both sides, not to mention its own!

Investor information needs and the complexity of the deal depend on the following:

- **The amount of information that is already available on the issuing company itself**. Clearly, an initial public offering of shares in a company unknown to the market will require a big effort to educate investors on the company's strategy, business, financial profile and perhaps even the sector in which it operates. This information is already contained in the share price of a publicly traded company, as that price reflects investor anticipations. This is why it is generally easier to offer shares in a company that is already listed.
- **Investor risk**. Investors need more information for shares than for bonds, which are less risky.
- **The type and number of investors targeted**. In addition to regulatory restrictions, it is generally more difficult for a European company to sell its securities in the US than in Europe, especially if the company and its industry are not known outside its home country (sometimes the opposite can occur, as in the oil services sector, for example). Meanwhile, a private placement with a few investors is simpler than a public offering.

The type of offering will depend on the complexity and risk involved.



2/ THE ROLE OF BANKS

The bank(s) in charge of an offering have four roles, whose complexity depends on the type of offering:

1 **Arranging the deal**, i.e. choosing the type of offering on the basis of the goal sought: volume of securities to offer and in what form and timetable, choosing the market for the offering, contacts with market authorities, preparation of legal documents in liaison with specialised attorneys.

2 **Information**: an offering is often an opportunity for an issuer to report on its recent activity, prospects and strategy. The consistency of this information is checked by the bank and the lawyers in charge of the deal during a phase called "due diligence", which consists of interviews with the company's management. Information is also gathered by the brokerage arm of the bank and then put out in research notes written by the bank's financial analysts. The bank also organises meetings between the issuer and investors in one or more markets (road shows or one to one meetings).
3 **Distribution**: the bank's sales teams approach their regular clients, the investors, to market the securities and take orders. The issue price is then set by the bank in liaison with the issuer or seller, and the securities are allocated to investors. An equilibrium price is established in the "after-market" phase. In the days after that, the bank may intervene in the market in order to facilitate exchanges of blocks among investors.
4 **Underwriting**: in some cases the bank provides the issuer (or seller) with a guarantee that the securities will find buyers at the agreed price. The strength and timing of the guarantee varies with the deal. The bank thus assumes a certain market risk.

Most offerings, especially public offerings,[1] require a **syndicate** made up of several banks. Depending on how involved it is in the deal, and in particular the degree of guarantee, any one bank may play the role of:

1 *That is, for a flotation on a regulated market or a public retail offer.*

- **global co-ordinator**, who coordinates all aspects of an offering; global coordinators usually serve as lead and book-runner as well. For fixed-income issues, the global coordinator is called the **arranger**;
- the **lead manager** is responsible for preparing and executing the deal. The lead helps choose the syndicate. One (or two) leads also serve as book-runners. The lead also takes part in allocating the securities to investors;
- **joint-leads** play an important role, but do not usually serve as book-runners;
- **co-leads** underwrite a significant portion of the securities but have no role in structuring the deal;
- **co-managers** play a more limited role in the transaction, normally just underwriting a small portion of securities.

For some transactions (a block trade of already existing shares or a bond issue), the banks may buy the securities from the seller (or issuer) and then sell them to investors. This is called a **bought deal**. Unsold securities go onto the bank's balance sheet.

A **firm underwriting** agreement carries less of a commitment than a bought deal. A firm underwriting is a commitment by the bank to buy the securities only if the offering fails to attract sufficient investor interest. In some cases, the bank may be released from its commitment in the event of *force majeure*.

Before agreeing to underwrite more complex deals, banks may wish to have some idea of investors' intentions. They do so via a process called **book-building**, which occurs at the same time that information is sent out and the securities are marketed. Volumes and prices from potential investors are listed in the book. This helps determine if the transaction is feasible and, if so, at what price. Only after the book-building process do banks choose whether or not to underwrite the deal. Book-building allows the banks running the transaction to limit their risk, by assuring them that investors are willing to buy the securities.

Book-building helps to determine, at a given moment, the best price for the seller and/or company and to allocate the securities on a more or less discretionary basis.

In some cases, the bank does not pledge that the transaction will go through successfully, only that it will make its best efforts to ensure that this happens. This is rare in a formal documented offer, as investor confidence could be sapped if there is no formal pledge that the deal will go through. As a result, best efforts is the rule only in offerings by smaller companies or in very special cases (companies in difficulty, for example).

In some transactions, the bank's commitment is half-way between an initial bought deal and a post-book-building bought deal. When a block of existing shares is being sold, a bank may make a "back-stop" or floor underwriting commitment, i.e. go through the book-building process but guarantee the seller a minimum price.

There are two techniques for adjusting the offering to anticipations of investor behaviour, as well as to their actual behaviour: **greenshoe** and **clawback**.

To stabilise the price after the transaction, the issuer or seller may give the bank the option of buying a number of shares over and above the shares offered to investors (as many as 15% more in a capital increase and 25% for block trades of existing shares). This is called a greenshoe (named after the first company to use it) . The bank allocates all the securities to investors, including the greenshoe shares, i.e. more than the official offering. These additional shares are borrowed by the bank:

- If the price falls after the offering, the bank buys shares on the market up to the limit of the greenshoe. This supports the price. It then has 30 days to resell these shares if the price moves back up. If the price doesn't rise, the bank repays the loan using the shares it bought to support the price. In this case the greenshoe is not exercised.
- If the price moves up the bank can resell the shares or, if the price rises immediately after the transaction, the bank no longer has the shares so it will pay back the loan by exercising the greenshoe. The company will thus have sold more shares than originally planned.

Greenshoes are used for secondary offerings (i.e. sale of existing shares), new share issues (the lead bank receives, free of charge, warrants that it may or may not exercise), or convertible bond issues (when it takes the form of a simple extension of the issue, decided two or three days after its launch).

An offering targeted at several categories of investors (institutional, retail, employees, etc.) will be split into several tranches reserved for each of them. The **clawback** clause guarantees the company some flexibility in the size of each tranche. Hence, if institutional demand is very heavy and retail demand very light, the clawback allows the shares initially allocated to retail investors to be reallocated to institutional investors.

To simplify the transaction, the bank may advise the company to target a limited number of investors, thus avoiding the rules governing a public offering, including supervision by market authorities, obligation to present information, etc. This is called a **private placement** and is possible on all types of products. Private placements are often used in offerings to US investors (generally under rule 144-A), as the offering would otherwise be subject to extremely strict restrictions.

3/ ISSUE DISCOUNTS

Studies show that when a company is floated, its stock normally rises by an average of about 10–15% over its issue price, depending on the country, the timing (and how the rise is calculated!). Meanwhile, shares in a company that is already listed are usually offered at a discount ranging from 2–5% although the range varies profoundly according to different countries.

Country	**Period**	**Sample size**	**Mean underpricing** (%)
Australia	1976–1994	328	+15.2
Austria	1984–1996	67	+6.5
Belgium	1984–1990	28	+10.1
Brazil	1979–1992	66	+74.1
Canada	1971–1992	258	+5.4
Chile	1982–1997	55	+8.8
China	1990–1996	226 (A-shares)	+388.0
	1987–1995	57 (B-shares)	+37.1
Denmark	1989–1997	29	+8.0
	1984–1992	76	+3.9
Finland	1984–1997	102	+9.9
France	1984–1995	228 (Second Marché)	+20.9
	1992–1998	264	+13.2
Germany	1970–1993	180	+9.2
Greece	1987–1994	129	+51.7
Hong Kong	1980–1996	334	+15.9
India	1992–1994	386	+72.3
Indonesia	1989–1994	106	+15.1
Israel	1993–1994	28	+4.5
Italy	1985–1998	135	+20.3
Japan	1970–1996	975	+24.0
	1989–1995	456 (OTC market)	+15.7
Korea	1980–1990	347	+78.1
Malaysia	1990–1994	220	+72.6
Mexico	1987–1990	37	+33.0
Netherlands	1982–1991	72	+7.2
	1984–1994	64	+4.0
New Zealand	1979–1991	149	+28.8
Nigeria	1989–1993	63	+19.1
Norway	1984–1996	68	+12.5
Philippines	1987–1997	104	+22.7
Poland	1991–1998	149	+35.6
Portugal	1992–1998	21	+10.5
Singapore	1973–1992	128	+31.4
Spain	1985–1990	71	+10.8
Sweden	1979–1997	233	+29.3
Switzerland	1985–1994	55	+34.6
Taiwan	1971–1990	168	+45.0
Thailand	1988–1989	32	+56.73
Turkey	1990–1995	138	+13.6
UK	1959–1990	2,133	+12.0
	1989–1996	385	+10.1
USA	1960–1997	13,910	+13.7

Source: Paleari (2000).

This discount is theoretically due to the asymmetry of information between the seller and the investors or intermediaries. One side knows more about the company's prospects, while the other side knows more about market demand. The transaction is therefore possible. It's all a matter of price! Selling securities generally sends out a negative signal, so the seller has to price his securities slightly below their true value to ensure the deal goes off and that investors are satisfied.

Some authors suggest that the discount is due to the "**winner's curse**" that pursues the winner of an auction. The winner in fact shouldn't be (economically) pleased about the win because it is clear that everybody else apparently thought the object's value was less than the price paid by the winner!

IPOs after all are similar to auctions. The IPO discount could then be due to the fact that there are both informed and uninformed investors. Uninformed investors cannot distinguish which issues are really attractive and thus are exposed to the winner's curse. This is why an average discount is offered, to guarantee an appropriate return for uninformed investors who will be receiving many shares of a "bad deal" and few shares of a "good deal".

Others suggest that the discount is a way of remunerating the banks underwriting the deal. The discount makes the issue easier to market, reduces their risk and allows them to meet institutional client demand.

The issue discount is another way to persuade investors to invest in a transaction that appears to carry some risk.

The greater the asymmetry in information between an issuer and investors, and the lower the liquidity of the security, the greater is the issue discount. The issue discount will thus be high for an initial public offering, less for the sale of shares in an already listed company, low or nonexistent for convertible bonds and totally absent for bonds.

So much for the major principles. Let's look now at how the main types of securities are offered. As you will see, the methods converge towards two main techniques: bought deals and book-building.

Section 30.2
INITIAL PUBLIC OFFERINGS

1/ HOW AN IPO WORKS

The purpose of this section is not to analyse the motivations, strategic or otherwise, of an initial public offering (IPO) but simply to describe how it works.

IPOs are surely the most complex of transactions. They involve selling securities, about which prior information is extremely limited, to a large number of investors, including institutional and retail investors and employees.

An IPO can include a primary tranche (i.e. shares newly issued by the company) and/or a secondary tranche (i.e. existing shares). The techniques are the same for both tranches and, in fact, existing shares and new shares are bundled up in the same lot of shares to be offered.

However, the techniques vary depending on whether the shares are being offered to institutional investors, retail investors or employees.

2/ HOW IPOS ARE DONE

A number of techniques exist for floating a company. However, in the past few years, IPOs on regulated markets have almost all been in the same form: that of an **underwritten deal** with institutional investors and a **retail public offering** with retail investors.

(a) Underwriting

Offerings of securities to institutional investors are often underwritten. This is the main tranche in almost all IPOs. Under this system, one or more banks organise the marketing and sale of securities to investors via a phase of book-building. The price set after book-building will serve as a basis for setting the price of the retail public offering. Other techniques are used for the other tranches (employees and retail investors, in particular).

IPOs that make use of book-building take place in several phases.

The initial **review phase** is handled by the banks. This consists in assessing and preparing the legal and regulatory framework of the deal (choice of market for listing, whether to offer shares in the US, etc.); structuring the deal; supervising documentation (due diligence, prospectus), as well as underwriting and execution agreements; preparing financial analysis reports; designing a marketing campaign (i.e. the type and content of management presentations, programme of meetings between management and investors).

Then comes the **execution phase**, with the publishing of financial analysis notes by syndicate banks. This is a pre-marketing period lasting one to two weeks prior to the effective launch of the operation. The notes are presented to investors during "warm-up" meetings, which help test investor sentiment. Analysts' research notes cannot be published during the black-out period that precedes the launch. The terms of the transaction, particularly the price range, are set on the basis of conclusions from this pre-marketing exercise.

The marketing campaign itself then begins, and the offering is under way. During this period, full information is distributed via draft prospectuses (certified by market authorities), which may be national or international in scope. The prospectus includes all information on the company and the transaction. The offering is marketed within a price range of about 15%. Company managers are mobilised during this period for numerous meetings with investors (roadshows) or for one-on-one meetings. The information given to investors is mainly on company results, markets and strategy.

In the meantime, investor intentions to subscribe in terms of volumes and prices are recorded in an order book, on the basis of the preliminary price range.

After this period, which can last 5–15 days, the sale price of the existing shares and/or newly issued shares is set. The price reflects market conditions, overall demand as reflected in the order book and the price sensitivity that investors may have expressed.

Not until after this phase might banks enter into a firm underwriting agreement. The shares are then immediately allocated, thus limiting the bank's risk. After allocation, investors are theoretically committed. However, up to the actual settlement and delivery of the shares (three days after the transaction), banks still face counterparty risk. There is also business risk in the form of an institutional investor who decides he does not wish to take delivery of the shares after all. In sum, the only risks the syndicate takes is that

of a market crash between the moment the price is set and the moment when the shares are allocated, and that of stabilising the price for around a month after the transaction by buying shares on the market.

The guarantee given by the bank to the company is also implicitly a guarantee for the market. The bank determines a value after review of internal information. This partly resolves the problem of asymmetry of information. The signal is no longer negative, because a bank with access to internal information is taking the risk of buying the shares at a set price if the market does not.

The final prospectus (with the issue price) is sent out after the price is set and the subscription period is closed. The lead bank knows the quantity and quality of demand. The book-runner allocates the new shares to investors in concert with the issuer and/or seller, who can thus "choose" his shareholders to a certain extent.

The shares are allocated on the basis of certain criteria determined in advance. Allocation is discretionary but not arbitrary. The goal may be to favour US, European or local investors. Generally, the main goal in allocation is to favour "quality" investors, i.e. those who are unlikely to sell their shares in the immediate after-market. The banks may steer the issuer to what it believes are quality investors, thus limiting excessive **flowback**, i.e. the massive sale of securities immediately after the offering.

Book-building offers several advantages, including greater flexibility. For one thing, the price can be adjusted as necessary during the marketing phase, which can sometimes last several weeks. Moreover, shareholders can still be chosen via discretionary allocation of shares.

BOOK-BUILDING

Book-building has also a cost. According to Ljungqvist et al. (2000), the direct costs of book-building are typically twice as large as direct costs for fixed-price offers. However, book-building leads to less issue underpricing.

(b) How shares are offered to retail investors

In an underwritten deal, shares are allocated at the discretion of the lead, based on the order book, as well as on criteria announced in advance. However, when shares are being sold to retail investors, the issue is centralised by the market itself.

➢ The retail public offering

In a retail public offering, a price range is set before the offering, but the exact price is set after the offering. The final price reflects market demand. French market authorities, for example, require a marketing period lasting at least three days, after which a draft prospectus is issued with the characteristics of the deal. Based on a price range, financial intermediaries collect orders from investors. The issue price is set jointly by the issuer and the syndicate lead and is generally equal to the underwriting price.[2] The final prospectus is then approved by the market authorities.

With the agreement of the market authorities, the banks can adjust the price if they have previously reserved the right to do so but, in general, they must begin the process anew if the new price is outside of the initial range. Shares are allocated on the basis of orders if supply is equivalent to demand and can be reduced on the basis of predetermined criteria. Allocation of shares to the various categories of buyers is done on the same basis as the fixed price offer.

Orders are filled on the basis of a percentage resulting from the comparison of supply and demand. Normally, at least 1% of the order is filled, but there may be provision for a minimum number of shares per order, so that broker fees do not end up swallowing any potential gain. Similarly, there are sometimes several categories of orders with different allocation priorities.

2 *Retail investors are generally offered a discount or are exempt from certain fees.*

➢ Fixed price offering

Under a fixed price offering, a certain number of shares are offered to the public at a preset price, which is generally identical to the price offered to institutional investors. The price is set after the book-building phase and is independent of market conditions. It is applied regardless of the number of shares requested. If it is far below what the market is willing to pay, the price will rise sharply in the days after the IPO and primary market buyers will have a capital gain to show for their initiative.

The only difference between a fixed price offering and a retail public offering is how the price is set.

➢ Minimum price offering

Under this technique, a number of shares is offered to the public at a certain price, under which they will not be sold. The local Securities Centralised Administration centralises orders, in which buyers must specify a floor price, and tries to find a sufficiently wide price range at which orders can be allocated in a certain proportion (about 6%) if there is sufficient demand.

In a minimum price offering, some orders may be shut out entirely, and orders at very high prices are paradoxically eliminated. This explains why the first quoted price is above the pre-set minimum price. If demand is too strong to quote the shares, trading

is declared "limit up" and resumes at a higher price or another technique is used for the initial quotation.

➢ **An ordinary full listing**

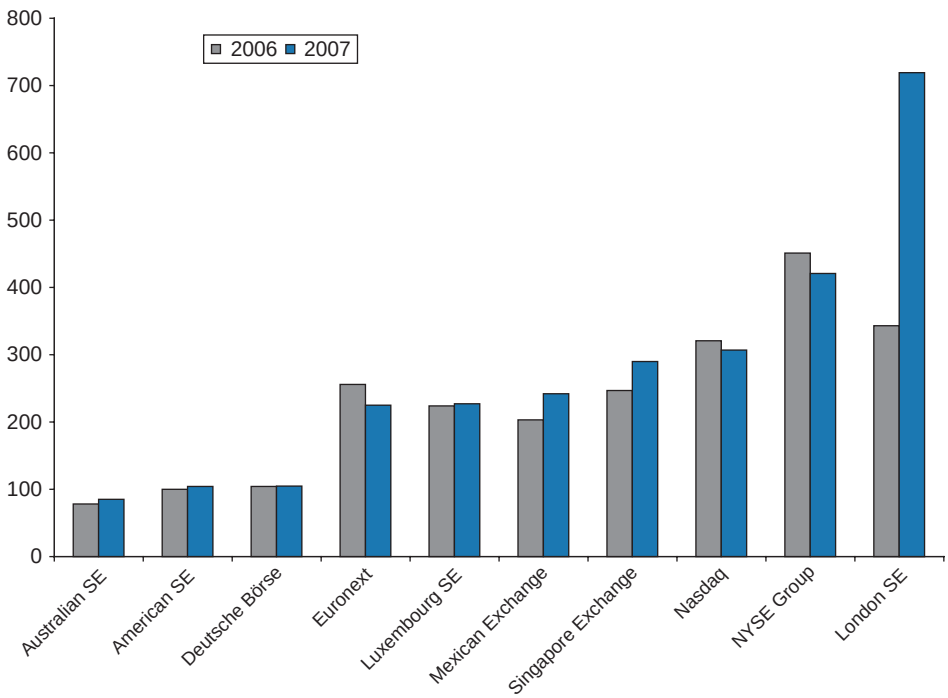
The principle of an ordinary full listing is simple: the shares are offered on the basis of the market's normal trading and quoting conditions. A minimum sale price is set, but buy orders are not centralised by the local Securities Centralised Administration. Quotation is possible at a price normally no higher than 110% of the minimum price; at least 6% of the buy orders are filled (4% in exceptional cases). As in a minimum price offering, trading may be suspended "limit up" and resumed at a higher price. In addition, orders may have to be covered by sufficient funds (the goal being to discourage speculation).

3/ US LISTINGS FOR NON-US COMPANIES

Companies normally list their shares on their domestic stock market, where they are better known. However, they may wish to tap foreign investors to widen their shareholder base and could thus seek a foreign listing.

As can be seen from the table below, this decision is not so unusual!

NUMBER OF FOREIGN COMPANIES WITH SHARES LISTED



Source: World Federation of Exchanges.

Since the American markets (NYSE and Nasdaq) are traditionally the preferred alternative for companies wanting to list, we focus our attention on US listing.

A company can list its shares on the US market via (1) a private placement, (2) American Depositary Receipts or (3) full listing.

(a) Private placements

Under rule 144A, companies may opt for private placement of their shares, but they may only do so with US **Qualified Institutional Buyer**s (QIBs). QIBs are then prohibited from selling their shares on the open market for 2 years, but can trade with other QIBs via the PORTAL system. Private placements are simply a means of gaining access to US investors, but do not allow a company to register its shares with the Securities Exchange Commission (SEC) or to quote them in the US.

This is the least restrictive way to raise capital on US markets, as private placements are not registered with the SEC and come under the 12g3-2(b) waiver. All the issuing company has to do is translate the information that it has provided to its domestic market.

(b) Indirect listing via American Depositary Receipt (ADR)

ADRs, also known as DRs or GDRs,[3] are negotiable instruments issued by a US bank and representing the shares that it has acquired in a foreign company listed on a non-US market – something like tracking stocks, except they are not issued by the company itself. ADRs are traded on a regulated market or an over-the-counter (OTC) market.

The ADR shares can be established either for existing shares already trading in the secondary market of the home country, or as part of a global offering of new shares.

There are several types of ADR:

- Level 1 ADRs are not traded on an organised market but only over the counter. They do not allow companies to raise funds on the US market, but nor do they require any particular information to be put out.
- Level 2 ADRs are listed on an organised market. This attracts some US pension funds, but requires the companies to publish a 20-F report every year. The 20-F is a more extensive document than a typical European annual report (it includes, for example, a table for converting from the company's accounting principles to US GAAP[4]). Companies are not allowed to raise funds with Level 2 ADRs.
- Level 3 ADRs provide the company with a listing (via its ADR) on an organised market, and also allow it to raise funds via a public offering. Level 3 accordingly requires full registration with the SEC (F-1). Moreover, the company is subject to strict obligations on information (based on the 20-F and 6-K). Among other things, the published documents must list plans for acquisitions or reorganisation, as well as a partial reconciliation of company accounts to US GAAP. Companies usually go this route when they have significant commercial interests in North America.

More than 3000 ADRs are listed from 50 different countries, including Axa, LVMH, Alcatel-Lucent, Ilog, Luxottica, Telefónica, Korea Telecom, Nokia, BP-Amoco and many others.

3 *American Depositary Receipts may be also called – generically – Depositary Receipts (DRs), or Rule 144A Depositary Receipts or Global Depositary Receipts (GDRs), which are the "private placement" discussed in the text. However, different names typically identify the market in which the Depositary Receipts are available:* ***ADRs*** *are publicly available to US investors on a national stock exchange or in the over-the-counter market;* ***Rule 144A ADRs*** *are privately placed and resold only to Qualified Institutional Buyers (QIBs) in the US QIB PORTAL market; and* ***GDRs*** *are generally available in one or more markets outside the foreign company's home country, although these may also be known as ADRs.*

4 *Companies following the IFRS norms will no longer be obliged to abide by this rule after 2009.*

The establishment of a Depositary Receipt programme should offer numerous advantages to non-US companies. Advantages may include:

- expanded market share through broadened and more diversified investor exposure with potentially greater liquidity, which may in turn reduce the cost of capital and increase the share price;
- enhanced visibility and image for the company's products, services and financial instruments in a marketplace outside its home country;
- flexible mechanisms for raising capital and a vehicle or currency for mergers and acquisitions.

The empirical evidence is generally consistent with the idea that US listing could be advantageous to companies. Here is a summary of the major results (Karolyi 1998):

1 Share prices react favourably to corporate decisions to list abroad, particularly in the case of US listing. The average positive abnormal return is 0.4% during the first week after listing (about 12% annualised).
2 Significant reductions in risk measures (as measured by betas) are observed following cross-border listings.
3 There are significant liquidity effects for firms that list their shares abroad.
4 There is a significant price decline during the post-listing period. Companies experience a decline of 12–19% in the year following listing. This decline is generally large enough to erase the price increase that occurs immediately after the listing (see Item 1 above). This evidence represents a puzzle for financial economists since no robust explanation has been found to explain this phenomenon.[5]

(c) Full listing

Companies can also list their ordinary shares in both their home countries and directly in the US. This gives them access to institutional investors whose by-laws do not allow them to buy shares outside the US.

The main difference between ordinary registered shares and ADRs is that ordinary registered shares carry lower transaction costs as there is no depositary. They are also more liquid and are less subject to arbitrage trading between domestic shares and ADRs.

Full listing is a relatively long and complex process suitable only for very large companies (UBS Warburg, Deutsche Telekom, DaimlerChrysler, Repsol YPF, etc.). US market authorities require more complete documents than the French Commission des Opérations de Bourse.

5 *Reese and Weisbach (2002) suggest the hypothesis that non-US firms cross-list in the United States to increase protection of their minority shareholders. Cross-listing on the NYSE or Nasdaq in fact subjects a non-US firm to a number of provisions of US securities law, and requires the firm to conform to US GAAP. It therefore increases the expected cost to managers of extracting private benefits, and commits the firm to protect minority shareholders' interests.*

Section 30.3
CAPITAL INCREASES

A financial approach to capital increases is developed in Chapter 39.

1/ THE DIFFERENT METHODS

The method chosen for a capital increase depends:

1 first of all on whether or not the company is listed;
2 then on how eager current shareholders are to subscribe.

(a) Listed companies

When the large majority of current shareholders are expected to subscribe to the capital increase and it is not necessary or desirable to bring in new shareholders, the transaction comes with pre-emptive subscription rights (the transaction is then called a rights issue). The issue price of the new shares is set and announced in advance and the offering then unfolds over several days. The price is set at a significant discount to the market price, so that the transaction will go through even if the share price drops in the runup to the listing of new shares. To avoid penalising existing shareholders, the issue comes with pre-emptive subscription rights, which are negotiable throughout the transaction period.

However, when current shareholders are not expected to subscribe or when the company wants to widen its shareholder base, no pre-emptive subscription rights are issued. The issue price is then not set until a marketing and pre-placement period has been completed, with a very slight discount to the share price at the end of this period. There are no pre-emptive subscription rights, but there may be a period during which current shareholders are given priority in subscribing.

(b) Unlisted companies

In this case, the issue price's discount will not be dictated by the fear that the share price will fluctuate during the operation (as the company is not listed), but rather by the wish of current shareholders to raise cash by selling the subscription rights they may have received.

If current shareholders do not wish to raise cash, the company will issue pre-emptive subscription rights at a price about equal to the share price, or may issue shares to identified investors that have been found via a private placement.[6]

WHICH METHOD SHOULD BE USED FOR CAPITAL INCREASE?

Rights issue subscribed mainly by:	Listed company	Unlisted company
Current shareholders	Pre-emptive subscription rights Steep discount to the market price	Pre-emptive subscription rights with a steep discount if current shareholders wish to raise cash Pre-emptive subscription rights with no discount or no pre-emptive rights if current shareholders do not want to raise cash
New shareholders	Offer without pre-emptive subscription rights (at a slight discount to the current share price) In some cases, a reserve rights issue	Pre-emptive subscription rights with a steep discount if shareholders want to raise cash Reserved rights issue if shareholders do not want cash

Shares cannot be issued below par value (this is also the case for listed companies). Book value or an expert appraisal constitutes a floor value.

6 *In the rare case of a capital increase with no subscription rights and not reserved for identified investors, the price is based on an expert appraisal or is set at book value.*

2/ RIGHTS ISSUE

A fixed-price rights issue with pre-emptive subscription rights (also called *privileged subscription*, or *rights issues*) is the traditional issue preferred by small investors (or their representatives). Such issues acknowledge their loyalty or, conversely, allow them to raise a little cash by selling their subscription rights.

In some countries such as the United States and Japan, rights issues are quite rare while in Continental Europe they generally have to be sold by rights.

Such issues remain open for at least 10 trading days. Banks underwrite them at a price well below the current share price, generally at a discount of 15–30%. No bank will guarantee a price near the current market price because, the longer the subscription period, the greater the risk of a drop in price. It is at this price that the banks will buy up any shares that have not found takers.

A steep discount would be a considerable injustice to existing shareholders as the new shareholders could buy shares at 20% below the current market price. Rights issues resolve this problem by allowing existing shareholders to buy a number of shares proportional to the number they already have. If existing shareholders use all their pre-emptive rights, i.e. buy the same proportion of new shares as they possess of existing shares, they should not care what price the new shares are offered at.

The price of the new shares plus the value of the pre-emptive subscription rights is equivalent to the stock's current market value (i.e. its share price if it is listed), even if the price of the new shares is below the current share price.

Even when existing shareholders do not wish to subscribe, the pre-emptive subscription rights keep them from being penalised, as they can sell the right on the first day it is detached.

(a) Definition

The subscription right is a right attached to each existing share allowing its holder to subscribe to the new share issue.

The subscription right offers the existing shareholder:

- the certainty of being able to take part in the capital increase in proportion with his current stake;
- the option of selling the right (which is listed separately for listed companies) throughout the operation. This negotiable right adjusts the issue price to the current share price.

The subscription right is similar to a call option whose underlying is the share, whose strike price is the issue price of the new shares and whose exercise period is that of the capital increase. Hence, its theoretical value is similar to that of a call option whose time value is very low, given its short maturity.

If the issue price and the current share price are the same, the subscription right's market value will be zero and its only value will be the priority it grants.

If the share price falls below the issue price, the rights issue will fail, as nobody will buy a share at more than its market price. The right then loses all value. Fortunately, the reverse occurs more frequently.

(b) Calculating the theoretical value of the subscription right

Let's take a company that has 1,000,000 shares outstanding, trading at €50 each. The company issues 100,000 new shares at €40 each, or one new share for each 10 existing ones. Each existing share will have one subscription right, and to buy a new share for €40, 10 subscription rights and €40 will be required.

After the new shares have been issued, an existing shareholder who holds one share and has sold his pre-emptive subscription rights must be in the same situation as an investor who has bought 10 pre-emptive subscription rights and one new share. So the share price after the deal should be equal to:

$$\text{Pre-deal price} - 1 \text{ pre-emptive right}$$

but also

$$\text{Issue price} + 10 \text{ pre-emptive subscription rights}$$

In our example:

$$€50 - 1 \text{ pre-emptive right} = €40 + 10 \text{ pre-emptive rights}$$

Hence

$$\text{The value of the right} = €0.91$$

The post-deal share price should be equal to:

$$€50 - €0.91 = €40 + 10 \times €0.91 = €49.09$$

It is easy to calculate the theoretical value of the subscription right:

$$\text{Subscription right} = \frac{\text{Value of the existing share} - \text{Issue price}}{1 + \text{Subscription parity}}$$

as it should make no difference to an investor whether he buys an existing share minus the right or the necessary number of rights plus one new share.

Mathematically, the value of the subscription right looks like this:

$$(V - E) \times \frac{N'}{N + N'}$$

where V is the pre-issue share price, E the issue price of the new shares, N' the number of new shares issued and N the number of existing shares.

We can see that this formula can be used to find the previous result.

The detachment of subscription rights is conceptually similar to a bonus share award. Hence the existing shareholder may, if he wishes, sell some pre-emptive rights and use the cash and remaining rights to subscribe new shares, without laying out new cash (see the exercise at the end of this chapter).

(c) Advantages and drawbacks of pre-emptive rights

The subscription right is valid for at least 10 days – a relatively lengthy amount of time. The issue price therefore has to be well below the share price, so that if the share price does fall during the period, the deal can still go through. The value of the right (i.e. the difference between the share price and the issue price) will fall but will remain positive, as long as the share price, ex-rights, is above the issue price.

This is a double-edged sword as, once the deal is launched and the rights issued, nothing can delay the capital increase, even if the share price drops significantly during the deal. This is why the initial discount is so significant.

Complicating the transaction further is the fact that shareholders who do not possess a number of shares divisible by the subscription parity must sell or buy rights on the market so that they do. This can be difficult to do on international markets.

The fixed-price offer with subscription rights is poorly suited to the current strong market volatility. That's why it is meant mainly for existing shareholders and is not feasible in transactions equal to a large portion of market cap, because the new shares must be marketed aggressively to new shareholders.

Another potential complication is the large proportion of US investors among current shareholders who are sometimes unable to exercise their pre-emptive subscription rights.

3/ CAPITAL INCREASES WITHOUT PRE-EMPTIVE SUBSCRIPTION RIGHTS

In rights issues without pre-emptive subscription rights, the company also turns to a bank or a banking syndicate for the issue. But their role is more important in this case, as they must market the new shares to new investors. They generally underwrite the issue, as described above for IPOs. A retail public offering can be undertaken simultaneously. Alternatively, the bank can simply launch the transaction and centralise the orders without having gone through a book-building phase. The company may issue 10–15% more shares than expected, via a *greenshoe*, under which warrants are issued to the banks (see above).

Local regulations tend to limit the flexibility to issue shares without subscription rights so that the shareholder will not be diluted at an absurd price. Therefore, in most countries regulation fixes a maximum discount to the last price or a minimum issue price as a reference to a price average.

When new shares are issued with no pre-set price, current shareholders can be given first priority without necessarily receiving pre-emptive rights. Indeed, such a priority period is the rule when pre-emptive rights are not issued. However, unlike pre-emptive rights, the priority period cannot be bought or sold. However, priority periods have the disadvantage of lengthening the total transaction period, as they generally last 3 trading days (this is the minimum amount of time required by the COB to allow individual shareholders the time to subscribe).

Legally speaking, a public issue of new shares, with or without pre-emptive rights, is considered to have been completed when the banks have signed a contract on a firm underwriting of the transaction, regardless of whether or not the shares end up being fully subscribed.

4/ EQUITY LINES

The way an equity line works is that a company issues warrants to a bank which exercises them at the request of the company when it needs to raise equity. Equity lines smooth the impact of a capital increase over time. The shares issued when the warrants are exercised are immediately resold by the bank.

The strike price is the average price over a short period (5 days in recent operations), less a discount of about 10%. The number of warrants that can be issued at any one time depends on the stock's liquidity (equivalent to a fraction of the number of shares traded over the 5 previous days), thus partly preventing the problem of overhang (i.e. the fear that the arrival of a large number of shares on the market will depress the share price).

Equity lines are suitable for young businesses whose stock performance history does not allow conventional rights issues. However, it opens the way to many uncertainties, particularly on the terms imposed on the banks in exercise warrants and reselling the shares.

Equity lines may be less convenient for low-liquidity shares and low market capitalisation because there could be strong pressure to reduce the price of the shares. This phenomenon has been defined as a "death spiral" in the US because it has determined the end of various new-economy companies.

5/ THE NEW EQUITY (OR ISSUES) PUZZLE

A study by Ritter and Loughran (1995) has compared how an investor would have fared buying stock in a company that made a seasoned equity offering vs. buying stock in similarly capitalised non-issuing firms ("**Seasoned Equity Offerings**", or SEOs, simply refers to a sale of additional stock by a company whose shares are already publicly traded.)

The authors studied 2680 companies that sold additional shares from 1970 to 1990. Each company that issued shares was compared to a company of equal market capitalisation that did not. As a result, two portfolios were created each with the same number of companies and a similar market capitalisation. The only difference was that one portfolio was made up of stock-issuing companies, while the other – the reference portfolio – consisted only of non-issuing companies.

The average annual return of the issuing companies was a measly 7% a year. The non-issuing companies averaged a return of 15.3% annually. In each case, the time frame studied was the 5 years following the date of the seasoned offering.

Other researchers have shown that many IPOs and SEOs start out well. Their stock price rise, but then over the following period (3–5 years) they perform far worse than the averages stock. In fact they underperform the rest of the market by around 30%. In academic circles this phenomenon is known as the "new equity puzzle".

Playing devil's advocate with their own study, Ritter and Loughran wondered if the poor performance of the issuing companies could have been due to something other than the fact that they had issued more stock. After all, the stock issuers' share prices had run up about 72%, on average, in the year preceding the second stock offering. Perhaps the subsequent slump merely evened out their returns.

Section 30.4
BLOCK TRADES OF SHARES

A block is a large number of shares that a shareholder wishes to sell on the market. Normally, only a small fraction of a company's shares are traded during the course of a normal day. Hence, a shareholder who wants to sell, for example 5% of a company's shares, cannot do so directly on the market. If he did, he could only do so over a long period and with the risk of driving down the share price. Blocks are sold via book-building and/or bought deals, which were described above.

1/ BOOK-BUILDING AND ACCELERATED BOOK-BUILDING

Like a rights issue, a block trade is done via book-building. However, while rights issues allow companies to raise significant funds for investment, a block trade does not raise any new capital or have any direct impact on the company's business.

Moreover, fewer shares are usually involved in a block trade than in a capital increase. Block trades are thus "simpler" deals than capital increases and require less marketing. Book-building is faster, top management is less involved or not involved at all, and the deal can sometimes be done within a few hours.

Bigger transactions involving a strategic shift (exit by a controlling shareholder, etc.), may require an intense marketing campaign, and the deal will be managed as if it were a rights issue.

Book-building can come with a public offer of sale when the company wants to allow retail investors to acquire shares, but only for the larger issues. Barring a waiver from Euronext, a retail offering is possible only if it involves at least 10% of the total outstanding shares or at least 20 times the average daily volumes during the previous 6 months.

Block trades use methods similar to those of IPOs, particularly in price setting. For example, prices can be set in advance or on the basis of terms set when the offering begins. However, in the latter case, no price range is required (but the price-setting mechanism and the maximum price must be spelled out). In the requisite filings with Euronext, the initiator can reserve the right to withdraw the offer if take-up is insufficient or increase the number of shares on offer by as much as 25% if demand is greater than expected.

2/ BOUGHT DEALS

When the seller initiates book-building or accelerated book-building, he has no guarantee that the transaction will go through. Nor does he know at what price the deal will be done. To solve this problem, he can ask the bank to buy the shares itself. The bank will then sell them to investors. This is called a "bought deal".

The bank is then taking a significant risk and will only buy the shares at a discount to the market price. In recent bought deals involving liquid stocks, this discount has ranged from 2% to 5%.

The way it works is this: the seller contacts a few banks one evening after the markets close. He may have mentioned to some banks a few days or weeks beforehand that he might be selling shares, thus ensuring better quality replies. The seller asks each bank the price it is willing to offer for the shares. Bids must be submitted within a few hours. The seller chooses the bank solely on the basis of price, and the shares are sold that very night. The bank must then organise its sales teams to resell the shares during the night in North America or Asia, taking advantage of the time difference, and then the following morning in Europe.

For the seller, bought deals offer the advantage of being certain that the deal will go through and at the price stated at the moment when it decides whether to sell. There are some disadvantages, however:

- the deal will generally be at a greater discount than in accelerated book-building;
- share performance can suffer, as the bank that has acquired the shares will want to sell them as quickly as possible, even if that means making the price fall.

Section 30.5
BONDS

As the bond market develops and becomes more international, investors need benchmarks to measure the risk of default by issuers they do not always know very well. Ratings have thus become crucial in bond offerings. Companies that do not have a rating from at least one agency are finding it increasingly difficult to issue bonds.

As we mentioned in Chapter 25, the corporate bond market can be separated between companies having a rating of at least BBB (investment grade) and companies rated BB or lower (below investment grade). When they want to issue bonds, the latter must offer higher interest rates. Such bonds are called "high-yield". The investment grade and high yield markets are separate, not just for the issuers, but also for investors and for the investment banks handling the offering.

1/ INVESTMENT GRADE BONDS

The euro switchover has naturally given rise to a pan-European bond market, and has allowed much larger issues than were previously possible on national markets. €1bn issues are no longer rare, and only issues of €10bn or more are exceptional. France Telecom, for example, issued €16.4bn in one go in 2001.

Bond offering techniques have thus evolved towards those used for shares, and market regulations have followed suit. For example, **competitive bidding** has gradually given way to book-building. Competitive bidding, consists in a tender from banks. The issuer chooses the establishment that will head up the offering on the basis of the terms offered (mainly price). It thus takes the risk of giving the lead mandate to a bank that is overly aggressive on price. The reason this is risky is that prices of bonds on the secondary market may fall after the operation begins as the bonds were issued at too high a price (hence at an excessively low rate). Buyers will not like this and will demand a higher interest rate the next time the issuer comes to the primary market. Competitive bidding is similar to a bought deal and is often used by state-owned companies, as well as companies that have already tapped the bond markets.

Corporate bonds are generally placed via book-building.

Book-building helps avoiding price weakness after launch, as the issue price (or spread) is not pre-set. The lead bank suggests a price range and sounds out investors to see what price they are willing to pay. Presentations to investors, one-on-one meetings and electronic road shows over the Internet or Bloomberg allow management to present its strategy.

The lead then builds a book of volumes and prices (either rate or spread) offered by each investor interested in the issue. There is little risk of miscalculation, as the issue price is set by the market. The period between when the price is set and the effective delivery of the shares is called the **grey market** (as well as for IPOs and rights issues). Shares are traded on the grey market without, technically, even existing. Transactions on the grey market are unwound after settlement and delivery and the first official quotations. The lead intervenes on the grey market to maintain the spread at which the issue has been priced. This is especially useful when an issue requires, or would benefit from, intense

marketing. Companies wishing to market investors aggressively (notably to return to the market when they wish), will use book-building.

So there are some similarities between share and bond offerings. *However, the process is much shorter for bonds and can be extremely short, especially if a company is a frequent issuer, and if the issue is on its local market.* The process is longer for a first issue or if the company is targeting a large proportion of international investors.

A sample timetable for an issuer who has issued bonds in the past is shown in the diagram below:

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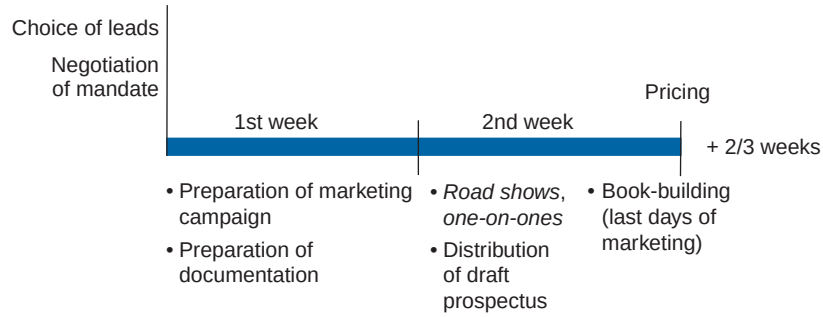


The role of the lead is not just to market the paper, but to advise the client, where applicable, for the obtaining of a rating. It determines the spread possible through comparisons with issuers having a similar profile and chooses the members of the syndicate to help sell the bonds to the largest number possible of investors.

When the company plans several issues in the medium term, it can put out an umbrella prospectus to cover all of them, under an issue of **EMTN** (**Euro Medium Term Notes**). This allows the company to tap the markets very rapidly when it needs to or when the market is attractive.

Underwriting syndicates routinely stabilise the secondary market price for poorly received initial public offerings. Few debt IPOs suffer sharp price declines during the first few days of trading, in part because the syndicate impose so-called 'penalty bids' whose common aim is to discourage investors from immediately reselling their shares.

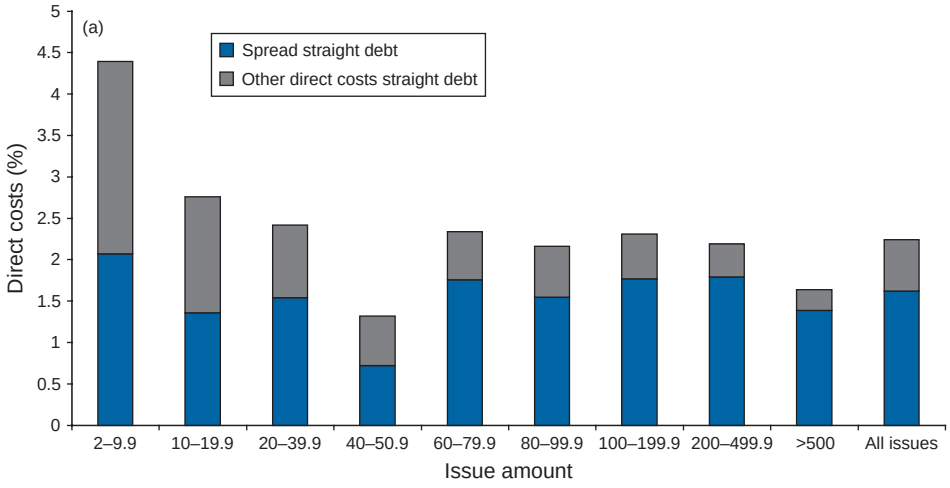
A number of studies have examined the determinants of the at-issue yield spread, which is an increasing function of the issue costs (the at-issue yield is measured by equating the net proceeds, after deducting the issue costs, with the present value of the coupon and principal payments). Datta et al. (1999), as well as other studies, have documented that the at-issue yield spread is *negatively* related to credit rating and *positively* related to bond maturity. As issue costs are an important determinant of the at-issue yield spread, these findings imply similar relations for the issue costs.

Several studies have investigated the determinants of direct issue costs, which consist primarily of underwriter fee (e.g. Lee et al., 1996; Altinkilic and Hansen, 2000). These studies generally find that the direct issue costs are positively related to bond maturity and are negatively related to issue size and credit quality. There is also weak evidence that bond issues are underpriced. Wasserfallen and Wydler (1988) and Helwege and Kleiman (1998) report results that indicate slight underpricing, but Fung and Rudd (1986) find "no clear evidence of underpricing".

Equity IPOs historically have recorded one-day returns of 15% at their offer date ("underpricing"). The prevalence of underpricing of equities, which is often thought to

arise from information hurdles, suggests that underpricing may extend to the pricing of public debt. Lee and others (1996) have investigated this aspect and their results are as follows:

STRAIGHT DEBT UNDERWRITER SPREAD AND OTHER DIRECT COSTS AS % OF THE SIZE OF THE ISSUE IN USA – 1990/1994



The two graphs show, respectively, the direct costs of straight and convertible debt (in % of the issue size). Underpricing is not included.

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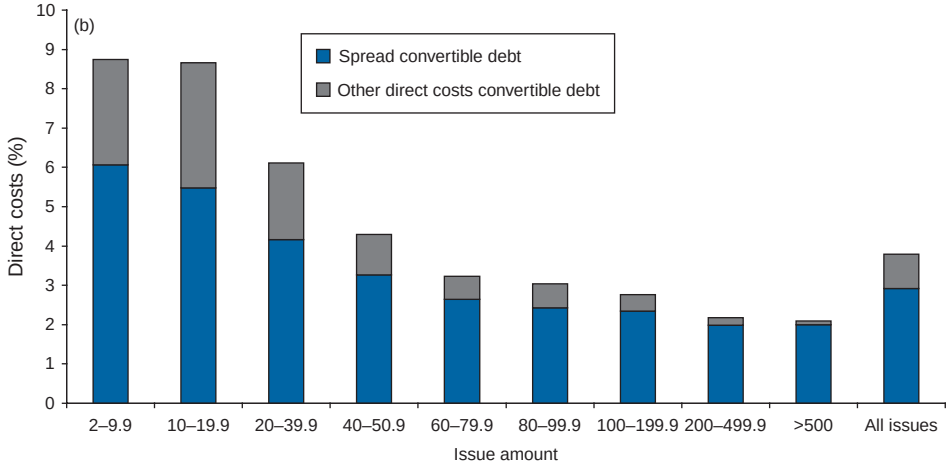
CONVERTIBLE DEBT UNDERWRITER SPREAD AND OTHER DIRECT COSTS AS % OF THE SIZE OF THE ISSUE IN USA – 1990/1994



Source: Lee et al. (1996).

2/ HIGH-YIELD BONDS

The high-yield bond market has developed in Europe only since the late 1990s. Until then, the financing needs of risky companies were covered exclusively by equity or bank loans.

By definition, high-yield, or non-investment grade bonds, are risky products.

High-yield issues take longer and require more aggressive marketing than a standard issue, as there are fewer potential buyers.

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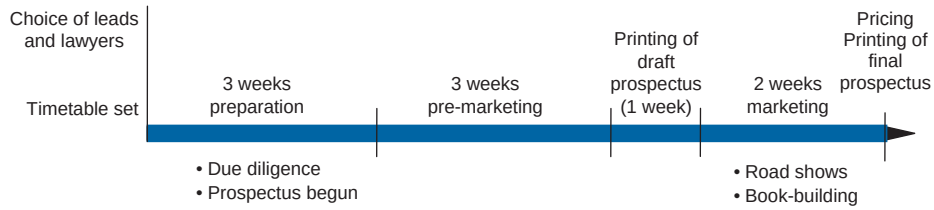
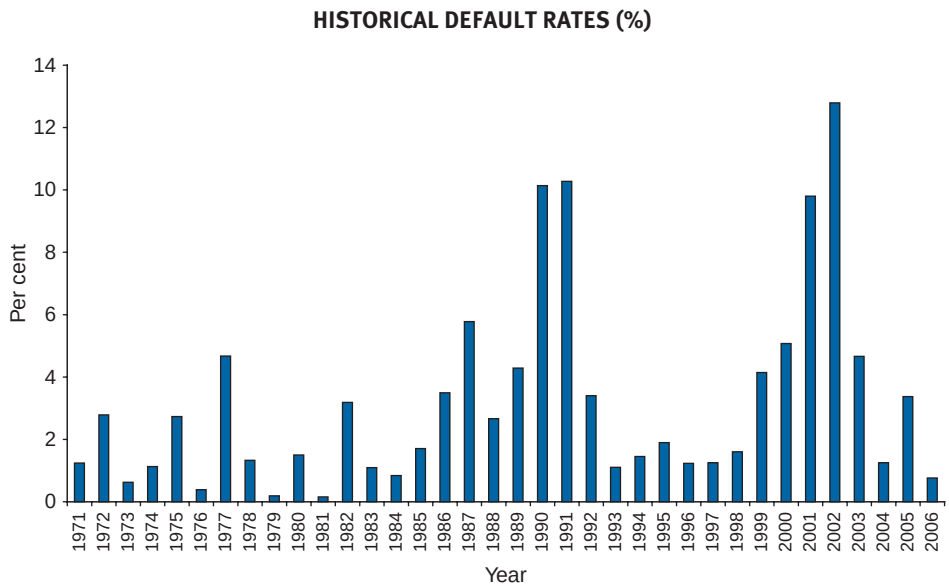


How much more risky are they? Look at the annual default rates provided by Altman (2007):



Source: E.I. Altman (2007)

In 2006, the level of default is particularly low; however, in 2002 a record $96.9 billion of developed country high yield straight bond defaulted or restructured under distressed conditions. The 2002 default rate is considerably higher than the 2001 rate, well above the historic weighted average annual rate 1971–2006 of about 4% per year. Therefore, it is important to remark that the probability of default in the high yield category is not irrelevant and should be included in the estimation of expected returns.

Melnik and Nissim (2003) investigate the pricing of initial offerings of public debt, using trader quotes of high yield corporate bonds and risk-adjusted benchmarks. They find underpricing that averages only 39 basis points, which is sharply lower than previous research indicates. Moreover, they find that underpricing is not related to the degree of information problems, such as how long the company has been public, its bond rating or size of the offering.

Their most interesting result is the tradeoff between the cost components. Underwriters appear to set the two cost components (fee and spread) so that one offsets the other.

3/ RULE 144A

As already explained, the US SEC approved Rule 144A in April 1990, an initiative that allowed for the immediate resale of private placements *among* **Qualified Institutional Buyers** (QIBs).[7] Rule 144A facilitates the resale of privately placed debt and equity securities and thus increase secondary trading among institutional investors.

Under this ruling, it is possible to resell privately placed bond securities to QIBs. Thus, large financial institutions can sell previously acquired private placements without having to register the securities or hold the securities for 2 years. The SEC rule has modified the 2-year holding period requirement on privately placed securities by permitting QIBs to trade these positions among themselves.

Thus, Rule 144A issues do not require SEC registration. By lifting the registration requirements for purchasers of 144A, the SEC sought to reduce regulatory costs and create a more liquid market for these restricted securities.

Rule 144A imposes less stringent disclosure and reporting requirements than a registered issue entails, so issuers can complete the offering fairly quickly. On the other hand, Rule 144A bonds have limited liquidity because only qualified institutional investors can buy and sell them. Despite this drawback, more companies have warmed up to Rule 144A.

Rule 144A is particularly important for foreign issuers. Under this rule, in fact, these firms have gained access to institutional investors without having to meet the strict disclosure standards required of US public companies. The Rule 144A market has evolved rapidly and now closely resembles the SEC-registered market in terms of underwriting practices, marketing, disclosure and credit rating requirements.

7 *A QIB, broadly defined, is a financial institution that owns and manages $100 million ($10 million in the case of a registered broker-dealer) or more in qualifying securities. For a banking institution to qualify as a QIB, a $25 million minimum net worth test must also be satisfied.*

	Rule 144A offering	**Public offering**
Size	$250–$1000m	$250m–$1b
Rating	Two ratings are required	Two ratings are required
Spread	Credit spread usually slightly higher than public	Lowest credit spread
Syndicate composition	Usually 3 or more underwriters, depending on deal	Usually 3 or more underwriters, depending on deal
Covenants	Covenants similar to those required for a public issue	Loosest covenant structure
	Long preparation time needed before accessing the market	Long preparation time needed before accessing the market

Source: Adapted from Johnson (2000), p. 91.

Given the growing convergence between the two forms, why should a company choose one form or the other? Basically there are reasons: (1) the different average sizes and (2) the desire not to report to the SEC on an ongoing basis.

While Rule 144A permits issuers to raise debt and equity capital, the total amount of capital raised via debt is nearly eight times the amount raised via equity.

Debt issuers pay a price – in the form of higher yields – for the convenience associated with Rule 144A offerings (Livingston and Zhou, 2002). Rule 144A issues, particularly those of private companies that do not file financial statements with the SEC, have substantially higher yields than their SEC-registered counterparts. Overall, they yield 19 basis points more than public bonds and 54 basis points more than private debt offerings. Investors apparently regard the lack of information about the issue as a risk factor and demand higher yields in return for the added uncertainty, which more dramatically affects private companies without SEC-mandated transparency.

Section 30.6
CONVERTIBLE AND EXCHANGEABLE BONDS

Convertible and exchangeable bonds are issued via accelerated book-building or bought deals.

Convertible bonds (CBs) (examined in Chapter 29) are a very specific product. They are first of all bonds paying interest and redeemed in cash at maturity. They are called convertibles, as the investor has the right to ask that the bond be redeemed not in cash but in shares, based on a parity set at issue, if the share price has risen enough by then. Holders of convertible bonds are entitled to all information put out by the issuer to its shareholders, while the share price tells them precisely how much the CB's option component is worth.

There is little problem of asymmetry of information between the investor and issuer in the case of a convertible bond, as the convertible's bond component protects the investor.

The only factor that could make an investor hesitate to invest in a convertible bond is the product's complexity. However, CBs are now well known to professional investors, and are sold mainly to specialised investors or *hedge funds.*

Section 30.7
SYNDICATED LOANS

Syndicated loans are not securities in their own right, but merely loans made to companies by several banks. A syndicated loan offering is nonetheless similar to a bond issue. The company first chooses the bank that will arrange the deal. This bank may do a bought deal of the entire loan and then syndicate it afterwards. The arranger is paid specifically for its advisory and placement role.

The main terms are negotiated between the arranger and the company and are put into a **term sheet**. Meanwhile, the bank and company choose a syndication strategy, as well as the banks (or financial institutions) that will be members of the syndicate.

After meetings with the company and a memorandum of information, the banks contacted will decide whether or not to take part in the syndicated loan. Once the syndicate is formed, the legal documentation is finalised. The entire process can take 2 months, between the choice of arranger to the delivery of funds.

Syndicated loans are closely dependent on the quality of the company's relationship with its banks. Syndicated loans do not often make much money for the banks when they are not the arranger, and they take part only as they wish to develop or maintain good relations with a client, to whom they can later market more lucrative transactions. Membership of a syndicate sometimes even comes with the stipulation that it will be remunerated through an implicit or explicit pledge from the company to choose the bank as the lead at its next market transaction or as advisory for its next M&A deal.

TOP 10 BOOKRUNNERS OF GLOBAL MARKET SYNDICATED LOANS – 2007

Rank	Bookrunner	Value (US$m)	Market Share	Number of issues
1	JP Morgan	591,754.96	12.4	1071
2	Citi	546,414.56	11.5	863
3	Banc of America	355,372.75	7.5	1140
4	RBS	322,446.52	6.8	561
5	BNP Paribas	188,691.45	4	556
6	Deutsche Bank	183,133.43	3.8	245
7	Barclays Capital	177,133.28	3.7	281
8	Goldman Sachs	140,566.55	2.9	200
9	Calyon	123,942.37	2.6	300
10	Credit Suisse	123,860.76	2.6	225

Source: Thomson.

Syndication forms of a loan can be of three types:

1 **Underwritten deal**, whose major characteristics are:

(a) the lead manager(s) guarantee that funds will be provided;
(b) the commitment of lenders can be of two types: *full commitment*, or committed for the entire amount; *partial commitment*, in which some commitment is contingent on market interest. Full commitment is an important competitive tool for lenders and it usually requires higher fees from the borrower,

2 **Best-efforts deal.** The commitment is only of the lead manager(s). The remainder of funds is contingent on sufficient market interest. However, best efforts deal are quite rare because the commitment of lenders is a major value of the syndicated loan
3 **Club deal.** This is typical of smaller deals (< $250m). They are pre-marketed within a group of relationship banks.

The members of a syndicate can have the following titles:

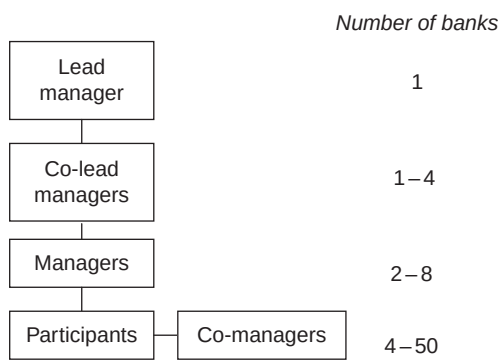
- **Lead manager/Arranger/Bookrunner**. This is the bank that handles the loan design and the structuring of the syndicate. Thus it: maintains the contact with the borrower; structures the credit terms so they meet the borrower's requirements; assists in preparing an information memorandum; provides counsel in preparing the credit agreement and related documents; arranges the bank syndicate.
- **Agent bank**. Often this is the lead bank or a co-lead manager bank who maintains a fiduciary relationship to the lending participants and coordinates two functions:

  (a) administrative functions – loan service payments;
  (b) coordination functions – when changes in terms are requested or when trouble looms.

- **Manager and co-managers**. The managing banks are appointed by the lead bank to help identify and organise a wider contingent of participating banks (*participants*) as the final bank lenders. Some of the lending banks participating with major amounts are referred to as *co*-managers; however, none of the responsibilities of the arranging and managing banks falls on them.
- **Participants (or selling group)**. *Other* lenders who supply funds for pieces of the loan. In order to avoid confusion, it is useful to specify that all intermediaries that make up the syndicate participate in the funding, but they must also accomplish other tasks, while the selling group is engaged exclusively in the selling activity.

Although the final structure of the bank syndicate can vary substantially – depending on the type of finance it tries to accommodate – a typical bank syndicate could be structured as follows:[8]

8 *In the simplest transactions, called "club loans", there are only two layers of intermediaries: the lead-managing and the participating banks.*



The syndication process normally generally develops in three steps:

1 **Preliminary contacts**: the borrower contacts the lender and gets the syndication mandate (sets pricing, terms, fees of loan, etc.).
2 **General syndication**: the lead manager canvasses market for commitments and closes the phase once all funds are committed.
3 **Secondary syndication**. The lead manager prepares an information memorandum and a term sheet on loan. Managers above the "hold target" sell off excess loan commitment to the "participants".

The fee system of a syndicated loan is:

- **Management fee.** This is a *front-end*, flat percentage (e.g. 1%) fee, determined as a percentage of loan proceeds.[9] It is usually sized by categories by giving a higher fee to banks that underwrite a higher amount. This fee is divided by:
  1 *Præcipium*. This is the part of the management fee that the lead manager reserves for its remuneration.
  2 *Underwriting fee*. The remaining management fee is then distributed among underwriting banks. The agreement may discipline an equal treatment between all participants or a differentiation in function of the efforts of each bank.
  3 *Residual pool*. This is the management fee net of the præcipium and of the underwriting. It normally pertains to the lead and the co-lead managers (if any).
- **Agent fee.** Annual fee due in order to administer the loan.

9 *This is an important difference with public bonds for which fees are "discounted" from the selling prices of the securities (gross spread).*

There may be two additional fees if the borrower can draw funds when necessary:

- **Commitment fee**. This is a flat percentage (e.g. 1/2%) per annum on the undrawn portion of loan;
- **Facility fee.** This is paid on the entire committed amount, annually, regardless of the amount drawn. This fee may replace the commitment fee for investment grade borrowers, or when a competitive bid option is used (a syndicate member may have unused commitment).

Let's consider this example. Suppose a fully committed syndicated loan of $100,000,000, lead managed by a single bank. Suppose these are the agreements regarding the fees:

- 1% management fee on the $100 mm = $1,000,000 in fees divided as follows:
  - lead bank retains of the *total* amount 1/4% as *præcipium*;
  - 3/4% of the *amount raised by each bank* is distributed among managers at the $10m level;
  - 1/2% of the *amount raised by each bank* is distributed among managers at $5 mm level;
  - 1/4% is for participants;
  - the remaining amount of the total fee is distributed discretionarily between the lead and co-manager.

The result is the following:

EXAMPLE OF FEES IN A SYNDICATED LOAN

	No. of Banks	Amount raised per bank	Total amount raised	Praecipium	Participation fees	Pool share	Total fees
Lead Manager	1	15,000,000	15,000,000	250,000	112,500	40,909	403,409
Co-managers	4	10,000,000	40,000,000		300,000	109,091	409,091
	6	5,000,000	30,000,000		150,000		150,000
	15	1,000,000	15,000,000		37,500		37,500
			100,000,000	250,000	600,000	150,000	1,000,000

SUMMARY

@ *download*

The aim of all types of equity offerings is to sell the shares to investors at the highest price at any given time.

To achieve this, the large gap in the quantity and quality of information available to the issuer compared with that available to the investor must be reduced. One of the roles of banks in equity offerings is to inform investors by passing on information obtained from the issuer. The bank has three other roles. It must structure the deal, distribute the securities and generally provide the issuer with a guarantee at a given level.

There are two main types of equity placements:

- book-building
- bought deals

Book-building means that the bank or the banking syndicate will only commit itself to the deal if it knows that there is investor appetite for the shares. Following a phase of dissemination of information to investors, investor intentions to subscribe are recorded in an order book. It is only at this stage that the banks will sign a firm underwriting agreement, thus limiting the risk taken. For a bought deal, the banks will buy the securities from the issuer, and it is up to the banks to place the securities with investors as quickly as possible in order to limit the risk.

Initial public offerings are very complex transactions and involve the dissemination of appropriate information to a variety of investors. Two types of offering exist side by side. There is the underwritten deal, when the banking syndicate places the securities with institutional investors on the basis of the orders recorded in the order book. Generally, a retail public offering is made to retail investors at the same time: In a retail public offering, a price range is set before the offering, but the exact price is set after the offering. The final price reflects market demand. When the offer to retail investors is a fixed price offer, the issue price is pre-set. Generally identical to the price offered to institutional investors, it is totally independent of the market. Minimum price offerings and full listings using standard market procedures are rarely used these days.

There are two techniques for carrying out capital increases of companies that are already listed, depending on how eager existing shareholders are to subscribe new shares.

There is the fixed-price capital increase with pre-emptive subscription rights, or a capital increase without pre-emptive subscription rights but possibly with a period during which existing shareholders are given priority to subscribe.

For the former, the issue price is set at a significant discount to the market price. In addition, in order to avoid penalising existing shareholders, the issue comes with pre-emptive subscription rights, which are negotiable. Accordingly, the price of the new shares is equivalent to the stock's current market value even if the price of the new shares is below the current share price. A pre-emptive subscription right is akin to a call option.

A capital increase without a pre-emptive subscription right, for which shareholder approval is required, is an underwritten deal. The issue price is close to the market price. For unlisted companies, capital increases are carried out with or without pre-emptive subscription rights, with defined investors who have been identified following a private placement.

Block trades and issues of convertible bonds are carried out via book-building (or accelerated book-building which takes only a few hours) or via a bought deal.

The procedure a company uses to issue bonds depends first and foremost on the company's rating (whether the stock is investment grade – i.e. rated BBB or higher – or noninvestment grade – i.e. lower than BBB). A company whose stock is rated as investment grade can invite banks to bid for the opportunity to carry out a bought deal, or opt for book-building. Whatever procedure is chosen, the deal is completed within a shortened time frame.

For noninvestment grade companies, the placement procedure is closer to the capital increase procedure via book-building.

Convertible bonds, despite their apparent complexity, are products that are relatively easy to place as they offer substantial guarantees. They can be sold to investors within a relatively short period.

The procedure for placing a syndicated loan is similar to that for placing a bond issue with a limited number of investors. The banks involved are generally keen to develop a business relationship with the borrower.

QUESTIONS

@ *quiz*

1/ What is a prospectus used for?

2/ Why does it take longer to set up a share issuance than a bond issue?

3/ What financial product can a greenshoe be compared to?

4/ Why is the timetable for a first issue for a company issuing a high yield bond much longer than for the issue of a standard bond?

5/ Which placement procedure carries the most risk for a bank? Why?

6/ Describe two different methods used for calculating the value of a subscription right.

7/ Will a shareholder who subscribes a capital increase with a pre-emptive subscription right become poorer if the share price drops after the operation? Why?

8/ Which party is the bank which places the shares working for – the issuer or the investor subscribing the shares?

9/ Which is more costly for an issuer – an underwritten deal or a bought deal? Why?

10/ Why can convertible bonds be placed so quickly?

11/ Immediately after bonds are placed on the market, the price rises. What is the good news for the issuer? And the bad news? Which is the most important?

EXERCISES

1/ In October 2007, Steria (a French IT services company) carried out a capital increase with subscription rights. 8,663,204 new shares were issued at a price of €23.20. Before the capital increase, the company's share capital was made up of 19,492,215 shares, which meant that four new shares were being issued for nine existing shares. Before the capital increase, the share was trading at €31.49.

(a) Calculate the theoretical value of the pre-emptive subscription right.
(b) Calculate the theoretical share price after the capital increase.
(c) If you own 91 Steria shares, what should you do before and after the capital increase so that your portfolio remains more or less as it is?

ANSWERS

Questions

1/ *For providing investors with a description of the company and the deal which will assist them in making a decision as to whether to invest or not.*
2/ *Because investors are taking a greater risk by investing in shares than in bonds. Further and better information is needed because of this risk.*
3/ *A call option held by the banks and sold by the company.*
4/ *Because a bond issued by a below investment grade company carries much more risk than a standard bond. The investor thus needs a lot more information on which to base an investment decision.*
5/ *A bought deal, as a risk is taken that the market will change before the shares can be sold.*
6/ *Equation described in the chapter and application of the equation of the Black–Scholes equation which we study in Chapter 33.*
7/ *No, because the shareholder was able to acquire shares with a discount to the share price.*
8/ *For the issuer, but the bank must also ensure that investors are satisfied with the deal or it may lose its clients!*
9/ *Usually a bought deal, because it transfers the risk of the deal failing to the bank, and this has a cost.*
10/ *Because a convertible bond provides the same guarantees as a bond along with the possibility of making the same gains as a share. Investors buying them are thus taking a limited risk.*
11/ *Investors will be happy. A lower interest rate could have been paid. If the rise remains reasonable, the former, because it will be possible to retain an open financial market.*

Exercise

(a) 2.55 €;
(b) 28.94 €;
(c) Sell 73 PSRs for €186.15, buy eight shares with the 18 remaining PSRs plus €185.6. I would then own 99 shares worth €28.94 each (or €2865.10) and €0.5 in cash, compared with €2865.60 for 91 shares before the capital increase.

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