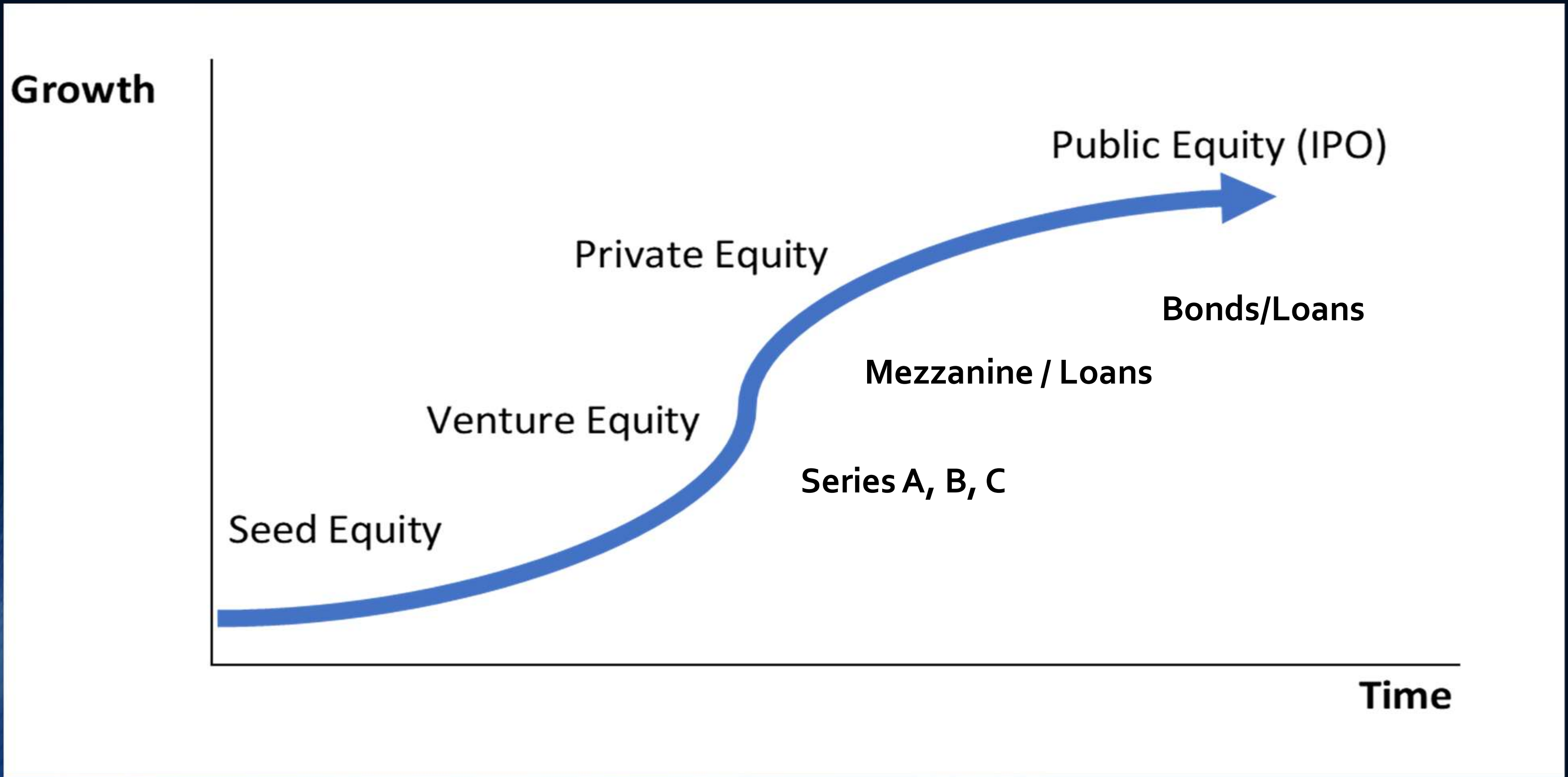
Chapter 6
"An Analytical Approach to Investments, Finance and Credit"

Equity Markets: Raising Equity in the Public Markets (IPO)

Initial Public Offering: An Overview

- Everyone knows what an IPO is. It is one on the most exciting milestones of the company. It validates that the company is already successful of what they are doing, and they are ready for the big league.
- A company that has successfully raise money via IPO has reached that last chapter of their early development and have proven that their selling product is in demand.
- Not all IPOs had successful outcomes after the IPO but given the rigorous process in order to go public it feels that the company is already successful. It feels like graduation. Its one of the best feelings of any student has after achieving such milestone but graduation is also a beginning of many more successes.
- Companies that achieve that milestone of becoming public are also in their beginning stage of many successfully years to come.
- Accessing capital in the public markets gives the company more options to continue their growth by accessing more ongoing capital from equity investors and other types of investors such bondholders.

The Life Cycle of the Public Company and its ability to raise capital though the cycle



Venture Capital

Investors

- **Series A ($2 mm - $10 million)**
- **Hedge Funds**
- **Institutional Investors (GP/LP structures)**
- **Industry Specific Venture Funds**

Purpose of Venture Equity:

- Revenue Growth (no necessarily initial income growth)
- Market Share / Penetration
- Continue to develop the product

What do you need:

- Exit Strategy
- Business Plan
- DCF Valuation

Private Equity Capital

Investors:

- Large and Middle Market PE firms (Higher than $10 million)
- Institutional Investors (GP/LP structures)
- Industry specific PE firms

Purpose of Private Equity:

- Revenue & EBITDA Growth
- Cost Efficiency and Plant implementation
- Financial Engineering (using leverage)
- Focus on Core Business

What do you need:

- 2-3 Year Financial Statements
- Operational Data (supporting Revenue, Income and Cash Flow)
- Industry Consulting Reports
- DCF Valuation and other Valuation Methods (Comparables)
- Exit Strategy and Estimated Terminal Values

Public Equity (IPO)

Investors:

- SEC Registration / ADR
- ADR (Level 1)
- Regulation S & D Non-Exempt Issuers

Purpose of Public Equity:

- Revenue, EBITDA and Net Income Growth
- Product Growth Feasibility - Normalization
- Back to Fundamentals (no need to financial engineering)

What do you need:

- File for SEC or Private Memorandum
- 3 Year Audited Financials
- Proven Management / Anchor Investors
- Third Party Valuation Analysis

Initial Public Offering
Objectives of the Owners to Go Public

- A company will seek equity financing from the public markets through a process called an initial public offering (IPO). When the company is IPO ready (discussed next), it will choose to offer its equity to a large market of investors to meet the existing owner's following objectives:
  - To provide liquidity for the founders and early private investors to sell their holdings to the public markets
  - To establish a broad-based valuation of the company by offering the stock to a large group of investors, hence increasing the existing value to the current owners who stay post-IPO
  - To fund the company's ongoing needs and access follow-on financings
  - To create stock that can be used to offer executives and employees retirement plans

Initial Public Offering
Purpose of the Investors to Invest in IPOs

- The institutional and public investors investing in a new company during and post IPO are looking to enhance their returns through earnings growth and multiple expansion. If this becomes a reality, the broader market will gain confidence and drive the stock price up. It will also continue to increase in the future if expectations for these higher multiples of earnings (PE or EBITDA) are realized. Dividends can also be a source of income for these investors, though typically new IPO companies are still in a growth stage of their development and do not pay dividends.

Initial Public Offering

Investors	Purpose of Investment	What do you need
Public Investors - Institutional - Individual	Revenue & EBITDA Growth	- File with the Securities Exchange Commision (SEC) and prepare Prospectus and Information Memorandum - American Depository Receipt (ADR) Registration - SEC Regulation S & D Non-Exempt IssuersInformation Memorandum
	Product Growth Feasibility - Normalization	3 Year Audited Financials
	Back to Fundamentals (no need for financial engineering)	Proven Management / Anchor Investors
		Third Party Valuation Analysis

Figure 6.1

The Shareholder's rights

- **Voting rights:**
  - Holders of common stock exercise control by electing the board of directors that vote on corporate policy
  - Each share gives the shareholder a share of the vote that represents their percentage of ownership as a percentage of total shares outstanding
  - The voting can be carried out by either a statutory voting method or cumulative voting method.
    - The statutory voting method is based on the stocks that the shareholders owns: one share = one vote.
    - The cumulative voting method is based on allocating the shares that the shareholder owns to each candidate.
- **Financial reporting and company information**
- **Dividends**
- **Preemptive Rights**

Dividend Payment Process

- **Declaration date:** This is the date by which the board of directors declares dividends. In their announcement they mention two other dates including the record date and the payable date.
- **Record date:** This is the date the shareholder must register on or before to receive the dividend.
- **Payable date:** This is the date that the dividend is paid to the shareholder on record.
- **Ex-dividend date:** This is the date 2 business days prior to the record date. Any regular way trades of the stock take 3 days to settle (T+3), which will give the official title of the stock

Dividend Payment Process

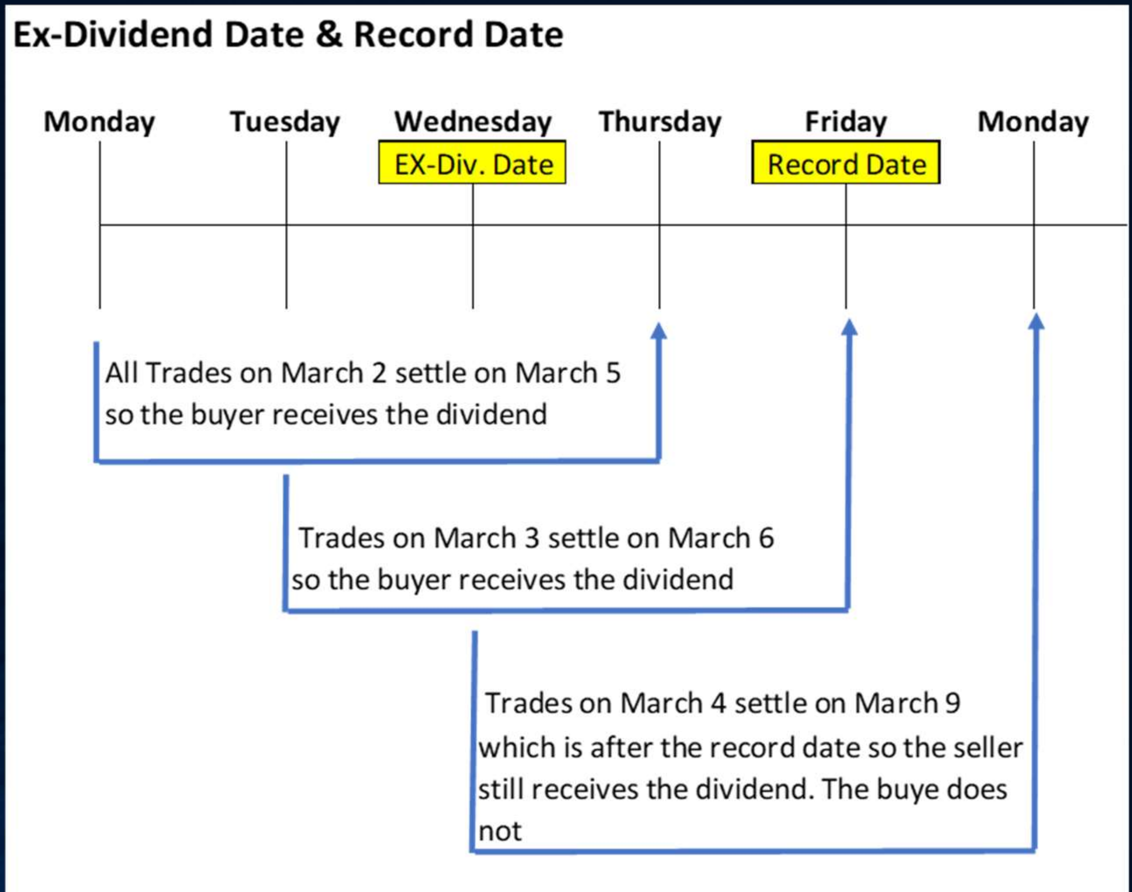


Figure 6.2

Other Stock Concepts

- Stock Splits and Reverse Splits
  - A stock split occurs when a company believes the price per share is too high to keep buyers interested in purchasing shares. This of course is due to the perception that the market of buyers shrinks once the stock price is too high, as the common unsophisticated investor looks for other cheaper stocks to purchase instead.
    - For example, a two-for-one split of a stock that is trading at $50 will result in the stock trading at $25 ($50/2). Note that holders of the stock will double their shares at the time of the split, preventing dilution of current investors.
  - A reverse split is when the stock price is too low, and the company decides to reduce the number of overall shares to increase the per unit price. For this to occur it usually indicates that current perception of the stock is weak and growing weaker, and the low per share price is contributing to that perception.
    - For example, in a one-for-five reverse split, five $5 shares become one $25 share (5 x $5).

Other Stock Concepts

- **Classifying Common Stock**
  - **Income stocks:** These are stocks of companies that consistently pay dividends. When an investor purchases income stock he or she expects to receive dividends. Most of the return for such an investment is based on consistent dividends. Companies that are classified as having income stock are more mature companies with limited research and development and stable cash flows. There are two methods of calculating the dividend payout ratio:

$$\text{Dividend payout ratio} = \frac{\text{Annual dividend}}{\text{Net income}} \text{ and per share,}$$

$$\text{Dividend payout ratio} = \frac{\text{Annual dividend per share}}{\text{Earnings per share (EPS)}}$$

The dividend yield (δ) % per share is calculated as follows:

$$\text{Dividend yield } (\delta)\% = \frac{\text{Annual dividend per share}}{\text{Stock price}}$$

  - **Growth stocks:** These are stocks of companies that reinvest most of their income into their business. Investors buying these stocks expect a higher capital gain from growth in share price due to expanding earnings/revenue multiples.

Stock Prices and Investment Opportunities: Growth Stock Versus Dividend Stock – An Example

	Cash-Is-King, Inc. (CIK)	Growth-Is-the-Only-Way, Inc. (GITOW)
Expected Net Income	\$10 per share	\$10 per share
Capitalization Rate (k)	10%	10%
Valuation based on k	\$10/.10 = \$100 per share	\$10/.10 = \$100 per share
Decision to pay out div or reinvest	100% Pay out (payout ratio)	50% Pay out - \$5 50% Reinvest - \$5 (Plowback ratio)
Expected profit to grow next year	\$15 million (50% increase)	\$15 million (50% Increase)
Shares outstanding	3 million shares	3 million shares
Additional Profit of Dividend Reinvested	\$0	\$7.5 million (\$5 x 1.5x)
Intrinsic Value	Price = $\frac{\text{D paid}}{\kappa - \text{g}} = \frac{\$10}{.10 - .0} = \$100$	Price = $\frac{\text{D paid}}{\kappa - \text{g}} = \frac{\$5}{.10 \quad .075} = \$200$

Syndication of Securities Offerings for IPO

- **Step 1: Selecting the Investment Company/Underwriter**
- Step 2: Preparing the Documents for the IPO
- **Step 3: SEC Registration and Approval**
- **Step 4: Marketing the IPO**
- **Step 5: Indication of Interest**
- **Step 6: Closing, Funding, and Free to Trade**

Types of Underwriting Commitments for IPO

- Firm Commitment
  - A firm commitment is a commitment from the underwriters that enables them to purchase all the shares that are offered in an IPO
- Best-Effort Commitment
  - A best effort's underwriting agreement is an agreement in which the underwriters seek to sell all the shares to the interested investors but have no obligation to purchase any unsold shares

Underwriting Fees and Compensation

- Underwriting Spread (fees)
  - Manager's Fee
  - Unwriting Fees
  - Selling Concession Fees

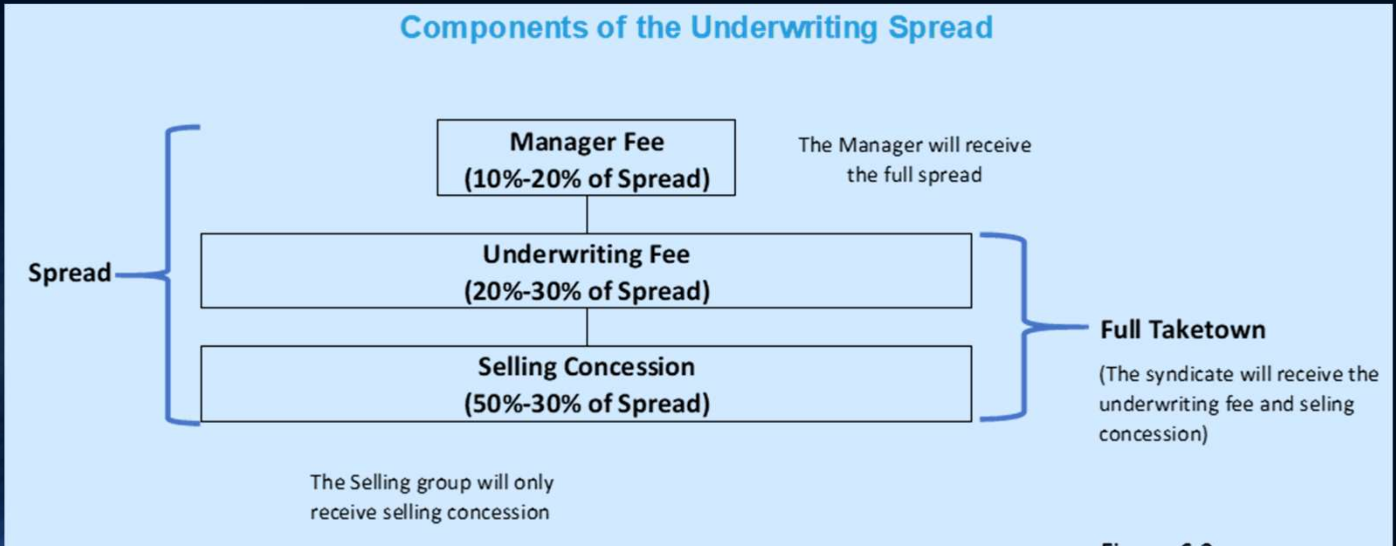


Figure 6.3

Underwriting Fees and Compensation

- **Breaking down underwriting compensation**
  - For small companies, a typical underwriting spread fee is around 12%, or a discount rate of 88% of the IPO proceeds raised from the offering. Figure 6.4 shows an example of a Celerity Technology Inc. IPO and the allocation of the spread compensation to the manager, the syndicate, and the selling groups.

Celerity Technogy Inc. ("CTI")

Initial Public Offering

Shares Sold: 15,000,000

Transaction Sources & Uses:

Sources:

Securities	Amount $	% Capital
Corporate Loan	-	0.0%
Corporate Bond	-	0.0%
Equity	600,000,000	100.0%
Total Sources:	600,000,000	100.0%

Uses:

Allocation of Capital		Per Share	Total Proceeds	% of Total
IPO Porceeds to the Issuer		$37.60	564,000,000	94.0%
Gross Spread (Fee)	6.00%	$ 2.40	36,000,000	6.0%
Total Offering Price		$40.00	600,000,000	100.0%
Other Trans. Expenses			00	
Total Uses			600,000,000	

Syndication Analysis

	Allocation	Shares Sold	Left-Lead Fees	U/W Fee	Selling Concession	Total Takedown	Total Spread
Percentage of Spread			20%	30%	50%	80%	100%
Per Share			$0.48	$0.72	$1.20	$1.92	$2.40
Left Lead Underwritter	9,000,000	8,000,000	7,200,000	6,480,000	9,600,000	16,080,000	23,280,000
Syndicate Member A	2,000,000	1,000,000		1,440,000	1,200,000	2,640,000	2,640,000
Syndicate Member B	2,000,000	1,000,000		1,440,000	1,200,000	2,640,000	2,640,000
Syndicate Member C	2,000,000	1,000,000		1,440,000	1,200,000	2,640,000	2,640,000
Selling Group (Total)		4,000,000			4,800,000	4,800,000	4,800,000
Total	15,000,000	15,000,000	7,200,000	10,800,000	18,000,000	28,800,000	36,000,000

Figure 6.4

The Celerity Technology IPO example (Figure 6.4) shows that the company or the issuer is planning to issue 15 million shares. The left lead manager keeps 9 million of the shares and the remaining 6 million are allocated pro-rata (equally) among the three underwriters.

Building the Book

- The first responsibility of the left lead manager is to pre-market the offering to institutional investors (qualified investors).
- The other underwriters in the syndicate also start pre-marketing to their own investors.
- Before they start this process, called building the book, each underwriter of the syndicate is allocated shares by the left lead manager.
- These institutional investors who are interested in purchasing the stock will give an indication of interest (IOI). These IOIs will become orders on the effective day, though they are not obliged at this point to commit and are able to cancel any time before purchase.
- The building-the-book stage is probably one of the most important stages during the offering as the manager, syndicate, and selling group receive a lot of market feedback and evaluate the demand, which can be used as the basis to start the discussion on the offering price (i.e. Celerity Technology IPO to be priced $38-40)

Building the Book

- **Setting Up the Investor List by Underwriter (Allotment):**
  - Before the building-the-book stage, which involves the pre-marketing of the offering, the list of investors could be allocated among the underwriters.
  - This process, which is the preferred process in the United States, is called a **fixed-pot arrangement.** This arrangement is sometimes cleaner to execute since each underwriter focuses on his or her allocated list of investors and fees are shared across all, despite one underwriter doing better than the other.
  - The **jump-ball arrangement i**s basically an arrangement that the credit of circling investors is on a first-come-first-serve basis and the underwriters are paid based on how big a book they are building with IOIs.
- **Pricing:**
  - The left lead manager is untimely responsible for letting the issuer know about the success or failure of the book-building effort and the state of the market, including records of other IPOs that have already been priced.
  - **The manager also confirms the final pricing and scheduling.** After looking at the final book with all the orders at different prices within the range, the manager sets the price and communicates it to the company.
  - Example: In the Celerity Technology IPO example, (Figure 6.4) the final price is $40:
    - 15 million shares issuance x $40 = $600 million
    - Less 6% gross fees or $36 million ($6 million x 6.0%)
    - Net proceeds to the company are estimated to be $564 million before any other transaction expenses.

Mergers and Acquisition Transaction Accessing Capital

Steps for the Transaction Analysis

- **Step 1: Select Comparable Acquisitions**
- **Step 2: Find the Necessary Financial Information Related to the Transaction**

Comparable Transaction Multiples

Target	Acquirer	Acquisition Price /Share	Shares Outstanding	Equity Value ($mm)	Total Net Debt ($mm)	Enterprise Value (EV)	EBITDA (last reported)	EBITDA Multiple
Hilton Hotels	Blackstone Group	$ 47.50	390,400,000	$ 18,544	$ 6,180	$ 24,724	$ 1,680	14.72x
Four Seasons*	Kingtom Hotels Int'l / Gates' Cascade	$ 82.00	33,078,000	$ 2,712	$ 279	$ 2,991	$ 94	31.90x
Fairmont/Rafles	Kingtom Hotels Int'l	$ 45.00	73,335,000	$ 3,300	$ 124	$ 3,424	$ 187	18.29x
Hilton International	Hilton Hotels Corp.			$ 5,578	$ -	$ 5,578	$ 504	11.07x
Starwood Hotels	Host Marriott					$ 4,096	$ 315	13.00x
La-Quinta Corp	Blackstone Group	$ 12.22	203,000,000	$ 2,481	$ 926	$ 3,406	$ 230	14.83x
Wynham Int'l	Blackstone Group	$ 1.15	172,053,000	$ 198	$ 2,682	$ 2,880	$ 275	10.47x
John Q. Hammons Hotels	JQH Acquisition LLC	$ 24.00	19,583,000	$ 470	$ 765	$ 1,235	$ 123	10.04x
Societe du Louvre	Starwood Capital					$ 1,029	$ 91	11.30x
Intercontinental Hotels	LRG					$ 981	$ 107	9.20x
Boca Resorts	Blackstone Group	$ 24.00	40,284,000	$ 967	$ 217	$ 1,184	$ 90	13.15x
Prime Hospitality	Blackstone Group	$ 12.25	44,808,000	$ 549	$ 244	$ 792	$ 55	14.38x
Extended Stay	Blackstone Group	$ 19.93	95,077,000	$ 1,895	$ 1,232	$ 3,126	$ 225	13.90x
							Average =	14.33x

Figure 6.6

Mergers and Acquisition Transaction Accessing Capital

Steps for the Transaction Analysis

- Step 3: Review Key Multiples for Trading Multiples

Comparable Trading Multiples

Company	Symbol	Stock Price	Stocks Outstanding ($000)	Equity Value ($000)	Debt (ST&LT) ($000)	Cash ($000)	Enterprise Value ($000)	EBITDA ($mm)	EBITDA Multiple
Choice Hotels International	CHH	$ 83.20	56,572	4,706,804	796,200	37,150	5,465,854	335,560	16.29x
Hilton Worldwide Holdings Inc.	HLT	$ 80.96	298,190	24,141,462	7,580,000	423,000	31,298,462	1,760,000	17.78x
Hyatt	HOT	$ 77.93	117,448	9,152,748	1,440,000	879,000	9,713,748	657,000	14.79x
Intercontinental Hotel	IHG	$ 62.58	190,000	11,890,200	2,040,000	233,000	13,697,200	843,000	16.25x
Marcus Corporation	MCS	$ 40.80	19,680	802,944	317,420	18,070	1,102,294	139,930	7.88x
Marriott International	MAR	$ 130.90	346,990	45,420,991	8,990,000	366,000	54,044,991	2,850,000	18.96x
Park Hotels & Resorts Inc.	PK	$ 32.89	201,180	6,616,810	3,080,000	421,000	9,275,810	734,000	12.64x
Wyndham Worldwide	WYN	$ 136.73	108,640	14,854,347	8,310,000	1,500,000	21,664,347	1,790,000	12.10x
								Average =	14.59x

Figure 6.5

Mergers and Acquisition Transaction
Accessing Capital

Steps for the Transaction Analysis

- **Step 4: Comparable and Benchmark Analysis**
  - After the trading and acquisition comparable analytical methods are done and justified as truly comparable, the banker sets the average or the range of multiples that are used to value the target company. The average or range of multiples are used as an industry benchmark and the basis for analyzing the target company
- **Step 5: Determine Valuation**
  - The mean (averages) and median multiples for both analytical approaches are used to value the relevant target company. Figures 6.5 and 6.6 show that the averages of the hotels sector for trading comparable and acquisition comparable are 14.6x and 14.3x EBITDA multiples, respectively. These multiples ranging from 14–15x EBITDA will then be used to calculate the relevant hotel company that is either an IPO or M&A candidate

Mergers and Acquisition Transaction
Round of Bids

- **First Round**
  - **Reaching out to prospective buyers**
  - **Execute the confidentiality agreement (CA)**
  - **Distribution of CIM and initial bid procedures letter**
- **Initial Bid**
  - Bid Procedure Letter also outlines the information that the buyers need to submit with their bid including their initial purchase price and the composition of payment such as all cash, stock, or a combination of the two.
  - **Preparation of management presentation**
  - **Setting up the data room**
  - **Receive initial bids**

Mergers and Acquisition Transaction Round of Bids

- Second Round
  - Management presentations and site
  - Data Room
  - Final bid procedure letter
  - Definitive agreement
  - Final bid
- Negotiations
  - Evaluating final bids:
  - Negotiate with the selected buyer:
  - Select winning bidder:
  - Board of directors' approval:
- Closing
  - Shareholders Approve the Transaction