

Free report on raising of capital

[Business](#), [Company](#)



Abstract

The following report describes different sources of capital a company may use in order to finance its operations and investing activities. In particular, it analyses debt financing (bonds and direct bank loans) and equity financing (Venture Capitalist Investments, Initial Public Offering, Seasoned Equity Offering and Rights Offering). Report also analyses recent IPO of Manchester United Football Club at New York Stock Exchange as a practical example of raising capital.

Sources of Capital

The impact and the importance of financing in modern business world could not be underestimated. Globalization and increasing competition have forced companies to explore new markets and offer new innovative products.

According to U. S. Census Bureau (2012), capital expenditures in US were constantly rising from year to year up until 2009, when the crisis hit the economy. Large corporations would not have been able to raise such funds by themselves, and that is the reason why financing sources play a vital role in business. Two main sources of raising capital are debt financing and equity financing, each of which has own benefits and drawbacks.

Debt financing suggests that a company is raising capital through direct loans or the issue of bonds. Debt financing brings interest liabilities, but it also brings certain tax benefits to a company (interest on debt is tax deductible) and adds more discipline to the management. As explained by Giddy (1983), if a company generates high income and positive cash flows each year, and has no debt, its managers might become complacent. This

can lead to inefficiency and investing in low-quality projects. Borrowing money may add more discipline, as managers will be forced to choose investing projects wisely in order to gain a return to cover the interest expenses. On the other hand, if your debt-to-equity ratio becomes very high, the risk of bankruptcy associated with it increases, which may result in increased direct and indirect costs (i. e. increased interest rates, suppliers demanding payments in smaller periods of time etc.). Excessed borrowing might also reduce company's financial flexibility, as it would be unable to finance its future projects with debt.

Equity financing suggests that a company is raising funds in an exchange for the part of ownership, which means that an investor would be able to receive part of company's future profits in the form of dividends and influence managing decisions. One of the benefits of equity financing is that it doesn't damage the credit rating of a company, and company has no financial obligations against new shareholders. However, the sale of the part of the company will result in reduced control and sharing profits with other shareholders. In addition, dividend expense is not tax deductible as in the case with debt financing, therefore there are no tax benefits from this source of financing.

Instruments of debt financing

Bank loans and bond issue are the most common types of debt financing. Ross (2002) highlights Term Loans as direct business loans of typically, one to five years, and Private Placements as loans, usually long-term in nature, provided directly by a limited number of investors. Public financing is usually represented by the issue of bonds, when general public may provide

company with additional funds in exchange for bonds which pay interest at a given rate.

According to Ross (2002), there are several important differences between direct private long-term financing and public issue of debt. Firstly, issue of bonds requires the registration from Securities and Exchange Commission, which increases flotation costs of an issue. Secondly, it is easier to renegotiate a term loan or a private placement in the event of a default. It is harder to renegotiate a public issue because hundreds of holders are usually involved. Thirdly, pension funds and life insurance companies dominate the bond market, while commercial banks are usually associated with term-loan market. Finally, the interest rates on direct bank loans are higher than on the bond issue. Higher interest rates are explained by the fact that direct loans have low flotation costs and banks provide more flexible arrangements if a company is unable to repay its debt.

Instruments of equity financing

Equity financing includes Venture Financing, IPO, SEO, and Rights Offering. In this section we will discuss them in more detail.

Venture Financing is applicable mostly to new start-up companies, which do not have sufficient credit history and collateral which could secure the loan. Venture funds invest in these kinds of businesses. Investing in new companies comprises high risk, therefore financing is provided in stages, so that in the case of failure financial impact could be reduced. Venture capitalist not only provide financing to the new ventures, but also participate in the management decisions and give guidelines to the owner of the business. As new ventures have a high risk of failure, the cost of venture

capitalist financing is extremely high. According to Brian Hamilton (2007), CEO of Sageworks, venture capitalists want 2 things: equity and control. Equity, because if and when the business is a hit, that stake will be worth piles of money, and control, because VCs want to reduce the risk that the entrepreneur will run a promising idea into the ground. As a result, even if your business becomes a success, you might lose control of your company and wouldn't be able to influence its growth.

Initial Public Offering occurs when a company wants to sell its shares to general public for the first time. Subsequent sale of shares is called Seasoned Equity Offering. In order to sell shares to general public, a company has to negotiate an agreement with an investment bank to underwrite and distribute new shares (Ross, 2002). A specified number of shares is bought by an underwriter, which later sells them at a higher price through stock exchange. The main task of an underwriter is to adequately price the securities and ensure their sale at the stock exchange. Typically, underwriter buys the securities at the price which is lower than the offering price, thus, taking the risks of not selling the securities. The spread between the offering price and underwriter's buying price becomes the profit of the underwriter. According to Citibank (1994), there are two types of agreements between a stock issuer and an underwriter which are the most common during IPO. These are Firm Commitment agreements and Best Efforts agreements. Firm Commitment suggests that underwriter takes over all the risk associated with the offering and purchases securities directly from the company for sale to the public at the price specified. In the case of Best Effort underwriting, an investment bank is obliged to sell the securities at the

best possible price, however the amount of raised capital is not specified in the contract.

A company, whose shares are offered to public on a stock exchange, is called a listed company. Financial analysts highlight several advantages of listing. According to managers of Citibank (1994), public companies tend to be more transparent and aligned with the regulatory environment. As a result, they become more reliable and credible to partners, investors and others groups of interests than any other non-listed company. Secondly, it is easier for listed companies to raise capital through secondary offerings. Thirdly, listed companies may use their shares as collateral to attract capital from other sources. Finally, an IPO gives companies an opportunity to increase public awareness about the company, i. e. attract new suppliers, reach new customer groups, improve company's image etc.

One more type of equity financing is the rights offering. Ross (2002) defines it as “ a public issue of securities in which securities are first offered to existing shareholders.” Usually, shareholders may purchase the amount of new shares proportionate to their current shares in order to avoid the dilution effect during the issue. In addition, the price of shares during rights offering is often discounted from the market price, thus, making it a favorable investment. Furthermore, a right offering does not require underwriter's services or SEC registration (in the case if stocks are sold to less than 35 investors), so the flotation costs are significantly lower than of those during IPO or SEO.

The procedure of IPO in United States

According to Securities and Exchange Commission, full legal procedure of an

IPO is listed in The Securities Act of 1933. After obtaining the approval from the Board of Directors, a company has to prepare a registration statement and provide it to SEC. Registration Statement contains the information about a company, its financial status, description of the business, plans for future development, etc. After the registration statement is submitted comes the Waiting Period of 20 days, when a company is restricted to provide any information to the public. During this period a company may distribute preliminary prospectus among potential investors and other concerned groups of interest. Preliminary prospectus contains main information regarding future IPO and is aimed to provide potential investors with all required information (i. e. financial statements, industry analysis, management strategy, potential risks, ownership structure, etc.). If SEC has approved the registration statement and all legal and regulatory procedures are in place, the registration statement becomes effective on the 20th day after the submission. At this time the price amendments should be filed with SEC. Afterwards the trading of newly issued securities begins. During the waiting period a company may attract attention to the upcoming IPO through the tombstone advertisements, which contain information about the stock price, number of shares and underwriters involved.

IPO of Manchester United F. C.

In August, 2012, one the most famous and titled football clubs in sports history went public aiming to attract additional \$300 million in equity. Previously, the club tried to get listed in Asian exchanges, but the deal broke down. This time, the owner of the company, American businessman Malcolm Glazer decided to raise capital by selling 10% of the company on the New

York Stock Exchange (NYSE) through class A shares. According to club's prospectus, however, the remaining 90% of the shares (Class B) will be concentrated in Glazer's companies. Notably, class B shares carry 10 votes for a piece comparing to only 1 vote for a piece from class A shares.

Basically, this means that Glazer family will be still controlling almost 99% of the business. Prospectus also mentioned that less than a half of the proceeds from the offering shall be used to reduce company's debt, which equaled almost \$670 million in August, 2012 (debt-to-equity ratio 1.8). Furthermore, the club announced that it does not intend to pay any dividends on its shares in the nearest future.

The company went public on August 12, 2012 with 16.7 million class A shares priced at \$14 each, thus adding almost \$244 million to shareholders equity. Manchester United initially expected shares to be priced at \$16-20 per share, so the initial proceedings were \$60 million less than expected.

The deal was led by Jeffries and Co. Credit Suisse, J. P. Morgan, Merrill Lynch and Deutsche Bank Securities complemented the syndicate.

In the first day of trading, MU stock (symbol MANU) reached its peak of \$14.20 per share, and started declining ever since (see Figure 1). At the end of the week the stock was priced at \$13.06 per share. Market analysts claimed that club's stock was overpriced by almost 280%. Simon English of London Evening Standard claimed that MU's stock price of \$14 had no reasonable economic basis, and that company relied too eagerly on company's brand awareness and international fanbase.

Figure 1. MANU share price

Source: <http://yahoo.finance.com>

In my opinion the stock of Manchester United might be interesting as a souvenir for a dedicated fan, but has no significant value as an investment asset. Firstly, Glazer family has concentrated 99% of votes at their hands, making potential investors unable to influence the management decisions, even if they had bought 10% of the company. Secondly, the decision of not paying the dividends in the nearest future repels potential income-oriented investors. Finally, history provides us with numerous examples, when sport teams went public and eventually underperformed the market, primary, because the main goal of the sport team is to perform well in the field, not essentially making profits, and this is the point where conflict of interests between club and its shareholders occurs (Smith, 2012).

All in all, it looks like Manchester's stock has more risks than benefits.

Nonetheless, some investors might have benefited from purchasing club's stock. Those who sold short right after an IPO could have improved their balances, as well as long-term oriented investors, who believed in club's performance (as of May 30, 2013 MANU is priced \$17. 21).

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