

# Equity Finance: The US & England

## Introduction

This unit looks at equity finance – the range of equity **instruments** and markets available to a company. First, we look at **private equity** and the role of **venture capital** companies that provide such finance. We look at the mechanics of an initial public offering (IPO) and at recent cases of companies 'listing' on a stock exchange for the first time. We go on to explore certain important strategic issues for a business when considering equity finance:

- When should a company list? What factors affect the timing of an equity issue?
- Why should a company list on more than one stock exchange? This is known as '**cross-listing**'.
- Why might a company choose to buy back its shares and why might it **de-list** from an exchange?

Throughout this unit you will find extensive references to literature and websites. These should be explored to deepen and broaden your understanding of the issues raised.

## Learning Outcomes

After studying this unit you should be able to:

- understand private equity and the role of venture capital companies in providing this;
- understand why and how **public equity** issues can be undertaken;
- look at the reasons for cross-listing on stock exchanges;
- Examine why a company might de-list from an exchange and return to private ownership.

## 1 Understanding Equity Issues

### 1.1 Equity instruments

Both public and private incorporated companies can issue shares in order to finance their operations. Those who invest in shares expect a return blended from dividend yield and capital growth – although the expectations of investors vary from country to country. In the USA, for example, many companies rarely, if ever, pay dividends, with the result that investors seek their returns through share price growth. You will have learnt from earlier finance studies that investors require higher returns from those companies deemed to have greater financial and operational risks. Additionally, you would have learnt that the required return on a share can be estimated using the **capital asset pricing model (CAPM)** or **dividend valuation models**.

Shares may take the following forms:

- **Ordinary shares:** these give the shareholders ownership of the company and entitlement to a share of the business after the creditors – including bondholders and the banks – have been paid. Ordinary shareholders have voting rights but no *automatic* entitlement to dividend earnings. Ordinary shareholders (known as common stockholders in the USA) stand behind preference shareholders (known as preferred stockholders in the USA) when it comes to the payment of dividends.
- **Preference shares:** these also give the shareholders ownership of the company. Like ordinary shareholders, preference shareholders cannot put the company into liquidation if a dividend is not paid. The rate of the dividend on preference shares is usually fixed and, as noted above, is payable before an ordinary share dividend can be paid. Most preference shares are cumulative. This means that all back payments of dividends on preference shares (if overdue) have to be paid before an ordinary share dividend can be paid. Preference shareholders usually only have voting rights in the event of a major issue affecting the company, such as an alteration of its capital structure.

Additionally, some companies issue **share warrants**. These are options that give the holder the right of exercise to obtain shares at defined strike prices.

**SAQ 1**

Shares have a nominal value (or par value) as well as a market value. What is the difference between the two?

### **Answer**

The nominal or par value of a share is the minimum price at which it may be issued. This represents the share capital in a company's balance sheet. If shares are issued above the par value the difference is termed the share premium and this is placed in the share premium account.

The market value of shares is the price at which they may be currently bought or sold in the market. To be prudent you should value shares you currently own at the 'bid' price on the exchange, since that is the price you would get if you sold them. The bid-to-offer spread for shares is normally small (e.g. a few dollars on the New York Stock Exchange) for shares in major companies where liquidity is good. For smaller companies (where there is less trade in their shares) the bid-to-offer spread is much wider.

There is no need for the market value of a share to be close to its nominal or par value. For example, a 25p share can trade at \$10. If the share is trading below 25p, however, new shares cannot be issued below the par value.

There are international differences. In the USA the nominal value of a share is normally higher than in the UK. Also, in the USA and other countries, but not in the UK, there are shares of 'no par value'. This allows shares to be issued at any price, with no minimum price being prescribed.

When new private companies issue shares, a major target group of investors, apart from the founders of the company and its management, are *venture capital* companies. Since the 1980s, venture capital has become a widely used source of finance for companies. Venture capital companies are suppliers of private equity finance to new or recently formed companies (note though that there is more than one definition of a venture capital company internationally). In the UK, venture capital companies invested £62 billion in 26,000 companies worldwide between 1984 and 2005.

As the company grows and establishes a track record of performance, a point may be reached where it needs more finance to support the development of the business. Additionally, a point is often reached where the founders of the company and those other investors who have provided the initial private equity want to realize at least part of their investment. It is at this point that the company may go to the public equity market to raise capital. This activity is known as the *initial public offering (IPO)*.

In the next two sections we will look at these two alternative means of raising equity finance and the factors that determine whether companies remain funded by private equity or whether they 'go public' through an IPO.

## [1.2 Staying private – private equity and venture capital](#)

For many companies – particularly in Europe and Asia – private equity together with retained earnings have been a sufficient source of capitalization, allowing these companies to avoid listing on a stock exchange. (Retained earnings are the post-tax undistributed – i.e. not paid out in dividends – profits of a company.) The capacity to remain private has been assisted by the rapid growth of private equity in recent years. Private equity has been employed not just by newly established or small companies but also by large established entities that have access to a range of financing alternatives. In recent years the larger private equity companies have begun to dominate the mergers and acquisitions business.

As we will see in [Section 1.6](#) private equity companies have now become active in buying existing public companies and returning them to private ownership.

Examples of private equity companies include the Carlyle and Blackstone Groups in the USA and 3i and Doughty Hanson in Europe. Most are supported by investments from banks and fund management companies including 'hedge funds'. The latter term incorporates a range of different types of alternative investment funds. Activities of these companies are global as highlighted in Case Study 1 below on 3i's activities in China.

(Note: while some hedge funds may pursue conservative or market-neutral strategies, many others take highly leveraged bets on the directions of currency or stock

movements that are not offset by a corresponding hedged position, making them more speculative and risky undertakings: [www.mlim.co.uk](http://www.mlim.co.uk), accessed 19 April 2007. With their equity investments, hedge funds are typically looking for a return over the short term and may take less interest in the management of the companies they invest in than the private equity companies themselves.)

### **Activity 1**

Locate the website of the Carlyle Group ([www.thecarlylegroup.com](http://www.thecarlylegroup.com), accessed 19 April 2007). From this site identify the various types of finance the group makes available to companies and the global areas in which the company is active.

### **Discussion**

Carlyle is active in North America, Europe and Asia – so like many venture capital companies, its activities are multinational. Carlyle provides finance for management buyouts, leveraged finance, venture capital and real estate finance.

### **SAQ 2**

For what reasons do companies use private equity as opposed to using a public offering of shares to raise finance?

### **Answer**

There are two major benefits. First, equity finance may simply not be available through the 'public' route. This may be because the company is too small or because it does not have an established financial track record. Alternatively it may have too high a business risk profile to be attractive to a wide investor base through a public share offering. Second, private ownership usually means a less onerous compliance and corporate governance environment for a company and the avoidance of the costs and management time involved in maintaining a public listing. Additionally, by remaining private, the company is less exposed to predatory attacks by those wishing to take it over – a fact that supporters of Manchester United Football Club might have reflected upon following the hostile takeover of the company in May 2005 by the US businessman, Malcolm Glazer.

The benefit to companies that provide private equity finance – particularly those providing venture capital – is the prospect of higher returns from their investments than through conventional investments in shares listed on the stock exchange. The spread of returns is, though, likely to be far wider than that resulting from stock exchange investments.

### **SAQ 3**

Why are the returns from venture capital investments more diverse and volatile than those from shares issued by public companies?

#### **Answer**

Venture capital investments tend to be riskier than investments in listed companies because the latter are more mature and less leveraged than the companies financed by venture capital. The greater risk for venture capital investments results in more volatility in respect of the returns to the investor.

### **Case Study 1: Venturing into China – plenty of alarm bells!**

In December 2004, 3i invested €16m in China's leading domestic fire alarm systems provider GST Holdings Ltd. GST is primarily engaged in the manufacturing and distribution of fire alarm systems and products. It also produces related products such as video entry security systems, building automation systems and electronic power meters.

Founded in 1993, in the space of only twelve years, GST grew to become the number one domestic fire alarm systems supplier in China, with a 20% market share by revenue, twice that of its closest competitors.

GST was looking for an injection of capital to fund further expenditure and wanted to broaden its shareholdings in preparation for a potential IPO in 2005. It chose 3i above other investors because of its ability to execute the deal swiftly within a tight time frame. Furthermore, GST believed 3i's international network and reputation would strengthen the company's status and raise its profile in the run up to a potential IPO.

In addition, 3i introduced GST to its contacts in the industry to discuss the company's international expansion strategy and explore potential strategic partnership opportunities.

Jiacheng Song, chairman and CEO of GST, said: 'With GST growing at a pace, we saw the introduction of an international investor as our next strategic step. The investment from 3i is another endorsement of our strength and we will be working closely together as we expand both domestically and internationally.'

Source: [www.3i.com](http://www.3i.com) (2005), website accessed 19 April 2007

In this section we have seen the circumstances under which companies may stay privately owned. In the next section we turn to those which decide to become a public company.

### 1.3 'Going public'

For many companies a point may be reached, particularly if the company has grown significantly in size and has aspirations for further expansion, to seek equity finance through an initial public offering of shares (IPO).

#### **SAQ 4**

In a recent research paper (Kim and Weisbach, 2005) the question was asked: 'do firms go public to raise capital?' Can you think of any reasons other than capital raising that would induce a company to 'go public'?

#### **Answer**

The company may find that its (private) shareholders, including those in company management, want to realize at least part of their investment so seeking refinance through a public offering may become necessary. Alternatively, companies may 'go public' to raise their profile in the business world and assist with the marketing of their products. The key reason, as Kim and Weisbach's research confirmed, is to raise capital, even if their findings showed that the funds raised through a public offering of shares were often saved and then subsequently used over several years.

**Table 1: The world's major stock exchanges**

<b>Exchange</b>	<b>More Information</b>
New York	www.nyse.com, accessed 19 April 2007
Tokyo	www.tse.or.jp, accessed 19 April 2007
London	www.londonstockexchange.com, accessed 19 April 2007
Frankfurt	www.deutsche-boerse.com, accessed 19 April 2007
Paris	www.euronext.com, accessed 19 April 2007
Hong Kong	www.hkex.com.hk, accessed 19 April 2007

The process of raising finance through an equity issue involves the following activities.

The initial decision for the company would normally be to appoint a 'lead' bank – or possibly a small number of 'co-leads' – to advise it through the listing process and to manage the sale of shares to investors. These banks would usually be expected to underwrite the transaction – in effect committing to buy those shares not subscribed to by investors on the launch date. Simultaneously the company would appoint legal advisers to take charge of the documentation requirements. It is also possible at this stage that other banks would be invited into the transaction to work under the lead or co-leads – this would be the case if the IPO was of a large size.

Broking firms may also be used to lead or co-lead share offerings. Currently, though, it is common for banks – particularly investment banks such as HSBC – to lead these transactions.

Next, the company must decide which stock exchange to list on. Among the key determinants of this will be the relative costs, where the company is domiciled and – particularly in the case of a multinational company (MNC) – where it conducts the largest amount of its business. Other factors will be influential though, including the size and diversity of the investor base which can be tapped through listing on a particular exchange – a factor that may encourage a listing on the largest exchanges – New York, Tokyo and London (see [Table 1](#)). Additionally, the regulatory and reporting

requirements of a listed company vary between exchanges and this could encourage some companies to seek a listing where such requirements are less onerous or to list on a 'subsidiary' exchange like the Alternative Investment Market (AIM) in London or NASDAQ in the USA. (Established in 1994 the AIM was developed by the London Stock Exchange to enable small growing businesses to go public. With access rules less restrictive and reporting requirements less onerous – particularly in respect of previous financial performance – AIM had attracted 1,000 companies from around the world to go public by January 2005. The European stock exchanges, including Germany and Switzerland, have similar initiatives to AIM.)

The next stage of the process involves the compilation of an issuing *prospectus* that has to be reviewed by the relevant regulator (e.g. in the USA this would be the Securities and Exchange Commission, the SEC). The information contained in the prospectus would include details of the company's financial performance in the recent past – normally up to five years – and projections for future business performance. Part of the process of producing the prospectus involves what is known as 'due diligence' where the company's financial performance, current financial standing and future plans are subject to review by the banks who are underwriting the transaction. Particular focus is placed on the viability of the company's business plan since the success (or otherwise) of this will critically influence both the company's share price and dividends in the years after the IPO. Supporting the information provided will be a report from the company's external auditors confirming that the details of the financial status and performance provided in the prospectus are accurate.

This process of 'due diligence' also gives the lead bank (or co-leads), and others who may have been brought in to advise on the transaction, the opportunity to assess the quality of the company's management – often a good guide to the probability of the company achieving the forecast financial goals set out in the prospectus. The depth of scrutiny involved in the 'due diligence' process varies in line with the risk to the investor. With equity issues the investor has a highly subordinate position among creditors and so the due diligence process is necessarily extensive and forensic in nature. (Equity investors normally rank behind all other creditors – including bondholders – in the event of the liquidation of a company.)

Once this review has been completed satisfactorily the prospectus can be issued to prospective investors who can then form their view on whether they wish to invest in the company and, after a review of the assessed risk, the price they would be prepared to pay for the shares. Simultaneously, but separately, a report may be produced by the lead bank which gives its own assessment of the company and the worth of investing in it. It is necessary for this report to be prepared by a unit of the lead bank which is independent of the team that is marketing the shares to investors to avoid the risk that the coverage in the credit report becomes biased towards engineering a successful IPO. Indeed, in recent years some investment banks in the USA have been accused of producing unduly favorable reports to support company IPOs.

Ahead of the launch, the company and the lead bank would be likely to 'road show' the issue by making presentations to groups of institutional investors. After assessing market sentiment, the lead bank and others in the syndicate of banks can advise on the appropriate price to offer the shares. This is often a range rather than a specific price. The underwriting banks can see how much interest there is from investors and where, within the price range, they are prepared to buy. The 'book' of bids for the shares at prices within the range can then be built up. In doing this the company will know where it has to price to sell its shares – so the exact price can then be set and the issue launched.

This process of **book building** to determine the share price is a practice that has spread to the other major financial markets from the USA – perhaps no surprise given how the US investment banks dominate the international markets. In 1999 book building accounted for 90 per cent of European IPOs compared with 30 per cent in 1994. The process is in contrast to the traditional UK approach where the shares are offered at a fixed price that has been predetermined by the lead banks.

### **SAQ 5**

Much interest has been shown by analysts in the apparent underpricing of shares offered through IPOs. How would this be evidenced and why do both the US book building and the UK fixed price methods, explained above, risk this occurring? Are there any practices that could prevent underpricing?

## Answer

Underpricing is evidenced by the price of shares rising (often sharply) in the immediate aftermath of the launch. Many traders known as 'stags' try to take advantage of this common phenomenon.

The fixed price method may encourage the banks leading the deals to set the offer price at a level where they are confident that all the shares will be sold to investors. This will mean that those underwriting the issue are not left to purchase a large proportion of the offer. With the book building method, investors – knowing that the lead banks want to see a successful launch – may indicate a 'low' price to the lead banks to force the issue price down as far as possible. Both methods thus often result in unmet demand at the final offer price with the resultant surge in the traded share price after launch.

The use of a when-issued market in forthcoming share offers (also known as the 'grey market') helps to limit underpricing. This is because the trade in a when-issued market establishes a pre-launch indication of what the post-launch price of the shares will be. Alternatively, a 'Dutch auction' could ensure that shares are not underpriced at launch – but this method is not without flaws: see Case Study 3 (later in this section) on Google's IPO.

Market conditions are critical for securing an effective equity issue. Companies will want to issue when conditions – particularly those for the sector in which the company operates – are conducive to a smooth launch with share prices at least stable and, ideally, rising. The banks underwriting the transaction have a clear interest here since favorable market conditions make it less likely that shares will be left unsold and have, as a consequence, to be bought and held by them. It should be noted, though, that the banks involved in the transaction may wish to hold on to a small proportion of the shares to provide liquidity in what is known as the 'secondary market' after launch. (Note: the 'primary market' relates to the trade in newly issued shares and securities. The 'secondary market' is the term used for trading in shares and securities after their launch.)

So how well do those managing new share issues perform in judging when to list? Evidence compiled by Henderson et al. (2003) indicates considerable success in this regard. They found 'that firms successfully time their equity issues when the stock market appears to be overvalued' and 'that stock market returns are abnormally low following periods of high equity issues'. The authors acknowledge the role in this successful judgment of **agency** factors: companies may not necessarily have expertise to predict future movements in equity prices; they will, however, have sufficient knowledge – including an inside view of the robustness of their profit forecasts – to assess when their company is being fully valued or overvalued by the market.

This analysis of IPOs leads to the conclusion that while companies may not get the highest price possible at the point they go public due to the vagaries of the price-setting process, they have a tendency to 'get it right' with the timing of their issue due to their informed position about the performance of the company.

### **Case Study 2: Admiral – an admirable debut on the London Stock Exchange**

Established in 1993, Admiral is a specialist motor insurer based in the UK. Admiral's IPO was one of the largest on the London Stock Exchange in 2004. The company was cash rich – so why did it need to raise finance through an IPO? The reason was that Admiral wanted to allow certain existing private venture shareholders, including Barclays Private Equity and XL, to sell their holdings in the company. The flotation also facilitated a windfall payment – averaging £37,000 – to Admiral's employees. With its team of advisers, led by Merrill Lynch International, Admiral offered 32 per cent of their total equity to institutional investors and indicated a price range for the shares of £2.45 to £3.00. The offer generated considerable interest from fund managers and a £1.5 billion 'book' of bids for the shares was built up – covering the size of the issue six fold. This enabled shares to be allocated in full at above the minimum of the range indicated by Admiral. The final issue price of £2.75 valued Admiral at £711 million.

The IPO was judged a success by the markets. Why?

The size of the book and the ability of Admiral to launch in the middle of the indicated price range – in market conditions which were less favorable than those seen during the boom time for IPOs in the late 1990s – suggested a well-marketed and well-managed

launch. The steady, although unspectacular, growth of the share price subsequent to launch – during improving conditions in global equity markets – again suggested that the issue had been priced appropriately at launch. After two months the shares were trading at £3.09 leaving Admiral and the investors happy with the outcome: the former had not sold their shares too cheaply; the latter had seen a modest return on their purchase.

Periodically, planned issues are withdrawn at short notice when weakness or uncertainty – for example in the aftermath of 9/11 in 2001 – prevails in the equity market. Such a withdrawal does avoid the risk of an equity issue being undersubscribed and, as a result of a low launch price, undervaluing the company. The alternative risk is that such a withdrawal – particularly if it comes close to the planned launch date of the equity issue – is viewed by investors as a sign that the company lacks confidence and this impression might be difficult to overcome if, and when, the company does come back and conclude its equity issue.

### **Case Study 3: Google – an unconventional IPO**

The internet search engine company Google adopted a very different approach to their IPO on the NASDAQ stock exchange. (NASDAQ is the largest electronic screen-based equity securities market in the USA.) Established in 1998 the company launched its IPO in August 2004. Controversy accompanied the run-up to the launch with Google encountering problems with SEC regulations for public offerings by issuing shares to staff prematurely and by talking about the issue to *Playboy* magazine. The company also declined to market the issue by ‘road showing’ it to potential investors – something that is commonplace when companies enter a market for the first time. The greatest interest, however, focused on Google's approach to pricing their IPO: they decided to use a Dutch auction to allocate the shares. With this method, shares are distributed to investors whose bids are at or above the price that sells all the shares available. In effect, Google was asking investors to say what they thought was the right price for the shares, rather than vice versa. In theory, this method should mean that at launch the issuer extracts the maximum proceeds possible. Did this work?

After a late decision to cut the number of shares offered from 25.7 million to 19.6 million, Google set a price range of \$85 to \$95 (below the range previously indicated). The Dutch auction allocated the shares at \$85 – the base of the indicated range. But once the shares started trading their price rose above \$100 and after three months they were trading above \$169. This was not entirely surprising since the Dutch auction appears to have been flawed: at \$85 there was unmet demand for Google's issue, with one quarter of the bids for shares being unsuccessful.

Despite the fact that equity markets were on the upturn in autumn 2004, it appears that Google underpriced its IPO. The complexity of the Dutch auction may have deterred investors from bidding for shares at the launch, thereby constraining the issue price.

The conventional process of marketing and book building would almost certainly have yielded the company more from its IPO – but Google is anything but a 'conventional' company.

In addition to providing an interesting case study of an IPO, the subsequent sharp rise in Google's share price prompted – not for the first time – interesting questions about the valuation of a technology company. Shortly after the issue, Allan Sloan of the *Washington Post* wrote:

The stock market is valuing Google at almost \$30 billion, or almost 87 times the \$1.26 per share profit it reported for the 12 months ended June 30 [2004]. Google earned \$7 million on \$86 million in revenue in 2001, its first profitable year, and \$191 million on revenue of \$2.26 billion in the 12 months ended June 30. But the company's not a small start-up anymore. To keep up this growth rate, Google will have to earn \$5 billion on revenue of \$60 billion in 2006. That's clearly not going to happen.

Source: Sloan (2005)

For the time being, at least, Google has dumbfounded the doubters. In April 2005 it announced profits of \$369 million for the first quarter of the year, up from \$64 million for the same period in 2004. The consequent surge in its share price resulted in Google overtaking Time Warner to become the world's largest media company – despite the fact that its sales were less than a tenth of the value of those of Time Warner.

Clearly this is a company and a share price to watch closely.

Having studied IPOs, in the next section we look at why and how a company may return to the market to raise more equity finance.

#### 1.4 Seasoned equity offerings

The issuance of additional shares is called a **seasoned or secondary equity offering (SEO)**. SEOs are common in the London market, but less common in the USA. In some countries, including the UK, one form of SEO is a **rights issue**. In such issues the existing shareholders are given the right to buy further shares, usually in an amount proportionate to their prevailing holdings. This is known as a pre-emption right.

While rights issues can support the need of a successful company to extend its capitalization to accommodate further growth, such issues can be seen as a distress signal, reflecting weak performance and diminishing liquidity and hence the need to raise new funds. In contrast, financial companies such as banks and insurance companies, often resort to SEOs to provide additional capital to maintain their solvency ratios.

Offering these new shares at a discount to the prevailing price highlights a vicious circle that applies to rights issues. Given the normal three week period of acceptance that is required when offering a rights issue, it is usual to offer the shares at a discount to their prevailing market price. This ensures – as far as possible – that during this acceptance period the prevailing price of the company's shares does not fall below the offer price of the rights issue. If this were to happen no shareholders would logically take up their rights. Yet, offering the rights at a discount almost inevitably reduces the company's share price towards the level of the price of the rights issue.

As a shareholder, taking up the rights issue will mean that proportionately you still own as much of the company as you did before the issue although, initially at least, each share is likely to be worth less than before. The alternative is not to take up your rights and sell them at their market value. Under these circumstances, though, your shareholding in the company is diluted: by not taking up your rights you will own a smaller proportion of the company than before the issue.

Rights issues are cheaper than other SEOs in respect of the fees that have to be paid to the lead banks and the other intermediaries involved in the transaction. Institutional investors also like rights issues since they ensure that investors maintain the same percentage holding of the companies' equities. This is important given that the performance benchmarks for these investors are usually stock market indices. On the other hand the nature of rights issues – issuing to *existing* shareholders – does not help to deepen or diversify a company's composition of shareholders.

In the USA, SEOs are sold like IPOs and there are no pre-emption rights.

Interestingly, Corwin (2003) found that like IPOs, SEOs are often underpriced. His research found underpricing by an average of 2.2 per cent during the 1980s and 1990s. Corwin provided a number of reasons for this finding – including 'temporary price pressure' (perhaps attributable to investors trying to influence the offer price ahead of the SEO) and the tendency of the lead banks to round down the offer price to the nearest dollar or \$0.25.

Underpricing relative to the prevailing market price is always going to be likely, given that the company making the issue normally has to offer some incentive to the investors.

So far in this section we have looked at the various forms share issues can take; in the next section we will examine why a company may want to list its shares on more than one stock exchange.

#### **Case Study 4: Pru's rights**

The international insurance company Prudential launched a £1 billion rights issue in October 2004. Shareholders were offered one new share for each six already held. The issue followed the abandonment of the plans to sell its holding in the online bank, Egg.

A proportion of the proceeds from the issue – *circa* £100 million – were used to enhance Prudential's solvency ratio (in effect, their reserves of equity and debt capital) in readiness for the implementation of the new EU Financial Group Directive in January 2005.

The terms of the rights issue showed what usually has to be done to encourage existing shareholders to put up more cash – the 337 million new shares were offered at £3.08, a discount of one third of the then prevailing price of Prudential's shares. With rights issues, shareholders need to be incentivized to take the rights. Those who did take up their rights were rewarded by seeing Prudential's share price rise dramatically to £4.52 at the end of 2004. At least in the short term those investors who were prepared to put more cash into Prudential were handsomely rewarded.

### 1.5 Cross-listing

For many companies, particularly MNCs, there are attractions in having a share listing on more than one stock exchange. The last decade has witnessed an increase in such cross-listings globally.

Chouinard and D'Souza (2004) noted that the proportion of non-US listings on the New York Stock Exchange (NYSE) doubled from about 8.5 per cent in 1994 to 17 per cent at the start of 2003. This period also saw a rise from 7 per cent to 10 per cent in the non-US listings on NASDAQ. [Table 2](#) provides the global breakdown of these cross-listers. The trend internationally has, though, been mixed, with the number of US companies listing in Europe decreasing between 1986 and 1997 (see Pagano et al, 2002).

**Table 2: Companies cross-listing on the NYSE and NASDAQ**

**At 31 December 2003**

	NYSE	NASDAQ
Asia/Pacific	80	50
Europe	189	95
Middle East/Africa	13	76
South America/Caribbean	106	42
Canada	81	78
Total	469	341

Source: Chouinard and D'Souza (2004)

The main perceived benefit of cross-listing is that by increasing the range of potential investors the cost of equity finance is reduced. Karolyi (1998) found evidence of improving liquidity in shares and a lower cost of capital, at least in the short term, after cross-listing.

By cross-listing a company does acquire access to a larger and more diverse investor base and would expect its equity issues to become more marketable as a consequence. Indeed, there is evidence (see Edison and Warnock, 2004) that the overseas ownership increases when companies cross-list their shares.

Listing on an exchange with more rigorous disclosure requirements may also help to reduce a company's cost of equity. Reese and Weisbach (2002) noted that stringent disclosure standards reduce the scope for company managers to benefit from information they hold about the company's performance thereby reducing agency costs. Investors may also be happier to buy shares with a lower expected rate of return when disclosures and accounting standards are more rigorous, since their own costs for credit analysis of the company are reduced. Such benefits – although these are not necessarily material – plus the enhancement of a company's international visibility may be sufficient to warrant the cross-listing.

There may also be, as Chouinard and D'Souza (2004, p. 23) relate, reasons for cross-listing based on 'obstacles to international capital flows, such as legal restrictions on capital mobility and foreign ownership' although the trend towards the globalization – and away from the segmentation – of financial markets is eroding this particular motive for companies to list in different countries.

Cross-listing does, however, incur additional costs for a company in the form of registration fees, listing fees and expenses arising from meeting the disclosure requirements of the additional exchanges (see Karolyi, 1998).



### **Case Study 5: Asea Brown Boveri (ABB) lists shares on the New York Stock Exchange**

Zurich, Switzerland, April 6, 2001 – ABB, the global technology company, today listed its shares on the New York Stock Exchange, saying the move was aimed at supporting the company's growth strategy.

'We are moving to broaden our shareholder base in the United States,' said president and CEO Jorgen Centerman, in reference to the company's morning listing of American Depositary Shares (ADS) under the symbol 'ABB'. 'The listing supports our growth ambitions and allows us to better benchmark ourselves against competitors.'

'If you want to be considered a truly global player, you've got to have a strong position in the United States,' Centerman said. ABB's US operations already employ more than 16,000 people in 40 states. More than 1,000 scientists and software engineers at 12 centers in the United States conduct research and development activities on behalf of ABB's US and worldwide businesses.

Source: ABB website (2005)

Going public and listing on a stock exchange is not an irrevocable act for a company. In the next section we will look at how and why some public companies have reverted to a private status.

#### [1.6 Equity buybacks, de-listing and reversion to a 'private' company](#)

Once its shares have been issued, a company has the option to buy back shares. Buybacks will occur if the company believes that it is overcapitalized and cannot

generate a sufficiently high return on capital through its operations. Under these circumstances it is effectively saying to the investor ‘thanks but please now have some of your money back – you can probably make it work harder elsewhere’. A further reason for buybacks arises when a major capital restructuring is undertaken by a company with debt being substituted for equity.

If a company believes that it can reduce its overall cost of capital by substituting debt for equity then a share buyback may be undertaken. Whether or not it does this may reflect whether the company adheres to the Modigliani and Miller (1958) proposition – which states that **imperfect markets** financial structure has no impact on the cost of capital – or to the same writers’ revised opinion in 1963 (Modigliani and Miller, 1963) which stated that corporate tax relief on debt interest means that the substitution of debt for equity adds value for shareholders. Under the latter circumstances such market imperfections provide an opportunity to push down the cost of capital *without* this benefit being eroded by equity investors requiring a higher return on their investment to reflect the greater financial risk being taken by the company (Culp, 2003; Curran and Donohue, 2004).

Certainly many companies – particularly in the USA – have sought to reduce their cost of capital by focusing on debt rather than equity finance and by replacing existing equity with new debt. However, as SAQ 6 explores, this strategy is not without its risks.

### **SAQ 6**

In practice what limitations might a company have on its ability to replace equity with debt?

### **Answer**

There is an upper limit on how much a company can access the debt markets: the sum of the maximum each investor is prepared to invest in the company's debt securities. Long before this upper limit is reached the cost of the debt issued (i.e. the interest rate payable) would rise to the point where it becomes prohibitive (even allowing for tax deductibility). This would happen because the greater the financial leverage adopted

(i.e. the higher the **debt/equity ratio**) the more investors would fear both a default on bond payments of interest and principal and the bankruptcy of the company.

An interesting recent example of a share buyback came from the mobile telephone operator Mm02. In March 2005 over 800,000 small shareholders agreed to sell their shares back to MmO2 at a premium of 5p above the prevailing share price. Why did Mm02 make this offer? The decision was reported as being related to the desire for the company to reduce the number of its shareholders, particularly small shareholders. This reduced the costs of distributing Mm02's share dividends – indeed the projected distribution cost for the smaller shareholders was greater than the forecast value of the dividends to be paid to them. In effect the move reduced one cost of capital – the dividend distribution cost. The move was, though, part of a wider capital restructuring by MmO2, which included de-listing from the New York Stock Exchange. This listing was a legacy from Mm02's de-merger from BT in 2001. With no business activities in the USA and none in prospect there was little rationale to continue with the listing.

In some cases the entire public issue is bought back, reverting the company to private status. Where this has happened it is not unusual to hear the company's owners state that the dividend and capital growth expectations of the investors (particularly the large fund managers) enforce a too short-term business planning horizon on the directors of the company.

### **Case Study 6: Virgin – private–public–private–public**

The Virgin Group of companies, headed by entrepreneur Sir Richard Branson, is an example of a company which has gone to the public market and found it not to its liking. Virgin Group – comprising its music, retail, property and communications businesses – was floated on the stock exchange in 1986 (the airline and travel businesses, in contrast, remained privately owned). The stock witnessed limited capital growth after the launch date and, like the equity market as a whole, suffered in the stock market crash of 1987. Richard Branson also expressed disappointment with the short-term expectations of equity analysts and fund managers. This dissatisfaction culminated in the decision in 1988 to make the company private again through a management buy-out at 140p per share – precisely the same as the price at the launch in 1986.

Sixteen years on, though, Branson was back in the market with the flotation on the London Stock Exchange of Virgin's mobile 'phone business. Branson commented at the time 'Virgin Mobile is a great business with an excellent growth record and I am delighted some equally excellent City investors want to share in its long-term future' ([www.londonstockexchange.com](http://www.londonstockexchange.com), accessed 19 April 2007). Perhaps the reference to the 'long term' was a reminder to those in the equity market of Branson's frustrations of 16 years earlier!

In addition (see Toronto et al., 2004) smaller companies whose valuation is too low to attract interest from either analysts or fund managers may find that the benefits of being a public company are offset by the costs of complying with stock exchange regulations. Here, we meet the theme of consolidation and its impact on markets. The mergers among asset managers in recent years have drawn upwards the minimum size of transactions in which these investors are prepared to deal. For the smaller companies, this consolidation among institutional investors means that their shares will not be actively traded. With reduced liquidity it becomes more difficult to value a company and there is evidence that this illiquidity drags down the share price regardless of the company's operating performance. The consequence is that lack of investor interest results in the risk of such companies becoming undervalued. Indeed for certain exchanges, including the New York Stock Exchange and NASDAQ, a major fall in share price can result in a company being de-listed from the exchange while remaining a public company – with all the associated compliance costs of such a company. Thus a company could end up with none of the advantages of going public and all of the disadvantages.

This demonstrates how consolidation in the finance industry clearly disadvantages the smaller players regardless of their performance. No wonder then that these potential pitfalls to 'going public' allied to the growing availability of private equity are affecting the appetite for IPOs. Indeed on the London Stock Exchange the amount of equity finance raised through IPOs in 2004 was a quarter of that raised in 2000 while, simultaneously, private equity activities grew rapidly.

Evidence, both of the international growth of private equity transactions and the attractions of de-listing and going private, were manifested by the announcement of the \$11.3 billion sale of the US technology group SunGard Data Systems to a consortium of seven private equity companies in March 2005. The size of the transaction reflected the growth in the size of private equity funds and the attractive market conditions prevailing (namely low interest rates and improving liquidity for corporate debt) at the time. The transaction showed the rapidly changing nature of financial markets: observers commented that just two years prior to the announcement such a transaction could not have been contemplated.

Having looked at how finance is raised by equity issues, we turn now to consider how the performance of shares may be measured.

### [1.7 Monitoring equity performance](#)

For those equities in issue their current market value and some indicators of their performance are provided in the daily press. [Table 3](#) shows the closing levels and the volume of shares traded in respect of a selection of companies on the London, New York, Frankfurt and Tokyo Stock Exchanges on 7 June 2005.

**Table 3: Selected MNC equity prices – 7 June 2005**

Company	Price	High *	Low *	Yield	PE	Traded volume
London	(p)	(p)	(p)	(%)		('000s)
BT	218	218	177.5	4.9	12.2	57,986
BSkyB	538.5	633.5	465.5	1.3	20.9	4,478
Cadbury Schweppes	543.5	567	421	2.3	19.4	41,699
GlaxoSmithKline	1,377	1,377	1,042	3.1	20.0	12,036
Hanson	510	536.75	360	3.6	10.2	3,877
HSBC	872	953.5	784	4.2	13.9	24,035
Shell Transport	487.5	505.5	384.5	3.5	12.8	38,793

<b>New York</b>	<b>(US\$)</b>	<b>(US\$)</b>	<b>(US\$)</b>	<b>(%)</b>		<b>('000s)</b>
AT&T	18.94	19.85	13.70	35.0	**	2,953
General Motors	30.73	48.26	25.60	6.5	34.9	5,644
IBM	75.04	98.58	72.01	1.1	14.7	4,053
Pepsico	55.90	57.12	47.85	1.9	22.2	3,697
<b>Frankfurt</b>	<b>(€)</b>	<b>(€)</b>	<b>(€)</b>	<b>(%)</b>		<b>('000s)</b>
Adidas	135.65	136.98	93.96	1.0	19.7	209
Deutsche Bank	64.31	69.39	52.90	2.6	13.8	3,603
Lufthansa	10.40	11.61	8.63	2.9	11.1	4,269
VW	36.68	38.38	30.71	2.9	21.0	1,907
<b>Tokyo</b>	<b>(¥)</b>	<b>(¥)</b>	<b>(¥)</b>	<b>(%)</b>		<b>('000s)</b>
Mitsui	983	1,074	801	2.0	12.8	2,352
Sony	3,890	4,400	3,590	0.6	22.1	3,918
Suzuki	1,719	1,986	1,642	0.5	15.2	1,423
Vodaphone	226,000	300,000	196,000	0.5	5.9	1

\* Over past 52 weeks.

\*\* Not available.

### SAQ 7

In [Table 3](#) what do the terms 'PE' and 'yield' mean? Why do they vary so much from company to company?

### Answer

PE is the price/earnings ratio – the ratio of the price per share to the earnings per share in the last reported period. Yield means the dividend per share paid by the company as a percentage of the share price.

The different PE ratios reflect the differing risk characteristics of the companies (and their business sector) and the view held by investors about the growth prospects for the company. A company with substantial growth potential will have a high PE relative to a peer company with limited scope for growth. Additionally a high PE may reflect a company which is experiencing business difficulties (and hence is generating low earnings) but one which investors expect to recover.

The differing dividend yields reflect, to a degree, current performance by the companies in generating earnings and different policies towards distributing these earnings through dividends. Here there are clear international differences which the data in [Table 3](#) bring out. Japan and, increasingly, the USA have traditions of paying out low, or no, dividends. In contrast the UK has a tradition of paying higher dividends – although this tradition was, to a degree, rooted in the tax advantages to certain shareholders (specifically tax credits to pension funds) that were removed in 1998.

### [1.8 Summary](#)

In this unit we have looked at how companies raise equity finance.

We have examined how companies may move from private equity finance, supported by the venture capital companies, to public equity finance through an IPO. We then went on to study seasoned or secondary equity offerings (SEOs) with particular focus on rights issues.

We looked at why companies may choose to list on more than one exchange and at the circumstances that might lead to a company de-listing and reverting to private company status.

We concluded the unit by looking at the details of the equities of a number of companies on the London, New York, Frankfurt and Tokyo Stock Exchanges.

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