Series 79 Top-Off

Investment Banking Representative

Study Manual – 43rd Edition

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When reviewing the online PDF Study Manual, a **keyword search** can be performed by holding down the “Control” key and clicking on the “F” key (Ctrl + F) or, for Mac users, the “Command” key and ”F” key (Cmd + F).

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DISCLAIMER *STC students are provided with both a print and online study manual. If discrepancies are discovered between these two manuals, please consider the online study manual to be the most current since it's updated in real-time.*

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Introduction

Securities Training Corporation's Series 79 Examination Training Program is designed to assist students in passing the examination regardless of their prior experience or educational level. Each phase of the program has been designed carefully to present concepts in a simple manner and logical sequence. Since this examination is under constant revision, we recommend that you visit our website at www.stcusa.com to see if there have been changes or supplemental materials created.

In order to obtain registration as an Investment Banking Representative, candidates must pass both the Series 79 Exam and a general knowledge co-requisite, the Securities Industry Essentials (SIE) Exam.

The Financial Industry Regulatory Authority (FINRA) Investment Banking Representative Qualification Examination (Series 79) is a two-hour and 30-minute examination which consists of 75 multiple-choice questions. There are also 10 additional, unidentified pretest questions which do not count toward a candidate's score and are designed to test the validity of new questions. Since there is no penalty for guessing, candidates should answer all of the questions. The minimum required passing score is 73%.

The Exam Breakdown

The exam questions are broken down based on the major job functions of an Investment Banking Representative. The allocation is as follows:

Topic Area	Covered in Chapter	Number of Questions
1. Collection, Analysis, and Evaluation of Data (49%)	8, 9, and 10	37
2. Underwriting/New Financing Transactions, Types of Offerings, and Registration of Securities (27%)	1, 2, 3, and 4	20
3. Mergers and Acquisitions, Tender Offers, and Financial Restructuring Transactions (24%)	5, 6, and 7	18
	Total	**75**

A detailed listing of topics tested may be accessed on FINRA's website at the link below:

http://www.finra.org/industry/series79

Purpose and Development of the Examination

The Series 79 is designed as an entry-level qualification examination that seeks to measure the knowledge, skills, and abilities needed to perform the major functions of an investment banker. The questions on the examination are based on the Series 79 Content Outline. This outline was created based on a job analysis of existing investment bankers and by conducting interviews and surveys with a committee of investment bankers.

The Series 79 committee identified the major job functions, tasks, and topics that are associated with the role of an investment banker. This committee also determined the number of questions to be allocated to each of the major functions in the outline.

With the guidance of FINRA, the Series 79 committee writes, reviews, and validates all of the questions on the examination. These questions are subject to multiple levels of review by the committee and are linked to the outline. Some of the questions require the candidate to calculate financial and valuation metrics, while others test the knowledge of SEC and industry rules. Each question has one correct or BEST answer that's chosen by the committee. When new rules are created or when existing rules are rescinded or updated, the questions on the examination are changed after a reasonable period of time.

STC will update its material in accordance with these changes. The online examinations are updated on a real-time basis. The written study manual will be updated periodically based on FINRA changes to the examination.

Registering For the Examination

To register for the Series 79 Examination, you must complete the Form U4 application. Your sponsoring firm will then send both Form U4 and your fingerprints to FINRA for processing. Give yourself ample time for processing to be completed. Once your information has been processed, a confirmation will be sent to your firm.

Taking the Exam

In order to take an exam, you will need to make a test appointment. Please use the following information to schedule an appointment and/or to learn more about the examination center:

Prometric Exam Centers
www.prometric.com/finra/
800.578.6273

The website will provide you with the most up-to-date information regarding "Test Center Security" and "Test Break Policies." At the testing facility, you will be provided with:

- A four-function calculator
- Two dry-erase boards
- Dry-erase pen

For more information regarding scheduling an exam, what to expect on the day of your exam, and what happens after your exam, please use the following link which provides information from FINRA:

www.finra.org/sites/default/files/external_apps/proctor_tutorial.swf.html

About the Training Program

Securities Training Corporation's Series 79 Program consists of the following materials:

- A study manual containing 10 chapters
- Online final examinations with detailed explanations
  - E-mailed instructions regarding access to the final examinations will be sent to each candidate.

Study Manual

The study manual represents the first phase of your exam preparation and is divided into the following 10 chapters:

Chapter 1: Industry Terminology and Data Collection
Chapter 2: Public Offerings
Chapter 3: Underwriting
Chapter 4: Exempt Securities and Exempt Transactions
Chapter 5: Mergers and Acquisitions
Chapter 6: Tender Offers and M&A Rules
Chapter 7: Financial Restructuring and Bankruptcy
Chapter 8: Financial Analysis
Chapter 9: Valuation Analysis
Chapter 10: M&A Analysis

After reading each chapter, STC strongly suggests that students go to their **my.stcinteractive.com** dashboard and create a 10-question Custom Exam that contains only questions pertaining to the chapter just completed.

The Custom Exam may be taken with or without the explanations shown after each question is answered. Students shouldn't proceed to the next chapter until they fully understand the explanation for any questions that were answered incorrectly.

Final Examinations

The final examinations and corresponding explanations represent the most important part of your test preparation. These examinations will assist you in applying the information that you learned in the study manual to questions that are posed in the multiple-choice format and used in the Series 79 Examination.

An examination should first be taken with the SHOW EXPLANATIONS turned on. As you read a question, try to answer it. However, whether your answer is correct or incorrect, read the entire explanation. You may find it helpful to highlight or take notes on any facts you didn't know for use in future studying.

Studying each explanation is a crucial step to passing the Series 79 Examination. By concentrating only on the correct response and disregarding the explanation, you run the risk of memorizing answers without fully understanding the underlying concepts.

After completing all of the examinations with SHOW EXPLANATIONS switched on, and if time permits based on the calendar you're following, begin the process over again by retaking each examination without the explanations shown. If taking the test for the second time, you should strive to achieve a score of 85% or better to show maximum retention of the material.

Instructor Support Hotline

As a convenience to students who are preparing for their licensing exams, STC offers an instructor hotline. A student with additional questions may speak with an instructor by calling 800-STC-EXAM (800-782-3926) during normal business hours.

Series 79 Lectures, Presentations, and Products

Series 79 On-Demand™

The Series 79 On-Demand™ is a pre-recorded presentation that is delivered through the Web. This product is supported with slides, mini-quizzes, and the STC instructor hotline. The On-Demand program covers the key concepts and applications of the Series 79 Examination and allows students to pause, go back, and view the presentation numerous times. Although it is intended for students to view this lecture before attempting the final exams, many students have indicated that it was beneficial to view the On-Demand lecture again after having completed the finals exams.

Traditional and Virtual Classes

Students should also consider the benefits of attending one of the two forms of classes that STC offers for the Series 79 Examination. Our traditional classroom programs are available in many major markets in the U.S. and are conducted over the span of three days.

STC also offers instructor-led virtual classes which students may attend in any location from which Internet access is available. These classes are also conducted over the span of three days, with each session scheduled for seven hours.

Flashcards

STC's Flashcards are an ideal additional study option for students who are interested in going beyond the practice exams. The Flashcards may be used whenever and wherever Internet access is available and can be organized by course, chapter, or FINRA exam section. Although the purchase of STC's study material is not required, students are strongly encouraged to use STC's study manual along with the Flashcard product. From the date of purchase, the Flashcards are available for 60 days (for an additional fee, extra time is available).

Standardized Test Taking Tips

As with any standardized exam, students will be able to increase their score by employing good test-taking techniques. The following are a series of suggestions that STC believes will help students perform more efficiently on their multiple-choice exam:

- **Be careful when reading the question.** The most common mistakes occur when students skim the question and responses. Students should read the question once, then read the question again and put the question into their own terms.
- **Use logic or common sense when analyzing the question.** Do not just simply guess "C" and move on out of frustration. Look for cues within the question and responses. If students get stuck, they should ask themselves whether the response is true or false and attempt to eliminate the incorrect answers in that manner.
- **Pay attention to key words and phrases including** "All," "None," "Exempt," "Excluded," "Except," "Unless," "True," "False," "Always," and "Never"

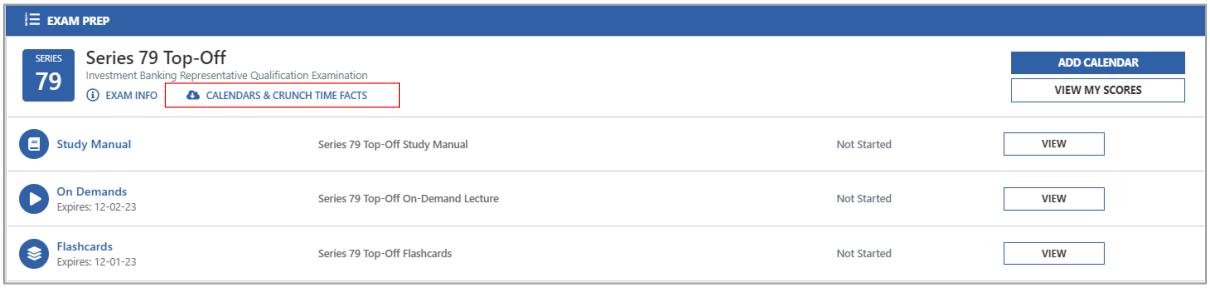
- **Do not be afraid to guess.** If all else fails, students should eliminate the statements that are wrong and make their best guess. There is no penalty for guessing. Do not allow the exam to expire without answering all of the questions.
- **Practice answering multiple-choice questions.** STC provides all students with final examinations that simulate the actual exam. These exams should be reviewed prior to the exam being scheduled.

Study Calendars

STC provides sample study calendars which are designed to help students in organizing their time and allowing for a manageable amount of daily study. Remember, these calendars are simply suggestions for how you may plan your studies. Feel free to make any modifications that you deem appropriate.

The calendars are available for download on your student dashboard on www.my.stcusa.com.

- Click on the link to "Calendars and Crunch Time Facts" that appears below the Series 79 Top-Off course title
- Choose the calendar that best fits your needs



Chapter 1

Industry Terminology and Data Collection

STC
Securities & Insurance Training

The process of matching investors who have money with issuers that need money is one of the primary purposes of the securities industry. Ultimately, the securities marketplaces and participants provide the bridge between those with capital (money) to invest and those that need the capital for financing purposes.

Issuers of Securities

An issuer is defined as a legal entity that sells securities in order to finance its operations. Issuers include businesses that need capital to grow and prosper, as well governments that typically borrow funds as a means of paying their bills or building infrastructure. Issuers include, but are not limited to:

- The U.S. Treasury and various U.S. government agencies
- Foreign governments
- State and local governments
- Corporations
- Banks

Types of Securities

There are two primary methods that issuers use to raise capital—issuing debt securities (bonds) and issuing equity securities (stocks). Let's briefly define each security type.

Debt Securities Both corporations and various government borrowers raise funds through the issuance of publicly traded loans, which are referred to as *bonds, notes,* or *debt instruments.* A bond is a security that represents the amount of indebtedness (principal) that the issuer owes to the investor. Investors who purchase bonds are considered *creditors* of the issuer and essentially lend their funds to the issuer for a specified period (until maturity).

The issuer is required to repay the principal balance of the bond at a future date and will typically make interest payments over the life of the loan. If the issuer misses an interest or principal payment, it's considered to be in *default*.

Promissory Notes A promissory note is similar to other debt securities. If the note's maturity exceeds 270 days (nine months), the SEC will typically consider it to be a security. Promissory notes that are considered securities must be registered with the SEC unless they qualify for an exemption. For example, promissory notes that are sold through a private placement are exempt from registration. The issuer of promissory notes will borrow funds and pay interest to the investor. The most common benchmark rate that these issuers use to determine the amount of interest they will pay is based on U.S. Treasury (UST) securities.

Bond Terminology and Pricing The term *basis* is derived from one method of expressing the yield or return on a bond. One *basis point* is equal to 1/100 of 1%; therefore, a 1% difference in yield equals 100 basis points (bps). For an issuer that's borrowing funds, the higher the credit quality of the issuer, the cheaper it's able to borrow funds. For example, a high quality issuer may borrow at 200 bps above the rate of U.S. Treasury securities, while a lower quality or junk bond issuer may borrow at 400 bps above the rate of U.S. Treasury securities.

If an issuer is struggling to raise capital through the offering of its bonds, it may offer a higher rate to attract investor interest (e.g., from 200 bps above UST to 225 bps above UST).

Interest-Rate Risk Investors who purchase bonds assume the risk that the market value of their investments may decline if interest rates rise—which is referred to as *interest-rate risk*. Interest-rate risk implies that, as market rates increase, investors will not be interested in purchasing existing bonds at par since they're able to obtain higher yields by purchasing new bonds. Therefore, existing bonds will need to be offered at a discount in order to attract purchasers.

Bonds with longer maturities tend to be more vulnerable to interest-rate risk than bonds with shorter maturities. When compared to bonds with similar maturities and higher coupon rates, bonds with lower coupon rates also tend to be more sensitive to interest-rate risk.

Increasing and Declining Interest Rates The most common benchmark that bond issuers use to determine the rate they will pay interest to investors is the London Interbank Offered Rate (LIBOR). For short-term securities, the rate is based on the Treasury bill rate. Finally, for intermediate or longer term securities, their rate is based on Treasury note or Treasury bond rates.

A CFO who's anticipating a declining interest rate environment, but wants to borrow funds for a long period, could issue bonds with a variable or floating rate coupon. On the other hand, a CFO who's investing surplus funds in a rising interest rate environment will expect an increase in its interest income

Call Risk A call feature on a bond is most advantageous for the issuers since it allows them to retire the bonds prior to maturity. The issuer will most likely call bonds prior to maturity if interest rates are declining. If bonds are called, the bondholders may receive par value or a premium above par value.

Equity Securities Traditionally, corporations raise capital through the issuance of stock (equity). If an investor purchases the stock, she has an ownership interest in the underlying business and, if the company is profitable, may be entitled to a portion of the profits (through a dividend distribution). The ownership interest typically doesn't have a maturity date and the payment of any dividends is voluntary for the issuer.

American Depositary Receipts (ADRs) ADRs facilitate the trading of foreign stocks in the United States. An ADR represents a claim to foreign securities while the actual underlying shares are held by U.S. banks located overseas. ADRs trade in U.S. markets, either on an exchange or over-the-counter, and are priced and pay dividends in U.S. dollars, rather than in a foreign currency.

Hybrid Securities A convertible security is a hybrid security that essentially merges a bond with an imbedded call option and permits the holder to purchase shares of common stock at a fixed price. The convertible security is issued and trades as one unit. In order to offer investors more of an incentive to buy its bonds, a corporation which has not previously offered debt securities or has a weak credit rating may issue convertible bonds. For the purchaser, the tradeoff for this opportunity is that convertible issues traditionally offer lower interest payments than similar non-convertible issues. If the bonds are converted, the debt becomes equity and the issuers' capital structure will be altered.

Rights and Warrants – Derivative Securities

Derivative securities are special types of investments that track the value of common stock or another underlying asset. For example, imagine a security which provides the owner with the opportunity to buy 100 shares of ABC stock at $75 per share regardless of how high the stock may rise. This is precisely the position in which the buyer of a warrant will find herself. If ABC rises above $75, the warrant has value since the investor is entitled to buy the shares at a price that's below the current market price. On the other hand, if ABC declines in value to below $75, the warrant will have little value since ABC stock is able to be purchased in the market at a better price than what's available through the warrant.

The following section will examine two types of derivatives that are issued by a corporation—*rights* and *warrants*.

Preemptive Rights If a corporation is seeking to raise more capital and intends to issue additional shares of stock, a *rights offering* may be conducted to provide current shareholders with the opportunity to buy the shares before they're offered to the public. By participating in the offering, the current shareholders are able to maintain their percentage of ownership in the company. If shareholders choose not to subscribe to the offering, their percentage of ownership and ability to control the company's future will be diluted by the new stock offering.

Warrants A warrant is another type of derivative on an equity security that may be issued by corporations. Like rights, warrants give the holders the ability to buy the issuer's common stock at a specified price (the subscription price) in the future.

However, unlike stock rights that have a relatively short life, warrants have a maturity that's often set years in the future. In fact, some warrants have a perpetual (endless) life.

	Rights	Warrants
Issued to:	Existing common stockholders	Purchasers of the issuer's stocks or bonds
Subscription Price:	Below current market value	Above current market value
Maturity:	Short-term (30-45 days)	Long-term (Years, not days)

Broker-Dealer

The term broker-dealer refers to the two capacities in which a firm may operate. A *broker* is defined as any person that engages in the business of effecting *agency* transactions in securities for the account of others. Essentially, brokers match up buyers and sellers and earn a commission for their efforts. As a comparison, think of how a real estate agent is employed by a real estate broker and acts on behalf of customers to earn commissions.

A *dealer* is defined as any person that engages in the business of buying and selling securities for its own account. Firms acting as dealers engage in *principal* transactions in which they buy securities directly from their clients and hold them in inventory, or they sell securities to clients from their inventory. For executing these trades, dealers are entitled to either a markup or markdown. Now, consider the similarity to a car dealer that buys for or sells from its inventory and will either markdown the car cost when buying or markup the car cost when selling.

Broker-Dealer Departments

Many brokerage firms (broker-dealers) are divided into several distinct departments.

Investment Banking (IB) Investment banking is the area that works directly with the issuers to arrange and structure their securities offerings. For example, this department may advise an issuer that intends to raise funds through an issuance of stocks, bonds, or a combination of both. Remember, investment bankers are often referred to as the *underwriters* of securities. IB may also assist companies that seek to merge with or acquire other companies (M&A) or those that need to restructure due to a bankruptcy.

Research The analysts in a firm's research department study both the markets and individual issuers in order to issue recommendations. The typical recommendations are to buy, sell, or hold.

Sales Financial professionals who work in the sales area typically market individual stocks or bonds, but also packaged products (e.g., mutual funds) to both retail investors and institutions.

Trading Trading professionals handle the execution of trades for both the firm's clients and the firm's own (proprietary) account. These trades may occur either in electronic marketplaces, such as Nasdaq, or hybrid marketplaces, such as the New York Stock Exchange (NYSE).

Operations The operations area ensures that all of the paperwork, funds, and securities transfers that are associated with a trade (or processing) are handled efficiently and according to specific industry standards. Operations personnel perform functions such as generating customer statements, confirmations, and tax records, as well as assisting in the transfer of securities and/or funds. These personnel are also responsible for ensuring that all firm and client assets are organized properly and safeguarded.

Markets

Primary Markets

The capital markets may be broken down into two basic types—primary and secondary markets. The *primary* market covers the sale of securities by issuers to investors. An example of this process is an initial public offering (IPO). An IPO represents a corporation's first public attempt to attract capital from financial institutions and the public. In a primary offering, the corporation (issuer) seeks to sell its securities directly to investors. Another example of a primary offering is the auction of Treasury bills by the U.S. government. In a primary market transaction, the key concept is that the securities are being sold by the issuer. Once the money has been raised by the issuer in the primary market, the resulting securities that are created will begin to trade in the secondary market.

Secondary Markets

Trading markets, also known as *secondary* markets, provide a system for the trading of existing financial instruments between investors. Although this resale of securities has no direct effect on the issuing entity, the ability to resell a stock or bond (liquidity) increases an investor's willingness to invest money in securities in the first place. This willingness to invest indirectly benefits corporations that seek to raise additional capital in the future. Trading markets are traditionally broken down into two categories—physical trading floors, such as the New York Stock Exchange, and electronic marketplaces, such as Nasdaq.

Third Market Electronic, internet-based trading doesn't require that orders be sent to the physical trading floor because alternative markets have emerged. The *third market* refers to exchange-listed securities being traded over-the-counter or away from traditional exchanges. While some of the trading in listed stocks still occurs on their primary exchanges, third-market volume has grown in the last several years. In a manner that's similar to traditional exchanges, the third market brings together investors and also accommodates after-hours trading.

Regulation

There are four tiers to regulation—federal laws, state laws, self-regulatory organization (SRO) rules and regulations, and firm-specific (in-house) policies and procedures. All of these different levels of regulation influence the activities of all persons who operate in the securities industry.

Federal Regulation

For broker-dealers, all of their capital raising, sales, trading, and operations activities are heavily regulated. The primary regulation comes from laws (also referred to as Acts) that have been passed by Congress. These Acts are enforced by the U.S. Securities and Exchange Commission (SEC), which is a part of the U.S. federal government.

The SEC The Securities and Exchange Commission is an independent, federal government agency that's responsible for protecting investors, maintaining fair and orderly securities trading markets, and facilitating capital formation in the primary market. The SEC is also charged with ensuring that Congress' demands are implemented.

Authority of the SEC The SEC has jurisdiction over securities transactions that are executed on an interstate basis (i.e., across state borders). The SEC may investigate potential securities law violations through its Division of Enforcement which prosecutes cases on behalf of the Commission. The SEC may also bring civil actions. If criminal activity is discovered by the Commission, the case falls under the jurisdiction of the Department of Justice (DOJ).

SRO Regulation

Although the SEC is in charge of overall regulation, the creation and enforcement of day-to-day rules that brokerage firms must follow are often handled by self-regulatory organizations (SROs), such as the Financial Industry Regulatory Authority (FINRA). The primary purpose of an SRO is to promote fair and equitable trading practices.

SRO rules require firms to use reasonable due diligence when dealing with customers and other broker-dealers. However, since SROs are not a part of the U.S. government, they lack the power to arrest or imprison any person who violates their rules. Financial service firms (e.g., broker-dealers) are required to join an SRO and are referred to as *member firms*. The employees of these member firms are referred to as *associated persons.*

The Securities Act of 1933

The Securities Act of 1933 was the first federal legislation to cover the securities industry and its main focus is the primary market. The Securities Act of 1933 demands that investors be provided with full and fair disclosure so that they're able to make informed investment decisions. The Act also provides specific rules for the conduct of both issuers and the investment bankers (underwriting firms).

The Securities Exchange Act of 1934

The Securities Exchange Act of 1934 establishes the rules for activities which are conducted in the secondary market. The two most recognized secondary markets are the New York Stock Exchange (NYSE) and Nasdaq. The Act of 1934 created the Securities and Exchange Commission (SEC) and gave it preeminent regulatory authority over domestic securities dealings in both the primary and secondary markets.

Types of Organizational Structures

Sole Proprietorship

In a *sole proprietorship*, one person owns a business and has control over all management decisions. The owner is personally liable for all of the company's debts and is entitled to all of the profits that are generated by the business. With this structure, it's the owner who's the taxable entity, not the business itself.

Corporations

Rather than establishing a sole proprietorship or partnership, many business owners choose to incorporate. For business owners, the main advantages of incorporation include:

- Not being personally responsible for the corporation's debts
- Continuity of life (i.e., unlike a partnership, a corporation continues to exist even if one of the owners dies or retires from the business)
- A centralized management structure
- Easy access to capital
- Freely transferable interests

Incorporating is a fairly straightforward matter. In most states, the process of incorporating simply involves the applicant filing certain documents with the Secretary of State and paying a fee.

C Corporation Corporations that may have an unlimited number of shareholders and are subject to regular corporate taxation are referred to as *C Corporations* (after Subchapter C of the Internal Revenue Code). C Corporations are required to pay corporate taxes on their income, while their shareholders (owners) must pay personal income taxes on any profits they receive in the form of cash dividends.

In other words, corporate earnings are subject to double taxation. Corporations do receive percentage exclusion from corporate income taxes from the receipt of dividends received from investments in common and preferred stock. Another disadvantage of a C Corporation is that its operations and reporting requirements are more complex than those of a partnership.

As a legal entity, a corporation has many of the same rights and abilities that apply to a natural person. For example, it may buy property, obtain loans, sue, and be sued. Although a corporation is owned by its shareholders, the business is considered a separate person under the law and, therefore, an individual shareholder generally may not be held personally responsible for the corporation's debts. If a business fails, the most that a shareholder may lose is her original investment—this feature is referred to as *limited liability*.

S Corporation Corporations that elect to be taxed like partnerships are referred to as *S Corporations* (after Subchapter S of the Internal Revenue Code). In order to qualify as an S Corporation, a company must meet the following requirements:

- It may have no more than 100 shareholders. For computation purposes, a husband and wife are treated as one shareholder.
- Its shareholders must all be U.S. citizens or resident aliens and must consent to the Subchapter S election.
- Its shareholders must all be individuals, estates, or certain types of trusts.
- It must be a domestic corporation with only one class of stock outstanding.
- It may not be part of an affiliated group of corporations.

For federal tax purposes, S Corporations avoid corporate taxation by electing to pass their corporate income, losses, deductions, and credits through to their shareholders. Therefore, shareholders of S Corporations report the flow-through of income and losses on their own personal tax returns and are assessed tax at their individual income tax rates. The Tax Reform Act of 2018 now provides a deduction of up to 20% of the pass-through amount. However, at the state level, there's no difference between the tax treatment afforded to an S Corporation and any other type of corporation.

S Corporation distributions that are received by shareholders reduce their basis and are considered a non-taxable return of capital. Any distributions that are made in excess of a client's basis are treated as capital gains. If a shareholder invests in an S Corporation and subsequently sells her shares, the gain is taxable as a capital gain based on the amount above her cost basis. If the shares have been held for more than one year prior to sale, the capital gain is long-term and taxable at a lower tax rate than the rate on ordinary income. The gain is immediately taxable in the year of the distribution or sale.

Limited Liability Company (LLC) As the name implies, a *limited liability company's* owners are not personally liable for the company's debts. The advantage of an LLC is that the IRS treats these companies like a partnership for tax purposes. An LLC passes through both income and losses to its owners (referred to as members); therefore, any income received by the owners will only be taxed at their individual tax rates. Compared to a C Corporation, a limited liability company has a more flexible management structure and is easier to establish.

LLCs may be created in any state; however, some states require that the company have at least two owners. The main disadvantages of an LLC are that, unlike C Corporations, it doesn't have continuity of life and the interests may not be freely transferred.

Partnership

A *partnership* is an association of two or more persons (partners) who have agreed to pool their resources to operate a business. Partnerships are more tax-efficient than corporations since the Internal Revenue Service (IRS) treats them as an extension of the individual partners, rather than as separate taxpaying entities. For that reason, any profits and losses generated by the partnership are distributed (passed through) to the partners and reported on their personal tax returns (i.e., profits are only taxed once).

General Partnership If a business is established as a general partnership, all of the partners have an equal voice in managing the business and are entitled to share in any profits that are generated based on a prearranged agreement. All of the partners have both personal liability for the partnership's debts and the right to bind the partnership to contracts. The partnership may be dissolved voluntarily by any partner, but will be dissolved automatically due to the death or disability of any one of the partners.

Limited Partnership If a business is established as a *limited partnership,* it consists of a minimum of one general partner and one limited partner. The general partner is responsible for managing the partnership's business and has unlimited liability for its debts. On the other hand, the limited partner has limited liability and contributes capital, but otherwise takes no part in managing the business.

Business Structure	Owner(s) Liability	Taxation
Sole Proprietorship	Unlimited	Flow-through tax treatment; profits and losses are reported on owner's personal tax return
C Corporation	Limited	Double taxation; initially at the corporate rate and then all distributed dividends are taxed at the owner's personal tax rate.
S Corporation	Limited	Flow-through tax treatment; profits and losses are reported on owner's personal tax return
Limited Liability Company (LLC)	Limited	Flow-through tax treatment; profits and losses are reported on owner's personal tax return
General Partnership	Unlimited	Flow-through tax treatment; profits and losses are reported on owner's personal tax return

Real Estate Investment Trust (REIT)

Real estate investment trusts raise capital and invest the proceeds in real estate-related activities and mortgages. REITs invest in many different types of residential and commercial income-producing real estate, such as apartment buildings, hotels, shopping centers, office complexes, storage facilities, hospitals, and nursing homes. An REIT's profits are derived from the rental income received from tenants and property management fees, as well as the difference between the purchase and sales prices of portfolio properties. Most real estate investment trusts attempt to provide investors with a stable dividend, based on the income being produced from the real estate activities and/or mortgages.

Equity REITs are primarily involved in owning and managing commercial real estate. *Mortgage REITs* provide financing to real estate projects through either temporary or permanent loans. Lastly, *Hybrid REITs* are involved in both ownership and lending. Typically, shares of REITs trade on an exchange and offer liquidity to their investors.

Forming a REIT The requirements for forming a REIT include the following:

- It must be organized under state laws within the U.S. and structured as a taxable corporation.
- Beginning with its second taxable year, it must meet the following two ownership tests:
  1. It must have at least 100 shareholders after its first year as a REIT
  2. No more than 50% of the stock may be owned by five or fewer shareholders (also referred to as the 5/50 test).

Tax Treatment of REITs In order to avoid the double taxation of income, REITs must meet the following IRS requirements:

- At least 75% of their total assets must be invested in real estate and cash.
- Two gross income tests:
  - At least 75% of their gross income must be realized from real estate (through rents or mortgage interest)
  - They must derive at least 95% of their gross income from the real estate sources listed above as well as dividends or interest and gains from the sale or other disposition of stock or securities from any source.
    - In other words, the additional 20% can be derived from dividends and interest
- At least 90% of their taxable income must be distributed to their shareholders annually. Therefore, if 90% of the ordinary income that REITs generate from their portfolios is distributed to shareholders, that 90% of income will only be taxed at the shareholders' level and the remaining 10% is taxed at the REIT's level. However, REITs don't pass-through operating losses.

Tax Treatment of a REIT Shareholder Any dividends that are paid to shareholders of REITs don't qualify for the reduced 20% tax rate that's given to qualified dividend distributions which are paid on common and preferred stock. Instead, the dividends being distributed by REITs are taxed as ordinary income for shareholders. However, under the Tax Reform Act of 2018, investors are permitted to deduct 20% of the divided income they receive from REITS, with the remainder being taxable at the investor's tax rate. Since the maximum tax for individuals is now 37%, the effective tax rate on REITs is now 29.6%, since 20% of the dividends paid out are deductible (37 x 80%).

Master Limited Partnerships (MLPs)

A *master limited partnership* is a limited partnership that's publicly traded on an exchange and its securities are traded in a manner that's similar to common stock. MLPs combine the tax benefits of limited partnerships (i.e., the flow through of income and losses to partners) with the liquidity of publicly traded securities. To obtain the tax benefits of a pass through investment, MLPs must receive their income from *qualifying sources* such as exploration, mining, extraction, refining of oil and gas, transportation (pipelines) and the production of alternative fuels (e.g., biodiesel). Other sources include certain passive income generators such as real property income, dividends, and gains from futures and other investment assets. In order to qualify for MLP status and ensure that its income is not subject to corporate income tax, the partnership must generate at least 90 percent of its income from these qualifying sources.

As with other forms of pass-through entities, an MLP requires investors to file Form K-1 to report their share of income, deductions, and credits. Most MLPs are valued based on a multiple of cash flow as investors purchase these securities for the cash distributions being paid quarterly. Ultimately, potential MLP investors must consider whether dealing with the potential tax complications is worth their contribution.

Types of Investors

Of course, there are retail investors who purchase securities through individual brokerage accounts or through pooled accounts (e.g., mutual funds), but there are also many different types of institutional investors.

Institutional Investors According to FINRA, an institutional investor is defined as:

- A bank and/or a savings and loan association
- An insurance company or registered investment company
- An investment adviser that's registered with the SEC under Section 203 of the Investment Advisers Act of 1940 or that's registered with a state securities commission
- A government agency or a subdivision of one
- A 403(b) employee benefit plan or a plan that meet the guidelines of Section 457 of the Internal Revenue Code (excluding the individual plan participants)
- A member firm or an associated person of a member firm, or any person who's acting on behalf of an institutional investor
- Any other entity (including a natural person, corporation, partnership, or trust) that has total assets of at least $50 million

Qualified Institutional Buyer (QIB) A QIB must generally pass the following three-part test:

1. It must be an eligible institution, such as an insurance company, registered investment company, pension plan, corporation, or registered investment adviser.
2. The buyer must be purchasing for its own account or for the account of another QIB.
3. The buyer must own and invest at least $100 million of the securities of issuers that are not affiliated with the buyer.

Hedge Funds Hedge funds are investments that resemble mutual funds; however, they're typically only offered to wealthy investors. Hedge funds often employ aggressive financial strategies such as short selling, using leverage (borrowing funds), and placing large bets on individual companies or sectors of the market. Due to the accredited status of their investors, these funds are generally not required to register with the SEC. On the other hand, a fund of hedge funds is actually a mutual fund that invests in unregistered, private hedge funds. Although hedge funds are not required to register with the SEC, funds of hedge funds are typically subject to SEC registration.

Private Equity Firms (PE Firms) Private equity firms raise capital from institutional investors and invest the proceeds in public and private companies and may also purchase divisions or subsidiaries of operating companies. In a leveraged buyout (LBO) transaction, PE firms will contribute equity and use financial leverage for acquisitions or they will take a public company private. The firms may take either a minority stake or controlling equity interest, but they generally have a predefined exit strategy. The exit strategy may include an initial public offering, a recapitalization, or the sale of the business for cash or securities.

Venture Capital Firms (VC Firms) These companies are similar to private equity firms, but they invest mainly in startup or new businesses. PE typically invest in more established companies, whereas VC firms provide seed capital. These firms are likely to invest in technology or internet-based companies.

Financial Strategies/Investment Strategies

Professional investors, such as hedge funds and other institutional investors, employ many different types of investment strategies. In fact, a fund may employ more than one type of strategy or create its own approach, but the list below explains some of the more popular strategies.

Growth Strategy This style of investing focuses on the stocks of companies or industry sectors that are expected to grow faster than those of its peers. These companies are expected to have above-average earnings or revenue growth, pay little or no dividends (since they retain most of their earnings), have higher risk (high P/E ratios), but also have higher potential for capital appreciation. Aggressive growth investing evaluates and selects prospects that are expected to have rapid or accelerated growth. Often these are smaller companies in industries such as biotechnology or software development. Also, small issuers that are located in emerging markets may be characterized as potential growth investments.

Value Investing This style of investing seeks to find companies that are underpriced from a fundamental or financial point of view. Companies that have low price-to-book ratios, low price-to-earnings ratios, and a high dividend yield often fit this method.

Growth at a Reasonable Price (GARP) This style of investing is a combination of both value and growth investing. By following this method, investors are seeking companies that have solid growth potential and appear to be undervalued. Characteristics of these companies may include low P/E ratios, low P/E-to-growth (PEG) ratios, and low price-to-book ratios.

Momentum Trading This term describes a situation in which prices are moving in a certain direction and there's a high level of trading volume. The expectation is that this pattern will continue in the near future. For example, if the S&P 500 Index has been trading with significant movements (up or down) over a period of days, along with heavy trading volume, some traders will anticipate that this pattern may continue for a few more days.

Short Sales This strategy involves the sale of a security that's not currently owned by the seller. Instead, the investor borrows the security for delivery at a future date. An investor typically sells short in anticipation of a decline in the price of the security.

> *For example, XYZ stock is currently trading at $50 per share and, because an investor anticipates a decline in XYZ's price, she sells short 100 shares of the stock at $50. At this point, her account is credited with the short sale proceeds of $5,000. Later, the market price of XYZ stock declines to $45 and the investor buys the stock in the market and closes out (covers) her short position. The result of the two transactions is a $500 gain ($5,000 in proceeds – the $4,500 cost to acquire).*

In this example, the profit was generated by the decline in the stock's price. However, the client will lose money if the value of the stock increased, since the client will be required to purchase the stock at a higher price to close out of the short position. Since there's no limit as to how high a stock's price may rise, short selling exposes the client to an unlimited potential loss. While most investors plan to profit from "buying low and selling high," a short seller takes the opposite approach by seeking to profit from selling a security first (by borrowing it from a broker-dealer) and then replacing the borrowed security by buying it back at a lower price.

Market Neutral This is a strategy in which investors attempt to profit by purchasing securities and, at the same time, selling short other securities within the same (or similar) sector. The investor identifies and purchases undervalued securities, while simultaneously identifying and selling short overvalued securities. The objective is to manage the risk of the portfolio and profit on the difference between the long and short portfolios (excess return).

Arbitrage Investing The objective of this strategy is to profit by identifying two related (although mispriced) securities. For example, an arbitrage investor establishes a long position in a convertible security (bond or preferred stock) and a short position in the underlying common stock. Another related type of strategy is called *risk arbitrage* which usually involves a merger transaction. In a cash merger, the investor attempts to purchase the shares of the target company below the announced merger price. The investor profits by either receiving the difference between the merger price and his cost basis or by receiving a higher offer price. In a stock transaction, a risk arbitrage investor buys the stock of the target company and sells short the stock of the acquiring company. Since there are many variables with a proposed merger transaction, it comes with a considerable amount of risk.

Index Investing This is a form of passive investing (passive management) that's designed to minimize transaction costs and taxable events (capital gains). This strategy is often accomplished by constructing a portfolio that mirrors an index, such as an exchange-traded fund or mutual fund that's designed to replicate an index (e.g., the S&P 500 or the Nasdaq 100). Conversely, active management occurs when a portfolio manager frequently trades the securities in a portfolio in an attempt to achieve results that outperform an index.

Distressed Investing This strategy involves investors actively searching for companies and/or securities that are in default, bankruptcy, or are moving in that direction. To be better positioned in the event of a corporate restructuring, these investors typically purchase the bank debt or fixed-income securities of the issuer, rather than the equity of these companies. Some of the investors that employ this investment strategy include hedge funds, private equity firms, investment banks, and mutual funds.

Deep Value Investing This refers to a high-risk investment strategy in which an investor purchases stocks which are selling at low price-to-earnings ratio and/or low price-to-book value ratios, as well as from industries that are out-of-favor. These companies usually trade at extremely low valuations as compared to value investing. With value investing, the stocks are trading at lower, but not deep, valuations to the market.

Organic Growth and Inorganic Growth

There are two methods by which a company can grow its revenues—organic growth and inorganic growth. Organic growth occurs if a company sells more of the same products or services to existing customers, if it expands its product line or increases its market share, offers a new product or service to existing customers, offers new products that may be sold to new customers (such as a niche product), or sells more of the same products to new customers. On the other hand, inorganic growth occurs as the result of a merger or acquisition. For example, offering a new product or expanding market share through the acquisition of another company that operates a related business is an example of inorganic growth. Therefore, if a media company creates its own new content to increase its revenue, it's considered organic growth; however, if it purchases a company to offer new programming, it's considered inorganic growth.

Reports, Forms, and Schedules

For an investment banking representative, it's important to understand the information that may be found in the various forms, schedules, and reports that are required to be filed according to the Securities Exchange Act of 1934. The SEC provides free access to all of its filings through its Electronic Data Gathering, Analysis, and Retrieval (EDGAR) system.

Reporting Requirements for Public Companies

A publicly traded company is required to register with the SEC if it has total assets of more than $10 million that are held of record by either (1) 2,000 or more persons, or (2) 500 or more persons who are not accredited investors, or if its securities trade on a national securities exchange (e.g., the NYSE or Nasdaq). This registration requirement is in addition to the requirement for the issuer to register its securities under the Securities Act of 1933 at the time that they're first offered to the public. For example, a private company that has fewer than 2,000 shareholders is not required to file reports with the SEC. Under the Act of 1934, issuers whose securities are registered with the SEC must file an annual report on Form 10-K and quarterly reports on Form 10-Q. These issuers are referred to as *reporting companies*.

Forms 10-K and 10-Q An SEC reporting company is required to file a Form 10-Q after the end of each of the first three fiscal quarters of its fiscal year. Form 10-Q states in its instructions that no report is required to be filed for the fourth quarter of any fiscal year since the last quarter's results are included in the company's annual Form 10-K.

Form 10-K provides information that a company is required to disclose to the SEC and also make available to the public, including:

- The business line and assets of the company
- Any legal proceedings in which the company is involved
- Risk factors
- Footnotes of accounting policies
- The market for the company's equity securities
- The number of outstanding shares
- Audited financial statements
  - Balance sheets for the last two fiscal years
  - Income and cash flow statements for the last three fiscal years

- Management's comments on the firm's financial condition
- A list of the company's directors and executive officers, as well as their cash and non-cash compensation

Form 10-Q and Form 10-K differ in several ways:

- Financial statements are not required to be audited and only go back to the previous fiscal year
- There's no listing of large shareholders
- Only one principal officer must sign the 10-Q

The annual report contains information which is similar to what's found in the 10-K, but is typically formatted in a more presentable way. The annual report is sent to the shareholders and must be signed by the principal executive officer, financial officer, controller, and a majority of the board of directors. The chairman of the board is not specifically required to sign the annual report, as long as a majority of the board members have signed it.

The required timing for the filing of these reports is based on the category of the filer.

- *A large accelerated filer* has a public float of $700 million or more, has filed one annual report (Form 10-K), and has been subject to SEC reporting requirements for least 12 months. This type of company is required to file Form 10-K within 60 days after the end of the fiscal year and Form 10-Q within 40 days after the end of the fiscal quarter.
- *An accelerated filer* has a public float of at least $75 million, but less than $700 million, has filed one annual report (Form 10-K), and has been subject to SEC reporting requirements for least 12 months. This type of company is required to file Form 10-K within 75 days after the end of the fiscal year and Form 10-Q within 40 days after the end of the fiscal quarter.
- If a company's public float is less than $75 million, it's defined as a *non-accelerated filer* and is required to file Form 10-K within 90 days after the end of the fiscal year and Form 10-Q within 45 days after the end of the fiscal quarter.

Since this document gives a detailed overview of the company's results for the past year as well as its business, an investment banking representative is able to obtain the company's audited financial statements from it. Information from the financial statements is necessary to create the ratios, models, and valuation metrics that are used by the firm's investment banking department.

Form 8-K If an event occurs that could *materially* affect the issuer's financial condition or share price, disclosure must be provided to the SEC on Form 8-K *within four business days* of the event's occurrence. The form is broken down into the following nine sections:

1. Business and Operations—Termination of a material definitive agreement or bankruptcy or receivership
2. Financial Information—Completion of an acquisition or disposition of an asset, results of operations and financial condition, an off-balance-sheet arrangement, and material impairment
3. Securities and Trading Markets—Notice of delisting or the unregistered sale of equity securities
4. Accountants and Financial Statements—Change in the certifying accountant
5. Corporate Governance and Management—Change in control of the company, the resignation or election of a director, amendments to corporate bylaws, code of ethics, and change in shell-company status

6. Asset-Backed Securities—Securities Act updating disclosures, failure to make a required distribution, and change in servicer or trustee
7. Financial Statements and Exhibits—The latest financial statement, which is included in the press release announcing the company's latest financial results
8. Other Events—Material events that are not listed in the form
9. Regulation FD (Fair Disclosure)

Compliance with Regulation FD Under Regulation FD, issuers that make disclosure of material, non-public information must do so publicly. In the event that an issuer accidentally discloses material, non-public information to a person who may trade the issuer's securities based on that information, the issuer must publicly disclose the information promptly thereafter. Public disclosure may be provided by the issuer on a Form 8-K filing or in a way that's broad and doesn't exclude members of the public. Reg FD will be covered in greater detail in a subsequent chapter.

Schedules 13D and 13G Section 13(D) of the Securities Exchange Act requires that if any person or group acquires *more* than 5% of an issuer's equity securities, notification must be made to the issuer, the exchange on which the securities are traded, and to the SEC within 10 days after the acquisition. If a number of individual funds and/or investors form a group and own more than 5% of the equity, they're required to file a Schedule 13D. Under the Securities Exchange Act, a group is defined as persons who agree to act together for the purpose of acquiring, holding, voting, or selling the equity securities of an issuer.

When filing a Schedule 13D, a person is required to provide certain information, such as:

- The issuer and the security
- The identity and background of the filer (e.g., whether an individual or a group)
- The source and amount of funds or considerations that were used for the purchase. This section will indicate whether the funds being used to purchase the securities were borrowed or if they were derived from an existing cash position of the filer.
- The purpose of the transaction. This is a very important section and indicates whether the filer intends to acquire the company, is purchasing the shares based on the belief that the shares are undervalued, or for any other reason.
- The interest in securities of the issuer, the number of shares, and the filer's percentage of ownership
- The contracts or relationships with respect to securities of the issuer. The filer may have a standstill agreement with the issuer which restricts it from taking certain actions.
- Any material to be filed as exhibits. For example, a merger agreement or tender offer agreement if that's the purpose of the filer's transaction, or a Schedule 13D that was filed under a joint filing agreement.

If there are any material change made to the information that was filed in Schedule 13D, the person must promptly file an amendment. Examples of material changes include the purchase or sale of 1% or more of the issuer's shares or a change in the purpose of the transaction.

Schedule 13G is an alternative to Schedule 13D and is typically filed by institutional investors that have no intention of influencing or controlling the issue (i.e., passive investors). The filing must be made within 45 days of the end of the year in which the beneficial owner acquired more than 5%, as well as within 10 days of the end of the month in which an investor's ownership first exceeds 10%.

Form 13F SEC Rule 13f-1 of the Securities Exchange Act of 1934 requires institutional investment managers (e.g., investment companies, holding companies, and hedge funds) to make quarterly filings if they exercise investment discretion over at least $100 million in equity securities. If the reporting level is reached as of the end of any month, Form 13F must be filed with the SEC within 45 days of the quarter's end. The form includes information concerning the equity securities that are owned by the filer and must be filed regardless of whether the filer is registered with the SEC.

This filing is an effective source of information to determine the number of shares of all companies that are owned by an investment manager. Additionally, if a firm intends to register with the SEC as an investment adviser, it must file a two-part registration document that's referred to as Form ADV.

Beneficial Ownership (Insider) Reports

According to SEC Rule 16a-1, an insider is defined as a director, officer, or owner of more than 10% of the stock of a corporation. Insiders are considered to have the ability to control or influence the actions of the corporation.

Forms 3, 4, and 5 Once a person becomes an insider, she's required to report to the SEC the amount of securities that she owns within 10 days of becoming an insider (*accomplished by filing Form 3*). The person is also required to report any changes in her position by no later than the second business day following the change in position (*accomplished by filing Form 4*). And lastly, an insider is required to make an annual filing that relates to certain transactions, such as gifts (*accomplished by filing Form 5*).

Short-Swing Profits To prevent the unfair use of non-public information, insiders are prohibited from taking certain actions related to the stock of the corporation with which they're affiliated.

Insiders may not sell the stock short; however, in some cases, a person may use a technique that's referred to as shorting against the box (i.e., executing a short sale against a long position that's held elsewhere) to ensure the timely delivery of securities that may be in legal transfer.

Insiders are also prohibited from keeping short-swing profits in the stock of the corporation for which they're insiders. A *short-swing profit* is defined as a profit that's earned on stock that has been held for less than six months from its purchase. For example, if an insider sells stock at a profit within six months of its acquisition, the corporation may sue for recovery of the profit (a process that's referred to as *disgorgement*). This restriction also applies if an insider sells stock that was held longer than six months, but then repurchases it within six months of the sale at a price that's lower than the previous sale price.

Proxy Statements

A proxy statement is a document that's issued by an SEC reporting company when it's seeking votes from its shareholders. There are two types of proxy statements—*the preliminary and definitive proxy*.

A preliminary proxy is used to notify the SEC of an impending shareholder voting issue that's unexpected, out of the ordinary, or unusual. The purpose of the filing is for the issuer to ensure the SEC that shareholders are being provided with full and fair disclosure and that they're able to make an informed decision about matters that will arise at an annual stockholders' meeting.

Once the preliminary proxy has been filed and amendments (if any) are made, the definitive proxy is sent to shareholders. (The preliminary proxy is essentially a rough draft of the definitive proxy, which requires review by the SEC prior to dissemination to shareholders.)

Proxy Filing Both types of proxies are filed with the SEC using Form 14A. The preliminary proxy is filed with the SEC at least 10 days prior to the date on which the definitive proxy is sent to shareholders. On the other hand, the definitive proxy is required to be filed with the SEC by no later than the date on which it's first sent to shareholders. For exam purposes, a common scenario that requires a preliminary proxy is a proposed merger or takeover. For ordinary or routine voting issues (e.g., voting on directorships or the election/approval of a company's accountant), there's no requirement to file a preliminary proxy.

Annual Proxy According to SEC Rule 14c-2, an issuer is generally required to provide a proxy statement or an annual report to its shareholders at least 20 calendar days prior to its annual meeting date. However, there's an exception to this rule when the issuer is sending its shareholders a notice regarding the internet availability of its annual proxy statement.

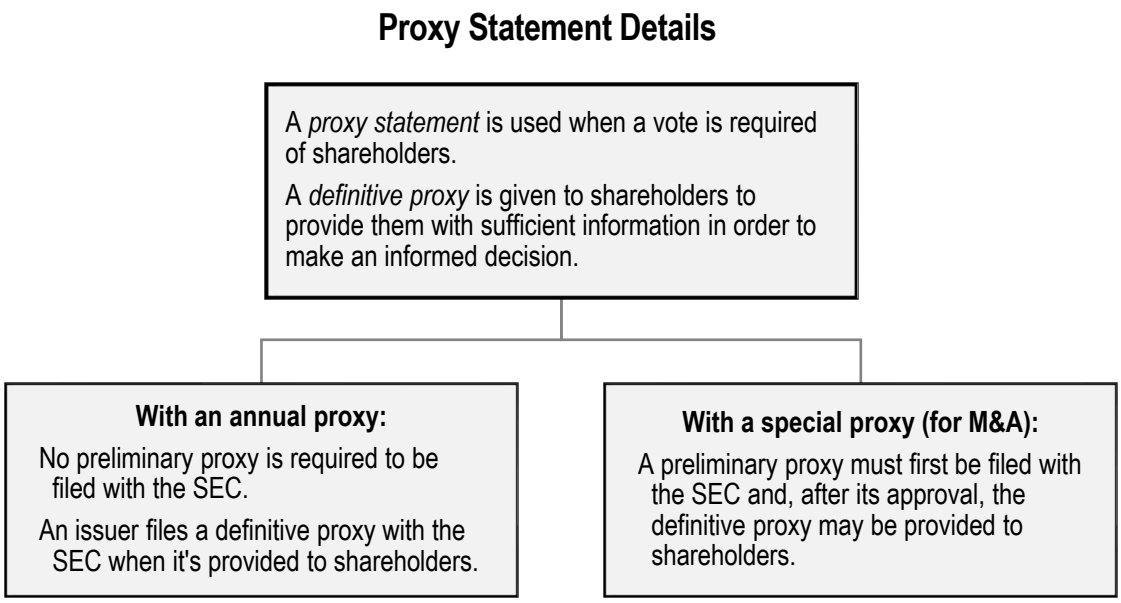
If this is the case, notification must be made at least 40 days prior to the meeting date. The notice will inform its shareholders regarding the process for obtaining proxy materials free of charge through a website.

The annual proxy statement contains:

- The names of the members of the board of directors
- Detailed information concerning executive compensation (stock options and change of control payments)
- Ownership of securities by holders of 5% or more of the company's common stock (based on 13D and 13G filings)
- The name of the independent public accounting firm that performs the audit, and other information which relates to matters that will be voted on at the annual shareholders' meeting.

Shareholder proposals will be presented with a supporting statement and the BOD's response—either for or against. The proxy doesn't include the voting records of board members or the results of board votes. In addition, proxies don't include the minutes from board of director meetings.

Special Proxies Certain M&A transactions and business combinations, such as proposals to be purchased for cash or spin-offs, require the filing of a preliminary proxy. These documents are a great source of information for business combinations. A company that's planning these types of events will hold a special meeting for shareholders to vote on the proposal. The information that's relevant to the transition will be contained in the proxy statement. These types of proxies will be discussed in greater detail in subsequent chapters.



Section 10A of the Securities Exchange Act of 1934

The Securities Exchange Act of 1934 addresses audit procedures and responses to audit discoveries. All issuers of securities are required to have audited financial statements prepared by a registered public accounting firm and, in accordance with generally accepted auditing standards, each audit must include:

- Procedures that are designed to provide reasonable assurance of being able to detect illegal acts that will have a direct and material impact on the determination of financial statement amounts
- Procedures that are designed to identify related party transactions that are material to the financial statements
- An evaluation as to whether the issuer is doubtful to continue as a going concern during the ensuing fiscal year

Sarbanes-Oxley Act

In 2002, Congress passed the Sarbanes-Oxley Act, also referred to as SARBOX or SOX, in response to a series of accounting scandals and bankruptcies involving public corporations. The Act required the SEC to implement new disclosure and corporate governance rules for publicly traded companies. These rules make senior management more directly accountable for the company's internal control system and the financial information that it releases to the public.

Major Components

The following is a summary of the major components of this legislation:

Annual Reports A company's management must institute a system of internal controls so that its financial reports will be as accurate and reliable as possible. Both an assessment of the effectiveness of these controls and an attestation by the company's public accounting firm must be contained in the company's annual report.

Financial Disclosure Annual and quarterly reports that are filed with the SEC must disclose all material off-balance sheet transactions. Companies that use non-GAAP (pro forma) financial data must also include the comparable GAAP calculations and a reconciliation of the two sets of figures.

CEO and CFO Certifications of Annual and Quarterly Reports The Act requires the principal executive officer and the principal financial officer (also referred to as the chief executive officer and chief financial officer) of a public company to personally certify that the company's quarterly and annual reports are accurate and complete. Also, effective controls and procedures must be established that relate to the disclosure of all material information. SARBOX uses the phrase "based on the officer's knowledge" since there may be errors and omissions that are tied to information of which the signing officer had no knowledge.

Loans to Officers and Directors Sarbanes-Oxley prohibits publicly traded companies from making personal loans to their executive officers and directors. However, this prohibition doesn't apply to executives of lending institutions who do so in the ordinary course of their business or to executives of broker-dealers who use loans to purchase securities in margin accounts.

Disclosure of Insider Transactions Under the Act, all insider transactions are now reported electronically by the end of the second day following the date of the transaction. The company must also make this information available to the public on its website.

Code of Ethics for Senior Executives The Act requires all public companies to either establish a formal code of ethics for their principal executive and financial officers or to disclose in their annual report the reason for not having a code of ethics. However, under NYSE rules, all listed issuers must have a formal code of ethics.

Section 404 Section 404 of the Sarbanes-Oxley Act requires an SEC reporting company (a public company) and its internal auditor (accounting firm) to test the internal controls that are relevant to its financial reporting. This "stress test" is considered to be the most costly component of SARBOX and ultimately has a greater impact on smaller firms. Although the requirements are only applicable to public companies, many private companies voluntarily comply with Section 404 as part of their best practices. Any private company that seeks to go public or is acquired by a public company must comply with Section 404.

Audit Committee

Listed below are some rules concerning the audit committee of an SEC reporting company:

- According to SARBOX, it's a general requirement for each member of the audit committee to also be a member of the issuer's board of directors and be independent.
- According to Regulation S-K (discussed in a later chapter), an issuer must disclose whether it has at least one audit committee financial expert severing on its audit committee.
  - If the issuer has a financial expert(s) on its audit committee, it must disclose the name(s).
    - A financial expert is generally defined as a person who understands GAAP and financial statements, has audit experience, is able to evaluate financial statements, and understands both the internal controls over reporting systems and the audit committee functions.

- According to the listing requirements of the NYSE and Nasdaq, an issuer must have at least one person on the audit committee who's considered a financial expert.

As a standard practice, most reporting issuers have at least one financial expert serving on their audit committee.

Illegal Act When conducting an audit, if an issuer's outside auditor (the accountants) determines that an illegal act may have occurred, it should be first reported to the audit committee of the board of directors. In some circumstances, law enforcement and the SEC should also be notified.

Chapter 1 Summary

Now that you've completed this chapter, for the following commonly tested concepts, you should be able to:

- Identify different types of issuers
- Define the terms related to debt securities
  - Promissory notes
  - Bond pricing (points and basis points)
  - Call risk
- Understand the effect of changing interest rates on bond prices
- Define the terms related to equity securities
- Describe the characteristics of ADRs
- Describe the characteristics of hybrid/convertible securities
- Define the terms related to derivative securities
  - Compare and contrast rights and warrants (*see table in chapter*)
- Understand the role of a broker-dealer
  - Agent versus principal
  - The functions of the different departments
- Recognize the differences between the primary market and secondary market
- Understand the role and functions of regulators (i.e., the SEC versus SROs)
- Recognize the different organizational structures for businesses
  - S corporations versus C corporations
    - The tax treatment and liability of owners (*see table in chapter*)
- Understand REITs and the different types
  - Rules for forming a REIT
  - Tax and income distribution rules for REITs
  - Tax treatment of dividends to shareholders
- Define the *term master limited partnership (MLP);* understand the tax treatment and valuation method
- Define the terms *institutional investor* and *QIB* and recognize the different examples
- Recognize the characteristics of hedge funds, private equity funds, and venture capital funds
- Recognize and understand the different investment strategies
  - Growth, value, GARP, arbitrage, distressed companies, short selling
- Understand the difference between organic and inorganic growth

- Define the term *SEC-reporting company* and its requirements
- Recognize the information that's required in a Form 10-K
- Recognize the difference between a Form 10-K and 10-Q
- Identify who signs the annual report
- Recognize the different categories of filers and the timing requirements for their reports
- Understand the purpose and timing of Form 8-K filings
- Understand the definitions and differences between Schedules 13D, 13G, and 13F
  - Including the timing/frequency and information included
- Understand the definition of an insider, prohibited activities, and the required reports
  - Form 3, Form 4, and Form 5
- Recognize the definitions, required information, and filing requirements of the various proxy statements
  - Annual proxy and special proxy (use of a preliminary proxy)
- Understand the SEC audit requirements as well as the procedures and information that must be included
- Understand the purpose and requirements of the Sarbanes Oxley Act
- Recognize audit committee rules and requirements

Create a Chapter 1 Custom Exam

Now that you've completed Chapter 1, log in to *my.stcusa.com*. From your Dashboard, select *Final Exams*, then scroll down and select *Create a Custom Exam*. Now, select *Chapter 1* and, at the bottom of the screen, enter 10 questions in the *Number of Questions* box, and then select *Build Exam*.

Chapter 2

Public Offerings

STC
Securities & Insurance Training

Types of Financing Transactions

Financing Alternatives

Public Offerings Securities may be offered or issued in two ways—public offerings and private placements. The primary advantage of a public offering is that an unlimited number of investors (both retail and institutional) are permitted to participate. However, the disadvantages of a public offering include the regulatory costs (legal and accounting) and time required to fulfill the disclosure requirements of the Securities Act of 1933.

Initial Public Offering (IPO) Versus Follow-On Offering When an issuer offers its securities to the public for the first time, the process is referred to as an initial public offering (IPO). Most issuers that conduct IPOs are selling common stock or other equity securities in order to raise capital. An IPO issuer generally offers its securities to a large number of investors and is often able to maintain majority ownership of the company in the hands of its original owners. The offering price is non-negotiable and the investors are not able to insist on the same demands that institutional investors place on private placement issuers. On the other hand, if a company has already gone public and intends to raise additional capital through a sale of common stock, it's conducting a *follow-on* offering. One of the major differences between an IPO and follow-on offering is that when an issuer conducts an IPO there's no previous market value; however, with a follow-on offering, the market value has already been established.

A *primary offering* is when the issuer is selling securities which will result in the company raising capital and the number of shares outstanding increasing. A *secondary offering* is when selling shareholders, such as insiders and other large owners of the issuer's stock, are offering their shares publicly which neither raises capital nor increases the number of shares outstanding.

Combined (Split) Offerings In a combined offering, some of the shares are offered by the issuer, while the remainder is offered by selling shareholders. The shares being sold by the company are newly created, constitute a primary offering, and increase the company's number of outstanding shares. The company issuing the securities receives the proceeds on this portion of the sale. When the company's existing shares are sold by some of its current (selling) shareholders, it's considered a secondary offering. The selling shareholders receive the proceeds on this portion of the offering, not the issuer.

If the offering is both a primary and secondary offering (split), it's imperative for the underwriters to disclose to any purchaser that a portion of the offering's proceeds will be paid to the selling shareholders. Selling shareholders may include officers of the company or early-entrance investors (e.g., the institutional investors that were mentioned previously) that are seeking to either cash out or reduce their holdings in the company.

Private Placements In some cases, institutional investors (e.g., pension funds, insurance companies, venture capitalists, and private equity investors) provide start-up capital to new companies. The capital is typically raised through a form of non-public offering that's referred to as a *private placement*. The primary advantages of a private placement are that it's faster and less costly than a public offering. However, there may be limits as to the type and number of investors that may participate in these types of transactions.

A private company that's in need of raising capital may have numerous financing options available. Some of the factors that affect the company's choices are its financial stability, profitability, name recognition, management team, and industry sector. In exchange for agreeing to invest its capital, a venture capital (VC) firm usually demands a large equity percentage or even majority ownership in the company. The VC firm may even negotiate for possible involvement in the management of the business.

A private placement of equity securities generally requires the company to offer a fixed-dollar price per share. The providers of capital (i.e., private placement purchasers) have a stronger negotiating position than the issuer does regarding the price of the shares. Since a private placement is sold to sophisticated investors, the purchasers normally demand a more attractive price per share for the same amount of capital being invested as compared to what retail investors expect to pay for a public offering of securities. Private placements are discussed in detail in a subsequent chapter.

If an issuing company offers non-convertible debt, it doesn't give up any equity in the firm. However, this type of offering may be difficult for a newly established private company since investors may not be willing to purchase debt securities being issued by a company that lacks an established track record.

Private Investment in Public Equity (PIPE) A PIPE offering is the private placement of securities of an already public company that's made to selected large or institutional investors (frequently hedge funds). From the issuer's perspective, the PIPE provides additional access to the equity markets, but through a process by which it may sell restricted (unregistered) securities at a discount to their current market price. In this case, the issuer already has public shares that are trading and this is simply an additional offering to investors under a securities purchase agreement. After the offering, the issuer often promises to register the shares within a short period of time (possibly days) through a resale registration statement.

The price discount is in part a reflection of the increase in the number of shares that become outstanding (potential dilution), but it's also due to the perception that the company is not only in need of capital, but that it has limited means available to raise the capital. Prior to the offering, a registered salesperson is permitted to solicit and accept indications of interest from investors for the purchase of shares through the PIPE offering. PIPE financing investors often hold the restricted securities for a short period and seek to quickly resell them in the public marketplace.

Registration Rights

When venture capitalists, private equity funds, and other large investors own shares of a private company, they may negotiate for registration rights. When an issuer conducts a public offering (IPO or follow-on offering), it's through the use of *demand registration rights* and *piggyback registration rights* that an investor is able to register and sell the securities (an exit strategy).

Investors purchasing securities as part of a private placement may also negotiate to have this provision since, if it's included, they will be able to sell a certain amount of their restricted securities without being required to comply with the volume limitations of a Rule 144 sale (covered later in this chapter). If included, the issuer agrees to notify these investors in advance of any offering and register its common shares or the underlying common shares upon conversion (in the case of the warrants) and pay all related expenses incurred in the registration. *Demand registration rights* create an obligation for an issuer to file a registration statement that covers any potential sale under certain conditions and *piggyback registration rights* allow investors to sell their shares.

Basically, demand registration rights force a company to register its shares so that the investors are able to sell them publicly. On the other hand, piggyback registration rights give investors the ability to register their shares when a company conducts a public offering. However, the piggyback registration rights don't entitle investors to initiate an offering; instead, they're merely entitled to include their shares in the event of an offering. For this reason, piggyback registration rights are inferior to demand registration rights.

Securities Act of 1933

A significant provision of the Securities Act of 1933 is that non-exempt securities are required to be registered. The process of securities registration includes the filing of a registration statement with the SEC. Section 5 of the Act states that it's unlawful to use an instrument of interstate commerce to sell a security, unless a registration statement is in effect. The Act allows foreign governments, as well as companies that lack a specific business plan (i.e., blank check companies), to register their securities and raise capital in the U.S. Since there's no requirement for a company to have an operational history or to be profitable prior to registering its securities, even development stage companies may issue shares under the Act of 1933.

The Securities Act of 1933 attempts to prevent fraud in the sale of new issues by requiring that investors be provided with enough relevant information about the offering to make an informed investment decision. This information is provided through the *registration statement* which is a public document that issuers file with the SEC. The registration statement is designed to provide full disclosure of all material information about both the issuer and the offering.

Under the Securities Act of 1933, a registration statement must contain the following details:

- The character of the issuer's business
- A balance sheet that was created within 90 days prior to the filing of the registration statement
- Financial statements that show profits and losses for the latest fiscal year and for the two preceding fiscal years
- The amount of capitalization and the intended use of the proceeds
- The monies paid to affiliated persons or businesses of the issuer
- The ownership of senior officers, directors, and underwriters, as well as the identification of any individuals who hold at least 10% of the company's securities

Issuers are also required to prepare a *prospectus* for distribution to potential purchasers. The prospectus is essentially an abbreviated version of the registration statement. Since both the issuer and the managing underwriter have liability for any omissions and/or inaccuracies in the documents being provided to shareholders, the managing underwriter must review all disclosure documents.

SEC Registration Forms

Form S-1 Form S-1 (or F-1 for foreign private issuers) is the registration form that's used for most initial public offerings. The form includes all of the relevant information concerning the issuer's business, competition, use of proceeds, risk factors, financial statements, and other important disclosures. For example, if an investment banking representative wants to review the business details of a private company that recently went public, she could review its S-1 filing since it's often difficult to find relevant information on this type of business.

In addition, by reviewing recent S-1 Forms, the investment banker may be better able to assist an issuer in its capital raising plans by gaining a sense of the market for IPOs. The volume of S-1 filings is also a great source of information to determine whether there may be a registration delay based on pending applications.

Form S-3 An S-3 registration statement is often referred to as a short form registration. The minimum requirement for an issuer to utilize an S-3 filing is a public float of $75 million in voting and non-voting common equity. Additionally, the issuer must have been filing reports under the Securities Exchange Act of 1934 for a minimum of 12 months. A large public company, such as a well-known seasoned issuer (WKSI), which will be discussed in detail soon uses a Form S-3 to file a shelf registration that will permit it to sell securities over a three-year period. Each time the issuer offers securities, it must file both a preliminary and a final prospectus supplement with the SEC for the specific securities being issued. An issuer is prohibited from filing an S-3 registration statement if it has failed to pay a dividend on any issue of its preferred stock, failed to pay interest on a bond, or if it's delinquent in its SEC filings.

A Form F-3 may be used by foreign private issuers that have a (worldwide) public float of at least $75 million.

Form S-4 For situations in which securities are being offered as a result of business combinations, such as mergers, acquisitions, consolidations, reclassifications of securities, or transfers of corporate assets, the SEC requires the issuer to file Form S-4. When securities are offered in this manner, the SEC believes that investors should still be afforded the protection of securities laws. S-4 filing are discussed in great detail in a later chapter.

Form S-8 Form S-8 is filed with the SEC in order to register securities that are made available through employee benefit plans.

Form S-11 Form S-11 is filed with the SEC in order to register securities that are being issued by a real estate investment trust (REIT).

The IPO Registration Process

Next, let's examine the IPO registration process for securities (which is similar to the process used for follow-on offerings). The process includes the following three phases:

1. The preregistration period
2. The cooling-off (waiting) period
3. The post-effective period

The Preregistration or Pre-Filing Period

During the preregistration phase, an issuer begins by preparing its registration statement (Form S-1). Once the registration statement is completed, the issuer files it with the SEC. The date on which it's filed marks the end of the preregistration period. An underwriter will often assist the issuer during this process; however, the underwriter may not yet discuss the new issue with its customers. It's during this period that the due diligence process begins for the managing underwriter.

Due Diligence The Securities Act of 1933 also establishes the responsibilities of the underwriters and any persons that assist in the preparation of the registration statement or the sale of the new issue. Such persons may be liable for false or misleading information contained in the registration statement and prospectus. To safeguard against potential problems, the underwriters are required to perform a due diligence investigation of both the issuer and the offering.

If an investment banking professional discovers misleading or inaccurate information when she's reviewing a registration statement of an issuer, the best course of action is to contact the issuer's legal counsel so that the error can be corrected. Issuers (not bankers) file registration statements which are reviewed by their legal representatives. The banker will neither rewrite the information nor suggest that the issuer make it correct since this is generally the responsibility of the issuer's legal representative.

A final meeting, referred to as the *bring down due diligence meeting,* is held prior to the issuance of the final prospectus. The term *bring down* refers to the process of ensuring that all of the parties involved in the offering (the underwriter, issuer, attorneys, and other interested parties) are brought up-to-date since the previous due diligence meeting. Essentially, all interested parties must be certain that the information being published in the final prospectus is complete and accurate.

The Cooling-Off Period

The second phase in the registration process is the cooling-off or waiting period. As a general rule, the effective date of a registration statement is the twentieth day after the filing date. Any amendment filed to a registration statement prior to the effective date will initiate the 20-day period. During this period, the SEC simply reviews the information contained in the prospectus to ensure that there's adequate information concerning the securities being offered; however, it doesn't attest to its accuracy. Remember, the SEC does *not* judge the investment merits of the issue or the appropriateness of the pricing of the issue.

The cover of a prospectus will include the SEC's no-approval clause to indicate that the SEC neither approves nor disapproves of the securities being offered. The SEC doesn't evaluate the merits of any transaction or determine whether the investment is appropriate for an investor. The responsibility for complete and accurate disclosure lies with the issuer and others involved in the preparation of a company's filings, not the SEC. If the SEC believes the registration statement to be incomplete or misleading, it sends a *deficiency letter* to the issuer. The issuer must then refile an amended registration statement for SEC review which will restart the 20-day period.

If any material information is added or altered with respect to the original filing, an amended Form S-1 is filed. Some of these events include stale or outdated financial statements, a change in the number of shares being offered, material changes related to the issuer's business, change of officers or directors, and additional required exhibits. If amendments are made under certain limited conditions, it will not delay the effective date. These conditions are:

- The registration statement is for registering additional securities of the same class as were included in the original registration statement.
- The new registration statement registers additional securities in an amount and price that represent together no more than 20% of the maximum offering price included in an earlier registration statement.

Red Herring During the cooling-off period, broker-dealers are able to send a condensed form of the registration statement to potential buyers. This document is referred to as the *preliminary prospectus* or *red herring*. The red herring has a statement on its cover page (in red ink) to indicate that a registration statement has been filed with the SEC, but has not yet become effective. Also, the final offering price is not included in the red herring; instead, it may indicate a price range (e.g., $14 to $17 per share). Five copies of the red herring must be filed with an issuer's registration statement.

During the cooling-off period:

Underwriters are permitted to:	Underwriters are prohibited from:
▪ Discuss the issue ▪ Provide the red herring to potential purchasers ▪ Record the names of persons who provide indications of interest (the indications are non-binding)	▪ Accepting payment for the new issue in advance ▪ Selling the new issue (since the deal has not been priced and is not yet effective)

Signatures An issuer's registration statement must be signed by the registrant, its principal executive officer(s), its principal financial officer, its controller or principal accounting officer, and by at least a majority of the board of directors or persons who perform similar functions. The term "principal" is used by the SEC, but the more common term is chief executive officer (CEO) or chief financial officer (CFO).

Blue Sky Laws While still in the cooling-off period, in addition to satisfying SEC registration requirements, issuers are required to comply with applicable state registration laws. State securities laws are established under the *Uniform Securities Act (USA)* and are often referred to as *Blue-Sky Laws*.

An issuer's only requirement is to register the securities in states in which the securities will be offered. Broker-dealers and their representatives are required to register in any state in which they're offering the securities to clients who reside in that state. If the broker-dealers and representatives are not properly registered, or if they violate state securities regulations, the state Administrator may take action against them.

Firms should have systems and procedures in place to ensure that securities are being sold only in states in which they're registered. Safeguards may include account coding in an effort to prevent transactions in states where no valid registration exists for the securities.

Accelerated Effective Date The *effective date* of a registration statement is generally 20 days after filing the last amendment. The effective date represents the end of the cooling-off period and the beginning of the post-effective period. If an issuer files what it considers to be the final amendment and doesn't want to wait 20 days to issue its securities, it may request an accelerated effective date from the SEC.

The request may be made orally or in writing by the issuer and the managing underwriter. The issuer may request a specific hour in the day when it wants the offering to be effective, but the SEC must be notified by no later than the second business day before the requested date.

The Post-Effective Period

On the effective date, the *public offering price* (POP) is usually set by the underwriters and it's at this point that sales of the offering may begin. Purchasers must be provided with a copy of the final prospectus which will now include the public offering price. This final prospectus must be delivered to purchasers by no later than the time a sale is confirmed.

Once the offering price is established, the information that was originally omitted in the registration is contained in a final prospectus that's filed with the SEC. This includes the offering price and other information based on the offering proceeds, such as the underwriting spread, the underwriter's allocation, and the proceeds to the issuer. This allows the issuer to offer the securities at a price that's outside of the range that was disclosed in the preliminary prospectus without filing an amendment; however this is contingent on the final price being included in the final prospectus.

For example, if the price range in the red herring was disclosed as between $17.00 and $20.00, but the final price was $15.00, no additional filing is required as long as the final prospectus discloses the $15.00 offering price. According to SEC Rule 424(b), this information may be contained in the final prospectus that's filed with the SEC, provided any increase or decrease in volume, or deviation from the low or high end of the price range, represents no more than a 20% change in the maximum aggregate offering price in the registration statement (and the total dollar value doesn't exceed that which was registered). If this is not done within 15 business days after the effective date, it must be contained in a post-effective amendment.

Broker-dealers are required to take reasonable steps to fulfill written requests for a prospectus. During the cooling-off period, the preliminary prospectus is sent; however, after the effective date, a final prospectus must be sent. In many cases, a client may request that disclosure documents be provided in an electronic format. Under SEC rules, providing clients with electronic access equates to the delivery of the relevant documentation.

In the case of a company that has not previously filed financial reports with the SEC, a preliminary prospectus must be delivered at least 48 hours before the sale is confirmed to any person who is expected to purchase the new issue. The goal is to ensure that the final prospectus will not be the first written information the purchaser receives regarding the new issue. Broker-dealers should be certain that registered representatives have received a copy of the appropriate prospectus prior to soliciting orders for the offering.

Stop Order New material information may become available after the effective date, but prior to the completion of the offering. If this happens, the issuer files a post-effective amendment with the SEC which doesn't become effective until it's declared so by the SEC. If the SEC becomes aware of information which indicates that the offering is not in compliance with the Act of 1933, it may issue a stop order to essentially cease all sales activities.

Prospectus Delivery Requirement

Although many assume that prospectus delivery is a primary market requirement, depending on the type of company issuing the security, a dealer may be required to satisfy an aftermarket prospectus delivery requirement. The main purpose of this rule is to always ensure that investors are provided with information concerning an issue of securities. If the issuer was already a reporting company, disclosure information is readily available to the public through the SEC's EDGAR system.

A broker-dealer's final prospectus delivery obligations can be satisfied by the filing of 10 copies of the final prospectus with the SEC as long as investors are sent a confirmation which informs them as to how they can access the document. When sent electronically, the confirmation will typically contain a hyperlink to the final prospectus. This process is referred to as "access equals delivery." Investors may still request a printed copy.

Unlisted Companies Unlisted companies are those whose stocks don't trade on exchanges, such as the NYSE or Nasdaq. A dealer that sells an IPO which will not be listed is required to continue to deliver the prospectus for 90 days. However, if that same unlisted company conducts a follow-on offering, the requirement is shortened to 40 days.

Listed Companies Companies whose stock trades on an exchange, such as the NYSE or Nasdaq, are referred to as listed companies. These listed companies are also considered reporting companies since they're required to file financial statements with the SEC. In some cases, a dealer that sells these securities may be required to deliver a prospectus even after the deal has closed.

If an issuer's stock is already listed on an exchange (e.g., the NYSE or Nasdaq) and it sells a new issue of common stock, there's no after-market prospectus delivery requirement (no requirement applies since adequate public information is already available). If the offering is an IPO and the issuer will be listed on an exchange, the prospectus delivery requirement is 25 days (a short time requirement since the company will be listed). On the other hand, if the offering will be quoted on the OTCBB (a quotation system, not an exchange), the delivery requirement is 90 days for an IPO and 40 days for a secondary offering (longer time requirements since the company is not well known).

Summary of Aftermarket Prospectus Delivery Requirements	
Security	**Time Frame**
For a non-listed, IPO	90 days
For a non-listed, follow-on offering	40 days
For an IPO of a security to be listed on the NYSE or Nasdaq	25 days
For an NYSE or Nasdaq-listed, follow-on offering	No requirement

Summary of the Registration Process

	Filing Date	Effective Date	
Preregistration Period	**Cooling-Off Period**		**Post-Effective Period**
- Prepare registration statement - No discussions or sales with customers	- Lasts for 20 days from the last amendment, unless accelerated - Preliminary prospectus is issued - Blue Sky (state) registration - Due diligence meeting is held - Indications of interest are accepted, but no sales		- Final prospectus is issued - Sales are confirmed - 25/40/90-day aftermarket prospectus requirement for dealers

Unlawful Representations The Securities Act of 1933 requires the disclosure of all material facts regarding securities that are sold publicly. Both criminal and civil penalties may be imposed for violations of the law, including:

- Failing to file a registration statement
- Material misstatements and/or material omissions of important facts in a registration statement
- Selling a security publicly before the registration is effective
- Failing to provide a copy of the final prospectus to a purchaser

Lock-up Agreement A lock-up agreement establishes the length of time that pre-IPO holders, such as management, venture capitalists, and other insiders, must wait to sell shares of their securities after an IPO begins trading in the aftermarket. Generally, a lock-up agreement will expire within six months following the closing of the company's IPO, but there's no statutory time limit.

The lock-up is designed to prohibit management and venture capitalists that initially funded the company from selling the stock and also provides a comfort level to investors who are concerned that holders of pre-IPO shares will sell their shares as soon as the IPO begins trading. The concern with these sales is that they would put selling pressure on the stock and cause the price to decline.

The lock-up period restricts or limits the supply of shares being sold in the market. Restricted shares may also have been sold by investors through the IPO without the volume limitations imposed by SEC Rule 144.

Sale of Securities by Existing Publicly Traded Companies

The previous description of the registration process focused primarily on an issuer's initial public offering (IPO) of equity securities. However, the process of raising capital for existing public companies may differ based on the category of issuer as defined by SEC Rule 405 and the type of securities being offered. The category into which an issuer is placed determines the level and type of communications that an issuer may distribute as it relates to a new issue offering. The categories also distinguish the level of familiarity that the securities industry will have with the issuers. For example, some issuers may be widely followed by the media and financial analysts, whereas others are not regularly followed and may not have the same amount of recognition. An issuer's category influences its status during the registration of new issues and determines the amount of additional disclosure that are required to facilitate the issuance. There are primarily five issuer categories including *well-known seasoned*, *seasoned*, *unseasoned*, *non-reporting,* and *ineligible*.

Well-Known Seasoned Issuer (WKSI)

An issuer that qualifies as a well-known seasoned issuer is required to file reports under Section 13(a) or Section 15(d) of the Securities Exchange Act of 1934 and is required to meet the following requirements:

- It must be eligible to register using Form S-3 or Form F-3. However, to file these forms, an issuer must have been a reporting company for the previous 12 months.
- As of a date within 60 days of the date of determining eligibility, the company must have either:
  - A worldwide market value of outstanding voting and non-voting common equity (public float) held by non-affiliates of $700 million or more, or

  - In the last three years, issued at least $1 billion aggregate principal amount of non-convertible securities, other than common equity, in primary offerings for cash—not exchange—that are registered under the Securities Act of 1933
- It cannot be an ineligible issuer

Majority-Owned Subsidiary A majority owned subsidiary of a well-known seasoned issuer may also qualify as a WKSI in connection with the offer and sale of its own securities based on:

- Its issuance of non-convertible investment grade securities that are fully and unconditionally guaranteed by its parent; or
- Its issuance of guarantees of non-convertible securities of its parent or of another majority-owned subsidiary whose non-convertible securities are so guaranteed by the WKSI parent

Seasoned Issuer

A seasoned issuer is one that's eligible to use Form S-3 or Form F-3 to register a primary offering of securities, but doesn't satisfy the other criteria to be considered a WKSI. For example, it's eligible to file Form S-3, but it has a public float of less than $700 million.

Unseasoned Issuer

An unseasoned issuer is one that's required to file reports under Section 13 or Section 15(d) of the Securities Exchange Act of 1934, but doesn't meet the requirements to file using Form S-3 or Form F-3 for a primary offering of its securities.

Non-Reporting Issuer

A non-reporting issuer is one that's not required to file reports under Section 13 or Section 15(d) of the Securities Exchange Act of 1934. This condition holds true even when an issuer is filing the reports voluntarily. An example includes an issuer that's in the process of going public through an IPO.

Ineligible Issuer

The ineligible issuer category includes:

- An issuer that's required to file reports under Section 13 or 15(d) in the Securities Exchange Act of 1934, but has not yet done so
- A blank-check company (i.e., an entity with either no specific business plan or one that has indicated its intention to merge with an unidentified company or companies)
- A shell company
- An issuer that's offering penny stock
- A limited partnership that's offering and selling its securities through methods other than a firm-commitment underwriting
- An issuer that has filed for bankruptcy or has had an insolvency filing made against it within the past three years. This provision will terminate if the issuer has filed an annual report or a registration statement which includes an audited final statement.
- An issuer or an entity of an issuer that has been convicted of a felony or misdemeanor involving securities laws violations or violations of antifraud provisions in the past three years
- An issuer that is or has been the subject of a refusal or stop order under Section 8 or 8A of the Securities Act of 1933

Issuer Type	Filing Form	Requirements
WKSI	S-3 (Automatic shelf provisions or ASR)	Must be S-3 eligible and have a minimum of $700 million public float or a minimum of $1 billion in public debt issuance over last three years
Seasoned Issuer	S-3 (Shelf provisions)	Must be S-3 eligible, but is not required to satisfy the minimums that apply to WKSIs
Unseasoned Issuer	S-1	Has less than $75 million public float
Non-Reporting Issuer (one that's in the process of conducting an IPO) or an OTC Pink Market Issuer	S-1	N/A

Shelf Registration (Rule 415)

The provisions of Rule 415 allow issuers to file registration documents and offer the subject securities on a delayed or continuous basis. The rule is available for securities that are to be sold on behalf of the issuing company as well as for securities that are to be issued for entities such as employee benefit plans, for securities to be issued upon conversion of other securities, and for securities to be issued in connection with business combination transactions.

For securities that are to be issued in connection with business combinations or securities that are being issued for the benefit of the issuing company or a subsidiary, registration is allowed only for an amount that may reasonably be expected to be sold within two years after the initial date of registration. The advantage of the delayed distribution is that it allows the issuing company and its underwriters the flexibility of selling the securities when the market conditions are most favorable.

A shelf registration statement may be used for *up to three years* after an initial effective date of a registration statement if the offering fits the following criteria:

- The offering will begin immediately and last for a period greater than 30 days from the effective date, or
- The offering is for securities that are registered on Form S-3 or F-3 and are being offered and sold on an immediate, continuous, or delayed basis by or on behalf of the registrant or a majority-owned subsidiary of the registrant.

Certain issuers are permitted to file immediately effective shelf registration statements; however, the prospectuses that are filed as part of automatic shelf registrations may omit information that's unknown or unavailable to the issuers. Information that may be omitted includes whether the offering is a primary offering, an offering on behalf of persons other than the issuer, or a combination of the two, as well as the plan of distribution for the securities, a description of the securities registered (other than an identification of the name or class of such securities), and the identification of other issuers.

One of the advantages to achieving WKSI status is that the issuer is permitted to file an S-3 ASR (automatic shelf registration) and offer the securities without SEC review. However, if a company files an ASR and it's no longer a well-known seasoned issuer, it should amend its automatic shelf registration statement.

Even after the loss of WKSI status, an issuer may continue to sell securities that were registered under a previously filed automatic shelf registration statement until the date on which its next Form 10-K (annual report) is required to be filed. Eventually, the issuer files an amended Form S-3 which converts the offering to a regular shelf registration and therefore subject to SEC review.

A seasoned issuer may benefit from shelf registration, but may not use the automatic shelf registration process that's available to a WKSI. For any issuer that's eligible to file under the shelf registration rules, there's no limit as to the amount of securities that may be offered.

Pay-As-You-Go Registration Since only a WKSI is permitted to use an S-3 automatic shelf registration (S-3 ASR), it's also the only type of issuer that may use the pay-as-you-go registration. Typically, at the time the issuer files its registration statement, it's required to pay the SEC's registration fee based on the amount of securities it will be offering. However, by filing an ASR, a WKSI is able to register an unlimited amount of securities and then file a prospectus supplement when it sells the actual securities. Ultimately, the issuer simply pays the filing fee at the time the prospectus supplement is filed (in other words, it pays as it goes).

At-the-Market Offerings Issuers that have existing shares outstanding may choose to conduct at-the-market offerings. The pricing of shares distributed through an at-the-market offering is based on the current market value of the existing shares that are trading in the secondary market.

This type of offering allows the company to raise capital and issue shares over an extended period, rather than all at once. The issuer has flexibility in the timing of the sale of its securities and, unlike conducting a registered secondary (follow-on) offering, is not limited to selling the securities at one time. At-the-market offerings may only be conducted by a company that's eligible to register its securities using Form S-3 or F-3 and able to sell under a shelf registration. If a security is not listed on an exchange, a broker-dealer is prohibited from representing the security as being offered at-the-market unless there's an existing independent market for the security. An independent market is considered one in which no one member firm dominates or controls the secondary market quotations (and trading) of the securities.

Types of Prospectuses

Definition

According to the Securities Act of 1933, a *prospectus* is defined as any notice, circular, advertisement, letter, or communication, whether written or broadcast on television or radio, which offers a security for sale. While this is a very broad definition, it includes an exemption if the communication only identifies the security, the price, the name of the underwriter(s), and from whom a prospectus may be obtained. This limited advertisement is referred to as a tombstone.

A prospectus may be filed as a part of the registration statement and used prior to the effective date of the registration statement if the following information is omitted:

- The offering price of the issue
- The underwriting discounts (or commissions)
- Discounts to dealers

- The amount of proceeds to be received by the issuer
- Conversion rates and call prices
- Other matters that are dependent on the offering price

Free Writing Prospectus (FWP)

A *statutory prospectus* is considered any significant disclosure document which is given to investors, such as a red herring and final prospectus. On the other hand, a *free writing prospectus* is any written communication that constitutes an offer to sell or a solicitation to buy the securities being issued in connection with a registered offering, but it doesn't meet the standards of a statutory prospectus.

Examples of free writing prospectuses include press releases, e-mails, preliminary or final term sheets, and marketing materials (e.g., a PowerPoint presentation). As it relates to the ability to use free writing prospectuses, issuers of securities are classified as either eligible or ineligible. Ineligible issuers include penny stock issuers, shell companies, and blank-check companies.

Communications by Well-Known Seasoned Issuers Well-known seasoned issuers are granted greater freedom regarding their communications, including written offers other than preliminary prospectuses. Under Rule 163, a free writing prospectus may be used by a WKSI *prior to the filing* of a registration statement (considered a pre-filing offer) or, under Rule 164, *after the filing* of a registration statement.

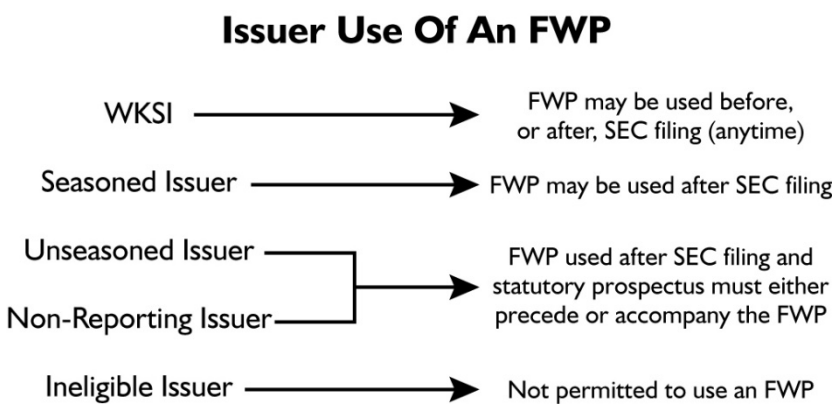
The following example describes the use of a free writing prospectus by a WKSI that's engaged a shelf registration:

- The issuer must file an S-3 ASR registration form for both the type of securities that it's planning to offer and a specific dollar amount (which for a WKSI may be unlimited).
- Each time the issuer offers securities, it will file both a preliminary prospectus and then a final prospectus supplement with the SEC (for the specific securities being issued).
- If the company issues a press release announcing the offering or term sheets describing the offering, they're considered a free writing prospectus and may be used prior to the filing of the prospectus.

A term sheet is a very frequently used type of free writing prospectus and provides a summary of the specific securities being offered. For example, with a debt offering, the term sheet may include the issuer's name, a description of the security, the offering's size, its maturity and coupon, the price to the public, its yield-to-maturity, the spread to a benchmark Treasury security, and other relevant information. According to SEC Rule 433, an issuer is permitted to use a term sheet for each offering provided it's filed as a free writing prospectus. In compliance with record-keeping rules, a free writing prospectus must be retained for three years.

If an offering is being conducted by, or on behalf of, a well-known seasoned issuer that will be registered under the Act of 1933, a legend is required to be included within the free writing prospectus to indicate whether the issuer will file a registration statement and how a prospectus may be obtained. If the free writing prospectus is distributed without the legend, it should be amended and retransmitted as soon as it's practical.

Other Users of Free Writing Prospectuses Seasoned issuers may also use a free writing prospectus, but only *after* a registration statement has been filed. Similarly, unseasoned and non-reporting issuers may use a free writing prospectus after the filing of a registration statement, but they're also required to include a statutory prospectus. These issuers are permitted to use a hyperlink to an electronic version of the statutory prospectus provided it accompanies or precedes the free writing prospectus.



Types of Offering Communications

The SEC provides details regarding the different types of communications being used by issuers and broker-dealers when they're engaged in an offering. These types include:

- **Written Communications** Written communications are considered materials that are written, printed, and broadcast on television or radio. This category also includes *graphic communications* which are communications made through the use of electronic media (e.g., audiotapes, videotapes, e-mail, text messages, faxes, CD-ROMs, Internet Web sites, and computer networks).
- **Oral Communications** Oral communications involve both live and real-time communications. For purposes of securities offerings, communications that are live as well as those that are retransmitted to a live audience using graphic communications methods are still considered oral communications. Discussions between registered persons and customers regarding a new offering are not permitted until *after* the filing date.
- **Research Reports** Research reports are written communications that contain information, opinions, or recommendations regarding the securities of an issuer, regardless of whether it provides reasonably sufficient information on which an investment decision may be based.
- **Advertising** An advertising campaign that relates to a new offering is prohibited.
- **Internal Syndicate Memoranda** These communications are not allowed to be distributed to customers.

While these rules limit the use of most written communications with customers regarding new issues, the SEC has provided some exceptions. For example, during the cooling-off period, underwriters may discuss an offering, but generally may not offer the securities in writing except through the preliminary prospectus. The same restriction applies to comments that are made in a research report.

The following rules are exceptions for certain types of communications:

Gun-Jumping Provisions The gun-jumping provisions of the Securities Act of 1933 restrict the type of communications that may be made during the registration process for a public offering. Gun-jumping violations may occur if prohibited oral or written communications are made by an issuer between the filing date of a registration statement and its effective date (i.e., the cooling-off period).

For example, a violation may occur if an issuer uses some type of written communication between the filing and effective date and did not file it with the SEC as a free writing prospectus. The theory is that clients should make purchase decisions based on the contents of a prospectus, rather than from selected information that has been released by the issuer and/or its underwriter(s). For many years, the preliminary prospectus was the only written form of information that was allowed to be released regarding an offering between the filing date and the effective date of a registration statement.

In relation to the gun-jumping provisions, the SEC has determined that if a research report includes information about a new offering, it may be considered a prospectus and its use could be a violation of the Act of 1933. The decision on whether a violation has occurred is based on when the report was released.

Rule 134 — Communications Not Deemed a Prospectus SEC Rule 134 permits the publication of a simple advertisement that describes the basic features of a new issue. If the advertisement meets the conditions of this rule, it will not be considered a prospectus. For corporate offerings, these advertisements are usually published in a newspaper and are referred to as tombstone ads. These ads may include:

- The name of the issuer
- The full title of the security
- The amount of securities being offered
- A brief description of the issuer's type of business
- The price of the security
- The date of sale
- The identity/names of the underwriters
- A statement which indicates that the registration for the securities is not yet effective and that orders for the securities may not be accepted until registration is declared effective
- The contact information of the person or organization that's sending the communication (e.g., name, address, phone number, and e-mail address) and a statement of any participation or expected participation in the distribution of the security
- An anticipated schedule for the offering (approximate commencement date of the proposed sale to the public) and a description of marketing events (including dates, times, locations, and information regarding how to attend)
- The securities exchanges or other markets on which any class of the issuer's securities are/will be listed
- The names of any selling security holders that have been disclosed in the prospectus that was filed along with the registration statement

Rule 135a — Generic Advertising SEC Rule 135a permits the use of advertising that's limited to general information about investment companies or to the nature of investment companies. The material may refer to different generic types of funds (e.g., balanced funds, growth funds, income funds, etc.), but may not discuss the desirability of owning or purchasing a particular investment company's shares. Provided the material doesn't mention a specific investment company, it's not considered an offer and may be used without a prospectus. An invitation to request further information may be included in the material; however, the communication must contain the name and address of the broker-dealer that sponsors the communication.

Gun-Jumping Safe Harbors

There are three safe harbors from the gun-jumping provisions for information that's released by, or on behalf of, reporting and non-reporting issuers.

Rule 168 — For Reporting Issuers

Rule 168 allows an issuer, or a person acting on its behalf, to continue to publish or disseminate *regularly released factual business and forward-looking information at any time*. Information is considered to be regularly released if, in the past, the issuer has released or disseminated the same type of information during the ordinary course of its business. However, the information must be consistent in the timing, manner, and form of release. Any person that acts on the behalf of the issuer may not be an offering participant (e.g., an underwriter or dealer). Also, the issuer must approve the release of the information prior to its dissemination. Factual business information includes:

- Information about the issuer
- Information about the business or financial developments of the issuer
- Information or advertisements regarding the issuer's products and/or services
- Dividend notices
- Information in reports that are filed with the SEC under the Securities Exchange Act of 1934

Under the safe harbor provisions, information related to a registered offering or activities surrounding the registered offering doesn't qualify as factual business information. There are some instances where information, such as advertisements, may be released outside of a schedule or timing that has been made in the past. These releases will be reviewed to determine whether they meet the requirement of regularly released information. Forward-looking information includes:

- Earnings forecasts (e.g., revenue projections, loss of income, loss of earnings per share, capital expenditures, dividends, and capital structure)
- Future management operations plans (e.g., plans related to products or services)
- Statements about future economic performance (e.g., statements from management discussion and analysis)
- Information contained in reports that are filed with the SEC

Rule 169 — For Non-Reporting Issuers

Rule 169 allows a non-reporting issuer, or a person acting on its behalf, to continue to publish regularly released factual business information that's meant for limited use by suppliers and customers, but not by investors (or potential investors). Under Rule 169, the list of factual business information is identical to that of Rule 168. However, non-reporting issuers are not allowed to release forward-looking information since these companies don't provide the same level of corporate issuer information and have not done so over any historical period.

For IPOs

The last safe harbor is specifically provided to IPOs. If a company is planning an IPO, it's permitted to communicate with the public at least 30 days prior to the filing of a registration statement without violating the SEC's gun-jumping provisions; however, it may make no reference to the offering.

Road Shows

Road show presentations allow company management to articulate the company's business plan and are usually hosted by the issuer and its investment banker(s) before a securities offering. Senior management of the issuer participates in the road show and the CEO and CFO typically make presentations. Although the syndicate is responsible for marketing the issue, in most offerings, only the lead manager(s) organizes the road show. These road shows are permitted once a registration statement is filed (before the effective date) to assist the issuer and lead underwriter in assessing investor interest and to determine the size and pricing of an IPO. Road shows may be attended by prospective retail and institutional investors, with the presentations being made to groups of investors or conducted one-on-one (generally for institutions).

In order to reach a larger audience of clients or prospective clients, issuers and underwriters may utilize *electronic road shows*. An electronic road show is one that's conducted or transmitted over the Internet or through other electronic means and may be either live or recorded. Live road shows are considered a form of oral communication, while recorded road shows are considered a form of graphic communication (written communication). A road show that's considered graphic communication is also deemed to be a free writing prospectus and, if the issuer participates, it's considered an issuer free writing prospectus. Any communication that's broadcast over the radio or on television is considered written communication.

Most road shows that are considered to be free writing prospectuses are not required to be filed with the SEC (unlike other free writing prospectuses). However, in the case of a non-reporting issuer that's conducting an IPO of its common equity or convertible equity securities, the issuer must file the electronic road show with the SEC at the time it files its registration statement. On the other hand, if the issuer makes a bona fide electronic road show (discussed below) and it's available without restriction to prospective investors, the issuer is not required to file the road show with the SEC. Electronic road shows for follow-on equity and non-convertible debt offerings are not required to be filed with the SEC.

Bona Fide Electronic Road Show A bona fide electronic road show is one that's transmitted by graphic means (i.e., as written communication) and contains a presentation by one or more officers of an issuer or other person who is a part of the issuer's management. Bona fide electronic road shows are generally used for IPOs only.

Jumpstart Our Business Startups (JOBS) Act

The Jumpstart Our Business Startups (JOBS) Act was signed into law in 2012 and its purpose was to make it easier for small businesses to raise capital and to ultimately create jobs. In order to accomplish this goal, the Act made major revisions to the securities laws.

For private companies that intend to remain private, the number of shareholders that they may have before being required to file reports with the SEC was increased. For companies that are classified as *emerging growth companies* and now want to go public, the regulatory strictures were eased.

Issuers using private placements to raise capital are now able to advertise their securities publicly for the first time. The Regulation A exemption for smaller companies was replaced by Regulation A+, creating a new option for these issuers to raise up to $50 million in *mini-IPOs*.

Finally, and most revolutionary, the Act incorporates the Internet phenomenon of crowdfunding into the securities laws. Starting in 2016, entrepreneurs attempting to raise capital online will be able to use Regulation Crowdfunding to issue securities to their backers.

The JOBS Act seeks to pave the way for emerging growth companies that want to go public. The regulatory burden is eased a bit for these companies before, during, and after their IPOs.

Emerging Growth Companies (EGCs) Emerging growth companies are issuers whose gross revenues are less than 1.07 billion (originally $1.0 billion now adjusted for inflation) during their most recent fiscal year. An issuer is no longer an emerging growth company once one of the following events occurs:

- Its gross revenues exceed more than $1.07 billion during its last fiscal year.
- Its total public float reaches $700 million or more.
- It has issued more than $1 billion in non-convertible debt securities during the last three years.
- It has been five years since the company's IPO.

Confidential Filings In the past, the initial draft of a company's IPO registration statement became public information as soon as it was filed with the SEC. This meant that the company would be disclosing previously private information that might be useful to its competitors. Once the information was released, there was no taking it back if the company later decided to cancel the offering.

The JOBS Act gave emerging growth companies the option of having the SEC review the drafts of their registration statements in confidence. If the company decides to go forward with the offering, then it must disclose publicly its initial confidential submission at least 21 days before it holds its first road show.

A large percentage of companies in the IPO market are EGCs and many have used confidential filings to go public. In addition, after EGCs go public, they have five years to phase in the internal controls and disclosures required by Sarbanes-Oxley. They also have a longer time to comply with new accounting rules. EGCs will also be covered in later chapters.

FINRA Rules on Securities Distribution

In addition to SEC regulatory requirements, firms that are engaged in new issue distributions are subject to various SRO rules. The next section will examine the FINRA rules that specifically apply to new issues.

Corporate Financing Rules – Filing Requirements

Broker-dealers are generally required to file with FINRA certain documents and information that relate to securities offerings. The FINRA Corporate Financing Rule has the following two different filing requirements that are based on whether the securities are registered or exempt from registration:

- If the securities are to be registered, the required disclosures must be filed with FINRA by no later than *three business days following* the filing of the issuer's registration statement with the SEC (or any state securities commission).

- If the securities are exempt from registration, the required disclosures must be filed with FINRA at least *15 business days prior* to the anticipated offering.

Member firms are prohibited from selling a new issue of securities unless the following two requirements are satisfied: (1) the appropriate documents have been filed, and (2) FINRA provides an opinion to indicate that it has no objections to the proposed underwriting arrangement, especially in regard to the fairness of the underwriter's compensation. If FINRA notifies the managing underwriter that the terms of the underwriting compensation are unfair and unreasonable, the managing underwriter must inform the other syndicate members of FINRA's ruling and instruct them to not offer the securities to clients.

Documents to be Filed The following documents must be filed with FINRA for review:

- Copies of registration statements, offering memorandums, offering circulars, or any other documents that are used to offer securities to the public
- Copies of any proposed underwriting agreements, agreements among the underwriters, consulting agreements, letters of intent, underwriter's warrant agreements, escrow agreements, or any other documents that describe the underwriting terms or arrangements
- Copies of any pre- and post-amendments to registration statements or any other offering documents
- Copies of final registrations (or equivalent offering documents) that were declared effective by the SEC

Information to be Filed The managing underwriter must file the following information with FINRA:

- An estimate of the maximum offering price
- An estimate of the maximum underwriting discount, commission, underwriters' counsel fees, or finders' fees, and a statement of any other type of compensation that may accrue to the underwriter
- A statement concerning the member firm affiliation of an officer or director of the issuer, or a beneficial owner of 5% or more of the issuer's securities
- A detailed statement that explains any other arrangement that has been entered into during the 180-day period prior to the filing date of the offering for which the firm received warrants, options, or other items of value from the issuer
- A statement demonstrating compliance with any exception from the definition of underwriting compensation

Exempt from Filing The following types of securities offerings are exempt from FINRA filing requirements:

- Securities that are offered by corporations, foreign governments, or foreign agencies that have unsecured non-convertible debt with a maturity of a least four years, or non-convertible preferred stock that's rated in one of the four highest rating categories by a nationally recognized statistical rating organization (NRSRO) (e.g., S&P or Moody's)
- Offerings of any securities which are permitted to be registered through a shelf registration by using SEC registration statements Forms S-3 or F-3
- Offerings of securities by a foreign private issuer that's organized under the laws of Canada using SEC Form F-10

- Exchange offers of securities where the securities being issued or acquired are listed on the NYSE, NYSE American (formerly the AMEX), or the Nasdaq Global Market
- Securities offerings by churches or other charitable institutions which are exempt from SEC registration

Exempt Offerings The following securities offerings are exempt from the Corporate Financing Rule:

- Securities that are exempt from SEC registration under Regulation D (private placements)
- Securities that are issued by open-end investment companies (i.e., mutual fund shares)
- Variable contract offerings
- Municipal securities offerings
- Tender offers
- Securities that are registered with the SEC and issued as a result of a merger, acquisition, spin-off, or any other similar transaction that doesn't result in public ownership of the member firm

Offerings Subject to Filing All other public offerings must be filed with FINRA including those involving real estate investment trusts (REITs), rights offerings, direct participation programs (e.g., limited partnerships), securities offered pursuant to SEC Regulation A, and exchange offers which don't involve the issuance of securities that are listed on the NYSE, NYSE American, or Nasdaq Global Market. Essentially, FINRA's Corporate Financing Rule applies to initial public offerings as well as offerings of securities in which the member firm or any of its affiliates are the issuer.

Review of Underwriting Agreements

In order to review the fairness of an underwriter's compensation, underwriting agreements must be submitted to FINRA's Corporate Financing Department. The agreement is usually submitted by the managing underwriter, but it may also be submitted by either another syndicate member or the issuer. When a syndicate is selling the securities of a member firm, it's the member firm's responsibility to file the agreement.

In the U.S., the underwriting fee or discount that's associated with most IPOs is generally 7%; however, FINRA rules don't specify a maximum percentage. Instead, the FINRA rule simply states that a firm is prohibited from receiving underwriting compensation in connection with a public offering that's unfair or unreasonable. The FINRA rule concerning the maximum amount of compensation (stated as a percentage of the dollar amount of the offering's proceeds) that's generally considered fair and reasonable will vary directly with the amount of risk being assumed by participating underwriters and inversely with the dollar amount of the offering's proceeds.

Fairness of Compensation FINRA reviews all distributions in which a member firm participates as an underwriter in order to ensure that the compensation being paid to the firm is not excessive or unfair. FINRA doesn't pass judgment on the merits of an issue or on the public offering price.

To determine whether the underwriting compensation is fair, the following factors are considered:

- The type of securities being offered
- The offering's proceeds
- The amount of risk assumed by the underwriters, including whether the offering is underwritten on a firm-commitment or best-efforts basis, and whether it's an IPO or secondary offering

Included as Compensation FINRA considers the following items as a part of underwriting compensation if a member firm receives them for distributing (underwriting) a public offering:

- The underwriting discount or commission
- Reimbursement of expenses
- Wholesaler's fees
- Fees and expenses of the underwriters' counsel (but not reimbursement of Blue-Sky fees)
- Finder's fees, whether in the form of cash and/or securities
- Financial consulting and advisory fees, whether in the form of cash and/or securities
- Common or preferred stock, warrants, options, or any other equity security, including convertible securities that are received at the time of the offering for acting as a private placement agent or for providing or arranging loans or M&A service
- Special sales incentive items
- Compensation received by the underwriter for acting as an adviser to the issuer's board of directors
- Compensation expected to be received as a result of exercising or converting any warrant or convertible security within one year following the effective date of the offering
- Fees for serving as a qualified independent underwriter
- Compensation paid to any member in connection to a proposed offering that was not completed, unless the member doesn't participate in the revised offering

Not Included as Compensation If any of the following items are received by a member firm, they will NOT be considered to be a part of the firm's underwriting compensation:

- Issuer-related expenses that were originally paid by the managing underwriter, but were subsequently reimbursed by the issuer
  - Such as registration fees, accounting fees, FINRA filing fees, accounting fees and prospectus printing costs
- Cash compensation for acting as a placement agent or providing a loan related to M&A services
- Non-convertible securities and derivatives that are acquired by a member firm at a fair price in the ordinary course of business, but are unrelated to the public offering

To determine whether an item of value is considered underwriting compensation, FINRA examines the period that begins 180 days immediately preceding the filing date of the registration statement and extends to the date on which sales begin.

Prohibited Arrangements According to FINRA's Corporate Financing Rule, the following arrangements are prohibited:

- Any accountable expenses granted by an issuer to the underwriter and related persons that includes payments for overhead, salaries, or similar expenses that are incurred in the normal business for the underwriters (e.g., reimbursement for investment banking personnel salaries)
- Any "tail (termination) fee" arrangement which is granted to the underwriter and has a duration of more than two years from the date the member's services are terminated. A tail fee is charged by an underwriter for any financial advisory services that have been rendered in the event the offering is cancelled and the issuer subsequently uses a different underwriter. This addresses the risk that, after having agreed in writing (i.e., signing an engagement letter), an issuer may receive financial advice and choose to use a different underwriter to execute a similar transaction despite having signed the engagement letter.

- Commissions or reimbursement of expenses that are paid by an issuer to an underwriter prior to the commencement of the public sale of the securities being offered. An exception is made for reasonable advance out-of-pocket accountable expenses
- The payment of any compensation by the issuer to a member firm in connection with an offering that was not completed
- Any right of first refusal that's provided to an underwriter or related person to underwrite or participate in future public offerings , private placements, or other financing that:
  - Has a duration of more than three years from the date of commencement of sales of the public offering or the termination date of the engagement between the issuer and underwriter; or
  - Has more than one opportunity to waive or terminate the right of first refusal in consideration of any payment or fee
- Any payment or fee to waive or terminate a right of first refusal regarding future public offerings, private placements or other financings provided to the underwriter and related persons that:
  - Has a value in excess of the greater of 1% of the offering proceeds in the public offering where the right of first refusal was granted (or an amount in excess of 1% if additional compensation is available under the compensation guideline of the original offering) or 5% of the underwriting discount or commission paid in connection with the future financing (including any overallotment option that may be exercised), regardless of whether the payment or fee is negotiated at the time of or subsequent to the original public offering; or
  - Is not paid in cash
  - The terms or the exercise of the terms of an agreement for the receipt by the underwriter and related persons of underwriting compensation consisting of any option, warrant or convertible security that:
    - Is exercisable or convertible more than five years from the effective date of the offering or with more favorable terms than those offered to the public
    - Has more than one demand registration right at the issuer's expense
    - Has a demand registration right with a duration of more than five years from the date of effectiveness or the commencement of sales of the public offering;
    - Has a piggyback registration right with a duration of more than seven years from the date of effectiveness or the commencement of sales of the public offering
    - Has anti-dilution terms that allow the underwriter and related persons to receive more shares or to exercise at a lower price than originally agreed upon at the time of the public offering, when the public shareholders have not been proportionally affected by a stock split, stock dividend, or other similar event; or has anti-dilution terms that allow the underwriter and related persons to receive or accrue cash dividends prior to the exercise or conversion of the security
- Any overallotment option (Green Shoe clause) that's offered in a firm commitment underwriting of more than 15%
- Any non-accountable expense allowance that exceeds 3% of the offering's proceeds

Restrictions on Securities Received If a member firm acquires securities in connection with acting an underwriter of an offering, their sale is restricted for a period of six months following the effective date of registration. However, if options or warrants are acquired in connection with the offering, they may be exercised at any time. However, the securities that are received due to exercise are restricted for the remainder of the initial six-month period.

Syndicates and Selling Groups

Both syndicate and selling group agreements must disclose the price at which the securities are to be sold to the public or the formula that's used to determine the price. The agreements must also identify to whom and under what circumstances concessions are allowed.

Remember, a *selling syndicate* is defined as a group of broker-dealers that distribute securities under an agreement that imposes a financial commitment on its members. On the other hand, a *selling group* is defined as a group of broker-dealers that distribute securities under an agreement that doesn't impose a financial commitment on its members.

Sale of Securities in a Fixed Price Offering A fixed-price offering occurs when an underwriter(s) sells securities at one fixed price as opposed to an at-the-market offering. Most offerings are conducted as fixed-price offerings. FINRA prohibits any selling syndicate member or selling group member from offering a discount to any firm that's not a FINRA member. Sales below the public offering price (discounts) are not permitted to be done with institutional or retail clients, but may be done with other selling syndicate and selling group members (FINRA members). Also, if a syndicate or selling group is being formed with the goal of distributing securities in the future, it may not invite a suspended member to participate, even if the suspension will terminate prior to the time of the distribution. Instead, suspended members must be treated as non-members.

The restriction against including non-members in a syndicate doesn't apply to foreign broker-dealers that are not eligible for FINRA membership. However, any foreign syndicate members must agree to abide by the same rules and restrictions that apply to member firms.

If a member firm joins an underwriting syndicate, but is subsequently suspended from membership, SRO rules prohibit the member firm from accepting delivery of the previously allocated securities. If a member of a selling group is subsequently suspended, the firm is allowed to purchase the securities, but only at the full public offering price (POP).

Occasionally, an issuer that intends to sell stock publicly may hire its own sales force to distribute the stock; however, if this is the case, a member firm cannot participate in the distribution in any way.

Selling Concessions Selling concessions and discounts for public offerings may only be granted to broker-dealers that are engaged in bona fide investment banking or securities business. A broker-dealer will be considered to have rendered investment banking services if it underwrites any part of the offering or is a member of the selling group.

Any member firm that receives a selling concession or discount must sign a written agreement that indicates its pledge to abide by the requirements of industry rules regarding selling concessions. Although member firms may not sell securities at a discount to persons to whom it provides research services, they may sell the securities to them at the public offering price.

Public Offerings — Conflicts of Interest

At times, member firms that participate in the distribution of securities experience conflicts of interest. If a conflict of interest exists, the member firm must follow specific FINRA guidelines to ensure that the conflict is handled properly. As with any other issuer, the firm is also subject to the requirements of the Securities Act of 1933 and applicable state laws.

Definition of Conflict of Interest

A conflict exists if a member firm is participating in a public offering and any of the following conditions apply:

- Securities are being issued by the member firm or an affiliated company.
- The issuer controls or is under the control of the member firm.
- At least 5% of the net proceeds of the offering, not including the underwriting compensation, are intended to reduce or retire the balance of a loan extended by the member firm.

Definition of the Terms Affiliate, Control, and Common Control The term *affiliate* is defined as an entity that controls, is controlled by, or is under common control of the member firm. *Control* is defined as having ownership of 10% or more of the common or preferred equity or subordinated debt of another entity, or the right to acquire 10% or more of the profits or losses of a partnership. *Common control* refers to a situation in which the same person or entity controls two or more entities. A conflict exists if a member firm is underwriting its own securities, the securities of an entity in which it has a 10% ownership, the securities of an entity which owns 10% or more of the member firm, or the securities of an entity in which another company owns 10% or more of both the member firm and the issuer.

Two Conditions Required to Participate

A member firm is prohibited from participating in a public offering in which it has a conflict of interest unless the offering complies with either one of the following two conditions:

Condition One *One of the following three requirements* must be met:

1. The member firm that's primarily responsible for managing the offering may not have a conflict of interest or may not be an affiliate of any member that does have a conflict, or
2. The securities being offered must have a bona fide public market, or
3. The securities being offered must be investment-grade

Condition Two If one of the three requirements of Condition One is not met, a member firm must appoint a *qualified independent underwriter (QIU)* to participate in the preparation of the offering documents. The QIU is a firm that has served as a manager or co-manager in at least three public offerings of a similar size and type during the three-year period preceding the filing of the registration statement. If a QIU is used, a prominent disclosure must appear in the prospectus or offering document which explains the conflicts of interest, the name of the qualified independent underwriter, and a brief statement regarding its role and responsibilities. The member firm is also required to notify FINRA once the offering is completed.

One of the critical responsibilities of any underwriter is performing the due diligence investigation. If a member firm is involved in the sale of its own stock or the stock of an affiliate, it may be extremely difficult for the firm (as the underwriter) to objectively perform due diligence. Therefore, in self-underwritings or underwritings for affiliates, FINRA generally requires the participation of another broker-dealer that has no conflict of interest to act as a qualified independent underwriter. The QIU exercises the same level of due diligence as any underwriter, even if it's not actively selling the new securities.

Regardless of which condition is being followed, disclosure of the existing conflict of interest must prominently appear in the offering's prospectus.

Placement in Discretionary Accounts If a member firm is participating in a distribution of securities in which it has a conflict and intends to place some of the stock into the account of a customer for whom the member firm holds discretionary authorization, the firm must obtain the customer's written approval of *the proposed transaction* before it may be placed in his account. This approval is in addition to the power of attorney (POA) that must already be on file.

Regulation S-K

Projections

This regulation describes the method and layout that an issuer must follow when making various SEC filings. Reg. S-K creates guidelines for presenting projections in the non-financial statements that are contained within a company's SEC filings. Often revenue, net income, and earnings per share are projected for a specified period; however, the basis of these projections must be reasonable and the time frame must be appropriate for the type of business. As long as the projections are appropriate, the registrant is not limited to projections for the items listed or to any specified time frame.

Under Reg. S-K, in order to increase investor understanding, the following items must be considered by management when filing registration and other statements:

- Whether a reasonable basis exists for current projections
- Whether management's ability to provide a review of previous projections will facilitate investor understanding
- Whether full and prompt disclosure of favorable and unfavorable material facts has been made
- The fact that management may resume or discontinue projections

The SEC permits, but doesn't require, outside reviews of the projections that are made by the registrant. If an external reviewer is used, the required disclosures include the:

- Qualifications of the reviewer
- Extent of the review
- Relationship between the registrant and the reviewer
- Material factors regarding the process and how the outside review was sought or obtained

Any person that provides a review must be qualified as an expert. To include a reviewer's statement in an SEC filing, it's necessary to obtain the reviewer's permission.

Regulation S-K requires specific disclosures that impact registration statements, tender offer statements, annual reports, proxy statements, and other SEC-related filings. These disclosures include:

- A description of the type of security being offered for sale and the use of the proceeds
- Compensation and ownership details concerning the company's management
- The detailed information required to be included on SEC Form 8-K (material change form)
- Certain details from SEC Form 10-K (annual report)

Board of Directors' Meetings Under Regulation S-K, an issuer is required to disclose the following in its annual filing with the SEC:

- The number of meetings held by the board of directors, including the regular and special meetings held by each committee of the board during the last fiscal year
- The name and function of the board members of each committee
- The name of each director who, during the last fiscal year, attended less than 75% of the meetings

This information is typically included in the company's annual proxy statement which is provided to shareholders.

Ratings Agencies The importance of obtaining independent ratings which are provided by nationally recognized statistical rating organizations (NRSROs) has been well-established. Institutional and retail investors often rely on these ratings for an objective view of an issuer's financial viability. A registrant may voluntarily disclose these ratings in its SEC filings for any classes of debt securities, convertible bonds, or preferred stock. If the rating disclosed by the registrant differs materially from the rating that was assigned by an NRSRO, the NRSRO's rating must be included. If an NRSRO issues a rating change on a security that's materially different, the registrant should disclose the change through an amendment to the prospectus.

Reference Documents A registrant may only incorporate another document into a registration statement by reference if the document is on file with the SEC. Normally, documents that have been on file with the SEC for longer than five years may not be incorporated into a registration statement.

GAAP and Non-GAAP Disclosures In most cases, a registrant must use generally accepted accounting principles (GAAP) when presenting financial performance and projections. If non-GAAP financial measures are used, the registrant must provide a statement which indicates the reasons for the non-GAAP measures and must provide a comparison using GAAP. This statement must be provided in a schedule or through another clearly defined method.

A non-GAAP financial measure is defined as any numerical measure of a company's historical or future financial performance, position, or cash flow that either includes or excludes amounts that are normally included in GAAP measures. For example, earnings before interest and taxes (EBIT) is a GAAP measure; however, adding back depreciation and amortization (EBITDA) is a non-GAAP measure.

Regulation S-X

Regulation S-X sets forth the form and content for the financial statements that are filed under the Securities Act of 1933 as well as for the reports that are filed under the Securities Exchange Act of 1934. The regulation requires the preparation of an attestation report by an independent accountant. The report may state that the registrant has a material weakness or it may indicate that a material misstatement within the report may not be prevented or detected on a timely basis.

Reg. S-X provides a general list of disclosure items that are used in various SEC filings, such as:

- Pro-Forma Financial Information
- Form and Content of Schedules
- Interim Financial Statements
- Qualifications and Reports of Accountants
- Consolidated and Combined Financial Statements
- Employee Stock Purchase, Savings and Similar Plans

Stale Financial Statements

According to Regulation S-X, financial statements in a registration statement may become stale and unusable based on the number of days that have elapsed between the date of the statements in the filing and the effective date of the registration statement. For IPO issuers, the period is 135 days, while for accelerated filers (WKSIs or seasoned issuers), the period is 130 days. Therefore, an IPO issuer may not use a financial statement which is older than 134 days.

Research Reports

The following rules are designed to provide a safe harbor for any broker-dealers that publish research reports in close proximity to the time of a public offering.

Rule 137 — Persons Not Participating in an Offering

Under certain circumstances, a broker-dealer may distribute or publish research reports for securities that are currently in the registration process. These research reports may be distributed or published by a broker-dealer that's *not* a participant in the distribution (i.e., the broker-dealer is not and has not received payment from the issuer, a selling security holder, or another distribution participant). The research report will not be considered an offer provided that there has been no form of consideration (monetary or otherwise) received by the broker-dealer from members of the distribution group. An exception to the prohibition on payment exists if the research is independent, a regular subscription price is paid for the research report, and the distribution of the research report is a part of the firm's regular course of business.

Under Rule 137, for a broker-dealer to be allowed to distribute a research report related to an issuer's securities that are currently in the registration process, the issuer may not have been a blank-check company, a shell company, or an issuer of a penny stock offering within the previous three years.

Rule 138 — Non-Equivalent Securities

If a registration statement has been filed for a non-convertible debt security or a non-convertible preferred stock, a broker-dealer may publish or distribute a research report regarding the common stock and/or convertible securities of the issuer during the normal course of business. Or, if the registration statement is covering the common stock, convertible debt, or convertible preferred stock of an issuer, a broker-dealer may publish or distribute a research report regarding the non-convertible debt and/or non-convertible preferred stock of the issuer.

The Rule 138 safe harbor applies regardless of whether the broker-dealer that publishes the research report is a participant in the distribution.

Rule 139 — Research Reports

If an issuer is subject to the reporting requirements of the Act of 1934 and it meets other conditions (such as being a WKSI), a broker-dealer that's also a participant in the distribution may conditionally publish or distribute a research report regarding the issuer's securities. If the research reports relates to a specific issuer, the report must be distributed by the dealer with *reasonable regularity* during the normal course of coverage of the issuer or its securities and the report *may not represent an initiation of coverage* on the company.

If the research report relates to a specific industry, the report must contain information about a substantial number of issuers in the industry as well as a comprehensive list of securities that are currently being recommended by the broker-dealer that's publishing the research report. The material regarding the issuer or its securities may not be given greater prominence than what's being given to other securities. The broker-dealer must publish or distribute research reports during the regular course of its business and the information presented in the report should also be presented in other published reports that are being distributed by the broker-dealer concerning the issuer or its securities.

Under this rule, a research report that's published or distributed by a broker-dealer in conjunction with a Rule 144A offering of a well-known seasoned issuer is neither considered advertising nor is it an offer for the sale of the security. Similarly, a research report that's published or distributed by a broker-dealer regarding a Regulation S offshore offering is not considered a selling effort and doesn't conflict with offshore transaction requirements.

Communication Related Liability (Section 11 of the Act of 1933)

Section 11 establishes liability for registration statements that contain untrue statements of material facts or omit to state material facts that are required to make the statements not misleading.

False Registration Statement

According to the Securities Act of 1933, the persons that may be sued for untrue statements and material omissions from a registration statement include:

- Every person who signed the registration statement
- Every person who served as a director or partner of the issuer at the time of the filing

- Every accountant, engineer, or appraiser named as having prepared or certified any part of the registration statement
- Every underwriter of the security

Section 11 exempts the persons listed above (*but not the issuer*) from liability if they're able to prove that they had no knowledge of the fraud and properly notified the Commission and is referred to as a "Section 11 Defense." This exemption includes an accountant or other professional who refused to sign or certify any of the documents that were used to prepare the registration statement.

SEC Rule 176 This rule is referred to as the due diligence defense and requires underwriters to perform extensive fact checking. Rule 176 of the Securities Act of 1933 is used to determine whether an underwriter's conduct constitutes a reasonable investigation or whether there are reasonable grounds to believe that the liability standards set by the Act have been met. This is a part of the due diligence process and addresses who is able to be sued for false registration statements.

When determining the adequacy and accuracy of due diligence, some considerations include the:

- Type of issuer
- Type of security
- Type of underwriting arrangement
- Role of the underwriter, and
- Availability of information with respect to the issuer

Civil Liability for Salespersons If any person offers or sells a security in violation of the registration provisions of the Act of 1933 and did not exercise reasonable care regarding untrue statements, he's liable for the investment amount, a reasonable amount of interest on the investment, minus the amount of income received from the investment. Any information that's conveyed to a purchaser after the time of sale is not considered when determining whether a prospectus included an untrue statement or omitted a material fact.

Regulation FD (Fair Disclosure)

Due to concerns about the unfair practice of issuers selectively disclosing inside information to research analysts and large investors, the SEC has established Regulation FD. Regulation FD was created to protect retail investors by barring issuers from selectively disclosing non-public, material information to securities professionals (including employees of broker-dealers and investment advisers) or to shareholders if it's "reasonably foreseeable" that they will trade on the information. Regulation FD applies to disclosures that are made by senior company officials of an issuer and those who regularly communicate with research analysts and investors. These senior officials include the company's investment relations or public relations departments. If any of these persons disclose non-public, material information to analysts or investors, the company must also disclose the information to the public at large.

The speed with which the information must be disclosed to the public is dependent on whether the selective disclosure was intentional or unintentional.

- If the disclosure was *intentional*, then the company must simultaneously disclose the information to the public.

- If the disclosure was *unintentional*, the company must publicly disseminate the information within 24 hours or by the opening of the next NYSE trading day (if the disclosure occurs on a weekend or holiday)—whichever is later.

The company may fulfill its disclosure requirement by filing Form 8-K with the SEC, issuing a press release, broadcasting the information on the Internet, or by some other method that's reasonably designed to reach a broad spectrum of the investing public.

Regulation FD doesn't apply to disclosures that take place during the normal course of business with persons who have a duty to keep the information confidential (e.g., the company's accountants, lawyers, and investment bankers).

Recordkeeping Requirements

According to industry rules, certain types of communications with the public, research reports, and correspondence (including e-mail and instant messages) that are used by a broker-dealer must be kept on file for a minimum of three years. Any type of correspondence that's used by a member firm (e.g., social media) must be able to be stored. However, SEC registration statements (e.g., Forms S-1 or S-3), prospectuses (including red herrings or preliminary prospectuses), and other documents that are created by an issuer are not required to be kept on file by member firms.

Chapter 2 Summary

Now that you've completed this chapter, for the following commonly tested concepts, you should be able to:

- Understand the different financing alternatives available to private and public companies
  - IPO versus follow-on offering
  - Primary versus secondary shares
  - Private placements and PIPE offerings
- Define the term *Registration Rights* and the use of piggyback and demand registration
- Recognize the purpose and information requirements for SEC registration under the Act of 1933
- Understand the requirements and use of the different SEC registration forms (e.g., Forms S-1, S-3, S-4)
- Recognize the order of events for an IPO
- Understand the disclosure requirements and communication restrictions during each period of the registration process
  - Pre-registration, Cooling-off, Post-effective
- Understand the concept of Due Diligence and the purpose of a Bring Down Due Diligence Meeting
- Identify the permitted and prohibited actions during the cooling-off period
- Understand the difference between the preliminary prospectus and final prospectus and their use
- Understand the after-market delivery requirements of the final prospectus (*see table in chapter*)
- Define the term *lock-up agreement* and its purpose
- Identify the five different categories of issuers and their requirements (*see table in chapter*)
- Define the term *shelf registration* and its purpose

- Understand ASR and the pay-as-you- go registration process that's used by a WKSI
- Define the term *at-the-market offering* and its limitations
- Understand the difference between a statutory prospectus and a free writing prospectus
  - Recognize how different issuers may use an FWP (*see chart in chapter*)
- Recognize the different types of offering communications
- Define the term *gun-jumping* and its safe harbor rules
  - Reporting versus non-reporting issuers and IPOs
- Recognize information that's permissible in a tombstone advertisement
- Define the term *road show* and understand its purpose
  - Who operates the road show? Who presents at the road show? Who attends a road show?
  - SEC filing requirements and bona fide road shows
- Recognize the changes attributable to the JOBS Act
- Define the term *emerging growth company (EGC)* and the confidential filing rules
- Understand the purpose and information requirements under FINRA Corporate Financing Rules
  - Recognize the securities that are exempt from and subject to the filing rules
  - Recognize what's considered compensation to an underwriter
  - Recognize what's considered fair underwriting compensation and the prohibited arrangements
  - Recognize the resale restrictions on securities that are received by an underwriter as compensation
- Define the terms *syndicate members* and *selling group members*
- Understand the rules for selling a fixed price offering
- Understand the rules relating to public offerings and conflicts of interest, including:
  - Disclosure requirements
  - The requirements of a qualified independent underwriter (QIU) and when it's used
  - Placement of securities in a discretionary account
- Understand the purpose of Regulation S-K
  - Rules for projections
  - Rules for disclosures by the board of directors
- Understand the purpose of Regulation S-X
  - Stale financial statements
- Recognize the safe-harbor rules for research reports during a public offering
  - Rule 137, Rule 138, and Rule 139
- Understand the persons liable for a false registration statement under Section 11
  - Section 11 defense and the due diligence defense
- Understand the purpose and timing requirements of Regulation FD
  - Intentional versus unintentional disclosure of material, non-public information
- Understand the recordkeeping requirements for underwriters
  - Underwriter records versus issuer records

Create a Chapter 2 Custom Exam

Now that you've completed Chapter 2, log in to *my.stcusa.com* and create a 10-question custom exam.

Chapter 3

Underwriting

STC
Securities & Insurance Training

The New-Issue Marketplace

As described earlier, when a corporation intends to raise capital, it usually does so by issuing securities. If a corporation is issuing securities to the public for the first time, the process is referred to as its initial public offering (IPO). However, when securities are subsequently issued by a company, the transaction is referred to as a follow-on offering. In either case, the process of raising capital is referred to as a *new issuance, primary offering,* or *primary distribution.* These terms are associated with new shares being created and the issuer receiving the proceeds from the sale.

In some offerings, all of the shares are being sold by the issuing entity; however, other offerings may be considered split sales. In a split sale, a portion of the shares are being offered by the issuer with the remainder of the shares being offered by selling shareholders. The shares that are sold by the company are newly created and constitute a primary offering in which case the company will receive the proceeds for its portion of the sale. The existing shares that are sold by shareholders are considered a secondary offering and the proceeds generated by these sales are directed to the individual sellers.

If the offering is split, it's important for the underwriters to disclose to any purchaser that a portion of the offering's proceeds will be paid to the selling shareholders, rather than to the company. The selling shareholders may be officers of the company or early-round investors (e.g., private equity investors or venture capital funds) that are seeking to cash out or reduce their holdings in the company. In certain offerings, all of the shares are being sold by selling shareholders.

Underwriting Securities

When a corporation intends to raise a large amount of capital, it will often utilize the services of an investment banking firm that will advise the issuer on the most efficient and cost-effective way to raise funds. One of the methods used to raise capital is through a public offering of securities. In the underwriting process, the investment banker that structures the offering for its client will normally participate in the placement/sale of the securities.

The Syndicate and Selling Group

Syndicate The sale of a public offering is typically conducted through a group of broker-dealers that's referred to as an *underwriting syndicate*. For firms involved in an underwriting, the term *syndicate* implies that a financial commitment (liability) is being assumed by the underwriters. The lead broker-dealer will take on the role of *syndicate manager* (*managing underwriter*) and form a syndicate with other broker-dealers that are invited to participate in the distribution.

An agreement, referred to as the *agreement among underwriters* or *syndicate agreement*, is signed by the participating firms to specify the rights and obligations of each participant. The role of the syndicate is to guarantee (underwrite) the offering. A broker-dealer's syndicate desk assists in the pricing of the offering, helps to build the book of orders, markets (distributes) the issue and, if necessary, places a stabilizing bid.

Selling Group In some cases, the syndicate recruits other broker-dealers to assist in the sale of the offering. These firms, referred to as the *selling group,* do *not* assume financial liability for the offering; instead, they act as placement agents. Any shares that the selling group is unable to sell are retained by the syndicate, which remains financially liable for any unsold shares. To join a selling group, a broker-dealer must sign a *selling group agreement*, which is a document that describes the relationship between the selling group and the syndicate.

Each firm that participates in a new issue distribution is responsible for reviewing its transactions for suitability; however, the syndicate manager is under no obligation to review the suitability of trades that are executed by selling group members. Additionally, a broker-dealer that participates in a securities distribution (primary or secondary) may not pay any third party or unregistered person (e.g., an accountant, finder, or attorney) for soliciting another person to purchase the security.

Pricing the Offering On or immediately prior to the effective date, the underwriters assess the demand for the issue and determine the public offering price (POP). If the offering price is satisfactory to the issuing corporation, the new issue distribution will proceed. Syndicate members are required to maintain the public offering price and, unless they're released from this commitment by the managing underwriter, they may not sell the issue at a lower price. Therefore, all investors will pay the same price, which is the public offering price (POP).

Types of Underwriting

The responsibilities of the syndicate members are dependent on the type of underwriting that's being used. A detailed description of each type is listed below.

Firm-Commitment If a syndicate agrees to purchase an entire issue and absorb any securities that are not sold, it's engaging in a *firm-commitment* underwriting. In this case, the syndicate is acting for its own account and risk. The syndicate is therefore firmly committing capital to the issuing corporation for the entire amount of the offering, regardless of whether it's able to sell all of the securities.

> *For example, a corporation wants to sell $10,000,000 of stock and the underwriting syndicate agrees to do so as a firm commitment. If the syndicate members are only able to sell $8,000,000 of the offering, they will absorb the $2,000,000 of unsold stock for their own accounts.*

Best-Efforts If the underwriters agree to make a bona fide effort to sell the entire issue, but are able to return any unsold securities to the issuer without penalty, they have agreed to a *best-efforts* underwriting. The underwriters are acting in the capacity of agents for the issuer, rather than committing capital and acting as principals for their own accounts. For this reason, the underwriting costs of a best-efforts underwriting are lower than a firm-commitment underwriting.

> *For example, a corporation wants to raise $10,000,000 through a stock offering and enters into a best-efforts agreement with the underwriting syndicate. However, if the underwriters are only able to sell $8,000,000 of the stock, the issuer retains the $2,000,000 of unsold stock.*

All-or-None Under certain circumstances, a corporation may require a specific minimum amount of capital to be raised for an offering to be completed. The belief is that by raising a certain amount below the entire offering, the corporation will not be able to accomplish its objectives. The issuer could specify that if all of the issue is not sold, the entire distribution will be cancelled. This type of distribution is referred to as *best-efforts, all-or-none*. As with the standard best-efforts arrangement, the underwriters act as agents for the issuer and attempt to sell as much of the offering as they can. However, if the all-or-none contingency is used and the entire issue is not sold, any sales that had been made are cancelled and the money is returned to the subscribers.

Mini-Maxi A variation of an all-or-none offering is the *mini-maxi* underwriting. With this type, there's a minimum threshold of sales that must be met in order for the offering to avoid cancellation. However, once that minimum is met, additional sales may be made up to a specified maximum amount.

> *For example, a corporation intends to raise $10,000,000 of capital through a stock offering; however, based on the company's capital needs, it requires that at least 70% of the offering be placed. Therefore, a minimum of $7,000,000 must be sold or the entire issue will be canceled. Once the minimum sales level has been satisfied, the underwriters may continue to sell the remaining $3,000,000 of securities without the risk of the offering being cancelled.*

Escrow Account For both best-efforts all-or-none and mini-maxi underwritings, since the offering may be cancelled if a certain amount of the issue is not sold, there's a requirement to establish an *escrow account* for the acquired funds until the contingency is met. If a broker-dealer is participating in a best-efforts distribution, it must promptly forward funds to an account with an escrow agent that has made a written agreement to hold the funds. The escrowing of funds is covered by SEC Rule 15c2-4 of the Securities Exchange Act of 1934. The SEC has interpreted "promptly" to mean by noon of the following business day.

Therefore, any funds that are being invested by clients must be placed into a separate bank (escrow) account, with a bank acting as the escrow agent. In the event that the contingencies outlined in the offering document are not satisfied, the funds must be returned to the subscribers.

Standby Agreements If an existing corporation intends to sell additional shares to the public as a means of raising capital, it may do so through a preemptive rights offering. In this process, all current shareholders are granted the opportunity to purchase the new issue shares at a slight discount before they're offered to the public. At this point, shareholders may exercise or sell the rights. If a stand-by underwriting arrangement is used, the syndicate agrees (for a fee) to purchase any unsubscribed shares remaining after the rights offering. In other words, if the current shareholders choose to not subscribe to the stock offering, the investment banker(s) will purchase all of the residual shares on a firm-commitment basis.

Type of Underwriting	Comments	Liability for Unsold Shares
Firm-Commitment	Syndicate must absorb losses on unsold shares	Syndicate
Best-Efforts	Unsold shares are returned to issuer	Issuer
Best-Efforts, All-or-None	Offering is cancelled if all shares are not sold	Issuer
Best-Efforts, Mini-Maxi	Offering is cancelled if a set minimum is not sold, but sales may continue up to a preset maximum	Issuer
Standby	Syndicate agrees to buy any shares that are not purchased by existing stockholders in a *rights offering*	Syndicate

Distribution of Securities

A broker-dealer that contemplates leading (managing) a distribution of securities will first perform due diligence on the issuer and the offering. This process involves an examination of the issuer's history, comparable companies in the same field, the quality of the company's management, labor relations, financial and operational data, legal matters to determine the feasibility of the distribution, and the price at which to market the issue.

Letter of Intent For an IPO underwriting, the managing underwriter creates a non-binding letter of intent (LOI). An LOI is generally one of the first steps in an IPO underwriting. There's no guarantee that the issuer will proceed with the offering and the underwriting agreement (a later step) is not executed until the IPO has been priced. The LOI is provided to the issuer and it outlines the terms of the deal, including:

- Whether the underwriter will be using a firm-commitment or best-efforts underwriting
- An agreement that the issuer will make all relevant information available to the underwriter for purposes of completing due diligence
- A commitment by the issuer to grant the underwriter an overallotment option (maximum of 15%)
- Whether the issuer agrees to reimburse the underwriter for any expenses if the offering is withdrawn
- The gross underwriting spread or discount

Road Shows Through a process referred to as book building, the underwriters will market the IPO to potential investors. Then, a few weeks prior to the effective date, the road show will begin.

Fully Marketed Road Show Since underwriters typically require a few weeks to market an IPO, they conduct what's referred to as a fully marketed road show.

One-Day Marketed Road Show For follow-on offerings of equity and some debt offerings, the underwriters will require a much shorter period to market the offering. In this case, they utilize a one-day marketed road show.

Block Trade This distribution process involves one underwriter purchasing a large quantity of stock (block) from an issuer or selling shareholders and marketing the block directly to investors. The issuer will be a publicly traded company and the shares are purchased as at a discount to the current market price.

Although this type of transaction will eliminate market risk to the issuer or selling shareholder, the underwriter will assume this risk. In fact, this imposes a very large financial risk on the firm since it's acting in a principal capacity and there's little or no time for the underwriter to market the shares. The firm will need to use its capital to purchase the shares and then liquidate them without causing the stock price to decline below the price it paid to acquire them.

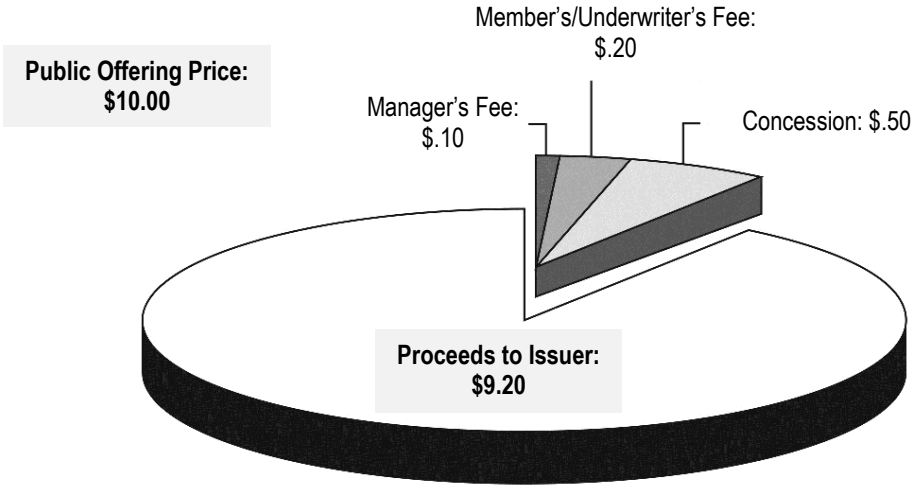
Underwriting Spread (Equities)

Corporate securities are typically underwritten on a *negotiated basis*, which means that the syndicate manager negotiates with the issuer in determining the *underwriter's compensation (spread)*. The underwriting spread refers to the difference between the amount paid by the investing public and the amount received by the issuing corporation; this amount represents the syndicate's gross profit. For example, if the public offering price of a new issue is $20, but the corporation receives $18.60, then the spread is $1.40 per share. The spread is shared by the manager, syndicate members, and possibly the selling group members. The syndicate will incur certain expenses when underwriting an issue and these expenses will be deducted from the underwriting fee that's paid to each member.

The spread consists of the following components:

- **Manager's Fee**—this portion is paid to the managing underwriter for each share of the offering
- **Member's/Underwriter's Fee**—this portion is paid to the syndicate member that assumes the risk or liability for the shares
- **Concession**—this portion is paid to the firm that ultimately sells the shares

Example: The Distribution of an Underwriting Spread



Syndicate Compensation In the example above, the corporation is issuing stock to the public at $10 per share, with a total spread of $.80 per share. Of the $.80 spread per share, $.10 is allocated to the manager, $.20 is allocated to the firm that assumes liability for the shares, and $.50 is allocated to the firm that sells the shares.

Selling Group Compensation Remember, the selling group is comprised of broker-dealers that don't assume financial liability. Therefore, if a selling group member sells the shares, it's only entitled to the $.50 selling concession per share.

A *reallowance* is compensation given to broker-dealers that are not members of the syndicate or selling group, but want to participate in the new issue offering. The reallowance is less than the amount that members of the syndicate or selling group receive.

Green Shoe A stipulation in an underwriting agreement that allows the syndicate to acquire more shares from the issuer so that it may sell more of an issue than the amount originally available is referred to as the *Green Shoe Clause*. This clause is typically triggered by significant demand for an offering. By including this provision, the underwriters are able to purchase up to 15% more shares than were originally being offered. Typically, the underwriter has 30 days from the effective date of the offering to exercise the Green Shoe Clause.

Market-Out Clause Under certain circumstances, conditions might change to the point where a syndicate is able to cancel an underwriting agreement—even one that was established as a firm commitment. However, this is only permitted if the agreement between the underwriting syndicate and the issuer contains a *market-out clause*. The clause allows the syndicate to cancel its commitment if certain events occur that make the marketing of the issue difficult or impossible. Difficulties may include a material adverse event which affects the (proposed) issuer or a general disruption in financial markets that's caused by external events. However, this clause may not be invoked due to the underwriter's inability to market or sell the issuer's securities.

Over-Subscribed IPO When an initial public offering is significantly over-subscribed, it suggests that the demand for shares exceeds the supply being offered by the company at a proposed offering price. In this situation, to increase the amount of capital raised by the issuer, the managing underwriter could increase both the shares offered and the price per share. However, the risk in doing so is that it may cause supply to exceed demand and the price of the company's shares to decline in the secondary market.

Underwriting Spread (Debt)

Corporate debt securities also have underwriting spreads; however, the fees (as a percentage of the offering price) are lower since debit securities have less risk than equities. The fees are usually expressed using the terms *points and basis points.* Bonds are generally offered at par value of $1,000 per bond, with each *point* equaling 1% of the bond's par value, or $10. Smaller increments are expressed in fractions, for example, ½ point is equal to $5.00 and ¼ point is equal is to $2.50. For every 1% of a bond issuance, there are 100 basis points. Therefore, one *basis point* is equal to 1/100 of 1%.

For example, on a per bond basis, if XYZ Corporation is entitled to the offering price of $1,000 minus the underwriting spread of $8.00, it will receive $992. The underwriting spread is comprised of the manager's fee of 10 basis points and the compensation paid to selling syndicate members of 70 basis points. The 70 basis points that's paid to selling syndicate members is comprised of a 40-basis-point selling concession for engaging in the selling effort and a 30-basis-point underwriting fee for the capital that underwriters put at risk. For that reason, if a selling group is involved in the distribution, it will only receive the 40 basis points for selling, but not the 40 basis points for capital risk since a selling group doesn't assume liability.

Research Related Rules

FINRA created rules which place certain restrictions on the research department of a broker-dealer as it relates to underwriting securities. These restrictions cover communications with the issuer, the relationship between the research analyst and the investment banking department, public appearances by the research analyst, and prohibitions related to offering favorable research.

Communication with the Firm's Research Department

The role of the investment banking department of a broker-dealer is to provide advisory services and assist its clients in underwriting their securities, while the firm's research department is responsible for analyzing many of the same companies. To avoid a conflict of interest between the investment banking and research departments, information barriers (formerly referred to as Chinese Walls) must be established between them.

The information barriers that separate investment banking and research must be reinforced through the supervision of these areas, including a member's written supervisory procedures. A member's investment banking department is restricted from exercising any control over its research department, particularly as it relates to the preparation of research reports. The approval of reports must be conducted exclusively by the appropriate personnel in the research department. Review and approval mechanisms which provide a member firm's investment banking department and other non-research personnel with review or veto power over research reports are strictly prohibited.

Joint Due Diligence Prior to the selection of underwriters for an investment banking services transaction, FINRA prohibits a joint due diligence meeting between research personnel and other departments, such as investment banking or sales and trading. The concern is that investment bankers may pressure research professionals to produce favorable research that may enhance the firm's bid to become an underwriter for the offering. Once the underwriter has been selected, *joint due diligence* is permitted; however, there must be procedures established to guard against interactions to further the interests of the investment banking department. In other words, the research analyst can be brought *over the wall.*

Managing Conflicts of Interest FINRA's equity research rules requires a member firm to establish, maintain, and enforce written policies and procedures that are reasonably designed to identify and effectively manage conflicts of interest related to the interaction between research analysts and persons outside of the research department. These persons include investment banking personnel, sales and trading personnel, the subject companies, and customers.

The following list identifies some of the specific requirements for handling conflicts:

- Prohibit prepublication review, clearance, or approval of research reports by persons engaged in investment banking services activities and restrict or prohibit such review, clearance, or approval by other persons not directly responsible for the preparation, content, and distribution of research reports. Legal and compliance personnel are permitted to review, comment, and/or approve a research report.
  - Prepublication by investment banking is not necessary since there are numerous other sources available to verify factual information, including the subject company.

- Restrict or limit the investment banking department's input into research coverage decisions to ensure that research management has independently made all final decisions regarding the research coverage plan.
  - Investment banking personnel and other non-research professionals are permitted to provide input and to discuss customer interest, but the final decision regarding coverage must be made by research management.
- Prohibit persons that are engaged in investment banking activities from supervising or controlling research analysts, including having influence or control over research analyst compensation evaluation, and determination.
- Establish information barriers or other institutional safeguards that are reasonably designed to ensure that research analysts are insulated from the review, pressure, or oversight by persons who engage in investment banking services activities or other persons, including sales and trading personnel, who might be biased in their judgment or supervision.
- Prohibit explicit or implicit promises of favorable research, a particular research rating or recommendation, or specific research content as inducement for the receipt of business or compensation.

Compensation Committee Member firms are required to form a compensation committee that's responsible for reviewing and approving the compensation for the firm's research analysts. The analysts whose compensation will be reviewed are those who are primarily responsible for the preparation and substance of a research report. This compensation committee:

- On at least an annual basis, must review and approve the analysts' compensation
- Must report to the board of directors (BOD) or, if the member firm has no BOD, a senior executive officer of the firm
- Is not permitted to include any representative from the member firm's investment banking department
- Must document the basis on which the research analysts' compensation was established

Solicitation of Investment Banking Business

The firm's written policies and procedures must restrict or limit activities by research analysts that can reasonably be expected to compromise their objectivity. Therefore, research analysts are prohibited from participating in pitch meetings and other solicitations of investment banking services transactions. *Investment banking services* include, without limitation, acting as an underwriter for either a debt or equity offering, participating as a part of a selling group in an offering for the issuer (or otherwise acting in furtherance of a public offering of the issuer), acting as a financial adviser in a merger or acquisition, providing venture capital or equity lines of credit, or serving as placement agent for the issuer (or otherwise acting in furtherance of a private offering of the issuer). This is meant as a broad definition and includes being involved in private investment in public equity (PIPE) offerings.

The reason for the limitations placed on analysts is to lessen the conflict of interest between the investment banking department's goals to cultivate business and the research analyst's responsibility to provide an unbiased review of a company that's being covered by her firm.

> *For example, a research analyst's former supervisor, who has moved to the firm's investment banking department, asked her to accompany him and other members of the investment banking department to a pitch meeting with Phone System Gateway Inc. (PSG). PSG is a public company that's looking to make a strategic acquisition. In this situation, the research analyst is not allowed to participate in the pitch meeting because the primary goal of the meeting is to solicit investment banking business from PSG.*

Road Shows For an investment banking services transaction, a *road show* is simply a form of solicitation. A road show encompasses the meetings that an investment banker and an issuer hold with prospective customers and brokers prior to a securities offering (debt or equity). A research analyst is prohibited from participating in a road show that's connected with an investment banking services transaction. Due to the promotional goal of a road show, a research analyst may feel pressured to provide a positive or optimistic outlook about the transaction, regardless of whether that outlook is truthful.

> *For example, Vanderpool Securities is the managing underwriter for the IPO of Toy Poodle America, Inc. and is doing road shows on the East Coast. Since Jennifer is a research analyst at Vanderpool, she may not attend road shows pertaining to the IPO of Toy Poodle.*

If a presentation is being held in a remote location, research analysts are permitted to listen to or view a live webcast of a transaction-related road show or a widely attended presentation being made by investment banking personnel to investors or to the sales force. If the analysts are in the same location as where the presentation is being conducted (i.e., the member firm's office), they must be in another room and may not be identified as a participant.

Investment Banking Personnel and Research Analysts To further distance research analysts from the investment banking department, investment banking department personnel are prohibited from directing a research analyst to participate in the sales and/or marketing efforts of an investment banking services transaction. Investment banking personnel are also prohibited from directing a research analyst to engage in any communication with either a customer or prospective customer about an investment banking services transaction.

The prohibition eliminates the ability of investment banking department personnel from directing research analysts and relieves the pressure on a research analyst from providing overly positive information regarding an investment banking services transaction. This restriction doesn't apply to non-investment-banking personnel. Therefore, an institutional salesperson is permitted to direct a research analyst to engage in sales or marketing efforts as well as communicating with current or prospective customers concerning investment banking transactions.

> *For example, Lauren is the director of the investment banking department at Cash & King Investments, which is the managing underwriter for an upcoming follow-on offering. She contacts Kaleb, a research analyst who prepares research reports on the issuer, to assist the investment banking department with contacting customers to discuss the secondary offering. In this example, Lauren is violating SRO rules by encouraging Kaleb to participate and contact customers to discuss the follow-on offering.*
>
> *As another example, Max is an institutional equity salesperson who's attending an investment banking road show in Chicago. Max is permitted to ask a research analyst who's located in the Chicago office to discuss the investment banking transaction. However, any communication must be fair and balanced and may not take place in the same location as the road show.*

Pitch Materials As previously mentioned, a firm is prohibited from offering the promise of favorable research. This restricts the inclusion of information in any pitch materials being provided to prospective investment banking customers that might suggest, either directly or indirectly, that the firm might provide favorable research coverage. FINRA considers the publication of a research analyst's industry ranking in a pitch book or related materials to imply the potential outcome of future research because of the manner in which such rankings are compiled. A firm is permitted to include in the pitch materials the fact of coverage and the name of the research analyst since this information alone doesn't imply favorable coverage.

Non-Deal Road Show Research analysts are permitted to attend non-investment-banking or non-deal road shows. A non-deal road show is considered a road show that's not related to an investment banking services transaction.

Three-Way Communications Another instance in which research analysts may feel pressured to provide a positive report is when they're communicating with either customers or prospective customers in the presence of personnel from the investment banking department or from the issuing company. SRO rules have prohibited these types of communications—which are referred to as *three-way communications.*

The rules against three-way communications are designed to prevent customers and prospective customers from confusing the research analyst's role in assigning a rating and the investment banking department's effort to solicit business. Research analysts are permitted to communicate with both prospective and existing customers, as well as personnel of their member firms, about research and investment banking services transactions if they adhere to the following two stipulations:

1. Any oral or written communication by the research analysts must be fair, balanced, and not misleading.
2. No personnel from the investment banking department or company management may be present.

By allowing communications under the premise that they're fair, balanced, and not misleading, a research analyst may objectively do her job.

> *For example, Morton is a research analyst at Founding Frontier Securities who has prepared a research report on Marble Industries. While speaking with a hedge fund customer at a research conference, he begins to discuss the potential merger of Greene Incorporated and Marble Industries. If the CEO of Marble Industries approaches the two, Morton may no longer continue to discuss the potential merger while in the presence of the CEO.*
>
> *As another example, the CEO of Donnelly Investments called a meeting that included different company personnel to discuss a recent news item that was released to the media—the merger between Simon Systems, Inc. and Joliet Methodology Corporation. Donnelly Investments is an investment banker involved in the M&A transaction. Larry, a research analyst at Donnelly Investments, has been called to the meeting to provide details about Simon Systems, a company on which he prepares research. If no personnel from the investment banking department or subject company are present, Larry may speak at the meeting about Simon Systems and the merger between the two companies because it has already been released to the media.*

Quiet Periods

To further delineate investment banking business from research recommendations, the rules incorporate a quiet period during which the investment banking client may not be the subject of a research report or public appearance. A *public appearance* is defined as any participation in a conference call, seminar, forum (including an interactive electronic forum), or public speaking engagement to 15 or more persons or with *one* or more representatives of the media (e.g., a radio, TV, or print media interview) in which a research analyst makes a recommendation or offers an opinion concerning an equity security.

A public appearance doesn't include a password-protected webcast, conference call, or similar event with 15 or more existing customers, provided that all of the event participants previously received the most current research report (or other documentation that contains the required applicable disclosures) and that, during the event, the research analyst who appears at the event corrects and updates any disclosures in the research report that are inaccurate, misleading, or no longer applicable.

The quiet period rules apply to both initial public offerings and secondary offerings. For purposes of this rule, an initial public offering is defined as the initial registered equity security offering by the issuer, while a secondary offering is defined as an offering by persons other than the issuer (e.g., selling shareholders) and registered follow-on offerings by the issuer. The quiet period provision is designed to prevent an analyst from providing a favorable rating or making a public appearance immediately following the offering.

During this quiet period, the participating broker-dealers (which include both syndicate and selling group members) may not publish or distribute research reports or make public appearances regarding the subject security. Additionally, the firm's analysts are prohibited from making public appearances regarding the issuer of the security. The length of the quiet period depends on both the nature of the transaction as well as the entity that issues the research.

The rule uses the term "from the date of the offering," which is defined as the *later* of the effective date of the registration or the first date on which a bona fide offering of the securities is made to the public.

The relevant periods are as follows:

Quiet Period for Initial Public Offerings (IPOs)	
For Manager/Co-Manager	**For all other participating firms**
10 calendar days from the date of the offering	10 calendar days from the date of the offering

Quiet Period for Follow-On (Secondary) Offerings	
For Manager/Co-Manager	**For all other participating firms**
Three calendar days from the date of the offering	No quiet period exists

For purposes of the quiet period, the phrase "from the date of the offering" is defined as the effective date of the registration or the first date on which a bona fide offering of the securities is made to the public—whichever is later.

Note: For secondary offerings, the quiet period related to both research reports and public appearances doesn't apply to issuers whose securities are *actively traded.* As defined under Regulation M of the Securities Exchange Act of 1934, *actively traded securities* are those with an average daily trading volume (ADTV) of at least $1 million and issued by a company whose common equity securities have a public float of at least $150 million.

Significant News Exception to Quiet Periods The occurrence of significant news or events will allow for research reports to be published or public appearances to be made during quiet periods. However, any firm that uses this exception must obtain the authorization of its legal and compliance department.

Significant news items or events are those that make a *material impact* or *material change* in a company's financial condition, operations, or earnings, and require the filing of SEC Form 8-K. Examples include the resignation of a chief executive officer or a regulatory investigation regarding a company's activities. However, a general announcement regarding a company's earnings is not considered a significant news exception under the quiet-period rules.

> *For example, two days after the initial public offering of a technology company, the CEO of the company suddenly resigns. A research analyst who is employed at the firm that was the managing underwriter could comment on how this might impact the company. The analyst could write a research note and/or participate in a public appearance.*

Unregistered Offerings The quiet period following secondary offerings doesn't apply to unregistered offerings. For that reason, there's no quiet period for private placements of 144A securities and offerings that are conducted outside of the U.S. under the provisions of Regulation S.

Emerging Growth Companies

In 2012, the Jumpstart Our Business Startups (JOBS) Act was enacted. This Act created a new category of issuer that's referred to as an emerging growth company (EGC). As previously mentioned, an EGC is a company that has total annual revenues of less than $1.07 billion during the most recently completed fiscal year (initially $1 billion, but is adjusted for inflation).

The following provides details regarding how FINRA's research rules apply to EGCs:

- In connection with the initial public offering (IPO) of an EGC:
  - The prohibition against a research analyst participating in a pitch meeting with investment bankers is not applicable.
  - The prohibition from joint due diligence meetings is also not applicable.
- All restrictions concerning non-IPO solicitations of investment banking business by research analysts remain in place.
- The three-day and 10-day quiet periods that restrict a research analyst's ability to publish a research report or make a public appearance concerning a securities offering, have been eliminated. Therefore, immediately following an IPO or secondary offering, a research analyst is permitted to write a research report or make a public appearance.

Anti-Retaliation

The Anti-Retaliation Rule prevents a firm or any of its affiliates from either directly or indirectly retaliating, or threatening to retaliate, against any research analyst who publishes a research report or makes a public appearance that may have a negative effect on the firm's current or future business interests. Essentially, this policy prohibits retaliation by personnel in the investment banking department or any other employees of the firm. This rule must be a part of a member firm's written policies and procedures in order to promote objective and reliable research.

Termination of Research Coverage

When a broker-dealer decides to terminate its coverage on an issuer, the firm must publish a final research report and provide the report to its customers in the same manner that it ordinarily uses when distributing material. The final report must be similar in scale and scope to its past reports and, unless it's impractical, it must include a recommendation. In the event that a final recommendation is not available, the broker-dealer must disclose its reason(s) for terminating research on the issuer and/or security. If a broker-dealer provides research coverage and also makes a market in a specific issue, the broker-dealer is not required to discontinue its market making for a stock simply because it terminates coverage on the stock.

Research Reports and Debt Securities

FINRA also has rules regarding debt research reports and debt research analysts which are similar to the rules for equity securities. Some of the key differences are described below:

Debt Research Report A debt research report includes an analysis of a debt security or an issuer of a debt security. However, research reports on government securities, municipal securities, and convertible bonds are excluded from the definition.

Sales and Trading Personnel and Compensation Sales and trading personnel, but not personnel engaged in principal trading activities, may provide input to debt research management into the evaluation of the debt research analyst compensation in order to convey customer feedback. However, the final compensation determinations must be made by research management and it's subject to review and approval by the compensation committee.

Limited Investment Banking Exception There's an exception to the provision in the debt research rule that carves out a limited investment banking activity exception. The exception is available for a firm that participated in 10 or fewer investment banking services transactions as manager or co-manager and generated $5 million or less in gross investment banking revenues from those transactions. Please note, the threshold is the same as what's provided in the equity research rule.

Exception for Limited Principal Trading Activity Limited principal trading activity is defined as trading gains or losses on an annual basis of $15 million or less over the previous three years on average per year and the member has fewer than 10 debt traders. If this requirement is met:

- The prepublication review, clearance, or approval of debt research by principal trading personnel and sales and trading personnel is not prohibited

- The prepublication review, clearance, or approval of debt research by other persons not directly responsible for the preparation, content, and distribution of debt research reports is not prohibited
- Limitations regarding input into debt research coverage decisions by principal trading personnel and sales and trading personnel are removed
- Limitations regarding the supervision of a debt research analyst by persons involved in principal trading activities and sales and trading are removed
- Limitations regarding the determination of the research budget by principal trading management are removed
- Requirements that debt research analyst compensation be reviewed by a committee reporting to the board of directors is eliminated
- The requirement to establish information barriers and other institutional safeguards designed to ensure that debt research analysts are removed from the review, pressure, and oversight of persons involved in principal trading or sales and trading activities and other persons who may be biased in their judgment are removed

Exception for Debt Reports Provided to Institutional Investors

The provisions of the debt research rule don't apply to reports that are distributed to qualified institutional buyers (QIBs). A QIB is an institution that owns and invests at least $100 million in securities, as well as any investors that's defined as an institutional account.

QIBs This exception applies if:

- The member firm has a basis to believe that the QIB is capable of evaluating investment risks independently
- The QIB has affirmatively indicated that it's exercising independent judgment in evaluating the member's recommendations and is able to make its own suitability determination

The firm must provide written disclosure to the QIB that reports intended for institutional investors are not subject to independence and disclosure standards that are applicable to reports prepared for retail investors.

Institutional Account An institutional account is also exempt from these rules if, prior to receiving a debt research report, it has affirmatively notified the broker-dealer in writing that it wants to receive institutional debt research and forego treatment as a retail investor.

Research reports that are provided to these institutional investors are required to have prominent disclosures on the first page of the report, such as the following:

- *This document is intended for institutional investors and is not subject to all of the independence and disclosure standards applicable to debt research reports prepared for retail investors*
- *The views expressed in this report may differ from the views offered in [Firm's] debt research reports prepared for retail investors.*
- *This report may not be independent of [Firm's] proprietary interests.*

New Issue Practices

There are a number of factors that may be important to the IPO market, such as the company's performance and the industry sector in which it operates, but the recent performance of the equity markets is also of great importance. In reality, a profitable, well-established company may still have difficulty raising capital if the equity markets have been falling for an extended period.

Due to market conditions, there are times when deals may be severely under-subscribed or over-subscribed. In these situations, the process of allocating shares between syndicate firms is determined by the manager and disclosed in the syndicate agreement. In one allocation method, the syndicate establishes an institutional pool from which shares will be available on a *jump ball* basis. This process sets aside shares for institutional clients and allows all member firms to compete for orders. Ultimately, the profit is allocated based on each member firm's sales. The institutions that receive allocations will generally designate the underwriters to whom the sales are credited; however, there's often a cap that's set on the amount of credits the manager may earn. If the pool agreement is fixed, the credit on these sales is based on the original risk percentages that are assigned to each member. The manager will often deliver the shares directly to the institutional clients through a bookkeeping process that's referred to as *Manager Bill and Deliver*.

Free Retention Although underwriters may initially receive a significant allocation of shares, in many cases, a large portion of these shares have already been presold to institutional clients. *Free retention* represents the amount of shares that an underwriter is allotted for placement to its own clients. Sales to the firm's retail clients are often filled from this amount, with the profit from the sales going to the member firm that made the sale.

Settlement of Syndicate Accounts

By no later than 90 days following the syndicate settlement date, syndicate managers must provide each syndicate member with an itemized statement of syndicate expenses. For firm commitment public offerings, FINRA rules require the syndicate manager to immediately, but by no later than the scheduled closing date, notify FINRA's Operations Department of any anticipated delay in the closing of the offering beyond the closing date that's stated in the offering document.

Regulation M

Most aspects of new securities offerings are regulated by the Securities Act of 1933; however, the Securities Exchange Act of 1934 also contains provisions that affect the sale of new issues—particularly the activities of the underwriters. The SEC recognizes that underwriters have an incentive to artificially influence aftermarket activity because they have underwritten the risk of the offering and that poor aftermarket performance could result in reputational harm and subsequent financial loss.

Before major federal securities laws were passed in the 1930s, syndicate members often *conditioned the market* for the new issues they were planning to sell. Once the underwriters sold their allotments and stopped their conditioning (manipulative) activities, the stocks involved would often drop precipitously. Ultimately, these types of activities caused unwary investors to suffer large losses.

In order to regulate trading practices involving new issues and those who initially profit from the sale of new issues, the SEC enacted Regulation M. This regulation covers company IPOs as well as existing issuers that are offering additional securities to the public. Under the rules comprising Regulation M, the SEC restricts distribution participants (e.g., underwriters and issuers) from bidding for or making secondary market purchases of the stock that's being offered in a distribution. This restriction is in effect for a limited period revolving around the effective date.

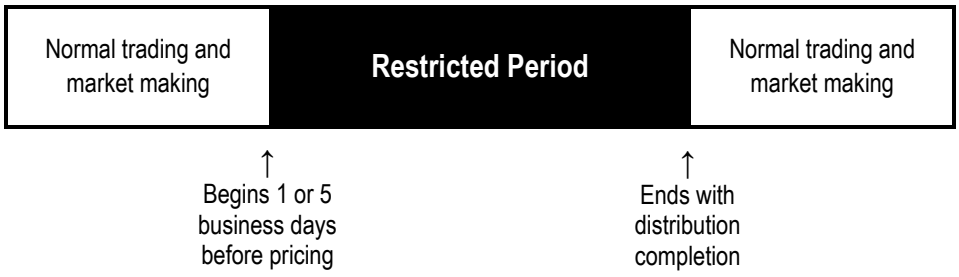
Regulation M attempts to prevent any upward price manipulation before the pricing of the deal since the motivation for the manipulation is to ensure that the issuer receives more proceeds and the underwriters receive greater fees. However, certain exceptions are permitted when the SEC believes the chances of manipulation are low. Under specific conditions, the Commission also makes exceptions available for market makers as well as for syndicates that are attempting to support (stabilize) the price of the new issue.

A *market maker* is defined as a broker-dealer that's qualified and stands ready to buy or sell a minimum quantity of a specific stock (usually 100 shares) on a regular and continuous basis at a publicly quoted price. By performing this function, these firms help to create and maintain liquidity for the securities in which they make a market.

Rule 101 — Activities of Distribution Participants

The purpose of Rule 101 of Regulation M is to prevent the *interested participants* in a distribution from manipulating the secondary market trading of the stock for their own benefit. Interested participants include syndicate members, selling group members, and any other broker-dealers that assist in selling the security being offered to the public (the *subject security*). These participants are not permitted to buy or bid for the subject security within a critical time frame are referred to as the *restricted period*.

Length of the Restricted Period The restricted period begins one or five business days prior to the pricing of the offering or whenever the broker-dealer becomes a distribution participant—whichever comes later. The period ends when the broker-dealer's participation in the distribution ends.



In the case of a distribution that involves a merger, acquisition, or exchange offer, the restricted period begins on the day that the proxy solicitation materials are first disseminated to holders of the securities and ends once the distribution is completed.

When determining the restricted period for a security, the SEC recognizes that securities with higher trading volume are more difficult to manipulate. For that reason, the restricted period for these securities will be shorter.

The following table provides details regarding the restricted period based on a security's public float and average daily trading volume (ADTV):

Five Days Prior to Pricing	▪ Public float of less than $25 million and ADTV of less than $100,000
One Day Prior to Pricing	▪ Public float between $25 million and $150 million and ADTV of at least $100,000
No Restricted Period	▪ Municipal securities, Government securities, and non-convertible investment-grade debt ▪ Actively traded securities – Public float of at least $150 million and ADTV of $1 million

Reference Security The prohibition on making purchases or bids doesn't only apply to the subject security (i.e., the security that's the subject of a distribution), but also to any *reference securities* into which the subject security may be converted. For example, if ABC Company convertible bonds are being distributed, the bonds are the subject security and ABC's common stock is the reference security. Together, both subject and reference securities are referred to as *covered securities* and are subject to the restrictions of Rule 101. Although common stock is a reference security for an offering of rights, warrants, or convertibles (subject securities), the reverse is not true.

Exceptions to Rule 101 There are numerous exceptions available to the restrictions of Rule 101; however, they're not to be considered as permission to interfere with market forces. Activity that's obviously manipulative will still violate general SEC antifraud rules. Exceptions to Rule 101 are based on either the type of securities being issued or the type of transaction and include the following:

- Transactions that involve government and municipal bonds, non-convertible investment-grade debt and preferred stock, and registered investment company securities
- Actively traded securities (as referenced in the previous table)
- Odd-lot transactions
- The exercise of any option, warrant, right, or similar instrument during the restricted period, regardless of when it was acquired
- Unsolicited brokerage transactions and unsolicited *purchases* when acting as a principal
- Securities of domestic and foreign issuers that are eligible for an exemption from the Securities Act of 1933 under Rule 144A if they're sold to qualified institutional buyers (QIBs), as well as certain Regulation S transactions
- Transactions in the subject security that are part of a basket strategy, provided the basket is not being used for manipulation. The subject security must be no more than 5% of the basket and the basket must contain at least 20 securities.

Unaccepted bids, as well as purchases that don't exceed 2% of the security's ADTV, are exempt from the rule provided the broker-dealer maintains and enforces written policies and procedures that are designed to prevent violations. Once inadvertent transactions are discovered, subsequent *de minimis* transactions are NOT exempt.

Research Both existing trading practice rules and Rule 101 of Regulation M prohibit underwriters from inducing others to purchase a covered security. In the past, this prohibition was interpreted to include the distribution of research reports by participating broker-dealers. Although the SEC granted certain types of no-action relief for normal research report mailings, it was often unclear as to what was acceptable.

Rule 101 addresses this issue more clearly by stating that research reports which are related to covered securities may be distributed during the restricted period if they meet the conditions of Rules 138 or 139 of the Securities Act of 1933. This usually requires that the reports be distributed with reasonable regularity in the normal course of business. The SEC also expects that the recipients of these reports either have or will regularly receive the broker-dealer's research. For example, adding new recipients to the mailing list is permitted if it's intended that they will continue receiving research in the future. However, sending a single report to a potential customer during the restricted period doesn't qualify for the exception.

Regulation M and IPO Allocations Regulation M applies to initial public offerings by preventing underwriters and broker-dealers from influencing a security's price prior to the completion of the distribution. The SEC states that any attempt to influence the aftermarket price of an IPO during the distribution is a manipulative act. This situation may occur if the offering is over-subscribed and underwriters are allocating a limited number of shares to their institutional clients.

The SEC specifies that broker-dealers and underwriters are prohibited from engaging in any communication with a customer which implies that the customer's ability to obtain IPO allocations will be improved if the customer expresses an interest in buying additional shares in the immediate aftermarket. In other words, it's a violation of Regulation M to make solicitations to customers before the completion of the distribution period about whether they intend to place immediate aftermarket orders for an IPO (including details of the price and quantity). This manipulative practice of allocating IPO shares based on having secured prearranged purchase orders from customers in the aftermarket at specified prices is referred to as a *tie-in arrangement* (or *laddering*). The intent of the practice is to inflate the aftermarket price of an IPO and cause other market participants to buy or bid for the security at higher prices.

This prohibition applies regardless of whether the transactions were actually executed. If, prior to the effective date, a client is contacted in regards to pricing information in the aftermarket prior, it may indicate to the prospective client that there's a shortage of shares in the IPO and that the remainder of their buying interest would only be filled in the aftermarket. In other words, making solicitations to customers before the completion of the distribution period about whether, and at what price and quantity, the customer intends to place immediate aftermarket orders for an IPO is a violation of Regulation M. In addition, it's a violation to encourage clients, prior to the trading of an IPO, to provide information on the price and number of shares they would be willing to purchase in the aftermarket.

Although there's no regulatory requirement as to how to allocate an over-subscribed issue, a syndicate manager's best course of action is to allocate the shares on a pro rata basis using a fair allocation system.

Rule 102 — Activities of Issuers

To understand Rule 102, let's imagine an insider is holding thousands of shares of a company that's currently conducting a follow-on offering. In this case, it's possible that the insider may be tempted to push the price of the stock up just before the company's offering reaches the secondary market.

Because of this temptation, Regulation M prohibits issuers and selling security holders (mainly insiders) from supporting or raising the price of a security that's being distributed. In other words, issuers and selling shareholders may not bid for, purchase, or attempt to induce others to bid for or purchase, any covered security during the applicable restricted period.

Exceptions to Rule 102 Similar to Rule 101, Rule 102 contains exceptions for certain transactions, including unsolicited purchases, transactions in Rule 144A securities, the exercise of convertible securities, odd-lot transactions, and transactions in exempted securities. However, since issuers and selling shareholders don't play the same role in the market as intermediaries (e.g., broker-dealers), some of the exceptions in Rule 101 are not available to them.

For example, issuers may NOT bid for or purchase the following:

- Actively traded securities of their own or of an affiliate
- Basket transactions involving a covered security
- Inadvertent (*de minimis*) transactions
- Unsolicited transactions executed through a broker-dealer

In addition, under certain circumstances, the Rule 101 provision allows for the issuance of research on a covered security that's not available to the issuer or its affiliates.

Rule 103 — Passive Market Making

Although Rule 101 of Regulation M normally prohibits distribution participants from purchasing or bidding for a subject security, Rule 103 allows distribution participants to continue making markets on a passive basis during the restricted period for a Nasdaq stock that's currently the subject of an offering. However, a passive market maker may not enter a bid or execute a purchase at a price that exceeds the highest independent bid on Nasdaq. Since the market maker's bids and purchases are limited by the highest independent bid, passive market making is not allowed if there's no independent bid that exists on Nasdaq.

Limit on Quantity Purchased A passive market maker's *daily purchase limit* (DPL) is limited to 30% of *its* ADTV in the stock (as determined by FINRA) or 200 shares—*whichever is greater*. For a single day, if a passive market maker's net purchases (i.e., purchases in excess of sales) exceed its purchase limit, it must withdraw from the market for the rest of the day.

When a passive market maker is near the limit, it's allowed to execute any single order, even if that trade causes the firm to exceed its daily limit. However, after executing the trade, it must then withdraw from the market for the rest of the day.

> *For example, let's assume that a passive market maker's daily purchase limit is 10,000 shares and it currently has made net purchases of 9,500 shares. Based on a single order, the market maker may purchase 1,000 shares, even though this will cause its total net purchases to exceed its limit. Of course, after execution, it must then withdraw from the market. For purposes of evading the rule, a passive market maker is prohibited from aggregating orders into a single transaction. In other words, for the example above, two 500-share tickets may not be combined into a single 1,000-share transaction.*

Limit on Price of Purchase In a *falling market*, when the last independent bid drops below that of a passive market maker, the passive market maker may maintain its bid, but only until its purchases have reached or exceeded *the lesser of*:

1. Two times the minimum quote size for that security (as set by FINRA), or
2. The passive market maker's remaining daily purchase limit

If twice the minimum order size is executed, the passive market maker must drop its bid to either the level of the highest independent bid or below. However, if the market maker's daily purchase limit is reached first, it must withdraw from the market for the rest of the day.

In a *rising market*, a passive market maker may raise its bid as the best independent bid rises, but is not required to do so.

> *For example, XYZ Broker-Dealer is involved in the secondary offering of BNBR and has consistently been a market maker in the stock. Under Rule 103, XYZ Broker-Dealer may continue to act as a market maker. MM A, an independent market maker, is at the inside bid for BNBR at 16.59. XYZ Broker-Dealer may enter a bid or execute a purchase up to, but not greater than, 16.59. The bids in the market for BNBR are as follows:*

	Bids
MM A	16.59 (Independent)
XYZ B/D	16.59 (Passive MM)
MM C	16.50 (Passive MM)

> *If MM A lowers its bid to 16.45, XYZ Broker-Dealer is permitted to purchase 200 shares of BNBR or may reach its remaining daily limit before it must lower its bid to 16.45. XYZ Broker-Dealer is not able to simply lower its bid to 16.50 since MM C is also a passive market maker; instead, XYZ must follow the best independent market maker.*

Rule 104 — Stabilization

Stabilization is defined as the placing of any bid, or the execution of any purchase, for the purpose of pegging, fixing, or otherwise maintaining the price of a security. Although stabilizing is generally a manipulative activity, in certain cases, the SEC considers that its benefits (facilitating an orderly distribution) outweigh its disadvantages. Stabilization conducted by an underwriter is a *permitted* manipulative activity provided the SEC's rules are followed.

Rule 104 of Regulation M attempts to strike a balance between the desirability of an orderly distribution and the need to prevent manipulation of a new offering. Purchases that are made by the syndicate are illegal if they're unnecessary to prevent or retard a decline in the security's price, or if their purpose is clearly manipulative. Also, stabilization is not permitted for *at-the-market offerings* since these offerings of securities are not being done at fixed prices.

Initiating a Stabilizing Bid Only one participant in a distribution may enter a stabilizing bid in a security and the maximum price at which a stabilizing bid may be initiated is the last independent sale price, or the highest bid in the market.

In the case of an IPO, the stabilizing bid may not be higher than the POP. The application of the rule depends on whether stabilizing begins when the security's principal market is open or closed. A security's principal market is the market that accounts for the majority of the security's trading volume.

Initiating Stabilization When the Principal Market Is Open After the opening of quotes for the security in the principal market, stabilization may be initiated in any market at a price that's no higher than the last independent transaction price if:

1. The security has traded in the principal market on the day on which stabilization is initiated or on the preceding business day, and
2. The current ask price in the principal market is equal to or greater than the last independent transaction price.

If the preceding two conditions are not satisfied, stabilizing may not be initiated in any market after the opening of quotes in the principal market at a price that's higher than the highest current independent bid for the security in the principal market.

For example, BNBR stock has just opened for trading in its principal market, but no transactions have taken place in the stock. XYZ Broker-Dealer, a participant in the security's initial public offering (IPO), intends to maintain a stabilizing bid for the security. MM A, an independent market maker, is at the inside bid for BNBR at 24.55. XYZ Broker-Dealer may not enter a bid that's higher than the highest independent bid (as shown below):

	Bids
MM A	24.55 (Independent)
MM B	24.54 (Independent)
XYZ B/D	24.55 (Stabilizing)

Disregarding the table above, let's assume that BNBR was trading in the principal market for one day prior to XYZ Broker-Dealer's attempt to place a stabilizing bid. If BNBR was quoted at a bid price of 24.56 and an ask price of 25.00, XYZ Broker-Dealer would be able to maintain a bid of 24.56.

Initiating Stabilization When the Principal Market Is Closed When the principal market for the security is closed, the price at which stabilization may be initiated is generally limited to the lower of the price at which stabilizing could have been initiated in the principal market at its previous close, or the last independent transaction or bid in the market on which stabilizing will be initiated.

If a broker-dealer enters a stabilizing bid, it must grant priority to any independent bid at the same price, regardless of the size of the independent bid. Once initiated, a stabilizing bid may be raised to match the independent bids that are already in the market.

Disclosure and Notification If a syndicate decides to stabilize, it must notify the market in which stabilizing will occur, and must disclose the purpose of the stabilizing bid to the person with whom the bid is entered. There's no specific time limit on how long a syndicate may maintain a stabilizing bid; however, once the syndicate has completed the distribution, the rules regarding stabilization no longer apply.

Penalty Bids and Syndicate Covering Transactions

A *penalty bid* is an arrangement that permits a managing underwriter to reclaim a selling concession from a syndicate member if the securities that were originally sold by the syndicate member are purchased in syndicate covering transactions. The imposition of penalty bids is designed to discourage the allocation of shares in an offering to investors that intend to immediately flip the shares. On Nasdaq, penalty bids are identified by the abbreviation *PBID*.

The syndicate manager must provide written notice to FINRA if it intends to either impose a penalty bid on a subject or reference security under Rule 101 or engage in syndicate covering transactions under Rule 104. The notice must be provided prior to the start of either of these activities and it must include the identity of the security, its Nasdaq symbol, as well as the date on which the member firm intends to impose the penalty bid and/or conduct syndicate covering transactions. A Regulation M Trading Notification Form, which is part of the Underwriting Activity Report, may be used for reporting this information. Also, no later than 30 days after the effective date of the offering, the manager must maintain information in its files about the amount of the syndicate short position.

Syndicate Covering Transaction A *syndicate covering transaction* is when any purchase is executed on behalf of the sole distributor or the underwriting syndicate or group in an effort to reduce a short position that's created during an offering. Underwriting agreements generally contain a clause authorizing the lead manager to act on behalf of the syndicate and engage in overallotment (sell more securities than what's listed in the prospectus).

After the completion of the distribution, the lead manager may cover any of these syndicate short positions by either exercising the Green Shoe option or through open market purchases. If the market price of the stock is trading above the IPO price, syndicate covering transactions could result in significant losses to the underwriters. However, if the *Green Shoe Clause* is included in a registration statement, the syndicate is allowed to purchase up to 15% more shares than were originally registered in order to cover overallotments at the same price and terms as the original shares. For example, let's assume that a stock's IPO price is $15 and the underwriter's price is $14 ($1.00 underwriting discount). If the stock's market price rises in the aftermarket to $20, the syndicate could exercise the option and purchase the shares at $14, rather than at $20.

Conversely, if the market price of the stock is trading below the IPO price, the underwriter would prefer to buy the shares in the open market (lower price), rather than at the higher IPO price. The underwriter could earn a profit on the difference. In addition, the price the underwriter pays for the shares from the issuer is the public offering price less the underwriting spread. As with other aspects of a new offering, overselling by a syndicate is covered by antifraud provisions and may not be manipulative.

Rule 105 — Short Sales in Connection with an Offering

Rule 105 of Regulation M addresses the concern of large institutions becoming buyers in securities offerings since it's been argued that the price-setting power has been transferred from the underwriters to large institutions. This shift occurred when investors believed that a securities offering of an existing issuer would be unsuccessful, resulting in the stock being sold short and then covered with securities purchased from underwriters. Ultimately, this activity disrupted the orderly distribution of the securities.

Rule 105 specifies that it's a violation for any person to first execute a short sale of a security that's the subject of an offering, and then purchase the offered security from an underwriter. For purposes of the rule, the concern is the short sale being executed during the period beginning five business days prior to the pricing of the offering and ending with the pricing of the issue. However, if the pricing of the offering occurs within five business days of the filing of the registration statement, then Rule 105 applies from the filing date until the pricing of the issue. The rule only applies to offerings that are conducted on a firm-commitment basis. The basic concept is that an investor is prohibited from buying securities in a firm-commitment underwriting if that investor had sold the securities short during the restricted period.

Bona Fide Purchase Exception This provision generally provides that investors can purchase securities in the offering even if they had sold the securities short during the five-day restricted period as long as they made a bona fide purchase that's equivalent in quantity to the amount of the restricted period short sale(s) by no later than one business day prior to pricing.

FINRA Rules Regarding Regulation M

According to SRO rules and the SEC's Regulation M, member firms are required to submit certain forms to FINRA in connection with their underwriting activities. For any distribution that involves a Nasdaq security which is subject to Regulation M, the managing underwriter may request an underwriting activity report (UAR) from FINRA's Corporate Financing Department.

The report will identify whether the security's restricted period begins one day or five days prior to pricing, or whether it's exempt as an actively traded security. For securities that are not exempt, at a point no later than the day prior to the commencement of the restricted period, the manager must submit a Restricted Period Notification Form to Nasdaq Market Operations. This form must be filed with FINRA for both exchange-listed securities and OTC equity securities (i.e., non-listed equities).

Some of the information that's required to be disclosed is whether the syndicate manager intends to effect syndicate short covering transactions, impose a penalty bid, or place a stabilizing bid. Other relevant information that must be disclosed includes the name of the security, the stock symbol, the type and number of shares being offered, the date and time of the pricing, the names of the managing underwriter and syndicate members (but NOT the selling group members) and, if applicable, the beginning and ending of the Regulation M restricted period. Ultimately, these records must be maintained for three years.

FINRA New Issue Allocations and Distributions Rule

Quid Pro Quo Allocations FINRA prohibits member firms from engaging in activities that are referred to as *quid pro quo* or *kickbacks*. Essentially, firms are prohibited from using their allocations of new issues (especially those that are over-subscribed) as a means of obtaining compensation that's excessive in relation to the services they provide in return. However, member firms are permitted to allocate new issue shares to customers based on the customers' willingness to separately retain the member firm for other services as long as the customers have not paid excessive compensation in relation to those services.

Spinning *Spinning* is defined as a member firm allocating shares of a new issue to certain corporate decision makers. Although this activity is prohibited, the term doesn't apply to the allocations that are made to all corporate employees.

Instead, the rule applies to both public and non-public companies that may be considering entering into an *investment banking relationship* with the member firm and includes the executive officers and directors of former, current, or prospective customers and any person who is materially supported by the executives or directors.

The rule specifically states that it's a violation to allocate shares of a new issue to those customers if:

- The company is currently an investment banking services client of the member firm or the member firm has received compensation from the company for investment banking services in the past 12 months
- The person who is responsible for making the allocation decision knows or has reason to know that the member firm intends to provide, or expects to be retained by the purchaser for, investment banking services within the next three months, or
- On behalf of the company they represent, the executive officers or directors make an expressed or implied condition that their company will use the member firm to provide future investment banking services

Flipping *Flipping* is defined as the initial sale of a new issue that occurs within 30 days following its offering date as an IPO. In many circumstances, flipping creates downward pressure on the price of the security in the secondary market and, therefore, underwriters may attempt to discourage these types of sales. FINRA prohibits a member firm and any person associated with a member firm from directly or indirectly recovering, or attempting to recover, any portion of a commission or credit that was paid or awarded to an associated person who originally sold shares of a new issue that were subsequently flipped by a customer. An exception to this prohibition is available if the managing underwriter has assessed a penalty bid on the entire syndicate.

New Issue Pricing and Trading Practices The lead underwriter is also referred to as the book-running manager. In some syndicates, there may be more than one lead underwriter and, if that's the case, one of the lead underwriters will be considered the *book-running lead manager.* This firm is required to adhere to the following new issue pricing and trading practices:

- In order to provide transparency to issuers and their pricing committees, the book-running lead manager must provide reports on indications of interest and final allocations to the committee (or, if the issuer doesn't have a pricing committee, to its board of directors):
  - A report including the names of interested institutional investors and the potential number of shares indicated by each
  - A report of the aggregate demand from retail investors
  - After the settlement date, a report on the final allocations of shares to institutional investors and aggregate sales to retail investors
- Any lock-up agreements or other restrictions on the transfer of shares by officers and directors of the issuer must provide the following:
  - The fact that these restrictions will also apply to issuer-directed sales
  - At least two business days before the release or waiver of any lock-up or other restriction on the transfer of the issuer's shares, the book-running lead manager will notify the issuer of the impending release or waiver and announce the impending release or waiver through a major news service

- The Agreement Among Underwriters (AAU) between the book-running lead manager and the other syndicate members must require that any shares trading at a premium to the public offering price which are returned by the purchaser of a syndicate member after secondary market trading:
  - Be used to offset the existing syndicate short position, or
  - If no syndicate short position exists, the member must either:
    - Offer returned shares at the public offering price to unfilled customers' orders pursuant to a random allocation methodology, or
    - Sell returned shares on the secondary market and donate profits from the sale to an unaffiliated charitable organization with the condition that the donation be treated as an anonymous donation

Market Orders FINRA rules prohibit a member firm from accepting a market order for a new issue prior to the beginning of trading for that stock in the secondary market. This rule applies to all new issues, including both exchange-listed and OTC equity securities. The shares of an initial public offering may experience volatility as they begin to trade; therefore, there may be a large difference between the public offering price and the price at which the stock begins to trade in the secondary market.

Since market orders guarantee an execution, but not a price, the rule exists to protect investors from paying an unexpectedly high price in the aftermarket when the stock is released for trading, only to later find the price to decline, causing the investor to lose money. Investors may only enter limit orders prior to the release of stock for trading. This ensures that investors will not pay more than their stated limit price.

Other SEC Rules Affecting Underwriters

Prohibited Representations In a contingent offering it's considered manipulative if the issuer makes a representation that the offering is being sold on an "all-or-none" basis unless purchasers are able to receive a prompt refund of their investment if the offering is cancelled because the contingency cannot be met (e.g., the entire issue cannot be sold). To meet the minimum contingency, all the securities offered must be 1) sold at a specified price, 2) within a specified time frame, and 3) the total amount of proceeds must be received by the issuer by a specified date.

Disclosure of Interest in a Distribution If a broker-dealer receives a fee from an investor for providing advice about securities; it's considered an investment adviser. However, a conflict of interest exists if a broker-dealer attempts to sell securities that are part of a distribution in which the broker-dealer is participating. For that reason, the broker-dealer must provide the customer with a written notice that discloses its participation in the distribution. The notice must be given or sent at or before the completion of the transaction.

Recordkeeping Requirements Relating to Stabilizing Activities

Syndicate Records According to SEC Rule 17a-2, an underwriter that's stabilizing an issue, effecting a syndicate short covering transaction, or implementing a penalty bid, must maintain a record of the following information:

- The percentage participation or commitment of each syndicate member
- The names and addresses of the syndicate members
- The dates for when the penalty bid was in effect

- The name and class of any security stabilized or any security in which a syndicate short covering transaction was executed
- The price, date, and time at which each stabilizing purchase or syndicate short covering transaction was executed

In addition, each syndicate member must receive information from the manager regarding the name, date, and time at which the first stabilizing purchase was executed, as well as the time that stabilization was terminated. These records must be kept for a minimum of three years.

Stabilization Typically, the syndicate manager places the stabilizing bid or conducts the syndicate's short covering transactions. However, if another member firm of the syndicate executes these types of transactions, the executing firm is required to notify the manager within three business days. By rule, the manager is still responsible for maintaining these records as a part of its recordkeeping responsibilities.

The New Issue Rule

FINRA has determined that restrictions should apply to the sale of all equity new issues, not only those that are over-subscribed and trade at an immediate premium in the aftermarket. Therefore, the *New Issue Rule* has replaced the former free-riding and withholding interpretation that only applied to hot issues.

Under the rule, a FINRA member firm is required to make a bona fide offering of new issues to the public and not withhold any shares for its own account, the accounts of any of its employees, or for any other industry insiders. The rule specifically prohibits a FINRA member broker-dealer from selling a new issue to any accounts in which a restricted person has a beneficial interest. However, an exemption exists that permits personnel of a limited broker-dealer to purchase shares of a new issue. A limited broker-dealer is one that restricts its business to investment company/variable contract securities or direct participation programs.

New Issue

For purposes of the rule, new issues include all initial public offerings (IPOs) of *equity securities* that are being sold under a registration statement or offering circular. However, the following securities are *not* subject to selling restrictions under the New Issue Rule:

- Secondary offerings
- All debt offerings, including convertible and non-investment grade debt
- Private offerings
- Preferred stock and rights offerings
- Investment company offerings
- Exempt securities that are identified by the Securities Act of 1933
- Direct participation programs (DPPs) and real estate investment trusts (REITs)

Preconditions for Sale

Prior to selling an equity new issue to an account, a firm must satisfy the *preconditions for sale* provision. In other words, a firm must first obtain assurance from an account holder, or any authorized party of an account, that the account is eligible to purchase new issues in accordance with the New Issue Rule.

For accounts that are held by banks, foreign bankers, broker-dealers, investment advisers, or other conduits that purchase new issues on behalf of their customers, the firm must obtain a representation that all of the conduit's purchasers of new issues are in compliance with the rule.

The representation from the account holders may be in the form of an *affirmative statement* which positively declares that the account is eligible. A firm may also use electronic communications to verify account eligibility for new issues; however, it may not rely on oral statements. A member firm that sells new issues must reverify eligibility every 12 months and must retain copies of all of the information and records that are used for verification purposes for a minimum of three years.

Restricted Persons

Member firms or any persons who are associated with a member firm are prohibited from offering or selling new issues to any accounts in which a *restricted person* has a beneficial interest. The following are considered restricted persons:

- FINRA member firms and any of their associated persons (i.e., employees)
- Immediate family members of member firm employees, which includes a spouse, children, parents, siblings, in-laws, and any other person who is materially supported by an employee of a member firm.

The immediate family members listed above are only considered to be restricted persons if *any one of the following three conditions applies*:

1. The associated person gives material support to or receives it from the immediate family member. *Material support* is defined as (a) providing more than 25% of the person's income or (b) living in the same household as the person who is associated with the member firm.
2. The purchase is being made through the associated person's member firm.
3. The associated person has the ability to control the share allocation of the new issue.

   For example, a person is employed in the investment banking department of a broker-dealer and he supports his brother. In this case, his brother is considered a restricted person.

   As another example, a person is employed by a broker-dealer that's serving as the managing underwriter for ABC Company's IPO. The person's immediate family members are restricted from purchasing any of ABC Company IPO shares from his firm.

Other restricted persons include the following:

- Finders and fiduciaries, such as attorneys and accountants, who are involved in the offering of the new issue as well as any persons to whom they provide material support
- Persons who own a broker-dealer. This generally includes any persons who own 10% or more of a brokerage firm, which requires them to report their interest on Form BD as a restricted person.
- Portfolio managers who are purchasing the shares for their own accounts. This includes persons who are able to buy or sell securities on behalf of institutional investors (e.g., banks, investment companies, investment advisers, insurance companies, savings and loan institutions) and any person to whom they provide material support.
  - The reason for their restricted status is that these are persons who are in a position to direct future business to the firm. (A portfolio manager is only a restricted person if she's purchasing an equity IPO for her personal account. There's no restriction if the portfolio manager is purchasing the shares for the fund that she manages.)

Note: Excluded from the rule are uncles, aunts, cousins, grandparents, and ex-spouses of the registered representative. Therefore, the cousin of a registered person may purchase equity IPO shares from any broker-dealer.

General Exemptions

The rule also provides a number of general exemptions. One exemption allows an equity security that meets the rule's new issue definition to be sold to the following accounts:

- Investment companies that are registered under the Investment Company Act of 1940
- The general or separate account of an insurance company
- A common trust fund
- An account that's partially owned by restricted persons provided the combined ownership of all restricted persons is 10% or less of the account. This is the *de minimis* exemption.
- Publicly traded entities, other than a broker-dealer or its affiliates, that engage in the public offering of new issues
- Foreign investment companies
- ERISA accounts, state and local benefit plans, and other tax-exempt plans under IRS Code 501(c)(3)

Another exemption allows a broker-dealer to purchase shares of a new issue if the offering is under-subscribed. As long as all of the public demand for the shares is met, an underwriter is allowed to place shares in its own investment account. However, this exemption doesn't allow an underwriter to sell shares of an under-subscribed issue to other restricted persons.

The rule also contains an anti-dilution provision which allows restricted persons that acquired the shares prior to the public offering to purchase shares of the new issue if the purchase is being made to keep their equity percentage at the same level. Under this provision:

1. The buyer must have owned the shares for at least one year prior to the offering, and
2. The new shares may not be resold for three months following the effective date.

Issuer-Directed Securities The prohibitions on the purchase and sale of new issues in this rule don't apply to securities that are specifically directed by the issuer to persons that would otherwise be considered restricted. However, the securities that are directed by the issuer cannot be sold to or purchased by:

- A broker-dealer
- An account in which any restricted person has a beneficial interest UNLESS the person, or a member of her immediate family, is an employee or director of the issuer, the issuer's parent, or a subsidiary of the issuer or the issuer's parent

Based on this exemption, the following are examples of permitted purchases of equity IPO shares:

- A registered representative acquiring equity IPO shares of her employing broker-dealer or the parent or subsidiary of the broker-dealer if the sale was directed to the RR
- A registered representative, whose sister is the CEO of a company that's conducting an IPO, acquiring the shares since his immediate family member is affiliated with the issuer and the sale was directed to the RR

Direct Participation Programs

Industry rules regulate *direct participation program (DPP)* offerings that are conducted by member firms. A direct participation program is a business venture that provides investors with flow-through tax consequences (a single level of taxation). DPPs may be structured as limited partnerships, joint ventures, Subchapter S corporations, and similar programs. However, real estate investment trusts (REITs), pension plans, investment companies, and tax-sheltered annuities are not DPPs.

Disclosures

Prior to participating in a public offering of DPP interests, a member firm must investigate whether full disclosure has been made regarding items of compensation, physical properties, tax aspects, the financial condition and experience of the sponsor, risk factors, and appraisals on properties.

Member firms are prohibited from distributing program interests unless investor suitability standards are disclosed in the prospectus. When recommending these securities to a client, member firms must have reasonable grounds to believe that the client:

- Will be in a financial position to realize the tax benefits of the program
- Has the financial resources to assume the risks and lack of liquidity presented by this investment
- Meets all suitability standards

Member firms are required to maintain records that show the basis for determining a participant's suitability. If a registered representative has been granted discretionary authorization over a client's brokerage account, executing transactions that involve DPP units is prohibited unless the member firm has obtained the client's prior written approval of the transaction. The requirement for written approval doesn't apply if the DPP interests trade on a national exchange, unless the broker-dealer involved is an affiliate of the DPP.

Limits on Compensation and Expenses

A broker-dealer may not participate in a DPP offering if the organization and offering expenses are unfair and unreasonable. The maximum amount of compensation to the underwriters may not exceed 10% of the gross proceeds of the offering. However, if the program sponsor is affiliated with a member firm that's distributing the interests, organization and offering expenses being paid by the program may not exceed 15% of the gross proceeds of the offering.

Participation in Roll-ups

A limited partnership *roll-up transaction* is one that involves the combination or reorganization of one or more limited partnerships. Typically, several similar partnerships are combined into a new entity, which is typically a corporation, REIT, or new partnership. Occasionally, member firms are compensated for soliciting the votes or tenders from customers who are investors in the partnerships that are a part of the potential roll-up. FINRA requires that roll-up compensation be:

- No more than 2% of the exchange value of the newly created securities
- Paid regardless of whether the partners reject the proposal
- Payable in an equal amount regardless of whether the partners vote for the roll-up proposal

In addition, the general partner or sponsor that proposed the transaction must agree to pay all solicitation expenses (including those associated with preparatory work), even if the proposal is rejected. Any dissenting limited partners (i.e., investors who vote against the roll-up transaction) must receive compensation that's based on an appraisal of the partnership's assets which is conducted by an independent appraiser, rather than by the general partners or an affiliate. The general partners must use the evaluation standards that are contained in the limited partnership agreement to value their interests and must employ an independent third party to count limited partners' votes. Typically, investors in the new entity have voting rights that are similar to those that were offered by the original entity, including the right to remove the general partner or alter the board of directors.

Listing Requirements

NYSE

For a company to obtain an NYSE listing, it must satisfy the following minimum criteria:

- 400 U.S. round-lot shareholders
- 1,100,000 outstanding shares
- A market value of all public shares of $100 million or $40 million for an IPO, carve out, or spinoff
- A stock price of at least $4 at the time of listing
- At least one of several alternative financial tests

Nasdaq

Nasdaq also has specific requirements that a company must satisfy in order to initially become listed as well as to maintain continued listing status. Although different requirements exist for Global Select, Global, and Capital Market listings, each tier is subject to corporate governance rules. Some of the general Nasdaq listing requirements include a minimum number of publicly held shares, round lot shareholders, market makers, bid price, and stockholder equity.

There are numerous standards that may be used when applying for Nasdaq's most prestigious listing—Global Select. Of the seven requirements for listing, only the following three must be satisfied under all three standards:

1. A $4 minimum bid price
2. Three or four market makers
3. Adherence to corporate governance rules

Other requirements that may apply depending on which of the three standards is used include:

- Pre-tax earnings
- Cash flow
- Market capitalization
- Revenue

Of these three listing levels of Nasdaq, the Capital Market has the least stringent initial listing requirements; the Nasdaq Global Market has more stringent listing requirements for net income, publicly held shares, and stockholders' equity; while the Nasdaq Global Select has the most stringent listing requirements of the three levels. In several areas, the NYSE initial listing requirements are less stringent than Nasdaq Global Select, including round-lot shareholders, publicly held shares, and financial criteria.

Transactions Related to Initial Public Offerings

Securities that are listed on one exchange are permitted to trade on other exchanges. In fact, the use of the term *third market* refers to trading of exchange listed securities in the over-the-counter (OTC) market. However, there's a restriction on this type of trading as it relates to IPOs.

According to industry rules, member firms are prohibited from executing, either directly or indirectly, any transactions in a security that's the subject of an IPO until the security has begun trading on its primary exchange. The signal that trading has begun is the reporting of an opening transaction on the listing exchange. For example, an issuer is conducting an IPO and its common stock will subsequently trade on the NYSE (the listing exchange). In this case, a broker-dealer may not execute a transaction away from the exchange (in the third market) until the first transaction has been reported by the NYSE.

Delisting

If a company has been delisted from either the NYSE or Nasdaq and intends to relist, it must comply with the initial (not continuing) listing requirements of that exchange. An *OTC equity* is a security that's not listed on an exchange or one that was delisted from an exchange. This designation may include both American depositary receipts (ADRs) and direct participation programs (DPPs). Quotes for OTC equities may be found with the help of the OTC Markets Group. The systems provided by the OTC Markets Group have no listing requirements and it don't provide execution services.

OTC Markets Group In an effort to create clarity in the investment process, the OTC Markets Group organizes its OTC equities into three tiered marketplaces—OTCQX Best Marketplace, OTCQB Venture Marketplace, and Pink Market. The differences in the tiers are based on the quality and quantity of the information that the companies make available.

The securities quoted are not required to be registered and the issuers are not required to provide filings to the SEC. For example, the OTC Markets Group provides quotes for many unsponsored American Depositary Receipts or ADRs (which are utilized by foreign companies that are not SEC reporting companies and want their common stock traded in U.S. markets) and securities of issuers that recently filed for bankruptcy.

Chapter 3 Summary

Now that you've completed this chapter, for the following commonly tested concepts, you should be able to:

- Understand the roles and liabilities of the different participants in a public offering
  - Syndicate manager, syndicate member, selling group
- Understand the different types of underwriting (*see table in chapter*)
  - Firm commitment, best efforts, all-or-none, stand-by
  - Recognize the purpose and requirements for an escrow account if securities are offered with a contingency
- Understand the concept of an issuer engaging a managing underwriter
  - Recognize what's included in a letter of intent (LOI)
- Understand the concept of book building via a road show
  - Recognize the types of offerings that use fully marketed versus one-day road shows
- Understand the concept of a block trade executed by an underwriter
- Recognize the components of the underwriting spread for both equity and debt offerings
  - Understand how the components are divided among syndicate members and the selling group
  - Define the term *reallowance*
- Understand common underwriting terminology, including g*reen shoe, market-out clause,* and *over-subscribed*
- Understand the role and restrictions of the research department
  - Information barriers
  - When joint due diligence is (or is not) permitted
  - The process of managing conflicts of interest between research and investment bankers
  - Rules for the compensation committee
  - Restrictions on attending pitch meeting and road shows
  - Communication restrictions with investment banking personal and three-way communications
- Understand the purpose and time frames regarding quiet periods for research reports and public appearances
  - IPOs versus follow-on offerings, significant news, and unregistered exemptions
- Understand the special exemptions on research restrictions for emerging growth companies (EGCs)
- Recognize the key differences of debt research reports
  - Exemptions for limited investment banking, limited trading, and institutional investors
- Understand new issue practices, including *jump ball, free retention,* and *settlement of the syndicate account*
- Understand the purpose of Regulation M
- Recognize the restricted period and how it pertains to the issuer, selling shareholders, and distribution participants
- Understand the manipulative practice of tie-in arrangements
- Recognize the price and volume limits for passive market makers
  - Actively traded exemption and to whom it applies
- Define the term *stabilization* and understand the price restrictions on stabilizing bids
- Define the terms *penalty bid* and *syndicate covering transactions*

- Understand the purpose and time frame of the restriction on short sellers buying new shares
- Recognize the purpose and the information required to be included on the restricted period notification form
- Understand the FIRNA new issue allocation rules and the prohibitions on the following activities:
  - Quid pro quo
  - Spinning
  - Flipping
- Understand the new issue trading practices, including:
  - Information reported to issuer
  - Rules for lock up agreements
  - Procedure for dealing with returned shares that are trading at a premium to the POP
  - Restrictions on market orders
- Understand the recordkeeping requirements for stabilization activities
- Understand FINRA's New Issue Rule
  - Recognize the offerings to which it applies and those that are exempt
  - Understand the precondition for sale
  - Identify restricted persons and specific rules for family members
  - Recognize the concepts of de-minimis and issuer-directed sales
- Understand the rules for DPP offerings, including disclosure as well as limits on compensation and expenses
- Define the term *roll-up transactions* and limits on compensation and expenses
- Recognize the listing requirements of NYSE and Nasdaq
- Understand the rule for the initial trade in a listed IPO
- Understand the process if a company is delisted

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Chapter 4

Exempt Securities and Exempt Transactions

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Securities Exempt from Registration

Certain securities are exempt from the registration and prospectus requirements of the Securities Act of 1933 based on the nature of the issuer. Among the exempted securities are:

- U.S. government and U.S. government agency securities
- Municipal securities
- Non-profit organization issued securities
- Short-term corporate debt instruments (e.g., commercial paper) with maturities that don't exceed 270 days
- Domestic bank and trust company issued securities (but not those issued by bank holding companies)
- Small business investment company issues (based on the federal legislation exemption for small businesses)

Rule 147 and Rule 147A

Rule 147 was created as a safe harbor under the statutory intrastate offering exemption which is provided by the Securities Act of 1933. The rule (also referred to as the intrastate exemption) allows companies to raise capital from their in-state investors. Typically, companies that are selling new securities are required to register their securities with the SEC; however, under Rule 147, if a company is conducting an offering and only selling its securities to its state residents, the offering is exempt from registration. Today, the strict issuer eligibility requirements and developments in both company business practices and communications technology have made Rule 147 outdated.

Amendments to the existing Rule 147 and the implementation of a new rule—Rule 147A—became effective on April 20, 2017. These new rules are designed to update and modernize the existing intrastate offering framework and permit a company to raise money from investors who reside within its state without being required to register the offers and sales at the federal level. Although it's similar to Rule 147, the new Rule 147A will allow for multi-state offers (not sales), which means that:

- Issuers will be permitted to use general solicitation and publicly available websites to locate potential in-state investors. Although *offers* are able to be made outside of the state, all *sales* must still be limited to in-state residents.
- Companies will be able to be incorporated or organized outside of the state in which they conduct the offering as long as they have their *principal place of business* in that state. Principal place of business is defined as the location from which the principal officers, manager, or partners primarily direct, control, and coordinate the activities of the issuer.
  - For example, ABC is incorporated in Delaware, but its principal business is conducted in New Jersey. Under Rule 147A, ABC will be allowed to sell securities to residents of New Jersey.

Both the amended Rule 147 and the new Rule 147A include the following provisions:

- For an issuer to sell securities in a state, it must have its principal office (under Rule 147) or principal place of business (under Rule 147A) in that state and satisfy one of four "*doing business*" requirements. By satisfying *one of the four* new requirements, the issuer can avoid having to comply with *all three* of the 80% tests for assets, revenue, and proceeds of the offering.

- If a Rule 147 or 147A issuer subsequently changes its principal place of business after issuing securities, it will not be able to conduct another intrastate offering under these rules in another state for a period of six months from the date of last the sale in the previous state.
- An issuer is considered to be "doing business" in a state as long as it meets just one of the following four new requirements:

  1. At least 80% of its consolidated gross revenues are derived from the operation of a business or of real property that's located in the state or territory or from the rendering of services within the state or territory;
  2. At least 80% of its consolidated assets are located within the state or territory at the end of its most recent semi-annual fiscal period prior to the first offer of securities under the exemption;
  3. At least 80% of the net proceeds from the offering are intended to be used by the issuer, and are in fact used in connection with the operation of a business or of real property, the purchase of real property located in, or the rendering of services within the state or territory; or
  4. A majority of the issuer's employees are based in the state or territory (this fourth requirement was not included in the original Rule 147)

- An issuer must utilize a reasonable belief standard when determining the residency of the purchaser at the time of the sale of securities. This standard is supported by the requirement that the issuer obtain a written representation from all purchasers as to their residency.
  - If the purchaser is a legal entity (e.g., a corporation, partnership, trust, or other form of business organization), residency is defined as the location where, at the time of the sale, the entity has its principal place of business.
- Resales to persons who reside outside of the state in which the offering is conducted are restricted for a period of six months from the date of the sale by the issuer to the purchaser (formerly nine months).
  - A legend requirement applies in order to notify offerees and purchasers about the resale restriction.

Regulation A

Regulation A contains rules which provide exemptions from the registration requirements and allows some companies to use equity crowdfunding in order to offer and sell their securities without having to register the securities with the SEC. Crowdfunding enables broad groups of investors to fund startup companies and small businesses in return for equity.

The Company The business entity that's seeking capital must be organized under the laws of the United States, Canada, or any district, territory, or possession of the U.S. or Canada. Additionally, the company's principal place of business must be in the U.S. or Canada. Regulation A requires the filing of two years of financial statements which may be unaudited in the event that audited information is not readily available.

In order to reduce the regulatory burden on small issuers, an exemption from the full registration requirements is available. Rather than a prospectus, the appropriate disclosure document is referred to as an *offering circular*.

Although it's not required, a preliminary offering circular may be made available. Print and broadcast advertising may be used; however, it must be in a limited form, similar to tombstone-type advertising for issues that are subject to full registration.

Aggregate Offering Price Under the original Regulation A, the maximum amount of securities that were able to be sold was $5,000,000 within a 12-month period. Of that amount, no more than $1,500,000 were able to be offered on behalf of selling shareholders. However, in 2015, the Jumpstart Our Business Startups (JOBS) Act expanded Regulation A into the following two tiers:

- Tier 1 – Sales of up to $20 million are permitted within a 12-month period. Of that amount, no more than $6 million may be sold on behalf of selling shareholders.
  - The offerings are subject to both SEC and Blue-Sky review
  - Continuing disclosure information must be filed on Form 1-Z (used to report sales and the termination of the offer)
- Tier 2 – Sales of up to $75 million are permitted within a 12-month period. Of that amount, no more than $22.5 million may be sold on behalf of selling shareholders.
  - The offerings are subject to SEC review, but not Blue-Sky review
  - Has stricter continuing disclosure information which includes the filing of:
    - Form 1-K (similar to 10-K) – annually
    - Form 1-SA (similar to a 10-Q) – semiannually, and
    - Form 1-U (similar to an 8-K) – as necessary for events that may affect the issuer's share price or financial condition
  - Investment limits apply to non-accredited investors (a person may invest no more than 10% of her net worth or income – whichever is greater)
  - Audited financial statements must be provided

The two tiers, which now comprise Regulation A, and their rules are summarized below:

Registration Exemptions		
	Regulation A Tier 1	**Regulation A Tier 2**
Maximum offering size	$20 million	$75 million
Time period	12 months	12 months
Maximum amount that may be offered by existing shareholders	$6 million (30% of maximum offering)	$22.5 million (30% of maximum offering)
Required audited financial statements/ ongoing reporting	No	Yes

- These are public offerings of securities; therefore, offering circulars must be provided and issuers are required to file SEC Form 1-A.
- With these types of offerings, all sales by selling shareholders are limited to no more than 30% of the aggregate offering.

Additional Information Regarding Regulation A

- Under the Act of 1934, Regulation A issuers are considered to be non-reporting.
- The issued securities are considered non-restricted and may be sold without limitations.
- Current SEC reporting companies may not use Regulation A.
- Both U.S. and Canadian companies are eligible.
- The offerings may be for either equity or debt securities.

Preliminary and Final Offering Circulars After filing the offering statement, but before receiving qualification by the SEC, a preliminary offering circular may be used to make a written offer of securities; however, it must contain substantially the same information that will appear in the final offering circular (excluding pricing information). A statement must be included to clearly indicate that the information contained within the circular is subject to change and that no sales may take place without a final offering circular and a qualified offering statement.

A preliminary or final offering circular must be provided to a prospective buyer at least 48 hours prior to the mailing of the confirmation of sale. If a preliminary offering circular is used, a final offering circular must be delivered to the purchaser with the confirmation.

Test the Waters Regulation A provides issuers with the ability to *test the waters* for purposes of obtaining indications of interest from investors prior to filing an offering statement with the SEC. The materials that may be distributed when testing the waters are limited to factual information which must include a description of the company's business, the background of the CEO, and a statement that no money should be sent to the issuer by interested investors.

The SEC may halt a Regulation A offering if any of the terms, conditions, or regulatory requirements of the deal are deficient. This includes the failure to provide the SEC with a copy of any script used in a radio or TV broadcast and the solicitation of money for the issue prior to completion of the review by the SEC. Additionally, there must be at least 20 days separating the use of a solicitation statement and the first sale of securities.

Regulation A offerings share many of the same characteristics as registered offerings:

- The purchasers must be provided with an offering circular, which is similar to a prospectus.
- The securities may be offered publicly using general solicitation and advertising.
- There are no resale restrictions since purchasers are not receiving restricted securities as they're not considered restricted securities.

Exempt Transactions

In some cases, it's the manner in which securities are being offered that provides the exemption from the registration requirements of the Act. These offerings are referred to as private placements.

Private Placements

The Securities Act of 1933 provides an exemption from registration for securities that are sold in a transaction that's executed "by an issuer that's not involved in a public offering." Although the process used for a private placement may be different than a public offering, the broker-dealer that offers the securities must still conduct a due diligence investigation of the issuer.

The main advantages to raising capital privately are that there are fewer legal and registration expenses and that the issuer is able to raise capital more quickly. Based on market conditions or a company's financial conditions, private offerings may be the only appropriate method for an issuer to use in raising capital. However, due to the demands made by institutional investors, the process of structuring and pricing the securities may involve more negotiation. The investment banker usually acts in an agency (not principal) capacity and doesn't commit its own capital to a private placement offering.

In a private placement, the issuer agrees to provide investors with relevant material information concerning the company so that they're able to make an informed investment decision. Although it may not be a regulatory requirement, the issuer will usually provide a disclosure document (referred to as a private placement memorandum or PPM) to avoid violations of the antifraud provisions of the Act. A disclaimer in a private placement memorandum will state that the appropriate regulators have not passed on the accuracy of the information that's provided in the document.

The investors who agree to purchase the securities must acknowledge that they understand the risks of investing and that they may lose their entire investment. These investors also agree not to share the information that's found in the offering document since the release of material, non-public information may be a considered violation.

Placement Agent A placement agent is a firm, usually a broker-dealer, which agrees to find institutional investors that are willing to purchase an issuer's securities through a private placement. The firm agrees to act in an agency (rather than a principal) capacity and receives a fee for selling the securities; it doesn't commit its own capital to the private placement. These agents are essentially intermediaries and may only offer securities to accredited or institutional investors.

Placement Agent Agreement The placement agent agreement specifies all of the terms and conditions that exist between a company (the issuer) that's planning to issue securities through a private placement and the investment banker that has been hired to act as its agent. The role of the investment banker is to find institutional investors that are willing purchase the securities.

The agreement typically includes the following stipulations:

- The issuer will provide business and financial information.
- Both the issuer and the investment banker agree to not disclose confidential information unless they receive prior approval.
- The agreement should state the amount of cash and/or securities the issuer agrees to pay as compensation.
  - The fee could be based on a percentage of the securities being offered, or it may include warrants to purchase the company's stock

- Other legal terms and conditions, including:
  - The length and termination date of the offering
  - The state which governs the agreement
  - Expenses to be reimbursed by the issuer
  - The fact that each party will comply with all federal and state regulations

Engagement Letter An engagement letter is signed by both the company that intends to issue securities and the investment banker that's hired (engaged) to market the securities to institutional investors. The terms and conditions that are agreed upon by the two parties are found in the placement agreement. The investment banker advises the company regarding the amount, pricing, type, and structure of the securities to be issued. General solicitations are generally not permitted in a private placement; therefore, a road show is not a part of this process.

Teaser The executive summary of a private placement memorandum is usually a short document that's referred to as a *teaser*. An investor receives this document in order to determine whether she might be interested in the offering. If the investor is interested, she then receives the complete PPM.

Term Sheet With a private placement, a term sheet contains pertinent information regarding the securities being offered. Some of the information found in this document includes the name of the issuer, the types of securities that are being offered and their characteristics, the price and aggregate proceeds, the expected closing date, liquidation preference in the case of a bankruptcy, voting rights, and any other specific terms and conditions of the offering.

Confidentiality Agreement Prior to investing, any person that's provided with a private placement memorandum must sign a confidentiality agreement (also referred to as a non-disclosure agreement or NDA). The investor agrees to maintain the confidentiality of the information that's found in the PPM unless the disclosure is done to provide information to her financial adviser. The adviser may be an accountant, attorney, banker, or other financial professional who uses the PPM to evaluate the offering. The confidentiality agreement normally contains a provision that requires the return of the disclosure documents if the securities are not purchased. Another acknowledgement made by the investor is that the issuer is under no obligation to complete the offering.

Subscription Agreement The subscription agreement is a sales contract that's used for the sale of securities through a private placement. The agreement sets forth the terms and conditions of the offering and usually contains the following information:

- A statement in which the investor agrees that she alone, or with a purchaser representative's assistance, has sufficient knowledge and experience to evaluate the investment's risks and merits
- A statement by the investor that provides her annual gross income and net worth
- A statement regarding the status of the investor and the category of accredited investor (also referred to as the qualification of investor section)
- The number of shares (or units) and the price per unit that the investor is purchasing
- A statement by the investor acknowledging that she has received and carefully reviewed a numbered copy of the appropriate disclosure document and any other related information concerning the issuer

- A statement that the investor understands that the investment is illiquid and involves a high degree of speculative risk
- A statement that the investor understands that the securities being purchased have not been registered and may not be sold unless a registration is effective
- A statement indicating the investor's state of residency

Regulations Pertaining to Private Placements

Section 4 of the Securities Act of 1933 provides two main exemptions for private placements —Section 4(2) and Section 4(5).

Section 4(2) Exemption

This section provides issuers with a registration exemption if the transaction doesn't involve a *public offering*. This is considered the private offering exemption and doesn't allow the use of any form of public solicitation. To qualify, the purchasers must have sufficient knowledge and experience in finance and business to understand and evaluate the risks and merits of the investment. The investors must also have access to the same information that's normally provided in a prospectus and must agree to not resell or distribute the securities to the public.

Section 4(5) Exemption

According to Section 4(5), formerly Section 4(6) of the Securities Act of 1933, an offering by an issuer may be an exempt transaction if the following conditions are met:

- The amount of the offering doesn't exceed $5,000,000
- No advertising or public solicitation is being used to offer the securities
- The offering is being sold only to accredited investors (which includes institutional investors)

This exemption is different from Regulation D which limits the number of non-accredited investors who may participate to no more than 35.

Regulation D

Since Section 4 originated in 1933 and did not provide sufficient guidance for the private placement market, Regulation D was created as a safe harbor. This regulation requires the filing of a uniform notice of sale (Form D) with the SEC by no later than 15 days after the first sale of the securities. Regulation D has two different forms of private placements, each of which have unique requirements.

Rule 504

Under Rule 504, which covers offerings not exceeding $10 million within a 12-month period, an issuing corporation is permitted to offer and sell the securities to an unlimited number of investors without regard to their experience and sophistication.

Also, the issuer is not required to provide a disclosure document to the investors. There are three types of issuers that are not permitted to use this exemption:

1. A company that's subject to the SEC's reporting requirements (a reporting company),
2. An investment company, and
3. A development stage company with no specific business plan or purpose (e.g., a blank-check company)

Rule 506

Rule 506 allows an issuer to raise an unlimited amount of capital and there are two types of offerings — 506(b) and 506(c) — based on how the issuer will be offering the securities to investors. For these types of offerings, Regulation D allows an unlimited number of accredited investors to purchase the securities.

Accredited investors are defined as:

- Certain financial institutions regardless of their assets such as banks, insurance companies, investment companies, and private business development companies
- Pension plans and ERISA accounts, which have total assets in excess of $5 million
- Any director, executive officer, or general partner of the issuer of the securities being offered
- Any 501(c)(3) organization (non-profit) or trusts which have total assets of $5 million AND were not formed for the specific purpose of acquiring the securities being offered
- Any entity in which all the equity owners are accredited investors
- Individuals who meet either of the two following financial tests:
    1. At the time of purchase, either individually or with a spouse, they have a net worth of at least $1,000,000 (excluding the value of primary residence), or
    2. Their gross income for each of the last two years was at least $200,000 ($300,000 with spouse) with the expectation of at least the same level of income in the current year.

Investors who purchase securities through a private placement must sign an investment letter to acknowledge that they understand the fact that the securities are unregistered and may not be resold unless they're registered under the Securities Act of 1933 or sold under an exemption.

Number and Type of Investors For Rule 506 offerings, Regulation D allows for an unlimited number of accredited investors and up to 35 non-accredited investors. For purposes of determining the number of purchasers, the relative of a purchaser who resides at the same address is excluded, as is a trust in which a purchaser is a 50% owner. Also, a single entity, such as an institution or a partnership that's owned by several persons, is generally considered a single purchaser. However, if an entity is formed for the sole purpose of acquiring the offering, then each participant is considered a separate purchaser.

Among the provisions of the rule, issuers must determine the suitability of their specific offering for the potential purchasers by determining the purchasers' financial means and investment knowledge. Issuers are also required to provide potential purchasers with information related to the offering and give them the opportunity to ask questions and receive answers about the issue.

When marketing a private placement, it's normally a prohibited practice to use general solicitation (e.g., cold calling or advertising) to attract investors. Since advertising for securities that are being sold under Regulation D is limited, the issuer may not advertise in the general media or disseminate information to the public regarding the sale.

Although an investment seminar that's open to the public is prohibited, an investment seminar that's limited to potential purchasers who are accompanied by their purchaser representatives (defined below) is permitted.

Purchaser Representative A purchaser representative is defined as a person who represents a potential purchaser of securities being distributed through a Regulation D offering. To avoid conflicts of interest, the following restrictions are placed on purchaser representatives:

- They may not own 10% or more of the stock of the issuer, and may not be an affiliate, director, officer, or employee of the issuer unless they're a close relative of the potential purchaser
- They must be knowledgeable and experienced in financial and business matters
- They must be designated in writing by the potential purchaser for each individual offering

Blanket approval to represent a potential purchaser as a purchaser representative in all Regulation D offerings is not permitted.

Restricted Securities Since securities that are issued under Regulation D are unregistered, they're considered to be restricted. In other words, the securities cannot be sold unless they become registered or are sold under a registration exemption. The issuer is required to place a legend on the certificates to indicate the unregistered status of the securities. Also, the issuer must obtain a written statement (i.e., an investment letter) from its purchasers to verify that the purchase has been made for investment purposes (not for quick resale). Due to these guidelines, the issuer must issue stop transfer instructions to the transfer agent to ensure that no illegal sales occur.

Information Whether an issuer has a duty to furnish information to prospective purchasers is dependent on the nature of the persons. If the offering is only made to accredited investors, then no information is required to be furnished. However, if the securities are offered to any non-accredited investors, the issuer must provide a specific detailed written disclosure document to all purchasers (both accredited and non-accredited). This document is referred to as an *offering memorandum*. Purchasers must be given the opportunity to ask questions regarding the issue and must be informed that the securities will not be registered under the Securities Act of 1933 and may not be sold unless they're either registered or are sold under an exemption. In addition, the issuer must disclose in writing any relationship between itself and the investor's purchaser representative.

General Solicitation and Rule 506 Regulation D generally prohibits an issuer, or any securities firm that represents an issuer, from using any form of general solicitation or general advertising to promote an offering. However, under certain conditions, the Jumpstart Our Business Startups (JOBS) Act of 2012 amended Rule 506 to allow for general solicitation and general advertising when offering securities under Regulation D. When using this method to attract investors, these are referred to as Regulation D 506(c) offerings. Remember, the solicitation and advertising restrictions still apply to offerings under Rule 504 (i.e., offerings of up to $5 million).

Under the newly created *Rule 506(c)*, the conditions that permit private placement issuers to use general solicitation and general advertising include:

- All purchasers must be defined as accredited investors.
- The issuers must take reasonable steps *to verify* that the purchasers are accredited investors.

Using a principal-based approach, the SEC provides issuers and any broker-dealers that act on behalf of the issuers with a number of factors to consider when determining the status of the investor, such as the nature of the purchaser and the type of accredited investor it claims to be, the amount and type of information that the issuer has about the purchaser, and the nature of the offering (e.g., the minimum investment amount).

The SEC has created the following *suggested methods* to use when verifying an investor's accredited status:

- To review previously filed IRS tax forms and other tax forms (e.g., Form W-2 and Schedule K-1) in order to determine the investor's income
- To review bank and brokerage account statements and other statements of assets for the prior three months to determine the investor's net worth
- To obtain written confirmation of the investor's accredited status from broker-dealers, registered investment advisers, attorneys, and accountants (CPAs)

The SEC doesn't stipulate that any one of these methods must be used; instead, the requirement is to take reasonable steps to ensure that the persons to whom the solicitations are being directed are accredited investors. Form D actually includes a box that's checked off to acknowledge that this provision is being used by the issuer. It's important to remember that verification of accredited status is not required if the issuer adheres to the prohibition on general solicitation or advertising that's a part of Regulation D.

Bad Actors and Rule 506 of Regulation D Under Rule 506, the SEC prohibits any offering if the issuer or any other participants (i.e., covered persons) are defined as *Bad Actors.* The objective is to prohibit persons who have been convicted or subject to administrative sanctions for securities fraud from raising unlimited amounts of capital through the private placement market. Regardless of whether general solicitation or advertising is being used, this prohibition applies.

The SEC defines covered persons as:

- The issuer and any affiliated issuer
- Any director, executive officer, or other officer participating in the offering, and any beneficial owner of 20% or more of any class of the issuer's outstanding voting equity securities
- Any promoter that's connected with the issuer in any capacity at the time of the sale
  - A promoter is defined as a person who organizes the business of the issuer, or receives compensation of 10% or more of any class of securities, or receives 10% of the proceeds from the sale of securities)
- Any investment manager of an issuer that's a pooled investment fund
- Any person who has been or will be paid (directly or indirectly) for solicitation of purchasers (referred to as a compensated solicitor)
- Any general partner or managing member of an investment manager or compensated solicitor
- Any director, executive officer, or other officer who participates in the offering of any investment manager, compensated solicitor, general partner, or managing member

The events that will disqualify a covered person and deem him to be a *Bad Actor* are:

- Criminal convictions of any felony or misdemeanor in connection with the purchase or sale of any security
  - There's a 10-year look-back period for covered persons; however, the look-back period is five years for the issuer and affiliated issuers
- Suspension or expulsion of membership with a securities self-regulatory organization (e.g., FINRA). There's no look-back for these disqualifications.
- Court injunctions and restraining orders
- Final orders of certain state and federal regulators, including the U.S. Commodity Futures Trading Commission (CFTC)
- SEC disciplinary orders relating to brokers, dealers, municipal securities dealers, investment advisers, and investment companies and their associated persons
- Certain SEC cease-and-desist orders

Rule 144A

Rule 144A is the provision which permits the sales of restricted securities (except for sales executed by the issuer) to *qualified institutional buyers (QIBs)* without the limitations which relate to the amount being sold and the frequency of sales that are imposed by Rule 144 (described later).

Ultimately, Rule 144A creates a more liquid private placement market since these exempt transactions are usually structured as private placements between an issuer and its investment banking firm(s). Due to the exemption provided under SEC Rule 144A, after acquiring the securities, the buyer may then immediately reoffer them exclusively to another buyer that's a QIB.

Eligible Securities Rule 144A is primarily used to offer corporate debt and, in some cases, equity securities. Certain securities are ineligible for Rule 144A transactions including any securities that are of the same class as those listed on an exchange or quoted on Nasdaq, certain convertibles and warrants, and securities that are issued by registered investment companies.

Qualified Institutional Buyer (QIB) A qualified institutional buyer must satisfy the following three-part test:

1. Only certain types of investors are eligible, including:
   - Insurance companies
   - Registered investment companies
   - Registered investment advisers
   - Corporations, partnerships, business trusts, and certain non-profit organizations
   - Small business development companies
   - Private and public pension plans
   - Certain bank trust funds
2. The buyer must be purchasing for its own account or for the account of other QIBs.
3. The buyer must own and invest at least $100 million of securities of issuers that are not affiliated with the buyer.

Individual investors, even if they have at least $100 million of investable securities, are not considered to be QIBs. Certain buyers are subject to special tests that are an alternative to the three-part test described above. For example, broker-dealers are considered QIBs if they own and invest $10 million of securities of issuers that are not affiliated with the dealer, or if they act in a riskless principal capacity for other QIBs. In addition, banks and savings and loan associations that have a net worth of at least $25 million are considered QIBs.

Notification In 144A transactions, it's the *purchaser* that must be a QIB; the seller is not required to be a QIB. However, the seller must reasonably believe that the buyer is qualified. In addition, the seller (or its agent) must notify the buyer that the seller is relying on the Rule 144A exemption.

Information Rule 144A transactions require a broker-dealer to establish whether the purchaser is a qualified institutional buyer. Although the SEC allows some flexibility, the following sources may be used for verification purposes and are specifically mentioned in the rule:

- The purchaser's most recent publicly available financial statements
- The most recent publicly available information that appears in documents that are filed with the SEC, an SRO, or a foreign regulator
- The most recent publicly available information that appears in a recognized securities manual (e.g., S&P and Moody's)
- A certification by the purchaser's chief financial officer or other executive who specifies the amount of securities owed and invested by the purchaser

Rule 144A and General Solicitation The SEC now permits general solicitation provided the purchasers are exclusively QIBs. In other words, the SEC permits *offerings* to be made to persons other than QIBs, provided the securities are *sold* only to QIBs.

Regulation S

As expected, when foreign companies issue securities in their home country, they're subject to any existing securities laws in that country; however, they would clearly not be subject to U.S. regulations. For many years, what was not so clear was whether and how U.S. laws applied to U.S. companies that issue securities outside of the country. The SEC clarified this situation by releasing Regulation S. Today, if a U.S. company issues securities under the provisions of Regulation S, the securities are not required to be registered under the Securities Act of 1933. According to Regulation S, a U.S. company may quickly issue an unlimited amount of securities outside of the country without filing any documentation with the SEC. There are no restrictions as to the type of non-U.S. investors who may purchase the security.

To qualify for a Regulation S exemption, the transaction must be executed offshore. An *offshore transaction* is one in which no offer is made to a person in the U.S. and *either:*

1. The buyer is outside of the U.S. at the time the buy order is originated, or
2. The transaction is executed through the facilities of a designated offshore securities market

Additionally, there must not be a directed selling effort in the U.S. This precludes activities such as sending printed material to investors in the U.S., conducting promotional seminars in the U.S., or advertising the offering in the U.S. through radio, TV, or print media.

Only a non-U.S. person may buy an overseas offering that's sold under Regulation S. The investor must not be defined as a U.S. person. A U.S. person is defined as any individual who is a natural person and resident of the U.S. as well as any partnership, estate, or account held for the benefit of a U.S. person. For purposes of the rule, a U.S. person who is traveling or resides outside the U.S. for a significant part of the year is still be classified as a U.S. investor.

Examples customers who can be offered securities under Regulation S are a non-U.S citizen employed by a company, but resides outside the U.S as well as a German investor located in Canada. However, a German investor located in the U.S. is NOT permitted to purchase securities under Regulation S.

An overseas investor who acquires securities as a result of a Regulation S offering may *immediately* sell the securities overseas through a designated offshore securities market. However, for Regulation S securities to be sold in the U.S., there's a distribution compliance (holding) period that must be satisfied. For debt securities, the holding period is 40 days, while for equity securities; the holding period is one year (six months for SEC reporting issuers).

FINRA Rule 5122

FINRA Rule 5122 relates to a private placement of securities in which a member firm is issuing the securities on its own behalf (also referred to as a *member private offering or MPO*). Due to potential conflicts of interest that arise when a member firm attempts to raise capital for itself (or for a firm it controls), the member firm is required to provide investors with a term sheet (private placement memorandum) or disclosure document. The member firm must also subsequently file this document with FINRA's Corporate Financing Department.

For purposes of the rule, control is defined as having ownership of more than 50% of the company. Rule 5122 provides two types of exemptions—one is based on the *type of investor* and the other is based on the *type of offering*.

The types of investors that are exempt from the rule include:

- Institutional investors, such as banks, insurance companies, investment companies (mutual funds), and investors with total assets of at least $50 million
- Qualified institutional buyers as defined by Rule 144A

The types of offerings that are exempt from the rule include:

- Offerings of securities that are exempt under the Securities Act of 1933
- Offerings that are exempt under Regulation S or Rule 144A
- Offerings of variable contracts
- Offerings of securities in a commodity pool
- Offerings of equity and credit derivatives
- Offerings of unregistered, investment-grade debt, or preferred securities
- Offerings of a member firm's securities that are sold in a public offering

FINRA Rule 5123

FINRA Rule 5123 relates to member firms that sell an *issuer's* securities in a private placement offering. Since the issuer is not required to file any offering documents with the SEC, there would be a lack of information available to FINRA when member firms offer private placements to their customers. This rule requires a member firm to file with FINRA a copy of any private placement memorandum (PPM), term sheet, or other offering documents that are used in connection with the sale within 15 calendar days of the date of first sale.

If no offering documents are used, FINRA must also be notified of this fact. Rather than approving or disapproving of any private placements, FINRA requires the filing of the offering documents.

The same exemptions that are available through FINRA Rule 5122 also apply to Rule 5123. Although FINRA provides an extensive number of exemptions from the filing requirement for sales that are made to certain accounts/investors and for specific offerings, both rules apply to the sale of private placements to individuals who meet the accredited investor definition.

Selling Unregistered Securities

Although private placements allow the issuer to avoid the expense of registration under the Securities Act of 1933, the securities that are received by purchasing investors are considered restricted. The restricted stock may not be sold unless it's registered under the Act or sold under an exemption. Since registration for investors is usually too difficult and expensive, other means of selling the restricted securities must be found. This is where Rule 144 becomes very helpful.

Rule 144

Rule 144 permits the resale of *restricted (unregistered) stock* and *control stock.* Restricted stock is any stock that's acquired through a private placement, while control stock is stock that has been acquired in the open market by an affiliated person of the issuer (e.g., an officer or director).

Rule 144 is usually the least expensive method for disposing of restricted and control stock since it assesses charges that are similar to normal transactions. Once the seller files Form 144, the restrictive legend placed on the securities may be lifted and all or part of the position may be eligible for sale through traditional channels.

> *For example, when a person was hired as the CEO of a corporation, the corporation gave her 10,000 shares of stock. This stock was not registered with the SEC and is therefore considered restricted. Later, the CEO bought 5,000 shares of the corporation's stock in the open market through her RR at a brokerage firm. Since this stock was trading freely in the open market, it's not restricted. However, because it was acquired by a person who "controls" the issuer (the CEO of the company), it's considered control stock.*

Availability of Information In order to take advantage of the Rule 144 exemption, there must be adequate public information available regarding the issuer. This refers to the type of financial information that reporting companies must file with the SEC.

Holding Period There are certain holding periods required under the rule. The owner of restricted stock of a *reporting issuer* must hold the stock for six months before selling it. The owner of restricted stock of a *non-reporting issuer* must hold the stock for one year before selling it. The applicable holding period begins at the time the securities were bought by the original purchaser and must have been fully paid for at the time of purchase. The holding period requirements apply to:

- An individual who purchases stock and wishes to subsequently sell the stock
- An individual who acquires the stock as the result of a gift from the original purchaser
- Securities acquired by a trust from a beneficiary who was the original purchaser
- Securities acquired by a pledgee from a pledgor who was the original purchaser

For the estate of a deceased person, there's no holding period and the securities may be sold at any time. However, the sale of the securities for an estate is subject to all other provisions of Rule 144.

For control stock, there's no mandatory holding period before the stock may be sold. A control person who acquires stock through an open market purchase may sell the stock at any time. However, an affiliate who acquires *restricted* stock is subject to the six-month or one year holding period.

For instance, in the preceding example, the 5,000-share block of the corporation's stock purchased by the CEO in the open market is control stock and not subject to the holding period. However, the 10,000 shares of unregistered stock given to the CEO by the corporation is restricted stock and is subject to the holding period.

There's an exception to the requirements of Rule 144 for the sale of restricted stock by non-affiliates. Any person who has not been an affiliate of the company for at least three months prior to the sale and has owned the stock for at least one year prior to the sale (six months for reporting companies if current public information is available), may sell the securities without complying with the restrictions of Rule 144.

> *For example, four years ago, a person who was the chief financial officer of a corporation received some unregistered shares of the corporation as a bonus. On July 1, 20XX, the person resigned from the company to work with a new firm. On October 1, 20XX, the person will be eligible to sell his shares without being concerned about the restrictions imposed by Rule 144 because he (1) will have held the shares for at least one year, and (2) will have been unaffiliated with the corporation for at least three months.*

The Nature of the Transaction The broker-dealer that handles the sale under Rule 144 may do so through *brokers' transactions* or in direct transactions with market makers. *Brokers' transactions* are defined as those that are made on an agency basis only and that don't involve solicitations, with the exception of the following two cases:

- A broker may make inquiry of a customer who has indicated an unsolicited interest in the securities within the preceding 10 business days.
- The broker may make inquiry of another broker that has indicated an interest in the security within the preceding 60 days.

Notice of Sale An individual who sells securities under Rule 144 must notify the SEC at the time her sell order is placed with a broker or when an order is executed directly with a market maker. The requirement for notifying the SEC applies to the sale of both restricted and control stock and is accomplished by filing Form 144. Once the filing is made, the investor is given 90 days during which the securities may be sold. However, notice is not required to be made if the amount of the sale doesn't exceed *5,000* shares or the dollar amount doesn't exceed *$50,000*.

Limitation on Amount Under Rule 144, there's a limitation which is imposed on the amount of stock that may be sold during any three-month (90 day) period. If the stock is listed on an exchange or Nasdaq, the maximum that may be sold is the greater of 1% of the total shares outstanding or the average weekly volume over the past four weeks.

On the other hand, if the stock is traded in the over-the-counter market, the limitation is simply 1% of the total shares outstanding. If a client owns more shares than may be sold under these guidelines, she may refile Form 144 at the conclusion of the current 90-day period.

> *For example, an issuer has 7,000,000 shares outstanding with an average weekly trading volume for the past four weeks of 60,000 shares. Since the limitation is the greater of 1% of the total shares outstanding (70,000 shares) or the four-week average (60,000 shares), the holder is able to sell 70,000 shares. However, if the issuer had 4,000,000 shares outstanding, 1% would only have equaled 40,000 shares. Therefore, the holder could sell 60,000 shares (the greater of the two amounts).*

Chapter 4 Summary

Now that you've completed this chapter, for the following commonly tested concepts, you should be able to:

- Recognize which securities are exempt from SEC registration
- Understand the Rule 147 intrastate offering exemption
  - General solicitation and advertising rules
  - In-state versus out-of-state sales restrictions; resident definition for business
  - Headquarters requirements and the four *doing-business* requirements
- Understand Regulation A(+) limited public offerings and its associated rules and limitations
  - Maximum dollar amounts per 12-month period for both Tier 1 and Tier 2
  - Differences in reporting requirements for Tier 1 and Tier 2 (*see table in chapter*)
  - Resale rules, types of securities offered, rules for the offering company
  - Offering circular requirements and testing-the-waters
- Compare and contrast private placements and public offerings
- Define the terms *placement agent, engagement letter, teaser, NDA,* and *term sheet*
- Recognize the purpose of a subscription agreement and its contents
- Understand SEC Sections 4(2) and 4(5) exemptions
- Understand the Regulations D exemptions and limits, including:
  - Rule 504 - dollar limit and permitted investors
  - Rule 506 - number and types of investors permitted
  - Define the term *accredited investors*
  - Understand the purpose and requirements of a purchase representative
  - Resale restrictions on unregistered securities
  - Disclosure requirements for accredited versus non-accredited investors
  - Solicitation/advertising rules for 506(b) versus 506(c) offerings
  - Methods for verifying accredited investors (if required)
  - Define the term *bad actors* and understand the restrictions
- Understand the provisions of Rule 144A
  - Types of securities
  - Define the term *qualified institutional buyer (QIB)* and provide examples
  - Rules regarding solicitation
- Understand exempt offerings conducted under Regulation S
  - Initial offering rules versus secondary market holding period for U.S. investors
- Understand the special disclosure requirements for member private placements
- Understand the FINRA notification requirements for private placements
- Understand the purpose and limitations of Rule 144
  - Difference between restricted and control stock
  - Filing requirement, time and volume limitations, prohibition on solicitation

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Chapter 5

Mergers and Acquisitions

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Overview

The Distinction Between Mergers and Acquisitions

The world of mergers and acquisitions involves the buying or selling of businesses, either in whole or in part. In a *merger*, two companies join together and reorganize as a new entity with shareholders from both companies surrendering their stakes and being given ownership in the newly created entity. For example, the combining of the two significant defense contractors, Lockheed Corporation and Martin Marietta Corporation, formed a new firm named Lockheed Martin.

In an *acquisition*, the buyer acquires the target company for cash and/or stock. In a legal sense, the target company ceases to exist. The owners of the target firm either tender their shares for cash or exchange their holdings for new stock in the acquirer. Often the distinction between the two activities is not based on a legal structure, but is more an issue of semantics. Referring to a transaction as a merger of equals is often viewed as more acceptable to the seller even if the transaction is actually an acquisition. Employees of the purchased company prefer to think of themselves as equal team members, rather than as human capital being obtained in a takeover. The purchase of Anheuser-Busch by InBev demonstrates this trend. Although the deal was billed as a merger, the formation of the new InBev Anheuser-Busch Companies, Inc. was really a buyout.

Regardless of the descriptions used, the logic behind these business combinations is based on the concept of synergy. In other words, the perceived value of the combined businesses is greater than the sum of the two separately (essentially, 1 + 1 = more than 2). However, achieving synergies based on business combinations is easier said than done. Unfortunately, if integration goes poorly, the merging of the two entities may add up to less than two.

Participants in a Deal — The Players

Sellers Sellers may range from publicly traded companies that are seeking to sell all or a part of themselves, to proprietors of family-owned enterprises who wish to cash out of the operations they have built. M&A bankers must realize that the desires and needs of sellers differ based on their individual situations; therefore, they need to answer a multitude of questions, such as—What are the tax ramifications of the transaction? Is the seller in a hurry? Does the seller want to continue to work at the combined company and, if so, for how long? Is there a widely dispersed shareholder base? Do any of the owners object to the sale, or is the sale of the business a foregone conclusion? What's the best currency for the deal? Will it be in the form of cash, stock, or some combination of the two? Is it better to have an open auction for the assets of the business, or is it advisable to discreetly negotiate with a few targeted potential buyers?

When acting as a client's adviser, an investment banking representative will need to provide guidance on these issues and many others. Additionally, representatives must manage the seller's expectations to ensure that the proposed sale price of the assets is reasonable based on the prevailing market conditions.

Sell-Side Investment Bankers When a company is seeking to sell its entire business or to simply sell a part of itself, the company may hire an investment banker to help it through the process.

The role of the *sell-side investment banker* is to assist in positioning the company, approaching potential investors, evaluating competitors and allies, negotiating a price, structuring the transaction, and satisfying due diligence.

Role of the Sell-Side Banker

- Assessing potential transaction forms (e.g., sale of the entire company, divestitures, stock sale, or asset sale)
- Performing due diligence on the seller by interviewing the seller's senior management, its consultants and accountants
- Extensively analyzing potential buyers by:
  - Reviewing their strengths and weaknesses
  - Evaluating their capacity to pay (preferably in cash)
- Assisting in evaluating financing requirements (including stapled financing)
- Making suggestions regarding methods to increase revenue and/or reduce expenses to increase valuation (valuation is the key)
- Populate the data room with due diligence information
- Advising the seller on whether to conduct an auction or one-on-one negotiation
- Preparing a fairness opinion
- Addressing potential antitrust concerns

Buyers There are also a wide variety of buyers. Some potential acquirers have significant cash positions, while others must incur significant amounts of debt to complete a deal. Purchasers may intend to fully integrate an acquisition into their current operations, while others attempt to improve an acquisition to make it more attractive and offer it for a quick resale. Generally, purchasers are able to be broken down into one of two types—strategic buyers or financial buyers.

Strategic Buyers A strategic buyer is in the same or similar line of business as the seller and is interested in meshing the target company's operations into its own. In essence, the strategic buyer bases the value of a target company on an estimation of how well the proposed purchase will enhance its existing operations. These buyers tend to take a long time to make an assessment regarding the potential benefits (synergies) of an acquisition. Strategic buyers are often willing to pay a significant premium for readily realizable or potential synergies. Additionally, strategic buyers are unlikely to retain all of the acquisition's existing personnel since an overlap between the buyer's and seller's operations is likely.

The goals of strategic buyers may include:

- Geographic expansion
- Enhanced scale and distribution networks
- Enhanced research and development (R&D) capabilities
- Client acquisition and cross-selling opportunities
- A broadened product line and access to new technologies
- Pricing power through the elimination of competition
- Control of patents or other intellectual property (IP)
- Retention of a key supplier or customer
- Increase distribution network

Financial Buyers Financial buyers (sponsors) are typically investors whose sole interest in an acquisition is the projected return on the capital being invested. These buyers are more likely to leave the acquisition's management team intact since these new owners usually lack operational expertise in the industry. A financial buyer's interests are not limited to any specific industry and/or geographic region; instead, their goal is to acquire the asset at a cheap price and resell it at a premium within a relatively short time frame (often five years or less). These acquirers often target companies that are inherently healthy, but tend to reside in industries that are currently out-of-favor with the general investing public.

Summary of the Two Types of Buyers

	Strategic Buyer	Financial Buyer
Operating Synergies	Very important	Less important
Potential Targets	Industry specific	Non-specific
Typical Currency	Cash and/or stock	Cash
Time Frame	Longer	Shorter

Buy-Side Investment Bankers When a company intends to expand either through acquisition or a leveraged buyout, a buy-side investment banker may provide assistance to the acquiring company. Some of the key responsibilities include identifying targets (sellers), conducting preliminary due diligence, and establishing price criteria. Although the following list highlights the role of the buy-side banker, the financial impact of an unknown event (e.g., a lawsuit) would be a significant concern when valuing a target.

Role of the Buy-Side Banker

- Researching the target's largest shareholders to determine how they should be approached
  - Review SEC filings such as a proxy, 13D, 13G, and Form 10-K
- Facilitating the due diligence process
  - Evaluating the leadership of the target company, including interviewing senior management and performing background checks
  - Interviewing suppliers and accountants
  - Interview the target's customers
- Examining the rationale for the acquisition and the value of the business
  - Analyzing the target's financial results, prospects, and potential synergies with the buyer
  - Producing preliminary and pro forma valuation analysis
- Reviewing both the confidentiality agreement and confidentiality information memorandum (CIM) that are prepared by the seller
- Uncovering the risks and impediments to the transaction, including:
  - Unfunded liabilities
  - Shareholders' rights plans
  - Staggered boards, and
  - The degree of off-balance sheet disclosures

Leveraged Buyout Firms

A leveraged buyout (LBO) firm is a type of financial buyer that borrows a significant amount of funds (often 80 to 90% of the deal size) when acquiring targets. LBO firms often attempt to use the assets of the acquired company as collateral and partner with public or private lenders to finance the transaction. Typically, their objective is to retain an equity interest in the deal, which could prove valuable once the debt holders are paid off. For LBO firms, the exit strategies may include IPOs or the full or partial sale of the company. If the company is being sold, the ideal result is to find a strategic buyer that's willing to pay a premium for the company's assets.

Since financial buyers (sponsors) seek to use the acquisition's cash flows to make interest and principal payments, they tend to target companies with strong balance sheets, robust cash flows, capable management teams, and defensible positions (also referred to as deep moats) within a given industry. Often LBO firms target industries that contain a limited number of strategic buyers that have the financial means to compete for the asset. The goal of LBO firms is to increase cash flow, either through revenue enhancement and/or expense reductions, and eventually resell some or all of the target's assets to de-leverage the capital structure. If done correctly, this process ultimately enhances the returns on an LBO firm's equity position.

Private Equity Transactions

Private Equity (PE) Recapitalization In a private equity (PE) recapitalization, the PE firm generally buys most, but not all, of the owner's interest in the company. The owner has liquidity, but still can participate in the equity upside when the business is sold the next time. The PE firm generally wants to acquire at least 51% of the company. A PE firm will usually buy a business through a leveraged buyout (LBO), using some equity and then financing the rest with bank debt. The PE firm will look to increase the business by increasing revenue, reducing expenses, and possibly by making other acquisitions. As the firm increases cash flow, it pays down debt to increase equity. The objective is to increase the value of the business so it can be sold to another entity or exit through an IPO.

Minority Recapitalization In a minority recapitalization, a company reorganizes its debt and equity mixture with a PE investor owning less than 50% of the company. This generally provides liquidity to specific shareholders while preserving capital structure flexibility to facilitate future growth.

Dividend Recapitalization In a dividend recapitalization, a PE firm that has already purchased a company takes on additional debt to pay a cash dividend to itself and possibly to management. Ultimately, the risk is that the market will not like this type of transaction since it increases the debt and, therefore, the possibility that the company will not have sufficient cash flow to pay the debt. However, PE firms like this type of transaction since it's a source of liquidity. The hope is that, after initially buying the company, its equity has risen and the buyer can tap into this excess by borrowing funds to pay the dividend.

Which Buyer Will Pay More?

What happens if strategic and financial buyers are both vying for the same target? Strategic buyers are often willing and able to pay more for a company than financial buyers.

The first likely reason for this is that strategic buyers may be able to realize a degree of immediate synergy with its existing operations due to economies of scale or the elimination of duplicate functions. The target's operations may be viewed as integral to the acquirer's business and there may be a limited number of firms for sale in a given industry. The second reason is that strategic buyers are often mature players in their industry and have access to relatively low-cost capital, either in the form of readily available credit or their own stock.

Financial buyers often incur much higher financing costs. The increased costs are based on the leverage employed in the acquisition and, typically, these buyers lack the advantage of offering their own stock as a means of acquisition. Also, these buyers cannot exploit synergies. Financial buyers simply seek to make the acquisition more attractive and then quickly flip it to a new owner. Due to their cost of capital, the sooner a new owner is able to be located, the better. Financial buyers are not willing to bid up the price of the acquisition since their time horizon is so short.

Conversely, strategic buyers tend to have significantly longer time frames and are able to extract operating efficiencies. They tend to bid more aggressively than financial buyers. The purchase price differentials have a lessor impact due to the lengthened time frame of the acquisition and the lack of any need for a prompt (and higher) exit valuation. If a bidding war ensues, financial buyers generally cannot and will not compete with strategic buyers. If outbid by a strategic buyer, rather than increasing their bid, financial buyers (including LBO firms) are more likely to move on to a new target.

Management Buyouts Management buyouts (MBOs) involve the acquisition of a company by its current management team. In many cases, the current management buys out a founder or family that owns a controlling block of shares in the company. Due to the buyer's intimate understanding of the proposed acquisition, the merger process is likely to be truncated and the due diligence process is limited. If the company is public and closely held, it will often be taken private in order to reduce regulatory expenses.

In many cases, MBOs are financed with the help of private equity firms or investment banks. Although these transactions are generally highly leveraged, in some transactions, management and the original owner agree to allow the buyer to use various forms of financing to complete the transaction.

Advisers Buyers and sellers enter into these negotiations with a full staff of supporting professionals. Accountants examine and verify the target's financial statements, attorneys draft contracts and assist in due diligence, while commercial and investment bankers provide advice regarding the structuring, evaluation, and financing of the transaction. The regulators that oversee the Series 79 Examination expect an investment banking representative to have a thorough understanding of the legal, regulatory, and accounting issues that are associated with merger or acquisition transactions.

Let's begin with a brief discussion of the methods used by bankers to aid potential buyers or sellers in valuing a business.

Valuation — The Heart of M&A

At the center of any deal is the perception of value. When considering the value, certain questions must be answered—Did the seller extract fair value for the asset? Did the buyer pay the right price? As stated earlier, financial buyers tend to focus on issues such as cash flow.

Their primary source of information is the target company's financials, with an emphasis being placed on the target's ability to support an increased debt load. Due to their use of leverage, financial buyers must also view the target's future earnings potential in light of a (likely) dramatically altered financial structure.

Strategic buyers also examine financial statements; however, they often have additional factors to consider since synergies may be available either immediately upon closing or at a later date. Both types of buyers must also take into account an almost endless list of ancillary issues such as pending lawsuits, workforce retention difficulties, existing employment and severance agreements, the durability of client contracts, environmental concerns, and potential antitrust issues.

Different targets require different forms of analysis. Based on the method of valuation employed and the assumptions that are made, two potential buyers may propose very different fair price conclusions. In a real world setting, bankers often mix and match aspects of each technique.

Although valuation will be examined in greater detail in a later chapter, below is a brief summary of some of the important terms.

Comparable Companies Analysis Comparable company analysis (*trading comps*) is based on the premise that companies operating in the same industry and having similar characteristics (a *peer group*) should be valued in a similar fashion. For example, if an acquirer is interested in a target within the retailing industry, it may compile a list of similar retailers (peer group members) and examine the market valuations applied to each member.

Once this screening process is complete, the buyer compares the valuation measurements (*multiples*) that are applied to each peer group member and then calculates a range of multiples for the industry. Common valuation measures that are employed include return on equity (ROE), return on assets (ROA), price-to-earnings (P/E), price-to-book (P/B), and enterprise value-to-earnings before interest, taxes, depreciation, and amortization (EV/EBITDA) ratios.

Once the peer group analysis is completed, the buyer has a benchmark against which it may frame its bid. This multiples-based approach is designed to value companies on current market conditions and sentiment. However, the shortcoming of this method is that no two companies are identical; therefore, caution must be used when making comparisons. The trading comps methodology is most useful in industries that contain a large number of publicly traded entities and where access to these firms' financial data is readily available (e.g., Forms 10-K and 10-Q).

Precedent Transaction Analysis While trading comps are typically used when the buyer has the advantage of using market valuations of similar publicly traded companies as a benchmark, there are some cases in which a limited peer group is available for comparison. Another possible process is to compare recent transactions in the same or a similar sector. These transaction comps examine the pricing of recent deals that have involved similar enterprises. Proxies, Schedule TO (tender offers), Forms S-4 and 8-K, and Schedule 13E-3 (going private transactions) are often used as sources of information by persons who use this valuation methodology.

However, this valuation technique also has its limitations. If a target company operates in an industry that's currently dominated by privately held firms, there may be few precedent transactions for comparison. Ultimately, this means that limited financial information will be available on any transactions that may have occurred.

Discounted Cash Flow Analysis Discounted cash flow (DCF) is a valuation methodology that follows the assumption that, over a given period, a target may be valued based on the present valuation of its projected free cash flows. Cash flows are used in lieu of GAAP earnings since earnings can be distorted (and manipulated) due to goodwill, asset value write-downs, depreciation, and numerous other non-cash charges. In a sense, DCF analysis attempts to determine the intrinsic value of an acquisition by using a mathematical model that's independent of the target's current market valuation.

When using DCF analysis to determine a fair value of a target, analysts first project the amount of operating cash flow that the company is likely to produce over a selected time frame (often 5 to 10 years). These projected cash flows, along with a terminal value, are then discounted (typically using the company's weighted average cost of capital or WACC) to arrive at a present value of the target. If the anticipated purchase price of the acquisition is below the present value (PV), the deal makes sense. If not, either the deal price must be adjusted downward or the transaction should not be completed.

Discounted cash flow analysis is typically used for mature companies with stable and predictable cash flows. However, DCF analysis has its limits; it's not a suitable tool to use when examining companies with little or no sales. If the expected rate of return and the size or timing of the cash flows is not estimated correctly, or if the discount rate being used is not suitable, the resulting fair value will be incorrect. An additional drawback to this technique is that DCF analysis generally assumes a constant capital structure (although some practitioners attempt to model potential capital structure changes). As with any tool, DCF analysis is only as good as the assumptions of the model's inputs.

Pro Forma Analysis In M&A transactions that involve a strategic buyer, bankers may generate hypothetical financial statements as if the two companies were merged. These statements are referred to as *pro forma* and show the potential assets, liabilities, anticipated income, and expenses. This analysis tool presents each company as a separate entity, but with a side-by-side comparison, and also provides a third column that details the potential cost savings (or other financial benefits) of the proposed combination. If the results of the third column are positive, the deal is expected to provide synergies for the buyer. Once again, if the merger achieves its goals, the belief is that 1 + 1 could equal more than 2.

The process of trying to create hypothetical post-deal financial statements is referred to as *recasting*. When performing this valuation exercise, the following factors are considered:

- Potential headcount reductions
- Potential facilities closures
- Enhanced bargaining power (and pricing concession) available from suppliers
- Potential pricing power if the merger reduces competition
- Revenue synergies available to the combined entity
- Tax status of the combined entity
- Savings related to regulatory compliance
- Costs associated with long-term employee retention
- Changes in the cost of capital

LBO Analysis LBO analysis combines the techniques of pro forma analysis and DCF analysis. Since an LBO transaction is likely to drastically alter the target's capital structure, the financial buyer's bankers must estimate a new (often higher) cost of capital. Once the valuation model has integrated the new cost of capital, the banker will run pro forma financial projections using these post-acquisition assumptions.

The resulting financial projections are then used to conduct a DCF valuation to determine if the proposed purchase price and projected exit valuation will result in an adequate return on the capital being invested.

Transaction Currency — Choosing Between Cash and Stock

Cash Buyout A cash buyout is the simplest type of deal. Once the buyer pays for the purchase in cash, the target company ceases to exist. An all-cash deal provides certainty for the seller since, whenever there's an equity component, the value of an offer will fluctuate with the mark-to-market of the buyer's shares. However, cash sales create an immediate taxable event for the seller.

Acquisition with Stock In a stock deal, the target's shares are tendered for shares of the acquiring company. The transaction itself doesn't create an immediate tax liability for the target's former owners since they simply assign the cost basis of their old position to the shares received from the buyer. Of course, in these transactions, both the seller and buyer are uncertain of the deal's final valuation, which is based on the fluctuating value of the shares that will be issued by the acquirer.

When entering into a *constant (fixed) share exchange agreement*, the buyer offers a fixed ratio of its shares (e.g., 2 for 1) to be exchanged for each target share, regardless of any price fluctuations that may occur in either stock between the time the deal is signed and the eventual closing. In this type of agreement, the buyer will know precisely the number of shares it will need to issue, but will be unsure of the final purchase price. Neither party has certainty about the final value of the transaction. If the acquirer's shares rise in value prior to the closing, the target is effectively being paid more; however, if the price declines, the seller receives less.

In a *fixed value agreement*, the deal's total dollar valuation (total purchase price in dollar terms) is guaranteed by altering the number of shares being issued to the target and is based on the performance of buyer's stock price prior to the closing. An increase in the market price of the buyer's shares results in fewer acquirer shares being issued to keep the dollar value of the deal unchanged. If the buyer's share price falls, more new shares must be issued to keep the dollar value constant. A fixed value arrangement provides certainty to the seller, but may result in greater than expected dilution to the acquirer's shareholders if the market reacts unfavorably to the news of the deal and the acquirer's shares subsequently fall in value.

Comparison of Cash and Stock Offers

Cash Offer	Stock Offer
Provides a known value for both buyer and seller	Provides an unknown value to both buyer and seller
No dilution of buyer's ownership structure	Dilutes buyer's ownership structure
Creates immediate tax liability for seller	Doesn't create immediate tax liability for seller
Impractical for large deals	May be impossible for private buyers
Often made at a discount to an all-stock deal	Often made at a premium to an all-cash deal

Collars — Creating More Certainty

In order to quantify and clarify the risk for each party, M&A transactions that involve the issuance of shares often have additional stipulations that are referred to as *collar agreements*. The buyer and seller negotiate parameters (collars) that set a lower range (the floor) and an upper range (the cap) on the acquirer's stock price; therefore, both parties have high- and low-end valuations for the transaction. If the target's share price falls dramatically due to a material event, many collars agreements also contain *material adverse effects clauses* that allow buyers to withdraw from a deal or renegotiate the terms of the contract. Similarly, sellers often have the right to rescind or renegotiate the deal if the acquirer's stock price drops below the lower collar range.

In a *floating collar agreement*, as long as the acquirer's share price remains within the collar range, the buyer and seller agree to a fixed exchange ratio. For example, let's assume Company A has agreed to buy Company B and will swap two shares of its stock for every one share of the target (i.e., 2-for-1). The collar is set at prices between $30 and $34, which puts a collar around the bid price between $60 and $68 (i.e., 2 x $30 and 2 x $34). If Company A's stock moves above or below the collar range, the agreement may call for an adjusted number of shares to be delivered.

In a *fixed value (payment) arrangement*, the buyer guarantees the target firm's shareholders that they will be paid a fixed dollar value in stock, provided the buyer's shares remain within the collar range. For example, let's assume Company X has agreed to buy Company Y and is willing to pay $60 in stock if its shares trade between $58 and $64. The number of shares will be adjusted if the stock trades within the range, but will not be less than .9375 ($60 ÷ $64) or greater than 1.034 ($60 ÷ 58).

Choosing Between Asset Sale or Stock Sale

Once the valuation is complete, consideration must be given as to how to structure a specific transaction. Of course, the wants and needs of the potential buyer and seller may be at odds. Price adjustments often occur as the parties negotiate over the preferred deal structure and method of payment.

As a starting point, it must be determined whether the target is being bought out entirely or is simply selling identifiable assets of its business. In an asset sale, a corporation is selling specific assets rather than selling shares of stock.

In other words, certain assets are being sold, but the target corporation itself continues on and will retain any residual assets and/or liabilities. In a stock sale, the entire company is being sold and (legally) ceases to exist; therefore, the buyer absorbs all of the assets and liabilities of the target firm.

Typically, buyers prefer to purchase the assets of a corporation's business, while sellers prefer stock sales. In an asset sale, the benefit to the buyer is the ability to exclude preacquisition liabilities from the purchase. Therefore, it's generally able to acquire only those assets (and liabilities) that it desires. In effect, this technique allows the buyer to cherry-pick the target's business. The buyer will normally have a stepped-up cost basis against which it may take increased depreciation and amortization deductions.

Alternatively, sellers usually prefer to sell the business entirely (a stock sale), since this process transfers all of the acquired firm's liabilities (including contingent liabilities) to the buyer. Also, individual owners of C Corporations prefer stock sales as opposed to asset sales because they produce only one level of taxation (to shareholders only). On the other hand, an asset sale normally creates an immediate taxable event for both the corporation and its shareholders (if the proceeds are distributed). In some cases, deals may be structured in such a way that the sellers are able to maintain an ownership interest and are better able to control the timing of their tax liability.

Tax Implications

With an asset sale, the selling corporation is required to pay tax on the difference between the cost basis of the assets and its sale price. However, the purchaser benefits by having a stepped-up (higher) tax basis on the assets which may produce a lower taxable gain when the assets are sold in the future. With a stock sale, the selling shareholders (not the corporation) pay a tax on the transaction based on the difference between their cost basis (which is not stepped-up) and the sale price.

Section 333(h)(10) Election A Section 338(h)(10) election refers to a part of the tax code which, if certain conditions are met, allows a stock sale to be treated as an asset sale for tax purposes. This election may be advantageous for both the purchaser and the seller. The purchaser benefits through being able to step-up (increase) the value of the target's assets to their fair value, rather than using their book value. The purchaser receives this stepped-up basis without being required to pay tax on the difference between the book value and fair value; therefore, the purchaser will have a lower tax when the assets are sold. Ultimately, it's the seller that will be required to pay tax on the difference between those two values. In many cases, the seller will demand a premium (higher) price as compensation for the tax it's required to pay on this type of transaction. In addition, if the seller has net operating losses that were carried forward, it may offset those losses against its gain on the sale of the assets.

Cross Border Legal Implications

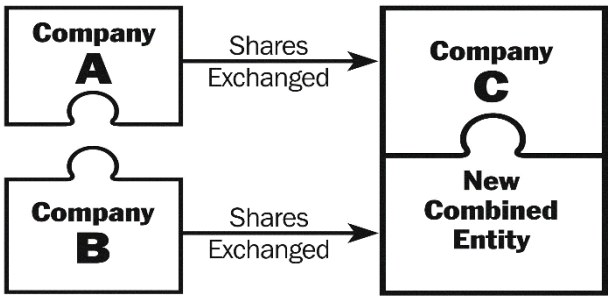
Foreign Corrupt Practices Act (FCPA) The law prohibits corrupt or improper payments to foreign government officials for the purpose of obtaining business. The anti-bribery provision of the law applies to U.S. companies, U.S. subsidiaries of foreign companies, as well as any foreign private issuers that are SEC reporting companies. The position of the SEC and the Department of Justice (DOJ) is that non-U.S. companies that issue stock or whose securities trade as American Depositary Receipts (ADRs) in the U.S. are subject to the FCPA. If improper payments are discovered as a result of the due diligence process, the best action for the investment banking firm is to provide disclosure to both the SEC and the DOJ.

Additional Cross-Border Due Diligence The Office of Foreign Assets Control (OFAC) has administered U.S. economic sanctions and embargoes with a number of countries, including Cuba, North Korea, Iran, and Syria. When performing due diligence in any potential M&A transaction, it's important to review OFAC's Specially Designated Nationals and Blocked Persons List (SDN List).

Any U.S. bank that has knowledge of a payment to or from one of these countries is required to block the transaction and report it to OFAC within 10 days. Broker-dealers and their representatives must be certain that they're not doing business with any person or entity that appears on the list and, therefore, must exercise special due diligence when executing M&A related transactions. They're also prohibited from maintaining correspondent accounts for foreign shell banks (i.e., banks with no physical presence in any country).

Transaction Types

Consolidation Mergers In a consolidation merger, a brand new company is formed for the purpose of buying two companies and combining them under the new entity. Shareholders of the original companies exchange their holdings and receive shares of the newly created entity.

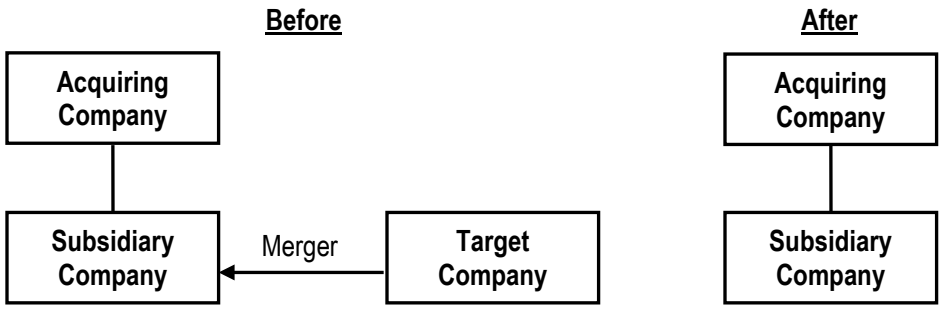


Spin-offs Spin-off transactions are executed by companies that are seeking to divest (dispose of) a division. In a spin-off, each shareholder of the parent company retains her original shares, but is also given shares in the newly created entity. There are no immediate tax consequences to the recipient of the new shares. Spin-offs are used by sellers in the hopes that the combined valuation which is assigned by the market to the two (now) separate companies will exceed that of the single combined entity.

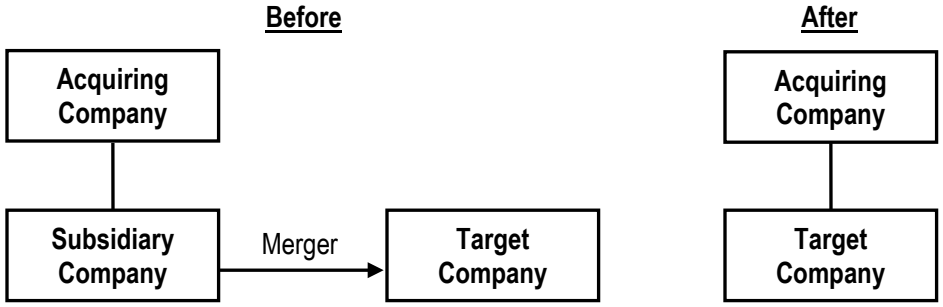
Split-offs These types of transactions involve corporations being split into pieces. The result of a split-off is that one group of shareholders will own shares solely of the original parent company, while the other group will own shares solely of the split-off entity. This strategy is often used to split corporate assets between groups of feuding shareholders. Ultimately, there's no tax liability created for either group.

Reverse Mergers In a reverse merger, a private company buys a public shell company (i.e., a corporation with little or no business activity) and the acquirer's shareholders exchange their shares for a majority stake in the publicly traded shell corporation. This technique allows a private company to quickly obtain publicly listed status and to forgo much of the regulatory expense that's incurred with an IPO. Once completed, the (former) private company has public shares with a determinable or known value (unlike that of private stock); therefore, it will be easier for the shares to be used at a later date for mergers or acquisitions.

Triangular Mergers A triangular merger involves three entities—a buyer (acquirer), a target (seller), and a subsidiary entity that's owned by the buyer. In a forward triangular merger, the target company merges with and into the subsidiary company. The subsidiary is the surviving company, while the separate existence of the target company is eliminated.



Reverse Triangular Merger In a reverse triangular merger, the buyer's subsidiary merges with and into the target company. The target company assumes all of the subsidiary's assets and liabilities. The subsidiary ceases to exist as a separate entity; instead, the target company survives and becomes the buyer's subsidiary. The reverse triangular merger is most often used when the selling entity has significant existing contracts that will not survive an acquisition transaction. By using this form, the target company's contracts with customers (and the resulting revenue) remain intact.



Proactive Buyers—Getting the Deal Done

An investment banking representative may be approached by a client that's intent on making an acquisition. When considering targets, the buyer may often be strategic in nature and have very specific goals, such as filling a hole in its product line or expanding its geographic reach. In other cases, the buyer may be a conglomerate or financial buyer that's seeking a broader range of acquisition candidates.

Given the various client objectives, investment banking representatives must ask certain questions.

- How large is the acquisition being contemplated by the buyer?
- Can the buyer's balance sheet support the purchase or will outside funding be needed?

- Is the potential target's universe constrained by antitrust concerns or other legal impediments?
- Is the buyer contemplating a cross-border transaction?

Once these and other questions are answered and a screening process of suitable candidates is completed, a list of the most desirable buyout targets may be presented.

Target Identification (Preliminary Assessment) Bankers may begin the process of finding suitable target companies by screening for all public and private companies in a given industry or by reaching out to industry contacts to inquire as to whether they have any insights regarding potential buyout candidates. Depending on the nature of the target(s), investment bankers may run into disparities concerning both the amount of information that's readily available and the potential impediments to closing a transaction. Although there's far more information available regarding public companies, the downside to targeting public firms is that closing a deal may be far more difficult. The difficulty is based on these targets' dispersed shareholder bases and the need to comply with a significant number of regulatory issues.

From the outside, private firms are harder to analyze; however, they may prove to be easier to negotiate with since ownership tends to be concentrated in the hands of a few large shareholders. Also, the deals with private firms are often able to be closed more quickly due to the fact that they're not subject to the same level of regulatory filing and disclosure requirements. Once the list of targets has been reduced to only the top contenders, the investment banker is expected to not only assess the current financial performance of the company, but also to aid the potential buyer in identifying any synergies that may exist. The buyer and its investment banker will engage in an analysis that includes the target firm's business, organizational and ownership structure, capital structure, sales, profitability trends, workforce composition, and takeover defenses. The next step is to ascertain whether the target's management has any interest in a deal.

One-on-One Transaction — The Simple Deal

Bilateral Negotiation If the buyer is initiating contact, early communications between the companies may be informal. The buyer's management may sit down with the target's owners to discuss the benefits of a proposed combination in very general terms. If the talks proceed, a confidentiality agreement (also referred to as the non-disclosure agreement or NDA) is signed and substantive due diligence information will begin to be exchanged. The benefit of bilateral negotiation is that extreme secrecy is able to be maintained since typically only the senior members of both the potential acquirer and target are aware of the discussions.

Often this form of one-on-one negotiation is utilized when the buyer and seller have an existing business relationship and there's a natural fit between the companies. The disadvantage to the seller is that it cannot be sure whether more attractive (competing) offers are available. For this reason, there's a natural tendency for sellers to explore alternatives to maximize value; however, buyers will often attempt to prevent this from occurring.

Bidders are always wary of having their target stolen by rival firms; therefore, the potential buyer may ask the seller to sign a *no-shop agreement*. By signing this document, the target firm essentially agrees to work in good faith toward a closing. The target company, its officers, and board of directors agree that they will not, directly or indirectly, take any action to initiate, solicit, or assist in the submission of any proposal, negotiation, or offer from any third party. However, in practical terms, these agreements are difficult to enforce.

On the other hand, the seller's bankers might negotiate a *go-shop provision* which allows the seller to shop the bid. This shopping may result in finding a buyer that's willing to pay a higher price.

Break-up Fees A breakup fee refers to a payment that a target or seller owes to a buyer or acquirer if a deal falls through due to reasons that are explicitly specified in the letter of intent or other merger documents. It's also called a termination fee since this penalty is paid in M&A transactions to compensate the acquirer for the time and resources spent in negotiating the deal. Buyers will ask for a breakup fee if the seller wants the option to receive other bids from other potential buyers. A third-party buyer will need to factor in the additional cost that the seller or target would need to pay the acquirer in launching its bid.

Seller Initiated Transactions

In some cases, a seller may initiate the acquisition process. Potential sellers may be the controlling shareholders of a family-owned business who have no heir apparent or may be a conglomerate that's seeking to divest a division that no longer fits into its long-term strategy.

For example, a biotech company that has failed to obtain FDA approval may decide that the best strategy is to try to capture any residual value left in the business by selling its patents and related intellectual property (IP). Although some sellers will seek to close a transaction through the bilateral process explained above, many (especially those with time constraints) choose to utilize an auction process to obtain broader exposure to potential buyers and potentially a quick resolution of a business need.

Auctions

Auctions are often a useful tool for sellers. In any sale, it's preferable to generate interest from multiple parties in order to induce competition among the buyers. The hope is that the increased competition will generate a higher final sales price. Selling by auction provides sellers with a contingency plan if the sales process with the selected bidder stalls or breaks down entirely. There may be a backup buyer that has already performed due diligence and is willing to step in—albeit at a reduced price. Sellers and their bankers must decide on the most appropriate auction process to use.

Controlled (Limited) Auction In a limited auction, the seller invites bids from a preselected list of likely buyers. This method provides the benefits of a competitive process, while maintaining some level of confidentiality for the potential seller.

Full Public Auction A full public auction is designed to provide maximum exposure to a company that's seeking to put itself up for sale. Often a press release is issued stating that a company is "considering its strategic options."

In all likelihood, what this means is that the issuer has just offered itself for sale. Since this auction method relies on publicity to generate interest, confidentiality regarding the proposed sale will likely be compromised. Sellers must obviously weigh the benefits of the increased exposure against the likelihood that a proposed sale may impact worker morale, client perceptions, and other aspects of its day-to-day operations.

The Step-by-Step Auction Process (From the Seller's Perspective)

Bake-Off When deciding to sell through an auction process, the selling entity often chooses an investment bank to conduct the auction through a bake-off. In a bake-off, competing investment banks pitch their capabilities in pitch meetings to demonstrate how they can obtain maximum value for the seller in the most efficient, time effective manner. This process is also referred to as a beauty contest, since the seller will typically hire the investment bank that looks the most attractive.

Step 1) Sign the Engagement Letter An *engagement letter* defines the legal relationship between the investment banker and the buyer or seller in an M&A transaction. This document details the scope of the engagement and the compensation to be paid to the banker. Typically, sellers engage the services of an investment banker to obtain advice when considering their strategic options and, if an asset or outright sale is seen as the likely path, it utilizes the investment banker's expertise to market the proposed transaction.

Step 2) Development of Contact/Prospect List The investment banker will help the seller by creating a list of potential buyers. The process starts by targeting firms that have natural synergies with the seller and the financial resources to complete the transaction. Additionally, the banker may solicit the interest of financial buyers if the universe of potential strategic buyers is too small. Depending on the nature of the auction, information regarding the asset/company for sale may be sent out widely or to only a few selected prospects.

Step 3) Create the Teaser A *teaser* is a slang term for a business profile that's usually jointly prepared by the seller and its investment banker as a marketing piece to generate interest in the transaction and is distributed to prospective counterparties. The teaser doesn't typically disclose the identity of the seller or other confidential information regarding the business to be auctioned. Instead, the profile is a very brief synopsis (often a few pages) that provides potential buyers with a snapshot of the business and summary descriptions of the company's financial and operational history.

Some of the details of the teaser include:

- The nature of the business
- The size of the business
- A basic P&L presentation
- A proposed deal timeline
- Reasons that a buyer may find the business attractive

Step 4) Confidentiality Agreements A confidentiality agreement is used when a company is planning to disclose confidential or proprietary information to another party that relates to a potential sale or merger.

Typically, the document is drafted by the seller's legal counsel and signed by both the disclosing party and the party that's receiving the information. In an auction process, any parties that receive the teaser must sign the agreement if they're interested in obtaining additional information regarding the business for sale.

Confidentiality (non-disclosure) agreements normally contain:

- A statement that all material received is confidential and may not be used for other purposes
- Anti-poaching clauses to prevent solicitation of the target's employees
- Details regarding the term during which confidentiality restrictions remain in effect
- Standstill agreements which prevent would-be buyers from acquiring a target's shares
- Details regarding the information that may be disclosed to third parties, such as the buyer's bankers or financing sources
- Restrictions concerning collusion with other buyers (also referred to as anti-clubbing provisions)

Step 5) Confidential Information Memorandum A confidential information memorandum (CIM) is a much more detailed document than the teaser (often 50 pages or more in length) and provides significant background information regarding the business, intellectual property and trademarks, and a variety of additional content. At a minimum, the CIM will include:

- An executive summary
- An overview of the seller's industry
- A general company overview
- Details regarding management
- Details regarding its manufacturing capacity and distribution channels
- An overview of products and services offered
- Details regarding customers, market share, and competitors
- Certified historical financials
- Projected financials
- Recent press releases

Essentially, confidential information memorandums are designed to give potential acquirers a more thorough understanding of the business and to help them assess whether it's worthwhile to continue to pursue the potential acquisition.

Step 6) Distribution of the Initial Bid Procedures Letter Once potential buyers have had the time to perform their due diligence, a *bidding procedures letter* (bid process letter) is generated by the seller and its banker. This document will indicate a deadline for prospective bids as well as any other requirements that are demanded by the seller, such as a description of the buyer's potential funding sources and/or the currency being proposed for the transaction.

Step 7) Creation of a Data Room For potential bidders to view detailed materials that relate to the business of the target (seller), a data room is established. As an alternative to a physical location, firms now use a virtual data room that's established by private data management companies. A data room is usually an online, secure, and confidential location from which all participating dealmakers (i.e., investment bankers, lawyers, and accountants) are able to review information.

The target's (seller's) bankers usually control the data room and provide potential bidders with access to certain information. Technically, the target will provide guidance to the bankers as to what information may be viewed and by whom. Therefore, the banker acts as a gatekeeper by requesting certain information from the seller and then providing this information to potential buyers.

Step 8) Indication of Interest (IOI) Once potential bidders have been contacted by the seller's investment banker or have read through the CIM and expressed an interest in the target, they're invited to submit a non-binding indication of interest.

Step 9) Conducting Management Presentations Potential bidders will likely have additional questions once they have received the teaser and the CIM; therefore, they may attend a management presentation that's designed to explain these documents and to answer the seller's questions prior to bidding. Although the stated goal is to educate counterparties on key business, operational, and/or financial issues, in reality, these sessions provide the seller's management team with the opportunity to make a compelling case for the value proposition of the proposed transaction. Essentially, the seller is pitching the deal and hoping to induce purchases by detailing synergies and potential upside opportunities to would-be acquirers.

Step 10) Evaluation of Initial Bids The seller and its investment banker will collect the first round of bids and sort them according to price and currency type. They will also evaluate the strength of each buyer and attempt to estimate the likelihood that a given counterparty will be able to close the transaction. Regret letters will be sent to bidders that have made offers that are too low or are deemed unlikely to be able to close the transaction. The seller and its banker will then move to the next step with the remaining bidders.

Step 11) Letter of Intent (LOI) Once the initial due diligence is complete, the seller often asks the buyer to provide a non-binding commitment to move forward with the transaction. This formal indication of interest, often referred to as a *letter of intent (LOI)*, *term sheet*, or *memorandum of understanding (MOU)*, typically contains the following information:

- Anticipated pricing
- Agreed upon reasons for price adjustments
- Proposed deal structure
- Proposed currency to be used
- Defined time frame for due diligence
- Period of exclusivity or a no-shop provision
- Potential break-up fees
- Go-shop provisions
- Earn out provisions
- Employment contract issues
- Warranties as to the validity of financial statements
- Agreements regarding disclosure of any subsequent material events

Although letters of intent are typically non-binding, these documents do specify the terms that have already been agreed to by both the buyer and seller. In essence, this term sheet is a written attestation regarding the general agreement to the proposed pricing and terms of sale. Term sheets often form the basis of a definitive agreement that will be drafted as the deal nears its closing.

Step 12) Final Bid Procedures Letter The remaining bidders will be given another opportunity to bid. Some may adjust their prices up or down, based on either information that's uncovered by their continuing due diligence process or their estimate of the seriousness of other potential buyers. Also, the seller will usually include a *draft definitive agreement* with the final bid procedures letter.

In some cases, the prearranged financing will be offered to final-round bidders. This *stapled financing* is usually offered by the investment bank that's advising the seller and includes all of the details included in the lending package (e.g., principal amount, fees, interest rates, and loan covenants). The term stapled financing is derived from the fact that it's often attached to the offering memorandum. There's no requirement for the bidders to use this financing or obtain permission from the seller to use alternative funding sources.

Step 13) Final Bid Placement The remaining bidders will then submit their final bids that contain a firm purchase price (NOT a range) and the specifications of the intended method of payment (cash, stock, or combination). If stock is being used, collar ranges are normally indicated. Committed financing guarantees are typically also provided by the potential buyers to give sellers greater confidence that the bidder has the ability to obtain any needed financing to close the deal. Additional information may include the approval of the transaction by the buyer's board of directors and an estimated closing date. The buyer then makes an attestation that its offer is binding and will include a markup of the *draft definitive agreement* (described below) that was provided by the seller as part of the final bid procedures packet.

Step 14) Selecting the Winner Once the final bids are received, the seller and its investment banker will attempt to evaluate each one. Unfortunately, it's not as simple as selecting the highest bid. Competing bidders will often offer different forms of currency or, based on the strength of their relative balance sheets or financing sources, may be seen as having a greater or lesser ability to close the deal. In other cases, antitrust concerns may arise with one bidder, but not another.

Step 15) Signing Definitive Agreements Once the buyer and seller agree to terms, a final version of the *definitive purchase agreement* will be drafted and executed. This document sets forth the details of the transaction, including the final price, proof of financing sources, escrow conditions, requirements for any regulatory approvals, and other specific conditions that have been agreed to by the buyer and seller. Generally, a nearly complete version of this document is presented when the potential buyer has finished its due diligence and an agreement has been reached regarding pricing terms.

Indemnification Clause Relating to an M&A transaction, one of the provisions that may be included in a definitive purchase agreement is *indemnification*. Indemnification clauses are often requested by buyers as protection against a seller's material breach of contract after the deal has closed and are most likely used in the purchase of private companies to quantify the amount of compensation that's due to the buyer if officers and directors of the selling firm fail to meet their legal obligations. Examples include misrepresentation of financials and/or the failure to disclose a material event, such as the loss of a major client prior to closing.

These agreements are heavily negotiated since the seller prefers a short time frame and a limited dollar amount of liability. An indemnification basket sets a certain dollar amount of losses that must be experienced by the buyer, as a result of the seller's breach of contract, for the buyer to claim any indemnification. This amount is usually based on a percentage of the purchase price and is included in order for the seller to not be liable for a negligible amount. An indemnification cap limits the seller's liability to a maximum amount of money that's based on the sale price due to any breach in the contract. It's rare for a contract to be signed that includes an unlimited amount of liability for either the buyer or seller.

If an offer is accepted, the board of directors of the seller is generally intent on assuring the shareholders that every effort has been made to obtain the best price and that the offer selected protects their interests. For this reason, an additional document—referred to as the *fairness opinion*—may be created.

Purchase Price Adjustments Some M&A transactions may include a purchase price adjustment, the terms of which are negotiated with the letter of intent and, if required, are paid at closing. A "working capital peg" is one of the key purchase price adjustments and must be agreed to by the two parties. It's typically based on the seller's past net working capital (generally one year or less). The buyer prefers a higher number and the seller prefers a lower number. The buyer pays the seller if the actual number at closing is higher, while the seller pays the buyer if the actual number is lower.

Step 16) Creation of a Fairness Opinion A *fairness opinion* is a document that's created by an outside entity (e.g., an investment bank) and is often connected to mergers, acquisition spinoffs, or going private transactions. The opinion is rendered to determine whether the proposed transaction price is fair (within a reasonable range of prices), but not necessarily that it's the highest offered price. Details regarding the fairness opinion will follow Step 17.

Step 17) Signing and Closing the Deal Once the definitive purchase contract has been agreed to, the parties may simultaneously sign off and close the deal. At times, the official closing (transfer of ownership and payment) will occur at a later time and may be based on the completion of a final event, such as a regulatory approval or filing. If, for some reason, the deal fails to close, termination fees may apply.

Fairness Opinions

The purpose of a fairness opinion is to provide a company's board of directors with an independent assessment of the company's value. The opinion is typically created by an investment bank at the request of the target's board of directors. More recently, the buyer's board of directors will also request a fairness opinion to determine or justify a transaction's value.

Although not required by law, fairness opinions are common in mergers and acquisitions that require shareholder approval. Examples include a public company being taken private in an LBO, a cash offer to purchase the shares of a company by a private equity firm, or a merger where shareholders receive cash, securities, or a combination of the two. Transactions that typically don't have a fairness opinion include, initial public offerings (IPOs), follow-on offerings, hostile takeovers using a tender offer, and a stock buyback using a tender offer.

In preparing this document, the investment bank that's hired will:

- Review certain publicly available financial statements and other business and financial information of the companies
- Review certain internal financial statements and other financial and operating data concerning the companies that are prepared by their management teams
- Review certain financial projections that are prepared by management
- Discuss with senior executives the details of past and current operations, financial condition, and the prospects of the companies, including information relating to certain strategic, financial, and operational benefits that are anticipated from the merger
- Review the pro forma impact of the merger on the acquiring company's earnings per share
- Review the reported prices and trading activity for the common stock of both companies

- Compare the financial performance of both companies and the prices and trading activity of their shares with that of certain other publicly traded companies
- Review the financial terms of certain comparable acquisition transactions (if publicly available)
- Review a draft of the merger agreement and certain related documents

The federal tax consequences of the transaction will be reviewed by the accounting and/or legal adviser in the merger transaction.

The fairness opinion doesn't specifically make a recommendation to the board or shareholders. Instead, it only indicates that the compensation is fair from a financial point of view. The board of directors that requested a fairness opinion is not relieved of its fiduciary duty to the shareholders. The last sentence of the opinion typically states the following:

> *Based on and subject to the foregoing, we are of the opinion that, as of the date hereof, the Merger Consideration to be paid to holders of Company Common Stock, in the Merger is fair to such holders from a financial point of view.*

When preparing a fairness opinion that will be distributed to public shareholders, regulators require the disclosure of any existing conflicts of interest. Also, a material relationship must be disclosed that includes any contingent compensation from related transactions, such as fees earned from a stapled financing transaction. Other conflicts include:

- Any current or prior relationship between the author of the opinion and any party to the transaction
- Compensation payable to the broker-dealer that prepares the fairness opinion if it's contingent on the deal closing

It's the fact that the broker-dealer will receive compensation that must be disclosed, not the amount of compensation to be paid. A firm that issues fairness opinions must have written procedures for approving the opinion. Most firms use a fairness committee to approve their fairness opinions and must establish a process for selecting the members who serve on this committee.

Since deal team members typically have an inherent bias due to the fact that their compensation may be contingent upon the deal closing, the fairness committee must include some members from outside the firm's deal team to promote a balanced view. Additionally, the firm must have a process to determine whether the different types of valuation metrics being used in the opinion are appropriate. After the investment banking firm that's hired to prepare the fairness opinion has examined and analyzed the relevant data, it will prepare a summary that may include the following:

- An analysis of selected, similar publicly traded companies in the same sector for the purpose of comparing certain financial ratios and market multiples. Some of the ratios or multiples are price-to-earnings ratios, price-to-book value, PEG ratios, enterprise value-to-revenue or sales, and enterprise value-to-EBIT/EBITDA. In some cases, the fairness opinion may be based on a comparison to a single company, especially if the transaction was recently completed.
- An analysis of selected recent M&A transactions or business combinations that focus on the same sector, the same or similar equity transactional values, and similar consideration (cash and/or stock). The opinion writer may also examine whether the implied multiple for the seller is within the range of multiples paid on similar transactions.

- An analysis of the premium or exchange ratio paid for selected, similar equity transactions and similar consideration (cash and/or stock). This may be used to compare the acquisition price per share, as a premium to the closing price of the stock, within a selected time period prior to the announced date of the merger, to the premiums paid on similar transactions.
- A discounted cash flow (DCF) analysis based on the projected free cash flow of the company, a terminal value or terminal multiple (usually based on EBITDA) and using a discount rate (typically based on the firm's weighted average cost of capital). This allows the investment banking firm to arrive at a range of implied enterprise values. If the enterprise value is estimated and the debt and cash values are known, a range of share values may be determined.
- A sum-of-the-parts analysis (if applicable), which is used if the target company has many different business lines and each unit could receive a separate valuation.

Regulations Regarding Fairness Opinions

Industry rules regulate pricing or fairness opinions that are produced by member firms regarding transactions which result in a change in the control or assets of a company. This is the case with mergers, acquisitions, tender offers, or the sale of a division of a company. A pricing opinion addresses whether the price being offered is fair (within a reasonable range of prices).

However, pricing opinions don't address factors that are related to the solvency or creditworthiness of the companies involved in the transaction. When contemplating acceptance of a takeover or the sale of an asset, directors of a company depend on pricing opinions to demonstrate that they have acted in the best interests of their shareholders. The rule requires any broker-dealer that renders a pricing opinion to disclose any conflict of interest that exists between itself and the issuer. Any fairness opinion being provided to the shareholders must include any of the following disclosures (as applicable):

- Whether a financial adviser to any party in the transaction will receive compensation that's contingent on the completion of the merger or takeover
- Whether the broker-dealer will receive any other significant payment that's contingent on the completion of the transaction. (Note: the specific amount of the fee is not a required disclosure item)
- Whether any material relationship existed within the past two years between the broker-dealer and any party that's subject to the fairness opinion. (Note: An investment bank involved in the transaction may write the opinion if proper disclosures are made).
- Whether any information that formed a substantial basis for the fairness opinion which was supplied to the firm by the company requesting the opinion concerning the companies that are parties to the transaction has been independently verified by the firm, and if so, a description of the information or categories of information that were verified. (Note: The broker-dealer is not required to verify any of the information and cannot be held liable if the information provided is inaccurate.)
- Whether the fairness opinion was approved by a fairness committee
- Whether the fairness opinion addresses the fairness of the compensation being paid to corporate insiders, relative to the compensation being received by public shareholders

Broker-Dealer Fairness Committee If a broker-dealer establishes an internal committee to render fairness opinions; it must create written procedures that address the following:

- The types of transactions on which it will issue a fairness opinion
- The circumstances in which it will use a fairness committee

- The process used to select members of the fairness committee and the standards necessary to become a committee member
- The process it will use to promote a balanced view by the fairness committee. This is accomplished by selecting some members from outside the deal team.
- The process it will use to determine whether the valuation analysis used by the committee and reflected in the fairness opinion is appropriate

Takeover Defenses

Not all business combinations are executed on friendly terms. In the case of a hostile takeover, the target's board of directors doesn't support the transaction. The potential acquirer is often seeking to remove a company's existing management and replace it with its own team. Most companies have created takeover defenses that are designed to either repel an unwanted acquirer or provide the target with options to consider.

Shareholder Rights Plans In a shareholder rights plan (referred to as a *poison pill plan*), the target company issues rights to existing shareholders (not the potential buyer) which allows them to acquire a large number of new securities—usually common or preferred shares. This tactic dilutes the percentage of the target that may be acquired by a hostile bidder and makes it more expensive to acquire control of the target company, unless the bidder and target's board of directors come to an agreement on terms.

Staggered Boards Issuers may employ a staggered board structure to prevent hostile buyers from quickly gaining control of the board. For example, a company has nine board members and the term for each director is three years. The company has staggered the terms so that only three seats come up for vote each year. Therefore, the maximum number of seats that a hostile takeover could capture is three seats in the first year, thereby giving the issuer time to mount a counter-offensive.

Supermajority Approvals Companies often require that a significant majority of its board members agree on certain issues, such as mergers or the sale of the firm. These supermajority provisions are outlined in the company's corporate charter and are often part of its anti-takeover strategies. By establishing this requirement, a hostile shareholder who has acquired minority representation on a board will still need to convince a significant majority of the other board members that a corporate transaction is in the best interests of the shareholders.

Golden Parachutes A *golden parachute* is a severance payment that's made to a senior officer of a company in the event of a takeover or change in control. In many cases, the payments are significant and designed as a form of takeover defense. Care must be taken when crafting these contracts since, under Internal Revenue Service rules (IRC Section 280G), companies that pay excess golden parachute payments (defined as those greater than three times the individual's annualized compensation) could potentially lose the corporation's tax deduction for such payments and expose the recipient to a 20% excise tax on the excess payments. These tax provisions were enacted to protect a corporation's shareholders from the potential losses resulting from excessive compensation payments being made in connection with a change in ownership or control of a corporation. The portion of the parachute payments that's subject to excise tax and non-deductibility is the amount that exceeds three times the employee's base salary. This amount is computed as the person's average annualized taxable compensation for the five most recent tax years prior to the change in ownership or control.

Chapter 5 Summary

Now that you've completed this chapter, for the following commonly tested concepts, you should be able to:

- Understand the difference between a merger and an acquisition
- Understand the role of both sell-side and buy-side bankers
  - Recognize the specific details of the activities and actions taken by each participant
- Understand the difference between strategic buyers and financial buyers (*see table in chapter*)
  - Which one will pay more for an acquisition?
- Understand the concept and analysis associated with leveraged buyout firms
- Understand the three different private equity recapitalization strategies and how they're used
- Understand the concept of management buyouts
- Recognize the concept of valuation (*valuation will be fully described in later chapters*)
  - Comparable companies versus precedent transactions
  - Basic principles of discounted cash flow analysis
  - Define the terms pro-forma analysis and LBO analysis and their purposes
- Understand the difference in deal currency, cash versus stock (*see table in chapter*)
  - Fixed share versus fixed value agreement and the function of collars
- Compare and contrast asset sales and stock sales, including their tax implications
  - Section 333(h)(10) election
- Understand the purpose of the Foreign Corrupt Practices Act and the OFAC list and their requirements
- Define the terms *consolidation merger, spin-off, split-off, reverse, triangular mergers,* and *reverse triangular mergers*
- Recognize the objectives of proactive buyers and potential target companies
- Identify the steps involved in a bilateral negotiation
  - Letter of intent, break-up fees, no-shop versus go-shop provisions
- Understand the auction process and the steps involved
  - Open versus limited auction
  - The 17-step process and the basic order of events
  - The contents of the letter of intent (LOI)
    - No-shop, go-shop, and break-up fees
- Define the terms *indemnification clause, cap,* and *basket*
- Define the term *fairness opinion* and recognize its purpose
  - When it's needed
  - Recognize who prepares it and the required disclosures
  - The information that must be reviewed
  - The function and construction of the fairness committee
  - Required regulatory disclosures for fairness opinions that are provided to shareholders
- Understand the various takeover defenses, how they work, and any negative effects
- Define the term *excessive golden parachute* and understand the tax consequences

Create a Chapter 5 Custom Exam

Now that you've completed Chapter 5, log in to *my.stcusa.com* and create a 10-question custom exam.

Chapter 6

Tender Offers and M&A Rules

STC
Securities & Insurance Training

Tender Offers

A tender offer is defined as a company's or third party's broad solicitation to purchase the securities of another company for a limited period of time at a price that's typically at a premium. According to the Securities Exchange Act of 1934, any person that makes a tender offer and becomes the owner of more than 5% of a company is required to file Schedule TO (tender offer) as soon as it's practical on the commencement date (this is in addition to a 13D filing).

Schedule 14D-9

SEC Rule 14d-9 is the provision which requires a company that's subject to a tender offer to notify its shareholders of the offer no later than 10 business days from the date the tender offer is made and to also disclose its recommendation regarding the offer. This rule also requires the filing of Schedule 14D-9 or Schedule TO (tender offer) which must contain information regarding the following items:

- Summary term sheet
- Subject company information
- Identity and background of the filing person
- Terms of the transaction
- Past contacts, transactions, negotiations, and agreements
- Purposes of the transaction and plans or proposals
- Source and amount of funds or other consideration
- Interest in securities of the subject company
- Persons/assets that are retained, employed, compensated, or used
- Financial statements

Note: Schedule TO forms the basis for the proxy statement and is filed in all types of tenders including partial issuer buybacks, going private transactions, and purchase offers that are initiated by a third party.

Schedule 14D-9 or Schedule TO must be filed by certain persons, such as:

- The subject company, any officer, director, employee, or affiliate of the subject company
- An owner of any security of the subject company, the bidder, or any affiliate of the bidder
- Any other person who makes a solicitation or recommendation to shareholders on behalf of any of the previously mentioned persons

However, an exception to the filing of Schedule 14D-9 or Schedule TO is given to:

- Attorneys, banks, broker-dealers, and investment advisors that are not participating in the tender offer and that are furnishing information only on an unsolicited basis to their customers
- The subject company, if it's providing "stop-look-and-listen communication," which only identifies the tender offer by the bidder, states that the tender offer is under consideration by the subject company's board of directors, and that, on or before a specified date (no later than 10 business days from the commencement of the offer), the subject company will advise its shareholders.

Since Rule 14e-2 covers both third-party tender offers and issuer buybacks (described below), it's common for an issuer that conducts a tender for its own shares to state that it makes no recommendation regarding the tender.

Recommendations and Solicitations SEC Rule 14d-9 also relates to recommendations or solicitations which are made by the subject company and other parties that are involved in a tender offer. The rule requires the filing of *Schedule 14D-9* by certain persons, such as:

- The subject company, or any officer, director, or employee of the affiliate of the subject company
- Any owner of any security of the subject company, the bidder, or any affiliate of the bidder
- Any other person who makes a solicitation or recommendation to shareholders on behalf of any of the persons listed above

An exception to this filing is provided to the following persons:

- Attorneys, banks, broker-dealers, and investment advisors that are not participating in the tender offer and are furnishing information only on an unsolicited basis to their customers
- The subject company, if it's providing "stop-look-and-listen communication" which only identifies the tender offer by the bidder, states that the tender offer is under consideration by the subject company's board of directors, and states that the subject company will advise its shareholders on or before a specified date (this may be no later than 10 business days from the commencement of the offer).

Tender Offer Process

Up to this point, the assumption has been that the potential buyer negotiates with the target's management in order to facilitate an M&A transaction. However, in a *tender offer*, the buyer will go directly to shareholders when seeking to acquire shares in a company. A tender offer is often a part of a takeover strategy or, at a minimum, an attempt to obtain sufficient votes to gain representation on the target's board of directors.

When using this process, the buyer places a public notice (often as a newspaper advertisement) to indicate its interest in purchasing stock in a public corporation at a price that's set at a premium over the current trading price of the target company's shares. The tender offer must specify the period during which the offer is extended, the price, and the quantity of shares that the buyer wants to purchase. Payment may be in cash or shares of the acquirer's stock; however, if payment is in the form of shares, the offer is generally referred to as an *exchange offer*.

In an exchange offer, the issuer is offering to exchange one security for another. For example, a large pharmaceutical company has decided to split off one of its healthcare divisions. In the exchange offer, shareholders of the pharmaceutical company may exchange some of their shares for those of the healthcare company (the split-off) at a discount.

As an alternative to an issuer purchasing its own securities in the open market (i.e., a stock buyback), tender offers may also be initiated. For example, if a company has sold off a business unit and changed its business plan, a partial tender offer would allow it to return a portion of the proceeds to shareholders. In this case, any shareholders who tender their shares are allowed to receive cash in an efficient manner.

To protect the interests of shareholders, SEC rules (e.g., Regulation 14E) require that tender offers be conducted in a manner that's fair. The conditions established by the rule include the following:

- Management of the subject company must disclose to shareholders whether it (1) recommends or declines the tender offer, (2) has no opinion and remains neutral, or (3) is unable to take a position on the tender offer. If any material change occurs in these disclosures, the subject company is required to publish it promptly or give notice to shareholders. Management is not permitted to advise shareholders to purchase additional shares of the company.
- Shareholders must be notified of a tender offer by no later than 10 business days from the date the tender is made.
- Tender offers must generally remain open for at least 20 business days from the time they're announced to the security holders.
- If the person making the offer increases or decreases the percentage of the class of securities being sought, the consideration being offered, or the dealer's soliciting fee, the offer must remain open for at least 10 business days from the date that notice of the change is given to security holders.
- In order to extend the offer, the person making it must make a public announcement (e.g., a press release) no later than the earlier of (1) 9:00 a.m., ET on the business day after the scheduled expiration date of the offer, or (2) for exchange-listed securities, at the opening of the exchange on the business day after the scheduled expiration of the offer. The notice must also disclose the approximate number of securities tendered to date.
- It's considered fraudulent for a person that makes a tender offer to fail to pay the consideration offered, or fail to promptly return the securities tendered, after the offer is terminated or withdrawn. (Prompt payment generally requires payment to be made no more than two business days from the conclusion of the offer.)

Purchase Limitations During the Tender Period

SEC Rule 14e-5 Buyers that are engaged in a tender may not purchase additional shares in the open market once the tender has commenced. According to *SEC Rule 14e-5*, a covered person in a tender offer may not purchase the common stock or convertible securities of the same issuer during the period that the tender is open. A covered person is considered an issuer or individual involved in making the tender offer, or the investment bank that acts as the dealer-manager in the transaction (usually a broker-dealer). The SEC has created a number of exemptions which permit firms to continue to engage in transactions in the stock of the subject company during the tender offer period.

Some of the permitted transactions include:

- Purchases that are made on an agency basis by the dealer-manager or its affiliates and not for a covered person
- Purchases that are made on a principal basis if the dealer-manager or its affiliate is not a market makers, and the purchase is made to offset a contemporaneous sale after receiving an unsolicited order from a customer who's not a covered person
- Purchases that are made by an affiliate of the dealer-manager as long as the affiliate maintains and enforces written policies and procedures which are designed to prevent the flow of information (i.e., information barriers) and the purchases are not made to facilitate the tender offer

NOTE: If an entity makes a tender offer for a company's stock, it may purchase the non-convertible bonds of the issuer without limitation.

Partial Tender Offers

In some cases, a buyer is only interested in purchasing a limited number of shares. For these partial tender offers, the exact number of shares that will be accepted from any person tendering stock is unknown until all tenders are collected and counted. For example, if a buyer is trying to acquire 10,000,000 shares, but 20,000,000 shares are tendered, each person tendering his shares may potentially only have 50% of their shares accepted for tender.

Acceptable for Tender Investors may tender stock that they own outright or the stock that they could own based on being in possession of equivalent convertible securities (e.g., convertible bonds). However, if the tendered convertible securities are actually accepted, the investors (the tenderers or tendering parties) must convert the securities into the underlying stock and make delivery. In order to be considered the owner of the securities that are the subject of the tender offer, an individual must own the stock (have a long position) and be prepared to deliver it to the person making the tender offer.

For a partial tender offer (when there's uncertainty as to whether the shares being tendered will be accepted), a person is considered to own (to be long) stock if:

- The person has title to the stock (or the person's agent has title to the stock). This includes owning the stock or an equivalent security such as a convertible security, warrant, or right.
- Has entered into an unconditional contract to buy the stock, but has not yet received delivery
- Owns a call option and has exercised the option

For an owner of a call to tender stock and be considered long, he must have exercised the call option. This is based on the fact that options are not issued by the company. However, owners of an issuer's convertible securities (bonds or preferred shares), warrants, or rights are not required to convert/ exercise since these securities are issued by the company that's the subject of the tender offer.

Investors may only participate in a tender offer to the degree to which they're net-long the stock. If an investor has existing option positions, these positions could impact the number of shares the investor is net-long. If an investor writes (sells) calls with an exercise price that's lower than the tender price, this reduces his long position by the amount of shares that he's obligated to deliver if exercised against.

For example, if an investor owns 10,000 shares of securities that are the subject of a tender offer at $40, but has written 10 call options (representing 100 shares each) with an exercise price of 35, the investor's net-long position is reduced by 1,000 shares.

If an investor has a long put position, it will not have an impact on the net-long position. The reason that long puts may be ignored is that long puts don't create an obligation to sell the underlying security. Instead, the owner of a put has the right to sell the underlying stock.

SEC Rule 14e-5 (No Short Tenders) Under SEC Rule 14e-5, it's considered a manipulative or fraudulent act for investors to tender securities that they don't own (i.e., short tendering). Securities may be tendered only if the investor is either long the stock or long an equivalent security. Again, equivalent securities include rights, warrants, and other securities that are issued by the company that's the subject of the tender offer.

SEC Rule 14e-1 (Extension of Time Period) Under SEC Rule 14e-1, a person may not extend the length of a tender offer unless they issue a notice of the extension through a press release or other public announcement. The announcement must be made by no later than 9:00 a.m., ET on the business day following the scheduled expiration date of the offer. The notice must include the approximate number of securities deposited to date.

Tender Offers—Prohibited Practices

Inside Information and Tender Offers In addition to the insider trading restrictions that fall under the SEC's general antifraud rules, there's another rule that specifically applies to inside information about tender offers. SEC Rule 14e-3 prohibits a person from trading while in possession of material, non-public information concerning a tender offer. In addition, a person (e.g., an investment banking representative) who acquires material, non-public information concerning a tender offer is prohibited from disclosing this information.

An exception is provided if the communication is made in good faith to the officers, directors, employees, or advisors of the person that's either making the tender offer or is the subject of the tender offer (i.e., the target company). The advisor's role involves the planning, financing, preparing, or executing the tender offer.

If a tender offer is proposed, the implication is that the information has not yet been made public. Therefore, an investment banking representative may not discuss a proposed tender offer with registered persons within her firm who are not involved in the transaction.

SEC Rule 14d-10—No Preferential Pricing SEC Rule 14d-10, which is referred to as the *Best Price Rule*, provides for equal treatment of all of the shareholders involved in a tender offer. A bidder is required to treat shareholders equally by making the offer open to all of them (both retail and institutional) for the same period and at the same price. A bidder paying different prices to different types of investors is a violation of this rule.

An exception is granted for changes in compensation arrangements for executives of the company, but only if the arrangements are approved by the compensation committee of the *target* company's board of directors. This is true regardless of whether the target company is a party to the arrangement. Alternatively, if the bidder is a party to the arrangement, the arrangement may be approved by a compensation committee of the bidder's board of directors.

One-Step versus Two-Step Mergers

There are two different types of mergers that may be utilized in an effort to obtain control of another company. A customary *one-step* merger generally requires several months to complete. The length of the process may create deal uncertainty since it allows time for competing bidders or dissident shareholders to form an attack. For the merger, the target company must obtain approval from its shareholders through a vote at a special meeting. Prior to the vote, the target company first files a preliminary proxy statement with the SEC. Once SEC approval is received, the definitive proxy statement is sent to shareholders to provide detailed information on the proposed transaction. In most cases, a simple majority vote of the target company's shareholders is required for the merger. However, if a cash transaction is being executed, the acquirer's shareholders are not required to vote on the proposed transaction.

In a *two-step* merger, the acquirer offers to purchase the shares of the target for cash or proposes an exchange offer. The terms of the offer may be negotiated with a controlling shareholder or through an unsolicited public tender offer. Typically, the *first step* is to make a tender offer directly to the target's shareholders without the burden of being required to obtain approval from the target's shareholders. However, the tender offer is conditional on receiving a large percentage of the shares tendered (e.g., a minimum of 90% is required by Delaware law). The tender offer must remain open for a minimum of 20 business days. The *second step* is a short-form merger agreement that doesn't require shareholder approval. The short form agreement permits the buyer to *squeeze out* the remaining shareholders without a vote if a certain percentage of shares are tendered. The merger agreement is a contract between the two parties to the transaction that stipulates the terms and conditions of the transaction.

The advantage of the two-step merger over the one-step merger is that it takes less time to complete the process. Since a tender offer is only required to be open for 20 business days, the entire process may be completed in approximately one month. On the other hand, with a one-step merger, the SEC may take much longer than 20 business days to review the preliminary proxy statement before it's able to be sent to shareholders.

Issuer Share Buybacks

Not all tender offers are hostile; in fact, there are situations in which an issuer will make a tender offer for its own securities. As regulated by SEC Rule 13e-4, an issuer share buyback is conducted through a modified Dutch auction, which involves shareholders selecting the price within a specified price range at which they're willing to sell their shares. For example, if a corporation is seeking to buy 7,000,000 of its own shares, it may set the auction range at between $30 and $35. If the tender offer is completed at $33.00 per share, then all of the shareholders who tendered shares at $33 or lower will receive the tender price of $33. On the other hand, any shareholder who tendered above $33 will not participate in the tender offer and will have her shares returned.

Shareholders are not required to select a purchase price and may simply agree to tender shares at the price that's determined in the tender offer. The issuing corporation (or any other person that makes a tender) is required to file a Schedule TO as soon as it's practical from the commencement date of the tender offer.

If the number of shares being tendered from all of the shareholders exceeds the amount of shares the issuer is attempting to purchase, the offering is considered to be oversubscribed. If this is the case, the corporation will purchase shares on a pro rata basis from all the shareholders who properly tendered their shares. Under certain circumstances, a company may purchase a greater percentage of shares than the amount that was announced in the tender offer; however, this is not a regulatory requirement.

SEC Review of Issuer Distributed Materials

When a Schedule TO is filed, the SEC's staff may review and comment on the disclosures that are contained in this document, as well as any other related documents. Additionally, the SEC may review and comment on the acquiring firm's compliance with Regulation 14E and Rule 13e-4. The SEC's Staff Office of Mergers and Acquisitions in the Division of Corporation Finance reviews the filings and, if necessary, promptly issues comments (usually within five to seven business days). Based on the SEC's comments, the issuer may be required to file amendments to the Schedule TO and promptly disseminate these changes to shareholders.

Going Private Transactions

Rather than selling the company to a private equity firm, a going private transaction permits the company's management to maintain control. SEC Rule 13e-3 applies to going private transactions that are executed by certain issuers (or affiliates of the issuer) that are purchasing their own common stock and will likely cause their company to become delisted from an exchange or no longer considered a reporting issuer (e.g., being below the SEC threshold of 300 shareholders). Some companies intend to delist in order to reduce the costs and administrative burden of being a publicly traded company. As a result of these transactions, the issuer:

- Must file a 14A proxy statement with the SEC since shareholders will need to receive information on the transaction
- Must file a Schedule 13E-3 with the SEC and make certain disclosures to shareholders
- Must file certain information with the SEC (e.g., reports and fairness opinions by financial advisors)
- Will usually attach a summary term sheet along with other required disclosures to the proxy statement that's provided to shareholders

Federal Filings Required in M&A Transactions

Schedule 13D Prior to a hostile bid, an acquirer may attempt to buy shares of a target company through a tender offer. These outside entities must file Schedule TO as soon as it's practical from the commencement date of the offer. Additionally, if an entity makes a tender offer (or acquires shares in any manner) and becomes the owner of more than 5% of the shares of a company, it's required to file a Schedule 13D form within 10 days of the transaction. If an entity is buying shares for investment purposes only and has no intention to influence or control the issuer, it may file Schedule 13G as an alternative to Schedule 13D.

Mini-Tenders If a tender is made for a minimum amount of shares (5% or less), the buyer is not required to file Schedule TO or Schedule 13D. These small tenders, often referred to as a *mini-tender offers*, are not governed by the normal disclosure and investor protection rules that are associated with larger tenders. The only applicable rules are the antifraud regulations, the minimum period for keeping tender offers open (i.e., 20 business days), and the provision to pay investors promptly. Mini-tenders are often discouraged by regulators since shareholders are being offered a discount to the stock's current market price. Unfortunately, this practice may be used by unscrupulous buyers that are seeking to acquire shares from unknowledgeable (often elderly) investors.

Proxy Statements A proxy statement is issued by an SEC reporting company when it's seeking votes from its shareholders. As covered in an earlier chapter, there are two types of proxy statements —*the preliminary and definitive proxy*. A preliminary proxy is used to notify the SEC of an impending shareholder voting issue that's unexpected, out of the ordinary, or unusual. This is usually the case in a merger or acquisition.

The purpose of the filing is for the issuer to ensure the SEC that shareholders are being provided with full and fair disclosure and that they're able to make an informed decision about matters that will arise at an annual stockholders' meeting. Once the preliminary proxy has been filed and amendments (if any) are made, the definitive proxy is sent to shareholders. (The preliminary proxy is essentially a rough draft of the definitive proxy, which requires review by the SEC prior to dissemination to shareholders.)

Proxy Filing Both types of proxies are filed with the SEC using Form 14A. The preliminary proxy is filed with the SEC at least 10 days prior to the date on which the definitive proxy is distributed to shareholders. On the other hand, the definitive proxy is required to be filed with the SEC by no later than the date on which it's first sent to shareholders.

Form 8-K *Form 8-K* is often the initial regulatory document that's filed in association with a friendly M&A transaction. A friendly merger between two public companies typically begins with a vote by the respective boards of directors to approve the proposed merger. The vote occurs prior to a public announcement and, since this is a material event, a Form 8-K must be filed at the time of the merger announcement. Thereafter, a press release will be issued to the public.

Form S-4

If securities are being issued in connection with a merger, a Form S-4 registration statement must be filed with the SEC. Also, since shareholders are required to vote on the proposed merger, a proxy statement must be issued. Issuers are permitted to incorporate most of the important details of the merger in their S-4 filings and the filing is a key source of information regarding the cash and/or stock that the shareholders of the target company will receive from the acquirer. Other information on the form includes:

- The purpose of the merger
- The merger agreement
- The tax implications of the transaction
- The conditions for completing the merger, including termination fees (if applicable)
- Whether the target is permitted to solicit other offers
- Historical financial information
- Risk factors of the merger and the overall business risk of the industry
- Recommendations of the target company's board of directors
- The fairness opinion rendered by the target's financial advisor, and
- The historical price ranges for the common stock of both companies

Rule 135 Rule 135 provides a safe harbor whereby certain limited announcements regarding proposed public offerings or business combinations are deemed not to constitute an offering. Notice of an offering is not considered an offer if it states that the offering will only be made by a prospectus and the notice contains no more than the following:

- The name of the issuer and anticipated timing of the offering
- The title, amount, and basic terms of the securities
- The amount to be offered by any selling security holders
- A brief statement of the manner and purpose of the offering without naming the underwriter(s)
- Whether the issuer is directing its offering to only a particular class of purchasers
- Any statements/legends required by the laws of a state, foreign country, or administrative authority

Regarding a business combination in which an S-4 is required, a notice of an offering is not considered an offer if it states that the offering will only be made by a prospectus (S-4) and it contains no more than the following:

- The names of any other parties to the transaction
- A brief description of the business of the parties to the transaction

- The date, time and place of the meeting of security holders to vote on or consent to the transaction
- A brief description of the transaction and the basic terms of the transaction

Rule 145 SEC Rule 145 of the Securities Act of 1933 applies to situations in which securities are being offered as a result of business combinations, such as mergers, acquisitions, consolidations, reclassifications of securities, or transfers of corporate assets. Since Rule 145 considers these types of securities reclassifications as sales, they're subject to both the prospectus and registration requirements (using Form S-4) of the Act of 1933. However, stock splits, stock dividends, and the resulting changes in par value are specifically exempt from filing under Rule 145.

Notice of the Offering There are specific guidelines regarding the limited information that may be provided regarding a Rule 145 offering. Any notice may include no more than the following information:

- The name of the person whose assets are to be sold in exchange for the securities being offered
- The names of any other parties to the transaction
- A brief description of the business of the parties to the transaction
- The date, time, and place of the meeting of the security holders to vote on, or consent to, the transaction
- A brief description of the transaction and its basic terms

Resale of Shares Securities that are subject to Rule 145 may not always be resold freely. If the shares that were held prior to the business combination are restricted, then the shares received as a result of the business combination remain restricted and are subject to the resale limitations set by Rule 144. These securities are usually received by affiliates of one of the companies involved in a merger, reclassification, consolidation, or transfer of assets. The securities may be resold according to any one of the following three conditions:

1. The person sells the securities in accordance with Rule 144 provisions requiring the availability of public information, as well as the limitations placed on the amount sold and the manner of sale (through a broker's transaction or directly with a market maker).
2. The person is not an affiliate of the issuer, has held the securities for at least six months, and the public information requirement is met.
3. The person has not been an affiliate of the issuer for at least three months and has held the securities for at least one year.

Not Covered by Rule 145 If an issuer is likely required to file an S-1 registration statement, Rule 145 doesn't apply. This includes a private equity company or any other company that's filing for an IPO to become publicly traded. Also, a company's repurchase of its own stock is regulated under Rule 10b-18 of the 1934 Act (the stock buyback safe harbor rule) and doesn't require a prospectus delivery to shareholders.

SEC Rule 165 According to SEC Rule 165, any written communication after the public announcement, and until the filing of a registration statement, must be filed with the SEC. These communications are referred to as *Form 425* filings and must be filed with the SEC on the date of first use. The SEC permits this information to be filed on Form 8-K by checking the box on the form titled "Written communications pursuant to Rule 425 under the Securities Act."

For example, a joint press release by the boards of directors of both companies announcing a merger, or an e-mail message from the CEO of the acquiring firm sent to the employees of the target company, would be filed with the SEC. Each document must contain a prominent legend that urges investors to read all of the relevant information concerning the offering on the SEC's website. There's no requirement to send these communications to shareholders.

Since securities will be issued in connection with this merger, the acquiring company is required to file a registration statement with the SEC, usually on Form S-4. The shareholders will then vote on the proposed merger.

Most firms are very cautious and file their communications with the SEC during this period. An exception to the filing requirement is made for non-public communications among participants, such as the notes from a meeting between the boards of directors and their investment bankers in which the benefits of the proposed merger were reviewed.

Regulation M-A The purpose of Regulation M-A is to facilitate communications and disclosures made by companies that are engaged in cash and stock tender offers or mergers and acquisitions.

In most domestic M&A transactions, holders of the subject security receive a disclosure document, such as a prospectus, proxy statement, or tender offer statement. As it relates to cross-border mergers, acquisitions, and tender offers, Regulation M-A relaxes some of the technical communication requirements that exist between broker-dealers and investors prior to SEC filings.

In general, Regulation M-A updates disclosure rules for the contemporary market while preserving investor protections. This is accomplished by:

- Reducing certain restrictions that conflict with an investor's need for information
- Setting rules to balance the treatment of cash tender offers compared to stock tender offers
- Simplifying disclosure requirements to facilitate compliance while still increasing investor understanding

Summary Term Sheet Regulation M-A requires that a summary term sheet be provided to investors as part of the disclosures that are made in a tender offer or merger. This information must be provided to the owners of the securities in a plain English format in order to increase their understanding of the proposed transaction and its essential features. The summary term sheet serves as an overview of material information and provides a cross-reference to the more detailed disclosures that are found in the document.

The summary term sheet must be on the first or second page of the disclosure document and must contain a plainly worded description, in bulleted form, of the most important information pertaining to a merger or similar transaction. The summary must include the following information:

- A brief description of the transaction
- The consideration being offered to security holders
- The reasons for engaging in the transaction
- The vote required for approval of the transaction
- An explanation of any material differences in the rights of security holders due to the transaction

- A brief statement regarding the accounting treatment of the transaction (if material)
- The federal income tax consequences of the transaction (if material)

Other Detailed Disclosures In the registration statement, tender offer statement, or other documents that are filed in conjunction with an M&A transaction or issuer tender, the following detailed disclosures must be made:

- Subject company information
- Identity and background of the filing person
- Terms of the transaction
- Past contacts, transactions, negotiations, and agreements
- Purpose of the transaction and plans or proposals
- Source and amount of funds or other consideration
- Interest in securities of the subject company
- Persons/assets retained, employed, compensated, or used
- Financial statements
- Additional information, such as agreements, regulatory requirements, and legal proceedings that are of material importance to the holder of the subject security
- The solicitation or recommendation
- Purposes, alternatives, reasons, effects and fairness of a going private transaction
- Exhibits, reports, opinions, appraisals, and negotiations

Proxy Statements According to SEC rules, certain information is required to be disclosed in a proxy statement that's filed with the SEC and provided to shareholders. Item 14 on this form specifically relates to mergers, consolidations, and acquisitions. Since the shareholders of a target company will be voting on the terms of the acquisition, the target company is required to file this information—regardless of whether the offer consists of cash and/or securities. If the transaction is done with cash, shareholders of the acquiring company are usually not required to vote on the deal; therefore, no proxy is required by the acquirer. The filing of Form S-4 by the acquirer is not required due to the fact that securities will not be issued in connection with the transaction. However, if the deal involves the issuance of a significant number of new shares (greater than 20% of the current shares outstanding), the buyer's shareholders typically vote on the transaction.

	Target Shareholders' Voting Rights	Acquirer Shareholders' Voting Rights
Stock Deal	Yes	Yes (unless issuance is minimal)
Cash Deal	Yes	No

Acquisition Summary

Ultimately, there are several different methods by which a company may attempt to acquire or merge with another company. The easiest method for the purchaser (acquirer) is to simply pay cash to the selling company's (the target's) shareholders. If this transaction is successful, all of the shareholders must sell their shares. For this reason, cash transactions require a vote of the selling shareholders. If the selling firm is an SEC reporting company, it's required to file a Form 14A for both its preliminary and definitive proxies.

The second method of completing a merger or acquisition is through an exchange or stock offer. In this case, the purchasing company issues new shares and provides them to the selling shareholders in return for their shares in the target company. Since this is a unique transaction, the SEC requires the new securities to be registered using Form S-4. This stock offer method is similar to a cash offer by including all of the selling shareholders; therefore, before the offer may be completed, a vote of shareholders is required. Additionally, the selling firm is required to file Form 14A for both a preliminary and definitive proxy. The SEC *does not* require the acquirer to request a shareholder vote if the share issuance is 20% or less of its outstanding shares.

A company may also acquire another company through a tender offer. However, since selling shareholders are given a choice as to whether or not to sell their shares, a vote of the selling shareholders is not required and Form 14A is not required to be filed. Since a tender offer is typically made for a significant number of shares (i.e., more than 5%), the acquirer is required to file Form TO at the beginning of the tender offer.

Summary of Filing Requirements for Acquisitions		
If using cash: ▪ Acquirer has no filing requirement ▪ Target files a proxy	**If using stock:** ▪ Acquirer files a Form S-4 ▪ Target files a proxy	**For tender offers:** ▪ Acquirer directly solicits the target's shareholders and files a Schedule TO

Hart-Scott-Rodino Act

The Hart-Scott-Rodino (HSR) Act is a federal antitrust law that requires certain companies or financial investors (e.g., hedge funds) that are planning a merger or acquisition to file notice with the Federal Trade Commission (FTC) and the Antitrust Division of the Justice Department before the deal is completed. In fact, the merger may not be completed until 30 days after the notice is filed (for cash tender offers, the delay is 15 days). In certain cases, the regulators may request additional information; however, this may delay the completion of the merger for an additional 30 days.

These notification requirements only apply to company mergers and acquisitions that meet certain thresholds. There are two different tests that are applied to determine whether filing is required. One test is based on the size of the companies involved (size of person test); while the other is based on the size of the deal (size of transaction test). Under the original HSR Act, any transaction in which the minimum size of a transaction is $50,000,000 may require filing. These numbers are indexed to the CPI (inflation) and are adjusted every year. Generally, smaller transactions are exempt from this Act.

If a financial investor's purchase was for investment purposes only and without the intent to control the company, it's not required to file a notice or comply with the 30-day waiting period. Broker-dealers may control or be affiliated with investment entities such as hedge funds, private equity firms, and venture capital partnerships; however, these types of investors may be subject to the filing and waiting periods required by HSR.

Chapter 6 Summary

Now that you've completed this chapter, for the following commonly tested concepts, you should be able to:

- Understand the concept of tender offers and their purpose
- Recognize the information that's required on Schedule TO and Schedule 14D-9
- Recognize those who must file Schedule 14D-9 or Schedule TO and those who are exempt
- Understand the rules regarding the tender offer process as well as the business day count requirements
- Understand the tender offer open market purchase restrictions and exceptions
- Identify the securities that are acceptable for tender and understand how to determine net long shares
- Understand the restriction on short tendering and extending the offer period
- Recognize the practices that are prohibited during a tender offer and understand the best price rule
- Understand the process and differences between a one-step and a two-step merger
- Understand the process of conducting a modified Dutch auction and how it's used for issuer self-tenders
  - Including how the purchase price is determined and how to handle an over-subscribed offering
- Understand the purpose of a going private transaction, and also the filing and disclosure requirements
- Define the term *mini-tender* and understand the limited requirements and potential abuses
- Understand the purpose and filing requirements for preliminary and definitive proxy statements
- Understand when an S-4 registration statement is used and know the information that must be included
- Recognize when a shareholder vote is required (*see voting right chart in chapter*)
- Understand the purpose of Rule 135 communications and recognize the permitted information
- Understand Rule 145 and recognize the information that must be included in the Notice of Offering
- Understand SEC filing requirements of Rule 165 (Form 425 filings)
- Understand the purpose of Regulation M-A, including:
  - Information required on summary term sheet
  - Other required detailed disclosure items
- Recognize the forms, schedules, and statements that are filed by companies involved in a merger or acquisition, including:
  - Proxy, Form S-4, Schedule T-O, (*see chart on summary of filing requirements for acquisitions in chapter*)
- Understand the requirements of the Hart-Scott-Rodino Act and recognize the exempt transactions

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Chapter 7

Financial Restructuring and Bankruptcy

Distressed Sellers

Occasionally, issuers are forced to sell their assets to either meet debt service obligations or to restructure their balance sheets. If the financial pressures are great enough, a corporation may find itself in such severe circumstances that it's forced to seek bankruptcy protection. Generally, this legal process is designed to give an issuer time to reorganize its business. Forced asset sales may occur as the issuer attempts to de-leverage its balance sheet. However, in extreme cases, the effort may ultimately be futile and the entire business may cease to exist.

Any public company that declares bankruptcy must file a Form 8-K and designate where the case is pending and which chapter of bankruptcy was filed. In Chapter 7 bankruptcy (liquidation), trustees are appointed. However, in a Chapter 11 bankruptcy (reorganization), the firm is run by existing management as a debtor-in-possession (DIP) and the DIP generally has exclusive rights to file a reorganization plan.

The Bond Indenture

The Trust Indenture Act of 1939 When a corporation issues new bonds, the bonds must be registered under the Securities Act of 1933 and are also subject to the Trust Indenture Act of 1939. According to the Trust Indenture Act, a corporation that issues more than $10 million of debt must create an *indenture*. The indenture is an agreement between the issuer and a trustee (usually a bank or trust company) that's responsible for acting in the best interests of the bondholders. The indenture must ultimately be signed by the trustee.

Indenture A bond's indenture consists of two parts—covenants and the process used to handle default. Covenants are agreements made by the borrower in which it makes pledges to protect the lender. Covenants may be positive, which require certain actions on the part of the issuer; or negative, which create limitations on certain actions. If debt covenants are broken, the loan may become immediately due. An event of default could occur if the issuer misses interest and/or principal payments or fails to comply with a covenant (commonly referred to as a technical default).

A *cross default clause* in a bond's indenture provides protection to current bondholders by triggering a default if any of the bonds issued by the same company default. In other words, a default on one loan automatically places a company in default of other loans, even if no payments were missed. Covenants may also include a requirement to maintain a minimum amount of working capital and a requirement that sets a maximum debt-to-equity ratio. Covenants may also restrict the company from having a change of control.

Chapter 11 Bankruptcy (Reorganization)

Contrary to popular belief, bankruptcy is not always the end of the line for a company. A bankruptcy filing is usually brought on by the issuer's inability to meet a debt payment. The goal of a Chapter 11 filing is to reorganize a debtor's obligations in order to allow the business to continue to operate and for the current management to remain in control. Generally, the courts grant an automatic stay, which prevents foreclosures, repossessions, and collection activities for a given period while the debtor seeks to structure a viable recovery plan.

A Chapter 11 (reorganization) bankruptcy may be either voluntary or involuntary. Once this form of bankruptcy filing is made, the company's management remains in possession of its property (again, as the DIP) and develops a plan to restructure and pay off its debt. However, if there's evidence of mismanagement or fraud, the courts may appoint a trustee. The filing of the petition begins the bankruptcy proceeding. For a voluntary bankruptcy, the petition is filed by the debtor or company that's filing the plan; however, for involuntary bankruptcy, the creditors file the petition.

Operations Under Chapter 11

During a Chapter 11 filing, the DIP operates in the capacity of a fiduciary and must act in the best interests of the creditors. Some of the actions of the DIP include closing the firm's existing bank accounts and opening debtor-in-possession bank accounts, filing both tax returns and operating reports (in most cases, monthly), and being responsible for making payments to professionals in a timely manner.

The DIP typically has a 120-day period, which may be extended by the court, during which it has an exclusive right to file a reorganization plan. Thereafter, the plan must be approved by the creditors and the court. After the initial 120-day period, the creditors can file their own reorganization plan with the court.

Reorganization Plan Approval A vote to approve the plan may not occur until a written disclosure statement is approved by the court. The disclosure statement addresses the DIP's current financial condition and provides creditors with enough information so that they can make an informed decision about the reorganization plan. Under the bankruptcy code, an entire class of claims is considered to have accepted the plan if the creditors holding at least two-thirds of the dollar amount, and representing more than one-half of the total number of creditors in that class, agree to the plan. Only impaired classes of creditors will vote. Unimpaired creditors (those which will be paid in full under the plan) will not need to approve the plan. If the plan is approved by some creditor classes, but not all classes, the court can apply a *cramdown*. A cramdown requires at least one impaired creditor class to approve the plan and the court must believe that the plan is fair to all creditors. In a cramdown, the votes of insiders of the company are not counted.

Intercreditor Agreements These agreements enable lenders to address the priority of their loans and security in relation to another lender to the same borrower. In some cases, both lenders may simply want an acknowledgement that they're each entitled to a specific priority over specific assets of the borrower, to the exclusion of the other lender. In other cases, additional restrictions on the rights of one of the lenders may be required.

Creditors' Committee In order to protect the interests of unsecured lenders during the reorganization, a Creditors' Committee is appointed by the U.S. Trustee and will typically consist of the seven largest unsecured creditors. The committee consults with the debtor-in-possession and investigates its conduct and the operation of the business.

The Creditors' Committee is not responsible for operating the business; instead, this is a function of the DIP. The committee plays a major role in the bankruptcy process by acting as a fiduciary for the other unsecured creditors. Also, the U.S. Trustee may allow other committees to be formed to represent the interests of secured creditors and/or stockholders.

Debtor-In-Possession Financing When operating under Chapter 11, issuers may find it difficult to raise new capital. A special form of financing, referred to as *debtor-in-possession financing*, is often utilized by the company to gain a capital infusion. The bankruptcy code may provide incentives for lenders to provide new capital while the debtor attempts to reorganize the business. The incentive often includes a superpriority that grants a higher priority to these creditors than other unsecured creditors. The lender that has superpriority status is entitled to be paid prior to any administrative claimant or unsecured creditor; however, this financing is generally required to be approved by the bankruptcy court.

Chapter 7 Bankruptcy (Liquidation)

Under Chapter 7 of the U.S. Bankruptcy Code, a trustee is appointed to handle the liquidation of the firm. The trustee may attempt to recover the payments that have been made by the debtor during the 90-day period preceding the bankruptcy filing by using its avoiding powers. Ultimately, these funds will be made available to creditors that have filed claims against the debtor. For a limited period, the bankruptcy court may authorize the trustee to operate the business if it will benefit creditors and enhance the liquidation.

Payment Priority

If a company files for bankruptcy, it's critical for any entity that's owed money to understand where it stands in the payment process. According to Subsection 507 of the U.S. Bankruptcy Code, unsecured creditors are ranked as follows:

- First priority is for administrative expenses. Subsection 503(b) of the U.S. Code details nine types of expenses that are allowed as administrative expenses and, therefore, are entitled to this priority. Administrative expense claims generally include the following:
  - Necessary costs of preserving the estate
  - Current wages and salaries
  - Lawyers' and accountants' fees
  - Trustees' expenses
  - Taxes
  - Trade vendors supplying goods after the bankruptcy filing
  - The value of goods received by the debtor within 20 days before the petition date
- Second priority is unsecured claims under Section 502(f). This subsection may occur in an involuntary case where a claim arises in the ordinary course of business after the filing, but before the appointment of a trustee.
- Third priority is employee back wages (but only up to $10,000 for each individual or corporation that's earned within 180 days before the date of the filing of the petition). Back wages receive a lower priority than the administrative expenses; however, after the filing, current wages do receive priority as an administrative expense.
- Fourth priority is for claims that relate to contributions being made to an employee benefit plan.
- Final priority is for any residual value that remains after all creditors' claims have been met. The payment is made to the owners, with preferred stockholders being paid first and the common stockholders last.

Secured Creditors Since secured creditors have a lien on specific assets, they're not included in the liquidation process. Instead, secured creditors must perfect their lien by recording it with the appropriate government agency. The recording of the lien serves as a public declaration of the lender's lien against the property, which means that property cannot be sold to pay other claims in the liquidation.

Bankruptcy — Creditors and Shareholders If a corporation defaults on its debt and declares bankruptcy, bondholders or creditors have priority over shareholders. As creditors, secured debt holders receive the first priority; however, secured debt is only secured to the extent of the value of the asset being pledged as collateral. If a secured creditor has a claim that exceeds the value of the asset to be sold, the creditor has a secured claim against the value of the asset and an unsecured claim for the excess amount owed. If the asset is worth more than the claim, the creditor is not entitled to the excess, but may be entitled to interest and reasonable recovery costs for the late payment(s).

Unsecured debt holders and unsecured creditors are paid next, followed by subordinated debenture holders. It's important to remember that subordinated debenture holders are generally the last type of creditor to be paid since they have no collateral protection and also have a lower priority than unsubordinated debentures (unsecured debt). After creditors are satisfied, preferred stock then has a higher priority than common stock, but warrants have the lowest priority. For exam purposes, the following list represents the order that investors are paid in a Chapter 7 bankruptcy:

1. Secured creditors
2. Unsecured creditors
3. Subordinated creditors (i.e., junior bondholders, mezzanine bondholders)
4. Preferred stockholders
5. Common stockholders
6. Warrant holders

Recovering Funds

Chapter 11 In a Chapter 11 bankruptcy case, an unsecured creditor is not required to file a proof of claim in order to recover funds unless (1) the debtor fails to list the creditor in its Schedule of Liabilities, or (2) it lists the creditor on the Schedule, but qualifies the debt as disputed, contingent, or liquidated.

This second situation may be the case when a company files for bankruptcy and lists the unsecured creditor's claim on a Schedule of Liabilities (unpaid debt) when it files with the bankruptcy court. If a creditor disagrees with the way the debtor listed its claim, the creditor should file a proof of claim. Actually, many attorneys recommend that creditors file a proof of claim even if its claim is listed on the debtor's schedule.

Chapter 7 In a Chapter 7 liquidation, both unsecured creditors and equity security holders must file a proof of claim in a timely manner in order to recover any funds. Bankruptcy law states that a proof of claim is filed in a timely manner (in most circumstances) if it's done by no later than 90 days after the first date is set for the meeting that's organized by creditors under Chapter 7. In a Chapter 7 liquidation, an entire class of claims must be paid in full before the next class can be paid. If a class of claims cannot be paid in full, that class will be paid on a pro rata basis. The remaining classes will not receive any payments.

> *For example: A corporation has $1,000,000 of assets being liquidated and three classes of creditors. The first class is a senior bond with a $600,000 claim. The second class consists of two different subordinated bonds with a total claim of $800,000. The third and final class are the common stockholders. The first class will be paid in full for $600,000. The remaining $400,000 will be divided between the two groups of bondholders on a pro rata basis. The shareholders will not recover any funds.*

Section 363 Sales

The sale of assets outside the normal course of business may be accomplished through a Section 363 sale. The benefits of this form of sale include its simplicity and that it avoids the requirement to obtain majority shareholder approval. Assets that are sold through this process will generally be free and clear of liens and encumbrances. The trustee or debtor must file a motion with the bankruptcy court in order to seek the court's approval of an asset sale. If approved, the debtor or trustee can proceed with the sale. On the other hand, opponents of the transaction will have a period of time to object to the proposed sale.

Investment banking representatives must realize that marketing a deal for a distressed seller is a very different process than a voluntary sale. Time pressure will be significant and bidders will likely exploit their advantage by not offering full value for an asset. A *stalking horse bidder* may be appointed and is the first firm to make an initial offer on a bankrupt company's assets.

The firm that's appointed as the stalking horse normally conducts the initial due diligence and provides a lead bid which sets a minimum price for the sale. In return for performing these activities, the stalking horse often receives incentives, such as overbid protection, break-up fees, and reasonable expense reimbursement.

Overbid protection provides the stalking horse with the comfort of knowing that any subsequent bidder will be required to top the bid by a specific minimum increment, or may require the stalking horse only to match the competing high bid to win. A break-up fee may be payable to the stalking horse if another bidder acquires the assets. Without these incentives, it's very difficult for a distressed seller to find a lead or stalking horse bidder.

Chapter 7 Summary

Now that you've completed this chapter, for the following commonly tested concepts, you should be able to:

- Understand the concept of bankruptcy
  - Reasons and resulting protections
  - Difference between Chapter 7 and Chapter 11
- Define the terms *trust indenture, default,* and *cross default clause*
- Understand the process of Chapter 11 reorganization bankruptcy
  - Recognize who files the petition with the court (voluntary versus involuntary)
  - Functions of the DIP
  - Timing and rules for the filing of the reorganization plan
  - Requirements for a creditor class to have approved the reorganization plan
  - Approval requirements for reorganization plan (cramdown)
  - Functions of the creditors' committee
  - DIP financing
  - Responsibilities of the DIP versus the creditors' committee
- Understand the process of Chapter 7 bankruptcy
  - Functions of the trustee
- Payment priorities
  - Unsecured creditors
  - Creditors and shareholders
- Understand the different requirements for recovering funds for Chapter 11 versus Chapter 7
- Understand the purpose and approval requirements of a 363 sale
  - Function of a stalking horse bidder

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Chapter 8

Financial Analysis

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Financial Statements

There are three different types of financial statements—the balance sheet, the income statement, and the cash flow statement.

The Balance Sheet

The balance sheet (also called a statement of financial condition) represents the financial picture of a company as of a specific date. A balance sheet example is located on Page 8-18. The balance sheet is divided into three major sections—Assets, Liabilities, and Stockholders' Equity. The name balance sheet is based on the fact that the total assets must always equal the sum of the total liabilities plus the stockholders' equity. Therefore, basic formula is:

Assets = Liabilities + Stockholders' Equity (Net Worth)

This can also be shown as:

Assets – Liabilities = Stockholders' Equity (Net Worth)

Assets represent all of the items that are owned by a corporation, while the liabilities section contains all of the items that are owed by the corporation. The difference between a corporation's total assets and its total liabilities is stockholders' equity (also referred to as net worth).

Components of the Balance Sheet—Assets

There are three basic subsections to the asset category—current assets, fixed assets, and intangible assets.

Current Assets Current assets represent cash and other items that may be converted into cash within a short period (usually one year) such as marketable securities, accounts receivable, and inventories.

Fixed Assets Fixed assets are items that are used by the company in its day-to-day operations to create its products. This section will list the company's physical property, such as land, buildings, equipment, and furniture. With the exception of land, fixed assets lose some of their value each year due to normal use. The IRS allows a company to claim this wear and tear on assets as a depreciation deduction against income. On the balance sheet, fixed assets are shown at a value which represents their original cost less the accumulated depreciation.

Intangible Assets Although intangible assets don't have physical value, they add substantial value to a company. Some intangible assets differentiate the company from its competitors and are proprietary such as patents, intellectual property, trademarks, franchises, and copyrights. Goodwill is another intangible asset and represents the amount that was paid to acquire an asset (or a company) above its fair market value.

The Liabilities Section

The liabilities section indicates the company's debts; some of which must be paid in a short period (current liabilities), while others are not required to be repaid for many years (long-term liabilities). Current liabilities are debts that become due in less than one year and are easily identified by the word *payable*. Included in this section are accounts payable (the amount a company owes for goods and services that are purchased on credit), interest payable, notes payable, and taxes payable. Long-term liabilities are debts that a corporation has incurred that become payable in one year or more, such as bonds and long-term bank loans.

Working Capital Working capital represents the net amount of a company's liquid resources. To calculate working capital, also referred to as net working capital, the formula is total current assets minus total current liabilities. Changes in current assets or current liabilities will affect a company's working capital. For purposes of discounted cash flow (DCF) analysis, the formula for working capital is *non-cash* current assets minus *non-cash* current liabilities (refer to the Valuation chapter.

The Stockholders' Equity Section

The stockholders' equity section represents the company's net worth and indicates the stockholders' ownership interest. The items listed in this section include the different classes of stock, retained earnings, and capital surplus. Preferred stock is listed in the balance sheet at the par value of the company's outstanding shares, which is typically $100. Common stock is listed in the balance sheet based at the par value of the company's issued common stock. However, the par value of common stock is arbitrary and is used only for bookkeeping purposes; it doesn't influence the market price of the stock. Additional paid-in capital (also referred to as Capital Surplus or Capital in Excess of Par) is the amount of premium that an issuer receives above the par value for the shares being sold by the corporation to the public.

For example, if a company's IPO is priced at $16 per share with an underwriting spread of $1.00 and a par value of $10 per share, then $5 is added to the additional paid-in capital in the stockholders' equity section of its balance sheet. This doesn't include the funds that the company derives from business profits. Earnings that are generated, but not distributed, are referred to as retained earnings or earned surplus. The retained earnings entry represents net profits that have been retained for future use by the corporation. Ultimately, it's from retained earnings that a corporation typically pays its dividends.

Book Value per Share and Tangible Book Value Book value represents the total equity of the firm (shareholders' equity) divided by the number of shares outstanding and includes intangible assets and goodwill. However, if a company has preferred stock in its capital structure, book value is based on common stockholders' equity, rather than total equity. A more conservative valuation is *tangible book value*, which is equal to the total assets of the company minus liabilities, intangibles, and goodwill. Certain intangible assets, such as patents and trademarks (which may be sold separately), are usually included when calculating tangible book value.

Market Capitalization One method of categorizing a stock is according to the total value of the company's outstanding common shares, otherwise referred to as its market capitalization. To calculate a company's market capitalization, the company's number of outstanding common shares is multiplied by its current price.

For example, if Widgets Co. has 100,000 shares of outstanding common stock and they're selling for $25 per share, Widgets' market capitalization is $2,500,000 (100,000 x $25). The number of outstanding shares includes shares held by institutions, retail investors, and the restricted shares that are held by insiders, but doesn't include treasury shares (i.e., shares that have been repurchased by the company). A company's outstanding shares are found by subtracting the number of treasury shares from the number of shares the company has issued.

The following table lists the main categories and their commonly applied capitalization values:

Category	Market Capitalization
Large-capitalization (large-cap) stocks	More than $10 billion
Middle-capitalization (mid-cap) stocks	Between $2 billion and $10 billion
Small-capitalization (small-cap) stocks	Between $300 million and $2 billion
Micro-capitalization (micro-cap) stocks	Between $50 million and $300 million
Nano-capitalization (nano-cap)	Below $50 million

The boundaries between the categories are neither officially defined, nor clear-cut. Over time, a stock's category can change as its market value rises and falls.

Small-cap stocks are generally the equities of newer, less-established companies, while more well-established issuers typically have mid-cap or large-cap valuations. Small-caps tend to be more volatile than large- or mid-cap stocks, but also often include companies that are growing faster and have more potential for capital appreciation. Large-cap stocks are usually the stocks of well-known, established companies.

Another category includes companies with very small capitalization ($50 million to $300 million) that are referred to as micro-cap stocks. Usually, these companies have a low price-per-share and are extremely volatile and risky. Lastly, the newest unofficial category is nano-cap for stocks of companies that have a capitalization that's less than $50 million. As with micro-caps, these stocks typically have a low price-per-share and are extremely volatile and risky.

Public Float The public float of a company represents the total number of shares that are held by public investors—both retail and institutional. Public float excludes any stock that's owned by the affiliated persons of a company and is calculated by subtracting a company's restricted stock from its number of outstanding shares.

The Income Statement

An income statement, also referred to as the profit and loss statement, indicates a corporation's performance during a specified period. An income statement example is located on Page 8-19. The purpose of this statement is to detail the company's net income (or net loss) by offsetting its revenues by its expenses.

Components of the Income Statement

Sales (revenues) represent the total money received and the amounts billed, although not yet collected, from the company's primary source of business. Sales are reduced by cost of goods sold to arrive at gross profit. Gross profit is reduced by operating expenses to arrive operating income. Operating expenses reflect the daily costs of doing business and include the amount claimed for the depreciation of fixed assets.

Operating income is adjusted for other income (or expenses) that are not generated by normal operations. The result is earnings before interest expense and taxes (EBIT). This represents how the company's core business is performing. Other income usually represents the income that's generated by investments (dividends and interest). However, other income may also reflect non-recurring items, such as earnings received from the sale of assets or losses that are incurred by discontinuing a part of the business. EBIT is reduced by bond interest and taxes to arrive at net income or net loss.

An important valuation measurement for investment banking professionals that can be derived from EBIT is EBITDA, which adds the non-cash expenses of depreciation and amortization to EBIT. If often serves as a proxy for operating cash flow and is popular valuation metric for comparing companies at the operating level (e.g., EV/EBITDA).

Effect of Refinancing on the Income Statement Since bond interest is paid from pre-tax dollars, any reduction that a company has in interest expense (such as from refinancing its debt at a lower rate) will not increase net income by the same dollar amount as the reduction in the interest expense.

For example, a company with a 21% marginal tax rate has a $600 million bond issue with a 12% coupon and is able to refinance the issue at a rate of 7%. The company's interest expense will decline from $72 million ($600 million x 12%) to $42 million ($600 million x 7%). The company's net income will increase by the decline in interest payments multiplied by the complement of the tax rate. The decline is $30 million and the complement of the tax rate is 79% (100% – 21%); therefore, the net income will increase by $23.7 million ($30 million x 79%).

Changes to Net Income If a company's revenue increases (decreases) and operating expenses remain unchanged, its net income will rise (fall). If a company's revenue remains flat, but its operating expenses decline, the net income will increase. If a company's revenue remains flat and both its operating expenses and net income decline, this could be the result of higher interest rates and/or taxes.

Statement of Cash Flows

In addition to a balance sheet and income statement, a corporation also prepares a *statement of cash flows*, which is also referred to as the *statement of sources and uses of funds*. This statement reconciles changes in a company's cash position from one year to the next by analyzing a firm's operating, investing, and financing activities. The statement of cash flows is a mandatory item in all annual reports. Operating activities relate to the cash flows that are generated by the running of a business. Investing activities relate to the capital expenditures and the businesses that the company has bought and sold. Financing activities relate to the amount of securities (both equity and debt) that the company has issued or retired, but also the dividends that have been paid.

Some corporate events may result in two different effects on the cash flow statement. For example, if a bond is issued, the first entry is applied to net income. This entry reflects bond interest expenses as interest that has been deducted in the calculation of net income. The raising of capital through the sale of the bonds will be reflected under the financing activities (not investing) section. Financing activities reflect the net proceeds (a source of funds) that are obtained from the issuance of securities.

An investment banking representative may be able to identify what has occurred at a company by examining the changes in the working capital accounts and reviewing other transactions. Usually this statement is prepared on a comparative basis over several years.

The example below will simply state whether a particular entry is a source or use of cash. It's assumed that the hypothetical company, ABC Incorporated, had a cash position of $7,000 at the end of 2016 and $2,400 at the end of 2017. During 2017, the following occurred:

Operating Activities		Comment
Net Income	$ 2,500	Source of cash
Depreciation	$ 3,700	A non-cash charge; add back
Reduction in deferred tax	$ (4,000)	Did not affect income; used cash
Reduction in receivables	$ 5,000	Clients have paid; a source of cash
Increase in inventory	$ (3,000)	Use of cash
Increase in accounts payable	$ 6,000	Viewed as a source of cash. If accounts payable has decreased, it's a use of cash.
Net Cash provided (used) in operating activities	$ 10,200	

Investing Activities		Comment
Increase in plant	$ (9,000)	Company used cash to expand equipment production capability
Payment for business acquired	$ (5,000)	Funds were used to purchase a related business
Net cash provided (used in) investing activities	$ (14,000)	

Financing Activities		Comment
Common stock issued	$ 6,400	Sale of stock; raises cash
Debt retirement	$ (5,000)	Use of cash
Dividends paid	$ (2,200)	Cash paid to shareholders
Net cash provided (used) in financing activities	$ (800)	

The net result of ABC Incorporated's activities is a $4,600 reduction in the cash position ($10,200 from operating, minus the $14,000 from investing, and the $800 from financing). The cash on the company's balance sheet will be reduced to $2,400 (from $7,000, it's reduced by $4,600). Other items on the 2017 balance sheet will also change.

For example, an increase in inventory (a current asset) will be $3,000 higher in 2017 than it was in 2016; a decrease in account receivables (a current asset) will be $5,000 lower in 2017 than it was in 2016.

Relationship Between the Three Financial Statements It's important to understand the interrelationship of the three financial statements of a company. For example, investment banking representatives often examine a company's 10-K forms and also review other financial statements. The income statement shows net income (or net earnings) which is the beginning number used to calculate the operating cash flow when examining the cash flow statement. At the end of the cash flow statement, the change in the company's cash flow for the year is reflected. This number is added to or subtracted from the cash value on the company's balance sheet from the previous year. The sum of this calculation is the cash value on the balance sheet in the current year.

Statement of Cash Flows—Summary

If an asset decreases	=	A source of cash
If an asset increases	=	A use of cash
If a liability decreases	=	A use of cash
If a liability increases	=	A source of cash

- A source of cash increases cash flow
- A use of cash decreases cash flow

GAAP Reporting

The standards that are set forth for the corporate reporting of earnings and other business transactions are governed by an extensive set of rules, regulations, guidelines, and operational procedures that are referred to as the generally accepted accounting principles (GAAP). GAAP standards and procedures provide guidance for accountants, auditors, and governmental regulators and require the presentation of corporate financial data in a manner that preserves credibility with the providers of capital to the firm. Compliance with generally accepted accounting principles indicates the accurate presentation of a company's financial position and allows any person who examines the financial documents to feel confident that they meet the necessary standards. GAAP reporting sets the basis for these activities since its provisions are established by either an authoritative entity or are widely accepted as the standard practice in the industry.

In order to establish the guidelines and regulations that are needed to standardize the financial reporting requirements, various federal and industry agencies have been created to make and interpret the rules and disseminate information about changes that may occur in the accounting and reporting of business transactions. The Securities and Exchange Commission (SEC) and the Financial Accounting Standards Board (FASB) are the primary regulators for this area. Announcements and releases that are issued by the FASB are normally distributed in the form of a Statement of Financial Accounting Standards (SFAS). The objectives of these agencies are to establish and improve the standards of financial accounting and reporting and to provide education to the various users of financial information (e.g., auditors, issuers, as well as the public at large).

However, one of the problems that may arise is the reporting of non-standard significant events that may occur within a company. Unusual or non-recurring items that are reported under GAAP may give misleading information to investors and other providers of capital. Certain events, such as changing the method of inventory valuation (e.g., from LIFO to FIFO) or changing the method of depreciation, may significantly impact the results of one quarter during the year, but may not affect the ensuing accounting periods. In these cases, the company may find it appropriate to report pro forma (adjusted) earnings.

Pro Forma Reporting

Under certain conditions, such as when a company has significant changes in its financial activities, it may be advantageous to report on a pro forma (hypothetical) basis. Pro forma reporting is a statement of the company's financial status with the unusual or significant items excluded. Earnings are restated so as to eliminate the effects of items that would otherwise impact the financial statements in one reporting period, but not the others.

However, a question that may arise is whether a pro forma report of earnings should be used. In a recent release that was provided by the SEC, the Commission indicated that, "pro forma financial information can serve useful purposes." Additionally, the Commission suggested that, "Public companies may quite appropriately wish to focus investor attention on critical components of quarterly or annual financial results, in order to provide meaningful comparisons." The intention is to provide information that's similar to management's interpretation and a discussion of the results.

For an investment banking representative who is reviewing the financial reports of a company, pro forma reporting often has significant implications. A primary concern is the fact that a company that's reporting pro forma information has departed from typical accounting conventions. The items in its financial statements must be identified and adjustments must be incorporated in order to make appropriate comparisons with other companies or over different time periods. It should also be noted that pro forma information is determined by selectively editing GAAP information. Selectivity may present that a company is in a better financial position than it would be using GAAP; therefore, the results could be misleading. An investment banking representative must take special care to ensure that the information being presented doesn't mislead or unfairly present a picture of the company.

Aggressive Accounting Aggressive accounting is a method of accounting that's used to report lower expenses and higher income, or to overstate assets while understating (not recognizing) liabilities. Accounting standards require firms to follow promoted opinions; however, there are situations that create uncertainties. For example, capitalizing software defers the recognition of expenses and effectively boosts earnings. Capitalizing research and development increases the cost basis of the future product, but boosts earnings since the costs are not taken as an expense in the short run. Expensing stock options and writing off goodwill through impairment (as opposed to amortizing over a lengthy period) lowers earnings. In regard to the accounting practices for *defined benefit pension plans*, using a low discount rate is conservative, while using a higher discount rate is aggressive. The present value calculation is based on dividing the liabilities by 1.0 + discount rate; therefore, the higher the discount rate, the lower the present value of the plan's long-term liabilities.

Special Issues in Accounting

Depreciation

One of the fundamental concepts of GAAP is to match costs and revenues over a specific period. Items such as labor, rent, and incidental office supplies are immediately expensed; however, fixed assets, such as buildings, equipment, vehicles, and fixtures, provide benefits over many years. The allocation of costs that reflect the wearing out or deterioration of an asset is referred to as depreciation. Depreciation represents a non-cash charge to the income statement. Because the calculation of depreciation is based on historical costs, profits may be overstated to the extent that replacement costs are greater than historical costs.

Straight-line depreciation produces a constant depreciation expense and a constant decline in the carrying value of an asset. On the other hand, accelerated depreciation allows for a faster rate of decline in the value of an asset in the early years of ownership, leading to a greater depreciation charge. Current IRS regulations, referred to as the modified accelerated cost recovery system (MACRS), require that the entire cost of an asset be written off over its depreciable life. Under this system, the asset has no salvage value.

Many firms use accelerated depreciation for tax reporting and then use straight-line for GAAP reporting to shareholders. Accelerated depreciation provides a larger level of expenses in the earlier years of an asset's life, thereby creating a reduced reportable earnings level for tax purposes.

The difference between the tax liability that's reported to the shareholders and the taxes that are paid is treated as a deferred tax liability on the report to shareholders. Since straight-line depreciation is used for reports to shareholders, the reported earnings are unaffected by the use of accelerated depreciation for tax purposes.

Let's assume that a firm buys machinery for $20,000 and it has an estimated useful life of five years. Under the *straight-line method*, the annual depreciation expense is:

$$\frac{\text{Original Cost}}{\text{Estimated Useful Life}} = \frac{\$20{,}000}{5 \text{ years}} = \$4{,}000$$

The five-year, straight-line depreciation schedule is shown below:

Year	Carrying Value	Depreciation Expense	Accumulated Depreciation	Book Value at Year-End
1	$20,000	$4,000	$4,000	$16,000
2	16,000	4,000	8,000	12,000
3	12,000	4,000	12,000	8,000
4	8,000	4,000	16,000	4,000
5	4,000	4,000	20,000	0

The firm's balance sheet will show the book value of the asset less any accumulated depreciation.

With few exceptions, the only accelerated depreciation method that's allowed by the IRS is the double declining balance method, also referred to as the 200% declining balance method. The straight-line rate of 20% per year is doubled, and 40% becomes the multiplier for the remaining carrying value in the asset account.

Below is the double declining depreciation schedule of machinery that was purchased for $20,000 which has a useful life of five years:

Year	Carrying Value	Depreciation Expense	Accumulated Depreciation	Book Value at Year-End
1	$20,000	40% x $20,000 = $8,000	$8,000	$12,000
2	12,000	40% x $12,000 = 4,800	12,800	7,200
3	7,200	40% x $ 7,200 = 2,880	15,680	4,320
4	4,320	40% x $ 4,320 = 1,728	17,408	2,592
5	2,592	Remainder of: 2,592 *	20,000	0

* The remaining amount of depreciation will be taken in the fifth year to fully depreciate the asset.

NOTE: The calculations are being shown for illustrative purposes only; real world amounts will vary considerably from these figures since MACRS allows only one half-year of depreciation in the first year the asset was placed in service. This is often referred to as the mid-year convention.

Deferred Taxes

When corporate accounting income and taxable income differ, it may create a deferred tax asset or deferred tax liability on a balance sheet. If taxable income is greater than accounting income, this will create a deferred tax asset. Naturally, the opposite result will create a deferred tax liability.

> *For example, a company anticipates receiving revenue of $30 million over three years, but records the entire amount in one year for tax purposes. In this case, the company's taxable income exceeds its accounting income and, in effect, the company prepaid its taxes on the income.*
>
> *To calculate the deferred tax asset, the amount of taxable income that exceeds the accounting income must be found first and then this amount is multiplied by the marginal tax rate (e.g., 21%). The company should have recorded income of $10 million in each of three years; therefore, taxable income exceeds accounting income by $20 million ($30 million – $10 million). The deferred tax asset is $4.2 million ($20 million x .21).*

Accounting for Investments in Stock

The *cost method* of accounting is used when one company owns only a nominal percentage (i.e., less than 20%) of another company's outstanding shares. For example, Company A is presumed to have little control over Company B and dividends are the only form of return being recognized. However, if Company B's shares experience a significant or a perceived permanent decline, Company A should recognize a loss by reducing the carrying value of its investment.

The *equity method* of accounting is used when one company owns 20% to 50% of another company's shares. For instance, let's assume that Company A has a large ownership position and is able to exert considerable influence over Company B in regard to management issues and dividend policy. Company A may refer to Company B as an affiliate. When Company B reports its earnings, Company A will record its proportionate share of the P&L in its investment account.

> *For example, ABC owns 30% of XYZ and XYZ generates $120,000 of income. In this case, ABC will report additional income of $36,000 (30% of $120,000) under the heading "other income."*

Consolidated financial statements are prepared to record the results of a parent and subsidiary company. This is the required format when the acquiring firm purchases more than 50% of the outstanding shares of the other entity. To account for the acquisition, the appropriate method is referred to as the *purchase method*. The principal characteristics of the purchase method are summarized below:

- It's the mandatory method for cash deals.
- It's viewed as an acquisition of new assets.
- The book value which is used for plant, equipment, and other fixed assets may be adjusted (increased) to market value.
- Goodwill (an intangible asset) is created if the acquisition price exceeds the fair value of the assets acquired.
- Goodwill may be charged against earnings if an impairment occurs.

To calculate the amount of goodwill that's created after an acquisition, the company's net tangible assets are subtracted from the offer value. The net tangible assets are found by subtracting the company's liabilities, existing goodwill, and intangibles from its total assets. If a company is purchased below its book value, there's no creation of goodwill.

Non-Controlling Interest (Formerly Minority Interest) When consolidated financial statements are prepared, 100% of the assets and liabilities of the subsidiary are reflected on the books of the parent. If a parent company owns 80% of the stock of its subsidiary, with the residual 20% owned by persons other than the parent, an account titled *non-controlling interests* is shown in the stockholders' equity section of the parent's balance sheet. An additional account is shown on the income statement titled *non-controlling interest in net earnings of consolidated companies* to show the amount of income that belongs to minority shareholders (rather than the parent company) in a given period.

> *For example, Company A owns 70% of Company Z. If Company Z reports net income of $200,000, then both companies will consolidate their income statements. A deduction of $60,000 ($200,000 x 30%) will be shown as line item titled "non-controlling interest."*

Intangible Assets

Along with assets that are readily identifiable by their physical form or by an accounting record that evidences their value (e.g., accounts receivable), businesses may acquire or produce intangible assets. The difficulty in determining the future expected benefits makes this area of business evaluation problematic.

Identifiable intangible assets are those which can be separated from a firm's other assets and, in some cases, can be sold independently by the company. Examples include copyrights, trademarks, intellectual property, and trade names. On the other hand, *unidentifiable intangible assets* are those which cannot be separated from the other assets and cannot be sold independently. Goodwill is an example of an unidentifiable intangible asset.

If the intangible asset has a useful life, it can amortized. Copyrights, patents, and intellectual property fit into this category. Goodwill has a perpetual life and cannot be amortized. Trademarks are typically not amortized since the assumption is that they have a perpetual life. However, if a company determines it will no longer use the trademark, it will be amortized.

It's important to note that any intangible asset with an indefinite life (e.g., goodwill) must be tested for impairment at least annually.

The Goodwill Impairment Test is a two-step approach that's conducted at the reporting unit level (i.e., the lowest level of an entity). Business units, subsidiaries, operating units, and divisions are all examples of reporting units.

Step One: Identify potential impairments by comparing the fair value of an operating unit to its carrying amount, including goodwill. If the fair value of the reporting unit is greater than its carrying amount, goodwill is not considered to be impaired.

Step Two: *If an impairment is identified in step one*, the implied fair market value of goodwill must be compared to its carrying amount. If the carrying amount of goodwill exceeds its implied fair value, an impairment loss is recognized that's equal to the excess and presented as a separate line item on the financial statements.

Intangible assets that have finite useful lives, such as patents, intellectual properties, copyrights, and trademarks, will continue to be amortized over their useful lives, but without the constraint of an arbitrary ceiling. In estimating useful lives, consideration should be given to legal, regulatory, and contractual provisions. Also, the effects of obsolescence, the rate of technological change, and the expected actions of competitors should be considered.

Leasing

Rather than purchasing equipment or facilities, businesses may find leasing more attractive. The lessee is not required to put up its own capital or borrow funds to buy the asset. This leaves its debt ratios and coverage ratios unaffected. (However, many analysts treat lease payments as a type of fixed charge when computing coverage ratios.) The lessee may not want to own the asset for its useful life and/or may not want to assume the risks associated with resale.

The owner of the asset (the lessor) may deduct any depreciation in asset values, but may potentially profit from any appreciation in asset values. The latter benefit is subject to market factors, such as loss in popularity and technological obsolescence (e.g., computer and communications equipment).

If a lease contract is entered into for only a portion of the asset's life, the cash payment made by the lessee to rent the use of the asset is recorded as a rent expense. This type of lease arrangement is referred to as an *operating lease*. If the lessee agrees to lease an asset for most of its useful life, it's referred to as a *finance lease*. In a way, the lessee is actually buying the asset through installment payments.

A lease qualifies as a finance lease if one of the following criteria is met:

1. The title passes to the lessee at the end of the lease term.
2. The lease contains a bargain purchase element. (It's likely that the option will be exercised because the price is attractive.)
3. The lease term is equal to or greater than 75% of the useful life of the asset.
4. The present value of the minimum lease payments is greater than 90% of the fair market value of the leased asset.

In a finance lease, the firm that acquires the lease will report the lease payment as a depreciation expense and interest expense on its statement. The interest expense is calculated on the lease obligation and is reduced over time. As a result, the lease expense will be higher in the early years, but will decline in the later years. Depreciation or amortization on the leased asset is generally calculated on a straight-line basis.

Cash Dividends

There's a difference in accounting for cash dividends based on the dividend's declaration date compared to its payment date. When a cash dividend is declared, dividends payable increase (a current liability) and retained earnings (shareholders' equity) are reduced. However, when the dividend is paid, the current asset section (cash) is reduced and the current liabilities section (dividends payable) is also reduced. Therefore, working capital is reduced when a company declares a cash dividend, but not when it pays a cash dividend.

Cash dividends are paid out of a company's retained earnings, which allows a firm to pay a dividend even in unprofitable years. Dividends may even be larger than a company's net income. From a balance sheet standpoint, a dividend payment reduces retained earnings for that year (which is found in shareholders' equity). A company that pays a dividend that's greater than its earnings is essentially paying its shareholders with previous years' earnings.

On the cash flow statement, cash dividends are a use of cash. A company that pays a dividend that's greater than its earnings may still end up with positive cash flows. However, for this to happen, the company would require enough sources of cash derived from its investing or financing activities. Also, a firm that doesn't have positive cash flow may still pay a dividend by means of borrowing money.

Stock Splits and Dividends Consider the original equity capitalization for ABC Corporation:

2,000,000 common shares issued with a $2 par value:	$4,000,000
Paid-in capital in excess of par:	$10,000,000

After a 2:1 stock split, the balance sheet is adjusted as follows.

4,000,000 common shares issued with a $1 par value:	$4,000,000
Paid-in capital in excess of par:	$10,000,000

The ultimate result of a 2:1 split is that the number of outstanding shares doubles and the par value is reduced by half. However, there's no change to the dollar values in the capital accounts.

Rather than executing a stock split, what if ABC Corporation declares a 5% stock dividend at a time when its shares are trading at $25 per share? If ABC Corporation has two million shares outstanding prior to the dividend, the number will increase by 100,000 shares (2,000,000 x 5%). This also causes the common stock account to increase by $200,000 (100,000 x $2 par). The retained earnings account will be reduced based on the market value of the stock ($25) being multiplied by the increase in the number of shares (100,000), which is $2,500,000. In order to balance the accounting entry, the paid-in capital increases by the difference between the two, which is $2,300,000.

The par value of common stock is not reduced for small stock dividends. However, to adjust the capital account for large stock dividends (25% or more), GAAP requires the reduction in the par value rather than using the fair market value of the stock. Retained earnings don't change for large stock dividends.

Effects of Stock Splits and Stock Dividends		
Item	**Impact of Stock Split**	**Impact of Stock Dividend**
Total paid-in capital	No change	Increase
Total retained earnings	No change	Decrease
Total par value (common stock)	No change	Increase
Par value per share	Decrease	No change

Inventory

Inventory is a significant current asset for both manufacturing and retailing firms and may represent either finished goods available for sale or work in progress (i.e., additional inputs are needed to complete the product). The goal of businesses is to convert inventories into more liquid assets—either accounts receivable or cash.

GAAP requires firms to use historical cost to account for the value of their inventory, which is the cost at the time of acquisition. The phrase "lower of cost or market" appears in many financial statements and, for purposes of this section, "market" will represent the replacement cost to reacquire the product.

When analyzing an inventory system, a person should be familiar with the following terminology:

- *Cost of goods available for sale*—This is the sum of the inventory at the start of a period, plus the purchases that are made during the period.
- *Cost of goods sold*—This is usually the most significant expense item on a manufacturer's or retailer's income statement and it's listed immediately below the revenue line. The cost of goods sold is determined by the inventory method selected.
- *Periodic inventory system*—No specific record is maintained to reflect the reduction in inventory when goods are sold. At some interval, the firm ceases business and counts the units that remain.
- *Specific identification method*—This is a system to be used when the inventory is very unique and the matching of products sold and invoiced is easily accomplished. This system may be used for businesses where luxury cars, boats, or furs are sold.

- *First in, first out (FIFO)*—This is an inventory method in which the first costs are matched with the first units sold. The ending inventory is matched with the cost of the most recent purchases.
- *Last in, first out (LIFO)*—This is an inventory method in which the last costs are matched with the first units sold. The ending inventory is matched with prior purchases. The earliest purchases are assumed to be available for sale.
- *Weighted average*—This represents the blended or average price that's computed and assigned to all of the units that are sold as well as those in final inventory.

During a period of rising rates or inflation, prices are also rising. How the method used will have an effect on cost of goods sold (COGS), profit margins, earnings, taxes, and inventory valuation is summarized as follows:

- First in, first out (FIFO) is an inventory method that matches the first costs with the first units sold. The ending inventory is matched with the cost of the most recent purchases.
  - FIFO has lower COGS, but higher margins, higher profits (earnings), higher taxes, and higher inventory valuation.
- Last in, first out (LIFO) is an inventory method that matches the last costs with the first units sold. The ending inventory is matched with prior purchases. The earliest purchases are assumed to be available for sale.
  - LIFO has higher COGS, but lower margins, lower profits (earnings), lower taxes, and lower inventory valuation.

Switching Inventory Valuation Methods If a company changes its method of inventory valuation, the change may have an impact on its EBIT and EBITDA. This is an important consideration since EBITDA is used often by investment banking professionals. For example, if a company switches from FIFO to LIFO during a period of rising prices, the cost of goods sold (COGS) will increase and EBITDA will decrease. On the other hand, if the company switches from LIFO to FIFO, COGS will decrease and EBITDA will increase.

Restructuring Charges

Restructuring charges are reflected on a company's income statement in the operating section, but also appears in the footnotes of a company's financial statement. This type of entry has a negative impact on the earnings of the company and, to account for the charges, there are journal entries that are made on a company's balance sheet.

For example, when a restructuring occurs, such as the write down of obsolete inventory, there's no net change to cash. This is because the reduction in retained earnings, which is use of cash, is offset by the reduction in inventory assets, which is a source of cash. The result is no net change to cash, because of the balancing effect.

Similarly, when a restructuring occurs, such as the layoff of employees, there's no net change to cash. This is because the reduction in retained earnings, which is a use of cash, is offset by an increase in a liability called severance payable, which is a source of cash. The result is no net change to cash, because of the balancing effect.

Operating Leverage

Operating leverage measures the degree to which a firm or project relies on fixed (not variable) costs. Fixed costs remain constant regardless of the amount of goods or services being sold by a company. These fixed costs include salaries and other compensation costs, rent, and equipment. On the other hand, variable costs are based on the amount of goods and services being produced.

These variable costs, also referred to as *direct manufacturing costs*, include the materials and other related costs that are incurred in producing the products or services being sold by a company. A company with a high degree of operating leverage will derive a greater benefit if GDP is increasing, but a lesser benefit if GDP is decreasing.

Financial Leverage

This term is used to describe the degree to which an investor or business uses borrowed funds. Ultimately, borrowed funds may increase the return on investment for a company's shareholders. For a company, the borrowing will often result in tax advantages due to the company's ability to deduct the interest expense. However, companies that are highly leveraged may be at risk of bankruptcy if they're unable to make payments on their debt or are unable to find new lenders as their current debt matures.

Channel Stuffing Channel stuffing is an illegal and deceptive business practice that a company may use to inflate its sales and earnings figures by deliberately sending more products to the retailers in its distribution channel than they're able to sell. Through channel stuffing, distributors temporarily reduce their inventory and increase their accounts receivables. However, retailers will eventually return the excess items to the distributors, at which point the distributors must then make adjustments to both their accounts receivable and bottom line.

Channel stuffing ultimately catches up with the company since it cannot maintain sales at the rate at which it's stuffing. This fraudulent technique is often used by businesses that are seeking to overstate their sales and raise the value of their stock holdings. An investment banking representative must guard against this practice by carefully reviewing a company's financial statements to identify whether the accounts receivable growth rate exceeds the sales growth rate and analyze any significant changes in a company's days' sales outstanding (DSO). DSO measures how quickly a company turns its sales into cash.

Net Operating Losses Net operating losses (NOLs) that a company has experienced in past years may be used to offset income. This provision enables a company to use past losses to lower their taxable income by either carrying back or carrying forward these losses. Under IRS guidelines, an NOL may be carried back for up to two years and carried forward for up to 20 years. After December 31, 2017, net operating losses (NOLs) are deductible only to the extent of 80% of the corporation's income. These losses can now be carried forward indefinitely, but can no longer be carried back.

Financial Statement Analysis

An understanding of the conceptual basis of the financial reporting system and the preparation of financial statements is an essential prerequisite to financial analysis. Financial ratios are used to compare the risk and return profiles of different firms in order to help equity investors as well as creditors make intelligent investment and credit decisions.

This section will examine some of the fundamental financial tests that are conducted when analyzing a company. These ratios should be used as the basis for comparing the specific strengths and weaknesses of different companies within the same sector.

The following is a list of the ratios that will be described:

Turnover Ratios:

- Asset turnover
- Receivables and payables turnover
- Inventory turnover

Liquidity Analysis Ratios:

- Current ratio
- Quick asset (acid test) ratio
- Days' sales outstanding (DSO)

Profitability Analysis Ratios:

- Earnings per share
- Fully diluted earnings per share
- EBITDA margin
- Equity turnover
- Profit margins
- Return on assets
- Return on common equity

Capital Structure and Capital Market Analysis Ratios:

- Debt-to-total capital
- Debt-to-equity
- Debt-to-EBITDA
- Dividend payout
- Interest coverage

This section will identify the key formulas and then apply them to a set of comparative financial statements. To illustrate these financial statement formulas, let's examine KRT Industries. Some of the calculations involve averaging two years of data; however, for any calculations that require one year of data, December 31, 2016 should be used.

Use the following financial statements to calculate the indicated ratios and margins:

KRT Industries' Balance Sheets

	Dec. 31, 2016	Dec. 31, 2015
Current Assets:		
Cash	$ 929,375	$ 930,250
Accounts receivable	1,067,737	765,162
Inventories at cost (on last-in, first-out basis)	1,495,351	1,515,983
Prepaid assets	81,514	51,178
Total Current Assets	3,573,977	3,262,573
Gross plant, property, and equipment	2,308,539	2,039,199
Less accumulated depreciation	(945,569)	(760,720)
Net plant, property, and equipment	1,362,970	1,278,479
Investment in subsidiaries at cost	43,132	34,401
Deferred development expenses	$ 180,069	$ 116,878
Total Fixed and Long-Term Assets	$ 1,586,171	$ 1,429,758
Total Assets:	$ 5,160,148	$ 4,692,331
Liabilities:		
Bond sinking fund installment	$ 0	$ 100,000
Accounts payable (trade)	132,200	153,220
Provision for pensions	163,500	177,300
Provision for federal income tax	417,300	26,675
Other accrued liabilities	146,800	224,974
Total Current Liabilities	859,800	882,169
Long-Term Liabilities:		
Provision for deferred income tax	98,301	103,418
First mortgage bonds	800,000	800,000
Total Long-Term Liabilities	$ 898,301	$ 903,418
Total Liabilities:	$ 1,758,101	$ 1,785,587
Shareholders' Equity:		
Common stock ($1 par value) 350,000 shares authorized, 295,371 (for 2016) and 268,022 (for 2015) shares issued and outstanding	295,371	268,022
Additional Paid-in Capital	2,198,339	2,152,198
Retained Earnings	908,337	486,524
Total Equity	$ 3,402,047	$ 2,906,744
Total Liabilities and Shareholders' Equity:	$ 5,160,148	$ 4,692,331

KRT Industries' Income Statements

	Dec. 31, 2016	Dec. 31, 2015
Sales (Net)	$ 9,990,486	$ 8,821,121
Cost of goods sold	(6,755,013)	(6,339,304)
Gross profit	$ 3,235,473	$ 2,481,817
Selling expense	(1,482,635)	(1,365,342)
General and administrative expenses	(595,605)	(538,517)
Total selling, general, and administrative expenses	(2,078,240)	(1,903,859)
Income from operations	1,157,233	577,958
Bond interest	(48,000)	(48,000)
Income before provision for taxes	1,109,233	529,958
Provision for federal income tax	(487,864)	(219,744)
Provision for state income tax	(65,545)	(33,499)
Net Income	$ 555,824	$ 276,715

Note A: The weighted average number of common shares outstanding for 2016 and 2015 is 281,697 and 268,022, respectively.

Note B: In 2016, the company distributed dividends to the common shareholders in the amount of $134,011.

Turnover Ratios

Asset Turnover Asset turnover is an indication of how well a firm uses its asset base in generating sales. A low asset turnover ratio may indicate that the company is tying up capital relative to the other needs of the firm, while a high asset turnover may indicate that fully depreciated or dated assets are being used to generate sales. Ultimately, a higher asset turnover ratio indicates that a company is efficiently using its assets.

The formula for calculating asset turnover is:

$$\frac{\text{Sales}}{\text{Average Assets}}$$

$$\frac{\$9{,}990{,}486}{(\$5{,}160{,}148 + \$4{,}692{,}331) \div 2} = \frac{\$9{,}990{,}486}{\$4{,}926{,}240} = 2.03$$

Receivables Turnover An important consideration when measuring the liquidity of a firm is to determine how quickly the company is able to collect payment of its receivables. A high receivables turnover ratio indicates that the company is collecting on its accounts and has a greater ability to pay its current liabilities.

The formula for calculating receivables turnover is:

$$\frac{\text{Sales}}{\text{Average Receivables}}$$

$$\frac{\$9{,}990{,}486}{(\$1{,}067{,}737 + \$765{,}162) \div 2} = \frac{\$9{,}990{,}486}{\$916{,}450} = 10.90$$

Payables Turnover The payables turnover ratio is an indication of how quickly a company is paying its suppliers in relation to its cost of goods sold. If the firm is increasing its receivables turnover ratio while maintaining its payables turnover ratio, it's improving its cash conversion cycle.

The formula for calculating payables turnover is:

$$\frac{\text{Cost of Goods Sold}}{\text{Average Payables}}$$

$$\frac{\$6{,}755{,}013}{(\$132{,}200 + \$153{,}220) \div 2} = \frac{\$6{,}755{,}013}{\$142{,}710} = 47.33$$

Inventory Turnover The inventory turnover ratio indicates how often a company sells the goods that it produces and also implies a time frame for processing its goods. A longer time for processing materials indicates a greater amount of capital being tied up in the processing stage, while a shorter time frame indicates that the company is selling its inventory faster. In some cases, inventory turnover is calculated by using sales as the numerator; however, a preferred method may be to use the cost of goods sold since it excludes implied profits from sales.

The formula for calculating inventory turnover is:

$$\frac{\text{Cost of Goods Sold}}{\text{Average Inventory}}$$

$$\frac{\$6{,}755{,}013}{(\$1{,}495{,}351 + \$1{,}515{,}983) \div 2} = \frac{\$6{,}755{,}013}{\$1{,}505{,}667} = 4.49$$

Liquidity Analysis Formulas

A company's ability to meet its financial obligations is determined by evaluating the cash flow of the company, its working capital, and ratios such as the current ratio and the quick assets (acid test) ratio.

Current Ratio One of the most often used measures of liquidity is the current ratio. The current ratio calculates the ratio of current assets to current liabilities and indicates how many dollars of current assets are available to pay each dollar of current liabilities.

The formula for calculating current ratio is:

$$\frac{\text{Current Assets}}{\text{Current Liabilities}}$$

$$\frac{\$3,573,977}{\$859,800} = 4.16$$

If a question asks for the current ratio after two companies merge, a person needs to know whether the acquiring company used a line of credit. If it did, the amount being borrowed must be added to current liabilities.

Quick (Acid-Test) Ratio The quick assets ratio is more stringent than current ratio. The rationale is that when determining the current dollars available to pay current liabilities, inventories and prepaid expenses should not be included due to the fact that they're less liquid than other current assets.

The formula for calculating the quick assets (acid test) ratio is:

$$\frac{\text{Cash + Cash Equivalents + Accounts Receivable}}{\text{Current Liabilities}}$$

$$\frac{\$929,375 + \$1,067,737}{\$859,800} = \frac{\$1,997,112}{\$859,800} = 2.32$$

Days' Sales Outstanding (DSO) DSO is calculated as year-end trade receivables net of allowance for doubtful accounts, plus financial receivables, divided by net sales per day. A decrease in DSO represents an improvement, while an increase in DSO is considered a deterioration in net sales.

The formula for calculating DSO is:

$$\frac{\text{Accounts Receivable}}{\text{Total Credit Sales} \div \text{Number of Days in Period Being Analyzed (usually 360)}}$$

$$\frac{\$1,067,737}{\$9,990,486 \div 360} = 38.5$$

Profitability Analysis Formulas

Basic EPS Basic earnings per share indicates the amount of profit being generated by the company which is allocated to each share of common stock outstanding. EPS is calculated by subtracting preferred dividends from the net income of the company and dividing the result by the number of shares outstanding. At times, EPS may be measured as total earnings divided by the weighted average shares outstanding. The basic EPS excludes adjustments for the conversion of preferred stock and bonds and doesn't consider the potential exercise of warrants. If these adjustments were made to the number of shares outstanding, the calculation provides the earnings per share on a fully diluted basis.

The formula for calculating basic EPS is:

$$\frac{\text{Earnings Available to Common Shareholders (i.e., Net Income – Preferred Dividends)}}{\text{Weighted Average Number of Common Shares Outstanding}}$$

$$\frac{\$555,824}{281,697} = \$1.97$$

(Notice that KRT Industries has not issued any preferred stock.)

Dilution Dilution refers to a reduction in earnings per share of common stock that occurs due to the issuance of additional shares or the conversion of convertible securities. Diluted EPS assumes that all of the convertible securities will be exercised. In other words, diluted earnings take into account the possibility that all warrants, stock options, convertible preferred stock, and convertible bonds are converted into stock. These actions will result in an increase in the number of shares outstanding.

The formula for calculating fully diluted EPS is:

$$\frac{\text{Earnings Available to Common Shareholders (i.e., Net Income – Preferred Dividends)}}{\text{Weighted Average Number of Common Shares Outstanding + Weighted Average of CSEs and OPDS}}$$

* CSE = Common stock equivalents
** OPDS = Other potentially dilutive securities

Convertible Debt Since KRT Industries doesn't have any convertible securities, the following example has been included:

Let's assume that a corporation has taxable income of $50,000 and the following capital structure:

5% Convertible bonds (conversion price of $20)	$100,000
5% Preferred stock	$100,000
Common stock; par value of $1.00; with 5,000 shares outstanding	$5,000
Tax rate of 21%	

The fully diluted EPS is calculated as follows:

If all of the bonds are converted, there will be an additional 5,000 shares outstanding.

$$\frac{\text{\$100,000 par value of bonds}}{\text{\$20 conversion price}} = \text{5,000 shares}$$

Due to conversion, the company will no longer be required to pay bond interest. The fully diluted EPS is calculated as follows:

Taxable income:	$ 50,000
Taxes at 21%:	– 10,500
Net income:	$ 39,500

$$\text{EPS} = \frac{\text{Net Income – Preferred Dividends}}{\text{Number of Common Shares Outstanding}}$$

$$\frac{\text{\$39,500 – \$5,000}}{\text{5,000 original shares + 5,000 additional shares due to conversion}} = \frac{\text{34,500}}{\text{10,000 shares}} = \text{\$3.45 EPS}$$

Follow-on Offering An investment banking representative may also be asked to calculate the adjusted EPS for an existing publicly traded company that's conducting an additional common stock offering (a follow-on offering).

Consider the following example:

JYS Sports Entertainment Company has the following financial information:

> EBIT of $125 million
> EBIT growth rate of 9%
> 21% tax rate
> 29 million shares outstanding
> $350 million of 7.5% debentures outstanding

The company is planning to conduct a follow-on offering in which it will sell an additional 6 million shares and selling shareholders will also be selling an additional 6 million shares. Using the growth rate given, what will the company's EPS be after the offering?

The following steps are needed to calculate the answer:

1. The EBIT will increase to $136.25 million ($125 million x 1.09).
2. Subtract the interest expense of $26.25 million ($350 million x 7.5%), which leaves earnings before tax of $110 million ($136.25 million – $26.25 million).
3. Calculate the tax liability: $110 million x 21% = $23.1 million.
4. The net income equals $86.9 million ($110 million – $23.1 million).

5. The number of outstanding shares will increase by 6 million shares, not 12 million, since the selling shareholders' shares are already included in calculating the existing outstanding shares. In other words, only the shares being sold by the company increase the shares outstanding.
6. The EPS after the offering is $2.48 ($86.9 million ÷ 35 million shares outstanding).

Some companies raise capital by selling additional shares of common stock and use some or all of the proceeds being received to pay down their existing debt. In this situation, when determining the pro forma EPS, an investment banking representative must reduce the interest expense of the company when calculating the earnings before tax.

Anti-Dilution Provision The anti-dilution provision is an investor's right to maintain their fractional ownership in a company by being entitled to a proportional number of shares of any future issue of common stock. This provision is typically attributed to option contracts or to convertible security indentures which protect investors from the potential dilutive effects of additional issuances of stock.

Gross Profit Margin The gross profit margin is an indication of the amount of each dollar of sales that's available to cover operating expenses and profit. Gross profit is calculated by subtracting the cost of goods sold from net sales. Gross profit margins will be higher if revenue increases at a higher rate than cost of goods sold (COGS), or COGS decreases at a higher rate than revenue.

The formula for calculating gross profit margin is:

$$\frac{\text{Gross Profit}}{\text{Sales}}$$

$$\frac{\$3,235,473}{\$9,990,486} = 32.4\%$$

Operating Profit Margin The operating profit margin is the relationship of income from operations (operating profit) to net sales. Income from operations is calculated by subtracting administrative, selling, and other operating expenses from gross profit. If the cost of goods sold (COGS) decreases by a higher rate than an increase in operating expenses, the company's operating profit margin will be higher.

The formula for calculating operating profit margin is:

$$\frac{\text{Income from Operations}}{\text{Sales}}$$

$$\frac{\$1,157,233}{\$9,990,486} = 11.6\%$$

The income from operations is equal to the earnings before interest and taxes (EBIT).

Earnings Before Interest, Taxes, Depreciation, and Amortization (EBITDA) Margin EBITDA may be used to analyze the profitability between companies and industries by eliminating the effects of financing and accounting decisions which allows for comparisons between the companies to be made on a more equitable basis. EBITDA represents the earnings of a company before the deduction of interest expenses, taxes, depreciation, and amortization. Although often referred to as operational cash flow, EBITDA doesn't represent cash earnings. EBITDA is an effective metric to evaluate profitability, but not cash flow, since it ignores the capital expenditures that are necessary to maintain and grow a business. The EBITDA margin indicates operating profits as a percent of sales and provides a stable indication of operating income to each dollar of sales.

The formula for calculating earnings before interest, taxes, depreciation, and amortization (EBITDA) margin is:

$$\frac{\text{EBITDA}}{\text{Sales}}$$

$$\frac{\$1{,}157{,}233 + 184{,}849\ *}{\$9{,}990{,}486} = 13.4\%$$

* $184,849 is the depreciation for the current year, which represents the difference between the two years' entries for accumulated depreciation ($945,569 - $760,720).

Earnings Before Interest, Taxes, Depreciation, Amortization and Rent (EBITDAR) Earnings before interest, taxes, depreciation, amortization, and rent is used in sectors that rely heavily on leases or sale and leaseback arrangements. Since different companies within the same sector may have different lease or rental agreements, the use of EBITDAR is preferable to EBITDA. Restaurants, retail clothing stores, and airlines typically have significant lease or rental agreements.

Funds From Operations (FFO) The most frequently used valuation metric for a real estate investment trust (REIT) is Funds From Operations (FFO). The formula for calculating FFO is net income plus depreciation, minus gains from the sale of assets.

Net Profit Margin The net profit margin is the relationship of net income to sales. The ratio indicates the amount of income (after operating expense, interest, and taxes) that's available per dollar of sales.

The formula for calculating net profit margin is:

$$\frac{\text{Net Income}}{\text{Sales}}$$

$$\frac{\$555{,}824}{\$9{,}990{,}486} = 5.6\%$$

Return on Assets The return on assets is an important indicator of a company's profits in relationship to its total assets. The calculation is an indication of the earnings being generated based on the invested capital.

The formula for calculating return on assets is:

$$\frac{\text{Net Income}}{\text{Average Assets}}$$

$$\frac{\$1,157,233}{(\$5,160,148 + \$4,692,331) \div 2} = \frac{\$1,157,233}{\$4,926,240} = 23.5\%$$

Some finance professionals will use EBIT rather than net income to calculate the return on assets. If a question related to return on assets appears on the examination, either net income or EBIT will be provided. (The example above used EBIT.)

Return on Common Equity The return on common equity indicates the rate of return that's available to the providers of common equity capital to the company. The calculation considers the amount of earnings available to common shareholders after all other capital providers have been paid their entitlement. The rate of return incorporates the business risk as well as the financial risk being assumed by the common shareholders. The net income available to common equity shareholders is the residual that's available after the preferred stock dividends are subtracted.

The formula for calculating return on equity is:

$$\frac{\text{Net Income Available to Common}}{\text{Average Common Equity}}$$

$$\frac{\$555,824}{(\$3,402,047 + \$2,906,744) \div 2} = \frac{\$555,824}{\$3,154,396} = 17.6\%$$

The return on equity (ROE) increases if a company reduces the number of shares it has outstanding since this action reduces the value of the common equity. This reduction in share value may occur if a company initiates a stock buyback program (assuming the earnings remain unchanged). If the common equity remains constant, the ROE will increase as long as the company either increases its earnings or experiences a gain on the sale of an asset.

Return on Invested Capital (ROIC) The ROIC measures how well a company is utilizing the capital that's being invested in the business. Although ROIC is similar to the ROE, it takes into consideration the debt of a company.

The formula for calculating return on invested capital is:

$$\frac{\text{EBIT x (1.00 – Tax Rate \%)}}{\text{Invested Capital}}$$

$$\frac{\$1,157,233 \text{ x } (1.00 - 21\%)}{\$800,000 + \$3,402,047} = \frac{\$914,214}{\$4,202,047} = 21.8\%$$

There are a variety of methods that may be used to derive invested capital. The example above used total shareholders' equity plus debt. Other methods will provide similar results and are listed below:

- Fixed assets + current assets – current liabilities – cash
- Fixed assets + non-cash working capital
- Total Assets – non-interest-bearing current liabilities + excess cash

EBIT x (1.00 – Tax Rate %) can also be referred to as earnings before interest after taxes (EBIAT) or net operating profit after taxes (NOPAT).

Capital Structure and Capital Market Analysis Formulas

Debt-to-Total Capital The debt-to-total capital ratio of a firm is a measure of the financial leverage to available capital. The formula indicates the percentage of the total capitalization of a company composed of debt. In this manual, the calculation uses the book value that's found on the balance sheet; however, some finance professionals use the market value of both the debt and equity to calculate the ratio. When calculating debt, some professional also use the long formula which consists of both short- and long-term debt as well as any other fixed payment obligations.

Other fixed payments include convertible debt, finance leases, mortgage payments, and a *revolver line of credit.* A revolver is a loan or debt from a bank which acts like a credit card for companies and is generally used to help fund a company's working capital needs. A company will "draw down" the revolver up to the credit limit when it needs cash, and then repay it when excess cash is available.

The formula for calculating the debt-to-total capital ratio is:

$$\frac{\text{Total Debt}}{\text{Total Capital (Debt + Equity)}}$$

$$\frac{\$800,000}{\$800,000 + \$3,402,047} = \frac{\$800,000}{\$4,202,047} = 19.04\%$$

Debt-to-Equity Ratio The debt-to-equity ratio of a firm is a measure of the financial leverage to available equity (not total capital).

The formula for calculating the debt-to-equity ratio is:

$$\frac{\text{Total Debt}}{\text{Total Equity}}$$

$$\frac{\$800,000}{\$3,402,047} = 23.5\%$$

Interest Coverage Ratio Interest coverage is an indication of the number of dollars of earnings (before interest and taxes) that are available to meet interest expenses and represents how many times during the year the company is able to meet its interest payments. A low ratio indicates a high debt burden, while a high ratio indicates a low level of debt-to-earnings.

The formula for calculating interest coverage ratio is:

$$\frac{\text{EBITDA}}{\text{Interest Expense}}$$

$$\frac{\$1,157,233 + \text{D and A of } \$184,849 *}{\$48,000} = 27.9$$

*** NOTE:** Although some finance professionals use the formula of EBIT (operating income divided by interest expense) to find a company's interest coverage ratio, many investment banking professionals choose to use EBITDA as the numerator.

Debt-to-EBITDA Ratio The debt-to-EBITDA ratio is an indication of a company's leverage. The higher the ratio, the greater the leverage. Also, a high ratio indicates a greater likelihood that a company may default on its debt. On the other hand, a low ratio is an indication that a company may have the ability to incur additional debt, without a significant increase in the risk of default. The debt-to-equity and debt-to-total capitalization ratios measure debt capital, but not a company's ability to meet its debt service obligations.

The formula for calculating the debt-to-EBITDA ratio is

$$\frac{\text{Short-Term and Long-Term Debt}}{\text{EBITDA}}$$

$$\frac{\$800,000 *}{\$1,157,233 + \$184,849 **} = 59.6\%$$

* Represents the first mortgage bonds from the balance sheet

** $184,849 is the depreciation for the current year, which represents the difference between the two years' accumulated depreciation ($945,569 – $760,720).

Dividend Payout Ratio The dividend payout ratio measures the percentage of earnings that are paid to shareholders in the form of dividends. A dividend payout policy is an indication of management's decision to distribute a percentage of the company's earnings.

The formula for calculating the dividend payout ratio is:

$$\frac{\text{Dividends}}{\text{Net Income}}$$

$$\frac{\$134{,}011}{\$555{,}824} = 24.1\%$$

For any questions regarding a stock's dividend yield, the calculation is the annual (not quarterly) dividend divided by its current market price.

Adjustments to Financial Statements

An investment banking representative may need to add or delete certain data from a financial statement in order to compare various companies within the same sector. Some examples are gains or losses on businesses or investments that are sold, a legal settlement, a restructuring charge, or impairment in goodwill. These events, referred to as non-recurring or extraordinary, are found in the footnotes of a financial statement.

Since an investment banking representative may be asked to adjust a company's earnings due to one of these non-recurring items, let's consider the following example:

> *SDS Industries has net income of $18 million, which includes the sale of a business at a loss of $15 million, and has a marginal tax rate of 25%. Assuming stable operations, what's the company's net income in the next period?*
>
> *To adjust for the $15 million loss based on a 25% tax rate, the loss is multiplied by the complement of the tax rate, which equals $11.25 million ($15 million x 75%). The next year's net income is expected to be $29.25 million (the previous year's net income of $18 million + $11.25 million). If the sale of the business generated a gain, the adjusted gain is subtracted from the previous year's net income.*

For these types of calculations, it's important to use the more conservative marginal tax rate, not the effective tax rate or the statutory federal tax rate of 21%. The marginal tax rate, which includes both the statutory federal and state taxes, is considered the rate for any additional dollars of income. However, the marginal rate doesn't include many of the adjustments that are made to calculate a company's effective tax rate (which is a blended rate and is usually lower than the marginal tax rate).

Chapter 8 Summary

Now that you've completed this chapter, for the following commonly tested concepts, you should be able to:

- Recognize the different sections of the balance sheet and what each includes
- Define the term *working capital* and recognize the formula
- Define the term *additional paid-in capital* and calculate it
- Understand and calculate book value and tangible book value
- Define *market capitalization* and calculate it
  - Define the term *public float*
- Understand the function of an income statement and recognize its components
- Understand the concept of EBITDA as a measure of valuation
- Understand the effects of refinancing and the changes in revenue/expenses to an income statement
- Understand the purpose of a cash flow statement and recognize the important information
  - Operating Activities, Investing Activities, and Financing Activities
- Recognize whether certain activities are sources or uses of cash (*see table in chapter*)
- Understand the relationship between the three financial statements
- Understand the concept and purpose of GAAP reporting versus pro forma reporting
- Understand the purpose of aggressive accounting techniques and recognize examples
  - Use of high discount rate in pension fund liabilities
- Understand the process/purpose of depreciation and difference in straight line versus accelerated
- Calculate deferred tax assets and liabilities
- Understand how to account for a non-controlling/minority interest
- Understand the accounting rules for intangible assets and testing for impairment
- Understand how to account for cash dividends, stock dividends, and stock splits (*see table in chapter*)
- Understand inventory terminology and accounting procedures
  - Effects on earnings using FIFO versus LIFO
  - Effects on financials when switching inventory valuation methods
- Understand how to account for restructuring charges, such as write-downs and layoffs
- Understand the concept of operating leverage and how it relates fixed to variable costs
- Define the terms *financial leverage* and *channel stuffing*
- Recognize the tax effects of net operating losses (NOLs)
- Understand the use of ratio analysis to compare and value companies
  - Recognize the formulas and identify when a high or low ratio is desirable
  - Calculate basic and diluted or adjusted EPS
  - Recognize the formulas for the various profit margins and rates of return
  - Calculate a company's revised EPS
    - When a convertible security is converted
    - When a company conducts a follow-on offering
- Define the term *capital structure* and recognize the formulas for determining financial leverage
- Understand how to adjust for non-recurring events
- Understand the different tax rates and recognize which one to use in calculations

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Chapter 9

Valuation Analysis

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This chapter will focus on the methods that are used to value a company. Valuation is one of the most important investment banking functions in the M&A process. Whether assisting a financial buyer in determining the correct purchase price for a target company or aiding a strategic buyer intent on expanding its business, valuation sets the stage for the negotiations. A description of the various methods that are used to calculate valuation will be included, as well as discussions of some of the strengths and weaknesses of each approach.

Valuation

There are two main approaches to valuing a firm—relative valuation and discounted cash flow analysis. Relative valuation attempts to value a company based on its price compared to its financials, such as revenues, earnings, book value, and enterprise value. Examples include the price-to-earnings ratio, price-to-sales ratio, price-to-book value ratio, and enterprise value-to-EBITDA. These ratios are then compared to other companies within the same sector (peer group members) to determine whether a firm is undervalued or overvalued. On the other hand, the discounted cash flow (DCF) methodology doesn't make peer-group comparisons. Instead, DCF analysis views a target independently based on the present value of its expected future cash flows. In many cases, both methods may be applied by using a primary and then secondary method to confirm a valuation.

For merger valuations that involve strategic buyers, the potential market valuation and financial status of the combined entity are examined after the proposed M&A activity is completed. Whether the proposed acquisition is accretive or dilutive to the earnings of the new entity is subject to review. Although this chapter will focus on the calculations involved in valuation, it's important to understand that many investors approach an acquisition using numerous other factors. Many buyers limit their targets to specific businesses in which they have expertise. As a famous investor once wrote, "We try to stick to businesses we believe we understand." Other investors may be less discerning regarding the intended type of target and may attempt to purchase assets that they regard as underpriced, regardless of the nature of the potential acquisition's business.

Relative Valuation

Price-to-Earnings (P/E) Ratio

One of the key ratios that investors may use for security valuation purposes is the price/earnings ratio. The P/E ratio allows comparisons from one company to another and incorporates the important elements of investors' concerns—the price of the security in the market and its earnings per share. The P/E ratio is an indication of how the market capitalizes a company's earnings or what the market is willing to pay for each dollar of earnings.

If the market value of a stock is trading at five times its earnings and the corporation's EPS is $3.20, it's expected that the price per share will be $16.00 ($3.20 x 5). A $1.00 increase in earnings will, in turn, project an increase in the share price by $5.00. Therefore, if the earnings increase from $3.20 to $4.20, the share price should increase from $16.00 to $21.00.

In calculating the P/E ratio, the numerator (i.e., the stock's market price) is relatively easy to determine since market data is always available and may be verified with little difficulty. However, the denominator (i.e., EPS) is subject to variables that include how it's calculated, the time period used, and adjustments to earnings (i.e., accounting activities that are related to non-recurring items). The P/E ratio may be defined using trailing or leading figures, and may need to be adjusted in order to make proper comparisons between companies.

P/E Ratio Using Trailing EPS

The trailing P/E of a stock is calculated by dividing its current market price by the earnings per shares of the trailing twelve months. This calculation is also referred to as the current P/E, earnings multiple, or multiple of the stock. However, an investment banking representative must be aware of the shortcomings of this measurement in order to compare different companies using the same criteria.

First, to compare two companies, the same time frames must be used when calculating the earnings per share. If different time frames are applied to the calculation, the comparisons will be invalid or not relative for two companies at a specific point in time, or for one company over comparable periods.

Second, there may be company-specific, non-recurring items that will impact earnings, such as a company changing its methods of accounting or inventory valuation. There may have been a sale of assets or a revaluation of assets for accounting purposes that will appear on the financial statement in a particular quarter; however, this will not appear in ensuing periods. Additionally, the earnings may be affected by the cyclical nature of the business. Each of these elements must be taken into consideration by the investment banking representative in order to apply systematic principles for comparison purposes. Due to the effects of non-recurring items, the trailing P/E may not always be appropriate for the projection of future earnings. In such cases, it may be more pertinent to use the second method of calculating EPS which is referred to as leading (forward) P/E.

P/E Ratio Using Leading EPS

The leading (forward) P/E ratio is calculated by dividing the common stock's market price by the projected earnings for the next year. The main reason for projecting earnings is to focus on the underlying earnings potential of the company without the effects of outside influences. The advantage is that the analyst is looking at the value of the company based on what it can do in the future and not what's been done in the past.

One of the drawbacks to using the forward P/E ratio is the limitation that's associated with accurately projecting earnings. The data being used to determine earnings may not be readily available and is subject to change over the period of the projection. Non-recurring items may not be easily identifiable, and additional research may be necessary in order to categorize these items and remove them from the computation.

Normalized P/E

The cyclical impact of an industry affects the P/E ratio computation as well. Cyclicality may occur over a longer time span than the projected period; therefore, the quarterly earnings may not accurately reflect the long-term earnings potential of the company. With companies that are particularly sensitive to business or industry cycles, the P/E ratio may not provide an adequate reflection of the company.

If the trailing P/E is used, it may be especially high at the bottom of a cycle and excessively low at the top of a cycle. The P/E ratio could be highly volatile without any change in prospects for future earnings of the company. This counter-cyclical concept is referred to as the Molodovsky Effect. In order to counter the problems of the Molodovsky Effect, analysts often use normalized earnings per share. Normalized EPS refers to the level of earnings that the business could achieve under mid-cycle conditions. One method of normalizing EPS is to use the average EPS for the most recent full cycle and another is to remove non-recurring or unusual events.

Relative P/E Many investors use the P/E as a proxy for the earnings growth rate. If the perceived growth is less than the growth of a benchmark index, it will be reflected in the P/E. This is true for both a trailing P/E and forward-looking P/E. If the market multiple is 15, a company with an identical P/E is considered to have a relative P/E of 1.0. All companies are able to be compared to the market P/E; however, some issues will sell for more than the relative P/E (premium), while others sell for less (discount).

Illustrative Examples—Trailing and Forward P/E

> *In November 2017, an investment banking representative is evaluating a manufacturing corporation by calculating the P/E ratio using the four previous quarterly earnings reports (i.e., the first three quarters of 2017 and the fourth quarter of 2016). While examining the financial statements, the representative finds that the corporation had acquisition expenses in December of 2016 that resulted in a reduction in earnings per share from $.24 to $.16. Earnings for the first three quarters of 2017 were $.19, $.21, and $.18 respectively, and the current market price of its stock is $16.40.*

To calculate the trailing EPS, earnings for the previous four quarters are totaled, which equals $.74. The trailing P/E ratio is then calculated by using the market price and dividing by the earnings; therefore, the P/E ratio is 22.16 ($16.40 ÷ $.74). However, it must be noted that $.08 of the earnings from the fourth quarter of 2016 was the result of a non-recurring item. When this item is factored in, the earnings per share being used in the valuation should be $.82 rather than $.74. By using the adjusted figure, the calculation shows a P/E ratio of 20.00 rather than 22.16 ($16.40 ÷ $.82 = 20.00).

Forward P/E When calculating the leading (forward) P/E ratio, certain assumptions must be made. In some cases, the analyst will use expected EPS for the next four quarters; however, in other cases, the actual EPS reported for the current period will be included along with the projections.

For illustration purposes, consider the following information:

> *On April 21, 2017, an investment banking representative is examining a retirement community construction company. The company has just released earnings of $.38 for the first quarter and its common stock is currently trading at $22.60. Last week, the company announced that it will acquire 1,200 acres of land in Florida and is planning a new gulf coast retirement community with approximately 2,400 units. The land acquisition is expected to create a write-down of $.12 per share in the third quarter of 2017. After the acquisition, increased legal costs are expected to reduce future EPS by $.02 in the fourth quarter. The company projects quarterly EPS to be $.36, $.20, and $.34 for the remainder of 2017.*

It's obvious that using the announced EPS plus the projections will not provide the proper valuation of the company. Adjustments must be made for the non-recurring item (the land acquisition) and the increased operating expenses over the projected period. The figures used in the calculation are:

	As Reported	Adjusted
First quarter actual	$.38	$.38
Second quarter projected	$.36	$.36
Third quarter adjusted	$.20	$.32
Fourth quarter adjusted	$.34	$.36
Total:	**$1.28**	**$1.42**

In this case, the P/E ratio is calculated by using the market price and dividing by the adjusted EPS; therefore, the P/E ratio is 15.92 ($22.60 ÷ $1.42).

Normalized Earnings Per Share When examining the historical data of the construction company, an investment banking representative identifies that, during the past 18 months, the economy has experienced a significant downturn and housing starts have declined. Prospects for a turnaround look uncertain in the near-term. Rather than using the current data and projections, the representative decides to normalize the earnings per share and determines that the past five years are a good indication of a complete economic cycle.

In its annual report, the following information is provided for this period:

	2017	2016	2014	2013	2012
Earnings Per Share	2.46	2.20	2.24	2.08	1.96

* Average EPS = $2.46 + 2.20 + 2.24 + 2.08 + 1.96 = $10.94 ÷ 5 = $2.188 or $2.19

To normalize EPS, the closing share price is divided by the average of the EPS figures for the five-year period:

$$\text{Normalized P/E} = \frac{\text{Market Price}}{\text{Average EPS}} = \frac{\$22.60}{\$2.19\ *} = 10.32x$$

Finding the P/E Ratio If given certain information about a company, an investment banking representative is able to find the price-to-earnings ratio.

For example, the P/E ratio can be determined if the annual dividend, the dividend payout ratio, and the dividend yield are given.

Annual Dividend	Dividend Payout	Dividend Yield
$1.50	40%	2%

The earnings per share of the company is equal to the annual dividend divided by the dividend payout ratio ($1.50 ÷ 40% = $3.75).

The current price is calculated by dividing the annual dividend by the current dividend yield ($1.50 ÷ 2% = $75.00).

The P/E ratio for the company is 20 ($75.00 ÷ $3.75).

Finding the Dividend Yield A company has basic EPS of $3.50 and diluted EPS of $3.00. If the company's stock pays a quarterly dividend of $.35 and trades at a P/E ratio of 16, what's its dividend yield?

The dividend yield is found by dividing the annual dividend by the market price of the stock. The P/E ratio indicates the stock is trading at 16 times its earnings. Although the P/E ratio may be calculated using basic or diluted EPS, the more conservative method is to calculate it using diluted EPS. Therefore, the market price is 16 times the $3.00 diluted EPS, or $48 per share. The annual dividend of $1.40 ($.35 quarterly dividend) is divided by $48, which equals a dividend yield of 2.9%.

Earnings Yield One of the inherent problems in using both EPS and the P/E ratio is that there are times when earnings are negative. When comparing various companies, an investment banking representative may use a ranking system that's based on the P/E ratio. The companies will be ranked from the highest P/E to the lowest, with the lowest being the most economic per dollar of earnings. However, if a company has negative earnings, the ranking system will put it below the lowest positive P/E. The error in this reasoning is that positive dollars must be invested to acquire zero returns which, in fact, is more expensive than a company with a low positive P/E ratio.

In such cases, it may be more advantageous to use the earnings yield. The earnings yield is calculated by using the earnings per share and dividing by the price per share; it's simply the inverse of the price/earnings ratio. To illustrate this concept, let's analyze the P/E ratio and earnings yield of three hypothetical companies.

The following table ranks the three companies in order of earnings yield:

	Market Price	EPS	P/E	Earnings Yield
Company A	$32.18	$3.52	9.14	10.94%
Company B	$15.82	($0.12)	N/A	– 0.76%
Company C	$11.85	($1.20)	N/A	– 10.12%

By using the earnings yield rather than the P/E ratio, the companies are ranked from the least expensive to the most expensive in terms of the earnings that one dollar of investment will purchase. In this case, the two companies with negative earnings may be considered more expensive per dollar of the share price than the company with positive EPS.

P/E-to-Growth Ratio

In the previous discussion of the P/E ratio, the market value of the stock and its earnings were used for either trailing 12 months or forward projections. Although the P/E ratio is a valuable tool and has been used as a historical benchmark for calculating valuation, it does have its shortcomings.

Primarily, the P/E is based on historical data and doesn't address expectations for the continued operations of the company. Intuitive investors will typically look to the future performance of a company rather than its past history and, therefore, will attempt to value different companies based on their growth potential and prospects for continued revenues. The ratio that's used to incorporate these prospects is referred to as the price/earnings-to-growth (PEG) ratio. This ratio indicates the relationship of price/earnings to the earnings growth rate and, when used to compare two companies, will provide a more insightful value. To calculate the PEG ratio, the price/earnings (P/E) ratio is divided by the annual growth rate of the company. The annual growth rate may be either a forward projection or based on trailing information. As a variation, some analysts use a one-year period, while others use a five-year time frame. When comparing companies, similar periods and growth factors should be used.

Using hypothetical earnings and projected growth, the following two companies may be examined in order to demonstrate how the PEG ratio is used:

1. The first company is a start-up, high-tech, Internet distribution company that's currently selling for 70 times its earnings and has a projected growth rate of 20% per year for the next three to five years.
2. The second company is a well-established grocery chain that's trading at six times its earnings and is expected to grow at a rate of 8% per year over the same period.

Investors typically search for companies with strong growth potential. Therefore, by simply comparing the two growth rates, an investor might be drawn to the start-up company with the higher potential of 20%. However, by considering the price/earnings-to-growth ratio, a different conclusion may become apparent.

If the P/E ratio of 70 is divided by the growth rate of 20, the PEG equals 3.5. In the second example, the P/E ratio of 6 is divided by a growth rate of 8, resulting in a PEG of .75. These calculations indicate that the start-up Internet company doesn't have sufficient growth to justify its higher price/earnings ratio. On the other hand, the second company's PEG of .75 indicates that it's properly priced, or that it may be undervalued based on its growth potential. When using the PEG, investors will normally look for a ratio of 1.0 or less.

Of course, an investment banking representative must recognize the weaknesses of using the PEG ratio for comparison. The assumptions of both earnings and growth rates are subject to change and adjustment; therefore, projected results may not be achieved. When comparing two companies that are in different sectors (as done above), there may be other factors that justify a higher PEG. Examples may include an aggressive investor's interest in technology or a lower cost of labor in the grocery chain. Ultimately, the PEG ratio is seldom used for large-cap companies since they have slower projected growth rates. Therefore, it's important to compare a company within its own sector and against other companies of equivalent size. Additionally, applying a PEG ratio is meaningless if a company doesn't have positive earnings.

Calculating the PEG Ratio

Let's calculate the PEG ratio when given a company's price per share, its number of outstanding shares, and both the last 12 months (LTM) and the next 12 months (NTM) projected net income.

Price Per Share	Shares Outstanding	LTM Net Income	NTM Net Income
$29.00	275 million	$438 million	$515 million

Step 1: Calculate EPS $\frac{\$438 \text{ million}}{275 \text{ million}} = \$1.59$

Step 2: Calculate P/E ratio $\frac{\$29.00}{\$1.59} = 18.23$

Step 3: Calculate the projected growth rate: $\frac{\text{NTM NI}}{\text{LTM NI}} - 1 \times 100$

$\frac{\$515 \text{ million}}{\$438 \text{ million}} = 1.175 - 1 = 0.175 \times 100 = 17.5\%$

Step 4: Calculate PEG $\frac{18.23}{17.5} = 1.04$

Multiples When using the PEG ratio as a valuation tool, an investment banking representative assumes that the price/earnings ratio will equal the growth rate (PEG ratio of 1.0). A ratio that's higher than 1.0 may indicate an overpriced stock, while a ratio of less than 1.0 may suggest that the stock is undervalued. Most professionals use the benchmark PEG of an industry for comparison to a company's PEG. An additional variable comes into play when asking, "What's an investor really willing to pay for the potential earnings and growth of the company?" If a company has historically traded at 15 times its earnings, but is currently trading at 12 times its earnings, this may signal a buying opportunity. Essentially, the thinking is that if investors are willing to pay up to 15 times the earnings potential, the stock's price should eventually rise up to its historical multiple of 15. Likewise, if the stock is trading above 15, this may be a sell signal since the stock is overvalued to historic earnings and may be expected to trade down to its historic level.

Using the PEG Ratio

Finding the Target Price If the PEG and certain other information that relates to a company is given, the next year's price target may be calculated.

When given the PEG ratio, this year's EPS, and next year's EPS estimate, the process for calculating next year's price target is as follows:

PEG	Current EPS	Next Year's Estimate EPS
1.30	$.85	$.95

Step 1: Calculate the growth rate $\frac{(\$.95 - \$.85)}{\$.85} = 11.7\%$

Step 2: Calculate the P/E ratio PEG 1.30 x growth rate of 11.7 = 15.2 P/E ratio

Step 3: Calculate next year's price target P/E 15.2 x next year's EPS .$.95 = $14.44

Finding the Earnings Yield Let's calculate the earnings yield when given the PEG ratio and the assumption that earnings will double.

PEG	Years for Earnings to Double
1.60	6 years

The first step is to calculate the growth rate. To do this without a complex financial calculator, the Rule of 72 may be used. When given the number of years it takes for funds to double, this rule calculates the approximate compounded annual growth rate that's required for this doubling to occur. In this example, 72 is divided by 6 years, which equals 12; therefore, the annual growth rate is 12%. To check for accuracy, notice that 72 divided by 12 indicates that funds will double in value in six years at an annual growth rate of 12%.

PEG 1.60 x growth rate of 12 = 19.2 P/E ratio

$\frac{1}{19.2 \text{ P/E ratio}} = 5.2\%$ Earnings Yield

Most/Least Undervalued An investment banking representative may need to compare a number of companies using the PEG ratio as the appropriate valuation metric. The company with the highest PEG is the most overvalued, while the company with the lowest PEG is the most undervalued.

Keep in mind, the growth rate should be expressed as a whole number (as shown below):

	Price	Earnings	P/E Ratio	Growth Rate	PEG
Company D	$22.50	$1.60	14	10%	1.40
Company E	$27.20	$1.35	20	11%	1.83
Company F	$59.60	$3.10	19	10%	1.90
Company G	$31.50	$1.75	18	9%	2.00

Calculating the Implied Equity Value Range

In certain cases, an investment banking representative will need to find the implied equity value range of a company. This may be used to value a company that's involved in an initial public offering (IPO) or to value a potential target in an acquisition.

Consider the following example:

> *A family-owned, privately held company wants to conduct a public offering in order to take cash out of the business. The company currently has net income of $35 million and the owners intend to sell 60% of their shares and retain the remainder. If the current IPO discount is 15%, the expected growth rate is 8%, and the forward P/E multiple range is 16 to 22, what's the range of proceeds to the selling shareholders?*

In order to answer this question, the implied equity value range must be determined using the forward P/E and the expected growth rate. Then, the implied equity value is multiplied by the percentage of the company that the owners intend to sell. The last step is to subtract the IPO discount of 15%. (Most IPOs are priced at a discount to their implied equity value.)

Step 1: The expected net income is $37,800,000 ($35 million x 1.08).

Step 2: The implied equity value range is $604,800,000 ($37,800,000 x 16) to $831,600,000 ($37,800,000 x 22).

Step 3: 60% of the implied equity value range is $362,880,000 to $498,960,000.

Step 4: The range at the current IPO discount of 15% is $308,448,000 to $424,116,000.

Compound Annual Growth Rate (CAGR)

When calculating the PEG ratio, the importance of determining the growth rate is key to the successful use of the valuation metric. The CAGR (compound annual growth rate) is the year-over-year growth over a specified period and is calculated by taking the *n*th root of the total percentage growth rate, where *n* is the number of years for the period being considered.

Use the following data to calculate the compound annual growth rate:

	2011	2012	2013	2014	2015	2016	2017
Sales	100	120	115	110	125	130	120
Growth		20.0%	-4.2%	-4.3%	13.6%	4.0%	-7.7%

Solution:

[(120 ÷ 100) raised to the power of (1 / 6)] – 1 = 0.0309 or 3.09%

$$\text{CAGR} = \left(\frac{\text{Ending Value}}{\text{Beginning Value}}\right)^{\left(\frac{1}{\text{Number of years}}\right)} - 1$$

NOTE: CAGR cannot be calculated using the basic calculator that's provided at the testing center. Instead, another method to approximate the CAGR is to calculate the growth from every period and simply compute an average. Then, examine the choices that are close to the average calculated for a value that's slightly lower.

Average method:

-7.7 + 4.0 + 13.6 + -4.3 + -4.2 + 20.0 = 21.4

21.4 ÷ 6 = 3.57 or 3.57%

A value that's slightly lower is 3.09%.

A trial-and-error method could also be used as follows:

	INCORRECT	CORRECT
Year 1	100.00 x 1.0357 = 103.57	100.00 x 1.0309 = 103.09
Year 2	103.57 x 1.0357 = 107.27	103.09 x 1.0309 = 106.28
Year 3	107.27 x 1.0357 = 111.10	106.28 x 1.0309 = 109.56
Year 4	111.10 x 1.0357 = 115.07	109.56 x 1.0309 = 112.95
Year 5	115.07 x 1.0357 = 119.18	112.95 x 1.0309 = 116.44
Year 6	119.18 x 1.0357 = 123.43	116.44 x 1.0309 = 120.04

Price-to-Free Cash Flow and Free Cash Flow Yield

A commonly used valuation indicator is the price-to-cash flow ratio. Although the term cash flow is used in a variety of ways, in this context it uses its more narrow definition of cash flow from operations minus capital expenditures (CAPEX). Free cash flow to the firm represents the cash flow that's available to the providers of capital, both bondholders and stockholders, after operating expenses have been covered. Cash flow from financing debt, preferred stock, and equity has a significant impact on asset valuation.

Later in this chapter, a more detailed examination and calculation of free cash flow to the firm and free cash flow to equity will be provided. Cash flow per share is different than earnings per share; therefore, in the context of price-to-cash flow, it's important to define the proper elements of cash flow. This section will use the definition of price-to-free cash flow to equity (FCFE) since it provides a standard valuation of the entitlement to common equity suppliers of capital and makes viable comparisons between different companies.

In order to calculate the price-to-free cash flow and the free cash flow yield, it will be assumed that the closing market price on the day of calculation is $29.60 and the free cash flow is $2.86. Therefore, the price-to-free-cash-flow ratio is 10.3 ($29.60 ÷ $2.86). The formula for free cash flow yield is free cash flow ÷ price ($2.86 ÷ $29.60 = 9.7%). The free cash flow yield is the reciprocal of the price-to-free-cash-flow ratio (1 ÷ 10.3 = 9.7%).

Notice that by using free cash flow to equity in the ratio, it has accounted for payments of both interest on debt and taxes. If free cash flow to the firm is being used, these items will need to be accounted for on a net of taxes basis.

Price-to-Sales Ratio

The formula for calculating the price-to-sales ratio is the market value of the equity divided by the sales (revenue) of a company, or the stock's current price divided by its revenue per share. The price-to-sales ratio is most appropriate when evaluating companies that are unprofitable, have low profit margins, or are start-ups, since these companies don't have a useful P/E ratio. Additionally, the ratio is not influenced by a firm's accounting decisions, such as depreciation, research and development expenses, and non-recurring items. *Keep in mind, the average price-to-sales ratio can vary substantially depending on the industry in which a company operates*.

Price-to-Book Value

The price-to-book (P/B) ratio is a measurement that examines the value the market places on the book value of a company. The formula for calculating the P/B ratio is the current price per share divided by the book value per share.

The formula for calculating traditional book value is:

$$\frac{\text{Shareholders' Equity}}{\text{Number of Shares Outstanding}}$$

The formula for calculating price-to-book value is:

$$\frac{\text{Share Price}}{\text{Book Value Per Share}}$$

This number is a simple multiple, much like the price-to-earnings ratio or the price-to-sales ratio. If the ratio is below 1.0, it suggests that the company is selling below its book value and, theoretically, below its liquidation value. Some value investors will ignore any companies that trade for more than two times their book value.

The price-to-book value ratio uses historical balance sheet numbers. The ratio is less volatile than earnings per share and tends to be a positive number. Additionally, book value is more stable in times of abnormal earnings and provides for comparisons over the long term. It's a good method for comparison when evaluating companies that traditionally hold high levels of liquid assets, such as insurance and banking institutions.

As is true for the P/E ratio, the lower the P/B ratio, the better the value. Value investors use a low P/B ratio in their stock selection screens in order to identify potential purchase candidates. This valuation measure was traditionally used for capital-intensive companies and industrial companies (e.g., factories) that have hard assets to back up their stock. Currently, this method provides a fairly representative measure in the valuation of financial institutions.

Enterprise Value-to-EBITDA

Another important valuation method is comparing the enterprise value (EV) of a company to its earnings before interest, taxes, depreciation, and amortization (EBITDA). Before examining this relationship, let's first define the two respective components and explain why they're used.

Enterprise Value

The enterprise value of a company is the real, tangible price at which it may be purchased. However, EV is not necessarily the amount that a buyer is willing to pay, or the amount that a seller is willing to accept. Instead, it's calculated by starting with the market capitalization of the common and preferred stock and adding the debt (both short- and long-term), finance leases, and non-controlling interest (formerly referred to as minority interest) and then subtracting cash and cash equivalents. This value represents the actual purchase price that a person may pay to acquire the company on the day of the calculation. Many professionals simply define EV as a company's equity value plus its net debt.

In return for buying a company, the purchaser will gain access to the cash and investments of the company. Any cash or cash equivalents that are carried on the books are of economic benefit to the purchaser and will serve as a reduction of the overall acquisition cost. Therefore, these items are subtracted from the real economic purchase price of the company when determining the enterprise value.

If a company either has cash and no debt or has less debt than cash, the enterprise value (EV) will be less than the firm's market capitalization. If a company has no cash, the EV will equal the market value of the stock plus the market value of its debt. If the company has less cash than debt, EV is greater than the company's market capitalization.

Calculating the Enterprise Value Use the following information to calculate the company's enterprise value (other than the stock price, all of the numbers are in millions):

Short-term Debt:	$ 3.0
Long-term Debt:	$ 12.5
Cash:	$ 5.7
Common Shares Outstanding:	5.8
Stock Price:	$18.00

The formula for calculating enterprise value is market capitalization plus debt (short-term and/or long-term), minus cash and cash equivalents.

EV = [(5.80 x $18.00) + $12.50 + $3.00] – $5.70

EV = $104.4 + $15.50 – $5.70 = **$114.20 million**

Calculating the Equity Value Per Share

The market value per share is able to be calculated if given the company's enterprise value, its debt, and its cash. Using the company above, the formula for calculating market value per share is the equity value of common shares divided by the number of common shares outstanding. (Equity value equals the enterprise value + cash) – (short-term + long-term debt).

MV per share = ($114.20 + $5.70) – ($12.5 + $3.00)

MV per share = $119.90 – $15.5 = **$104.40 million**

Therefore, the market value per share is clearly $18.00 ($104.40 ÷ 5.80).

Earnings Before Interest, Taxes, Depreciation, and Amortization The calculation of the earnings before interest, taxes, depreciation, and amortization (EBITDA) begins with net income from the profit and loss statement. Interest expense and taxes are added to provide pre-interest earnings which are necessary to allow for comparisons between companies that have different amounts of debt and that use different methods of accounting for debt service. Depreciation and amortization are added back to the computation in order to neutralize the effects of the different calculation methods across businesses. The EBITDA method provides an easier comparison between companies that have high depreciation and amortization expenses versus companies with low expenses.

By calculating the EV/EBITDA ratio, an investment banking representative now has a value for the overall company, rather than a value based exclusively on common stock. When viewed against the P/E ratio, EV/EBITDA may prove to be a more appropriate valuation. Since EPS is an after-interest figure that doesn't make adjustments for depreciation and amortization, it's difficult to compare one company to another. By using EBITDA, these elements are minimized or eliminated. In addition, there are times when EPS is a negative number which makes the P/E ratio invalid; however, the EBITDA is still a positive figure that may be used.

When comparing the EV/EBITDA ratio of two companies, a lower ratio may signal an undervalued company, while a higher ratio may represent an overpriced company. Ultimately, it's yet another useful tool for an investment banking representative to use when measuring valuation.

When calculating the new enterprise value of a company after an acquisition, it's important to know what method of funding was used. For example, let's assume that a company is acquired for $70,000,000. The purchaser's stock is trading at $25 per share and it intends to fund the acquisition by using 50% debt and 50% stock. In order to calculate the new enterprise value, add 1,400,000 shares ($35,000,000 ÷ $25) to the current outstanding shares of the acquiring company, multiply that amount by the market price per share (to calculate the new market capitalization), add the net debt (debt minus cash) of both companies, and then add the new debt ($35,000,000) that was issued to fund the acquisition.

Enterprise Value-to-Net Sales Another measurement that's used when comparing companies is the enterprise value-to-net sales. Net sales represent revenue after trade discounts, returns, allowances, and excise taxes. Although the EV/EBITDA ratio is a better tool for comparing companies that have different interest and depreciation expenses, by using net sales instead of EBITDA, an analyst eliminates the effects of different methods for calculating (or recognizing) operating expenses such as lease accounting, inventory valuation, and capitalizing costs. The EV-to-net sales ratio indicates the economic value of the company and its use of capital to generate sales. In other words, it permits an investment banking analyst to address the question—Does the company use its available capital to generate sales volume and revenue in a manner that's sufficient to maximize its profits? Once again, by using enterprise value rather than market capitalization, it excludes other accounting variables and makes the comparisons between different companies more viable.

Discounted Cash Flow (DCF)

Before we provide a detail discussion of DCF, the following terms need to be defined:

- *Net Present Value (NPV)* is the calculation which compares the projected cash flow to be earned from a project (using a present value calculation) to the cost of the project (using present value). In other words, NPV compares projected inflows (revenues) to outflows (expenses). A positive NPV exists if a project's inflows exceed its outflows. For example, if a person invests $1 million today (present value) and she receives a cumulative return over a five-year period, these cash inflows need to be discounted to their present value. If the total present value for the five years exceeds $1 million the project will have a positive NPV. One of the key components of NPV is the discount rate being used to calculate the present value of cash flows. The lower the discount rate used, the greater the present value.
- *The Internal, Rate of Return (IRR)* is the discount rate which matches the present value of inflows and outflows. In other words, it's the interest rate which makes the NPV equal to zero (i.e., the project's return is equal to the 10% required rate). If the NPV is positive, then the rate of return earned on the project (IRR) is greater than the discount required. However, if the NPV is negative, then the rate of return earned on the project (IRR) is less than the discount rate required. Net present value (NPV) is generally used to determine whether a project should be accepted, whereas the internal rate of return is generally used to compare different projects

As previously described, DCF values a company based on the present value of its expected cash flows. In order to calculate either the value of an entire firm (both equity and debt) or the equity value of the firm using DCF, an investment banking representative needs the following information:

- An estimate of the discount rate to apply to the cash flows in order to calculate the present value
- An estimate of the cash flows for a given period
- An estimate of the ending or terminal value
- A calculation of the enterprise value using the discount rate
- The calculation of the implied equity value by subtracting the net debt from the enterprise value

There are two methods for estimating the discount rate—the weighted average cost of capital (WACC) and the cost of equity. In order to decide which discount rate to use, an examination of the cash flows must be done. To value an entire firm, the free cash flow to the firm (FCFF) may be used with the WACC as the discount rate. The WACC is used since it evaluates the entire firm. The equity of a company is able to be determined using this method by valuing the entire firm and then subtracting the company's debt and preferred stock.

Another method that may be used is the free cash flow to equity (FCFE) with the cost of equity as the discount rate. To calculate the cost of equity, there are two different methods that may be used—the Capital Asset Pricing Model (CAPM) or the dividend growth model. Another DCF valuation method, referred to as the dividend discount model (DDM), uses the dividends as the cash flow. The next section will discuss all of these methods in detail; however, it's important to match the appropriate cash flows with the appropriate discount rate.

The following is a summary of the two main formulas:

Value of the Firm	Value of the Equity
$\frac{\text{Cash Flow to the Firm}}{1 + \text{WACC}}$	$\frac{\text{Cash Flow to Equity}}{1 + \text{Cost of Equity}}$

To calculate the value of a firm or its equity, the present value of each cash flow is added for the number of periods for which the cash flows are being estimated.

DCF Limitations DCF analysis has its limits; it's not a suitable metric to use when examining companies that have little or no sales. Additionally, if the expected rate of return or the size and timing of cash flows are not estimated correctly, the fair value result will be in error. Another potential bias in the valuation relates to the discount rate that's selected for the present value of the future cash flows. A discount rate that's too high or too low can alter the valuation of the company. An additional drawback of DCF analysis is the assumption of a constant (stable) capital structure (also referred to as constant WACC); however, some sophisticated analysts may attempt to model the potential capital structure changes that occur after the acquisition. As is true with any valuation metric, DCF analysis is only as good as its assumptions.

Cost of Capital

To estimate the discount rate, the cost of capital must first be found. The cost of capital may be viewed as the required rate of return that's necessary to enter into and finance corporate projects. A basic definition of the cost of capital is the *opportunity cost of the funds being employed as the result of a business decision*. When corporations enter into ongoing business activities and commit working capital to finance these projects, they lose the ability to invest elsewhere. Put another way, the cost of capital is the required rate of return on a capital commitment that will not change the earnings that are available to investors (i.e., common stockholders).

This section will examine the cost of capital for each of the components of capitalization that are made up of debt, preferred stock, and common stock. It will also evaluate the combined cost of capital for each of these components which is referred to as the weighted average cost of capital (WACC). Formulas will be utilized in order to calculate the cost of capital and to show the effect of taxation and selling expenses (flotation costs) on the required rate of return. Finally, this section will also examine the impact on a company's stock price when earnings and dividend payouts vary from expectations.

Pre-Tax Cost of Capital on Debt Issues

A corporation has decided to expand its business in order to increase its sales. To finance this expansion, the company intends to issue bonds with a $5,000,000 face value and a 6% coupon. This illustration will ignore the effects of taxation, selling expenses, and discounts to maturity. Due to the bond issuance, the corporation must pay $300,000 in interest expense each year.

To calculate the cost of capital on this debt issue, the following formula is used:

$$\text{Cost of Debt} = \frac{\text{Interest}}{\text{Principal}} = \frac{\$300,000}{\$5,000,000} = 6.0\%$$

In order to maintain the same amount of earnings available to the common shareholders, the company must increase its earnings by $300,000. If earnings are increased by more than the cost of capital, the project will be beneficial for the investors. However, if the earnings increase doesn't cover the cost of capital, the share price may trade lower to reflect the loss of earnings to the investors.

Later, the effects of taxation and flotation costs will be examined in the illustration. Without these added elements, the cost of capital on debt is simply the interest rate that's being paid on the borrowed money. In the illustration, the cost of debt is 6% ($300,000 ÷ $5,000,000). When the company borrows money and invests it, the earnings should equal the interest expense in order to cover the cost of capital. Using the previous example, consider the effect on the corporation if it's assumed that the company has $20,000,000 in sales before it issues the $5,000,000 in bonds and its operating costs are 80% of sales. As a result of the increased capital being employed by the company after the bonds are issued, its sales increased by $1,500,000 and sales expenses increase by $1,200,000.
The income statement of the company will reflect the following change:

	Before	After
Sales:	$ 20,000,000	$ 21,500,000
Operating Costs:	16,000,000	17,200,000
Earnings Before Interest Expense:	4,000,000	4,300,000
Interest Expense:		– 300,000
Earnings:	$ 4,000,000	$ 4,000,000

Since the expansion has covered the cost of capital, the earnings have remained unchanged. Other factors that will enter into the scenario and impact the decision-making process include the effects of taxation, future increases in earnings from the expanded base, and improvement of the company's status in its market sector. When other items are introduced such as flotation, underwriting fees, legal, accounting, and printing costs, the cost of capital is increased to cover these added expenses.
Assuming that the underwriting syndicate charged a 2.0% spread for distributing the bonds and the other expenses are ignored for illustration purposes, the cost of capital on the debt issue is now:

$$\text{Cost of Debt} = \frac{\text{Interest}}{\text{Proceeds}} = \frac{\$300,000}{\$4,900,000} = 6.12\%$$

In this example, if the earnings available to common stockholders increase by 6.0% as a result of the expansion, the price per share will theoretically decline since the cost of capital was not covered.

Pre-Tax Cost of Capital (Preferred Stock)

Rather than borrowing the necessary capital, a corporation may finance its capital projects by issuing equity securities in the form of preferred or common stock. The effects of preferred stock will be examined first since they have some similarities to debt instruments.

When dealing with preferred stock, some basic assumptions need to be made. First, let's assume that the par value of the preferred stock is $100 and that any dividend to be paid will be fixed as a percentage of its par value. Therefore, if a corporation issues 7% preferred stock, it's obligated to pay an annual dividend of $7.00 per share. In this respect, preferred stock is similar to a bond in that both the par value and income to the investor are predetermined at the time of issuance. However, a major difference is that the interest being paid on the bond is a pre-tax item on the company's income statement, while the dividend is an after-tax item. The illustration to follow will examine the effects of taxation on calculating the cost of capital.

When considering the pre-tax cost of capital on preferred stock, the yield on the investment must be calculated using the following formula:

$$\text{Cost of Preferred} = \frac{\text{Preferred Dividend}}{\text{Price of Preferred}} = \frac{\$7.00}{\$100.00} = 7.0\%$$

Once again, if flotation costs are incorporated into the calculation, the cost of capital will be increased. For example, if the underwriting fee on the preferred issue is 5%, the calculation is now:

$$\text{Cost of Preferred} = \frac{\$7.00}{\$95.00} = 7.37\%$$

Now, let's incorporate the tax ramifications and compare an issuance of preferred stock to an issuance of debt instruments. If the corporation is in the 21% tax bracket and borrows $1,000,000 at 7%, it will need to pay interest expense of $70,000 per year. On the other hand, if it issues $1,000,000 of 7% preferred stock, it will need to pay $70,000 in dividends each year. However, remember, the bond interest expense is a pre-tax entry, while the dividend is an after-tax entry on the books of the company. Below is a comparison to show the impact to the cost of capital:

	Common Only	Debt	Preferred
Earnings Before Interest and Taxes (EBIT)	$ 4,000,000	$ 4,070,000	$ 4,070,000
Interest Expense	—	$ 70,000	—
Earnings Before Taxes	$ 4,000,000	$ 4,000,000	$ 4,070,000
Taxes at 21%	$ 840,000	$ 840,000	$ 854,700
Preferred Dividends	—	—	$ 70,000
Earnings Available to Common	$ 3,160,000	$ 3,160,000	$ 3,145,300

Notice that in the computation, the pre-tax cost of capital is 7% when financed with debt. However, when financed with an issuance of preferred stock, the pre-tax requirement exceeds 7%. In order to make that determination, the following formula may be used:

$$\text{Pre-Tax Cost of Capital} = \frac{\text{Preferred Dividend}}{(1.0 - \text{Tax Rate \%})} = \frac{7.0\%}{79\%} = 8.86\%$$

In the illustration above, the required increase in EBIT is determined by multiplying the proceeds of the issuance by the pre-tax cost of capital percentage ($1,000,000 x 8.86% = $88,600).

$$\text{Pre-Tax Cost of Capital} = \frac{\$70,000}{79\%} = \$88,608$$

In order to cover the cost of the $70,000 preferred dividend, the company must increase its EBIT by $88,608. Once again, let's analyze the comparison between the debt financed figures and the preferred stock financed cost of capital; however, the summary below uses the adjusted preferred stock calculation:

	Debt	Preferred
Earnings Before Interest and Taxes (EBIT)	$ 4,070,000	$ 4,088,608
Interest Expense	$ 70,000	—
Earnings Before Taxes	$ 4,000,000	$ 4,088,608
Taxes at 21%	$ 840,000	$ 858,608
Preferred Dividends	—	$ 70,000
Earnings Available to Common	$ 3,160,000	$ 3,160,000

After-Tax Cost of Capital

Another method to determine the necessary increase in EBIT is to base it on the after-tax cost of capital. In fact, shareholders are usually more interested in the after-tax figures than in the pre-tax numbers. Ultimately, the after-tax figure represents what the shareholders are entitled to after the project decision has been made.

Since the dividend is an after-tax number, the cost of capital on the preferred stock issuance is 7.0%. However, the pre-tax cost of the bond issuance is 7%; therefore, the after-tax cost of capital will be somewhat less than 7.0%. The formula to determine the after-tax cost of capital on debt is:

After-Tax Cost of Debt = (Pre-Tax Cost) x (1.0 – Tax Rate %)

After-Tax Cost of Debt = 7.0% x 79% = 5.53%

Using the after-tax cost of both the preferred and debt issuances, let's calculate the required increase in EBIT. The necessary increase in EBIT is equal to the proceeds of the issue multiplied by the after-tax cost of the issue.

$$\frac{\text{(Proceeds x After-Tax Cost)}}{\text{(1.0 – Tax Rate \%)}}$$

In the preferred issuance, the calculation is:

$$\frac{\text{(\$1,000,000 x 7.0\%)}}{\text{(1.0 – 21\%)}} = \frac{\$70{,}000}{79\%} = \$88{,}608$$

For the bond issue, the calculation is:

$$\frac{\text{(\$1,000,000 x 5.53\%)}}{\text{(1.0 – 21\%)}} = \frac{\$55{,}300}{79\%} = \$70{,}000$$

Once again, these calculations indicate the required increase in EBIT; however, the approach is from the after-tax standpoint rather than from the pre-tax number. Regardless of which approach is used, the required increase in EBIT is the same.

Cost of Equity Capital

The last element in the discussion on the cost of capital will relate to the equity portion of the balance sheet. For illustration purposes, common stock and retained earnings of the corporation will both be considered as the equity. The preferred stock issuance will be ignored since it was presented in the previous section. The illustrations presented in this section that relate to retained earnings will represent the current period retained earnings figure as found on the income statement. However, this should not be confused with the life-to-date numbers that are found on the balance sheet. The discussion will focus on the concept that equity is generated in two ways—either by increasing retained earnings or by issuing new shares of common stock.

Subsequently, there are two methods that are commonly used to determine the cost of equity capital —the capital asset pricing model (CAPM) and the dividend growth model (DGM).

Capital Asset Pricing Model

The Capital Asset Pricing Model (CAPM) is an important tool to use when analyzing the relationship between risk and rates of return. CAPM considers three variables to calculate the cost of equity—the risk-free rate (usually on a Treasury security), the expected return of the market (usually the S&P 500 Index), and a company's non-diversifiable risk or beta (β). The model is based on the proposition that a company's rate of return is equal to the risk-free rate plus the risk premium of the stock. (Some market professionals suggest that the *risk premium* is equal to the difference between the expected return of the market and the risk-free rate.)

For example, if the β is 1.06, the expected market return is 9.76%, and the risk-free rate is 3.35%, then the expected return is calculated as follows:

$$R_S = R_{RF} + [(R_M - R_{RF}) \times \beta]$$

In the formula:
- R_S = the required rate of return (cost of equity)
- R_M = the expected return of the market
- R_{RF} = the risk-free rate
- β = (beta) a measure of the sensitivity of the firm's stock returns relative to those of the market assuming the absence of diversifiable risk

$R_S = 3.35 + [(9.76 - 3.35) \times 1.06]$
$R_S = 10.14\%$

Changing Variables If the risk-free rate increases while the excess market return (expected market return minus the risk-free rate) remains stable, a company that has a beta of less than 1.0 will experience an increase in the cost of equity. This will have a negative effect on the valuation of the company since the WACC will increase. For example, if the expected return of the market is 9% and the risk-free rate is 3%, according to the Capital Asset Pricing Model, a company with a beta of .65 will have an equity cost of capital of 6.9%.

Expected return of the market	–	Risk-free rate	=	Excess market return
9%	–	3%	=	6%

(Excess market return x beta) + risk-free rate
= (6% x .65) + 3%
= 3.9% + 3%
= 6.9%

If the risk-free rate increases to 4% and the expected market return remains at 9%, the equity cost of capital will increase to 7.25%. The result is an increase to the WACC of the company and a negative impact on the valuation of the company.

Expected return of the market	–	Risk-free rate	=	Excess market return
9%	–	4%	=	5%

(Excess market return x beta) + risk-free rate
= (5% x .65) + 4%
= 3.25% + 4%
= 7.25%

The opposite is true if the risk-free rate increases, but the market return remains stable and the beta is greater than 1.0. In this situation, the cost of equity capital will decrease.

Calculating a Levered Beta if Given an Unlevered Beta Levered beta is the beta that contains the effect of the capital structure (the debt and equity). The unlevered beta is the beta of a company without debt. An unlevered beta removes the financial effects of leverage. In general, the more debt a firm takes on, the higher the beta for the equity. Unlevered beta is the beta after removing the effects of the capital structure.

The formulas to lever or unlever a beta are as follows:

- Unlevered beta = $\dfrac{\text{levered beta}}{(1 + [(1 - \text{tax rate}) \times (\text{debt/equity})]}$

- Levered beta = unlevered beta x (1 + [(1 - tax rate) x (debt/equity)])

In order to calculate the levered beta when the unlevered beta is 1.2, the debt/equity ratio is 35%, and the tax rate is 21%, the formula is applied as follows:

The levered beta = 1.2 x (1 + [(1 - 21%) x (35%)])
= 1.2 x [1 + (.79 x .35)]
= 1.2 x [1 + (.277)]
= 1.2 x 1.277 = 1.53

Dividend Growth Model

Cost of Equity Created by Retained Earnings When investors purchase a corporation's common stock, their expectation is that they will receive a rate of return on their investment. The expected rate of return is derived from dividends and the appreciation in their stock holdings. Later in this chapter, there will be a discussion of the process of valuing common stock based on dividends. For this example, a constant growth rate will be used. The formula for calculating the required rate of return is as follows:

$$k^* = \frac{D_1}{P_0} + g$$

In the formula:
- k^* = the required rate of return (cost of equity)
- D_1 = the dividend to be paid at the end of the year
- P_0 = the current market price (at time 0)
- g = the growth rate per year

To illustrate the formula, let's use a manufacturing corporation whose earnings per share figures for the year are expected to be $4.60. Historically, the company has paid an annual dividend of $1.15 and its earnings, dividends, and share price have been growing at approximately 4% per year, with the expectation that this trend will continue. The current market price of the corporation's common stock is $40.00 per share. The firm's next dividend is expected to be $1.20 ($1.15 x 1.04 = 1.196, rounded to $1.20).

Using this information, let's determine the expected rate of cost of equity for the corporation:

$$k^* = \frac{\$1.20}{\$40.00} + 4\%$$

$$k^* = 3\% + 4\% = 7.0\%$$

The expectation for the increase in price should be from $40.00 to $41.60—an increase of 4.0%. If the company invests the amount that it did not pay in dividends and doesn't earn the required rate of return (7.0%), the value of the stock should decrease. For example, if the $3.40 of retained earnings ($4.60 - $1.20) is invested and earns only 3.5%, investors will not achieve their expectations.

Theoretically, the stock's price will be reduced as follows:

$$P_0 = \frac{D_1}{k^* - g}$$

$$P_0 = \frac{\$1.20}{7\% - 3.5\%} = \frac{\$1.20}{3.5\%} = \$34.29$$

It's important to note that when the firm acquires new equity in the form of retained earnings, it must invest that equity in operations at the required rate of return. If it doesn't earn the required rate of return, the theoretical share price will fall. Conversely, if it invests at greater than the required rate of return, the theoretical price will rise.

Cost of Equity Created by a New Issue of Stock If a corporation intends to create additional equity through a new issuance of common stock, the cost of capital will be higher than through retained earnings. The reason for this is that there are underwriting fees associated with the distribution of the new issue. The cost of capital on the new issue will need to cover the flotation costs. To calculate the required rate of return on the cost of capital for a new issue, the following formula is used:

$$k^* = \frac{D_1}{P_0 (1 - F)} + g$$

In this formula, F represents the underwriting fee as a percentage of the sales price and, therefore, (1 – F) represents the net sales proceeds to the issuer. Remember, the equation is based on a constant growth rate.

Let's assume that the new issuance of stock will be sold to the public at $40 per share, with the underwriters charging a 5% underwriting fee. Using the previous assumptions for earnings, dividends, and growth, the required rate of return may be determined as follows:

$$k^* = \frac{\$1.20}{\$40 (1.0 - 5\%)} + 4\%$$

$$k^* = \frac{\$1.20}{\$38.00} + 4\%$$

$$k^* = 3.16\% + 4\% = 7.16\%$$

The additional cost of capital of .16% (7.16% – 7.00%) is necessary in order to cover the cost of flotation. If the capital projects that are financed by the new issuance are able to earn 7.16%, the dividends and growth of the company may be expected to continue with the share price not declining.

Weighted Average Cost of Capital (WACC)

As evidenced, the different components of capital—debt, preferred, and common stock—each have different required rates of return in order to maintain projected dividend payouts and growth in the company. Since many companies will raise capital through various methods, the weighted average cost of capital provides an appropriate valuation for all of these methods.

For example, let's assume that ABC Corporation's cost of debt is 5% and its cost of equity is 8%. Logic suggests that the company should finance future capital projects through the use of debt at 5%; however, there's an inherent consideration that will make the use of debt inappropriate for all future capital projects. When the firm issues debt, the debt-to-equity ratio changes and, if the company continues to finance future projects with debt, it will at some point incur too much leverage and be unable to issue additional debt. At that point, the firm will be forced to finance projects through equity.

For illustration purposes, if ABC Corporation finances next year's projects by issuing 5% debt and earns 6.5% on these projects, it has used up some of its ability to finance further projects with debt due to the increase in the debt-to-equity ratio. In ensuing years, it must begin to use equity with a cost of equity of 8%. If it's only able to earn 6.5% on these projects, it will not meet the required rate of return and its share price will decline. When considering this change in debt-to-equity ratio, the company must combine the two financing methods and weight them to their proper percentages.

To illustrate the method for determining the weighted average cost of capital, the following assumptions are made to simplify the calculations:

After-Tax Cost of Capital	
Debt	5.0%
Preferred stock	6.5%
Equity	7.0%

ABC's balance sheet shows the following debt and equity items:

	Balance Sheet	Percentage
Debt	$19,200,000	32%
Preferred	$ 4,800,000	8%
Equity	$36,000,000	60%
Total	$60,000,000	100%

To calculate the weighted average cost of capital, the component cost of capital is multiplied by the percentage of existing capital as follows:

	Balance Sheet	Percentage		Cost of Capital		Weighted Average
Debt	$19,200,000	32%	x	5.0%	=	1.60%
Preferred	$ 4,800,000	8%	x	6.5%	=	.52%
Equity	$36,000,000	60%	x	7.0%	=	4.20%
Total	$60,000,000	100%				6.32%

The weighted average cost of capital to the firm is 6.32%.

The various components are now brought together in their respective elemental costs of capital to represent proper financing without a detrimental effect on investor expectations.

Remember, when calculating the required rate of return on debt, the after-tax rate must be used; therefore, the pre-tax rate is multiplied by (1.00 – the tax rate %) to determine the after-tax rate. Return on equity requires no such adjustment since the payments being made to shareholders in the form of cash dividends are after-tax. Most market professionals use the CAPM as the cost of equity when calculating the WACC.

In some instances, a company's debt-to-equity ratio may be provided in order to calculate the WACC. However, to properly calculate the WACC, a person must know the percentage of a company's capital that represents debt and equity.

For example, let's assume that a company has $40 million in debt and $100 million in equity. The debt-to-equity ratio is 40% ($40 million ÷ $100 million), with the total capitalization of the company at $140 million ($40 million + $100 million).

The percentage of debt or equity to total capital may be calculated as follows:

$$\text{Debt Percentage of Total Capital} = \frac{\$40 \text{ million}}{\$140 \text{ million}} = 28.57\%$$

$$\text{Equity Percentage of Total Capital} = \frac{\$100 \text{ million}}{\$140 \text{ million}} = 71.43\%$$

An alternative way to convert the debt-to-equity ratio into the debt-to-capital is:

$$\text{Debt-to-Capital (Weight of Debt)} = \frac{\text{Debt-to-Equity Ratio}}{(100\% + \text{Debt-to-Equity Ratio})}$$

If the ratio above is used, the weight of equity will be:

$$\text{Weight of Equity} = \frac{100\%}{(100\% + \text{Debt-to-Equity Ratio})}$$

For example, if a company has a debt-to-equity ratio of 40%, the weight of debt and equity can be calculated as follows:

$$\text{Debt-to-Total Capital (Weight of Debt)} = \frac{40\%}{(100\% + 40\%)} = \frac{40\%}{140\%} = 28.57\%$$

$$\text{Weight of Equity} = \frac{100\%}{(100\% + 40\%)} = \frac{100\%}{140\%} = 71.43\%$$

If the company issues additional debt, the WACC will decline since the cost of debt is generally cheaper than the cost of equity. In addition, if a company replaces its debt with preferred stock, the WACC will increase since there's a tax shield (tax advantage) associated with debt. Interest on debt is tax-deductible, while preferred stock dividends are paid with after-tax dollars. For example, if the tax rate is 21% and the pre-tax cost of debt is 8.50%, the after-tax cost of debt is 6.72% (8.50 x [1 – 21%]).

Estimating Cash Flows

Free Cash Flow

Earlier in this chapter, free cash flow was defined as cash flow from operations less capital expenditures (CAPEX). This concept indicates that not all of the cash flow from operations is available for free use by bondholders and stockholders. The underlying requirement is that some of the cash flow from operations must be used to reinvest in operating activities or to purchase new equipment in order to maintain present production capacity. Without committing certain amounts of cash flow to ongoing operations, the company is unable to maintain its existing capacities and cannot take advantage of opportunities to expand or increase its capacities.

Therefore, the actual definition of free cash flow to the firm is the cash flow from operations that's available to providers of capital (bondholders and stockholders) after operating expenses have been covered. Operating expenses include working capital (investments in inventory), fixed capital (investment in new equipment or maintenance costs on existing equipment), and the payment of taxes.

Calculation of Free Cash Flow In the calculation of free cash flow to the firm (FCFF), depreciation and amortization are added to earnings before deducting interest and taxes (EBIT). This level of cash flow is reduced by capital expenditures. If working capital has increased, the free cash flow to the firm is reduced by this change; however, if working capital has declined, the change is added. In some cases, the tax rate of the company is given and, therefore, a person must multiply EBIT by (1.00 minus the tax rate %). In this context, working capital refers to non-cash related current assets minus non-cash related current liabilities.

Other methods of calculating free cash flow are:

1. EBITDA – taxes – CAPEX +/- changes in working capital, or
2. EBIT – taxes – net CAPEX (CAPEX – depreciation) +/- changes in working capital

Both formulas take into consideration taxes and interest expense. If a firm is unleveraged (i.e., has no debt), the formula is net income + depreciation – CAPEX +/- changes in working capital. For valuation purposes, regardless of whether free cash flow to the firm (FCFF) or free cash flow to equity (FCFE) is used, both models approach valuation from the standpoint that the value is determined by the present value of future cash flows to the firm or to its equity shareholders. In the FCFF model, the debt holders are included since they're contributors of capital to the firm; however, in the FCFE model, the interest on the debt is excluded.

Calculation of FCFF
EBIT x (1.00 – tax rate %)
+ Depreciation and Amortization
– Capital Expenditures
± Changes in Working Capital
Free Cash Flow to the Firm (FCFF)

Calculation of FCFE
Net Income
+ Depreciation and Amortization
– Capital Expenditures
± Changes in Working Capital
Free Cash Flow to Equity (FCFE)

Use the following information to compare FCFF and FCFE:

The Medical Supply Company Selected Financial Data (in millions $)	
EBIT	392.2
Interest Expense	82.0
Taxes	65.14
Net Income	245.1
Depreciation and Amortization	87.5
Capital Expenditures	114.7
Working Capital Changes (increase)	20.5
Tax Rate of 21%	

EBIT x (1.00 – tax rate %)	309.84
+ Depreciation and Amortization	87.5
– Capital Expenditures	114.7
± Changes in Working Capital	– 20.5
Free Cash Flow to the Firm (FCFF)	262.14

Net Income	245.1
+ Depreciation and Amortization	87.5
– Capital Expenditures	114.7
± Changes in Working Capital	– 20.5
Free Cash Flow to Equity (FCFE)	197.4

Present Value of Free Cash Flow

In the free cash flow to the firm approach, a firm is valued based on the present value of future cash flows that are discounted at the weighted average cost of capital. Free cash flow to the firm is defined as the cash flow from operations minus capital expenditures. When using FCFF, the WACC is the discount rate and the following formula is applied:

$$\text{Firm Value} = \sum_{t=1} \frac{FCFF_t}{(1 + WACC)^t}$$

By using free cash flow to the firm and the weighted average cost of capital, a value is derived for both the debt and equity holders of the company. To calculate the equity value, the market value of debt is deducted from the firm value. Another method that may be used to calculate the equity value is to discount the FCFE by the cost of equity.

As an example that uses the previous formula, the free cash flow to the firm will be calculated based on the following assumptions:

1. A corporation's balance sheet indicates that it has issued $2,000,000 of 10-year bonds that have a current market value of $1,800,000 and it also has 2,000,000 shares of common stock outstanding.
2. In reviewing the income statement, the calculation for free cash flow to the firm for the period is $8,000,000 and the weighted average cost of capital is 6.32%.

The value of the firm is calculated in terms of the present value of the future free cash flows to the firm. Let's consider an example using simply a one-year period.

$$\text{Firm Value} = \frac{\$8,000,000}{(1 + .0632)} = \$7,524,454$$

If either the FCFF or the WACC are altered, the firm valuation will change. For example, if depreciation is increased or capital expenditures are decreased, it will cause the FCFF to increase. If the cost of equity or debt increases (due to rising interest rates or a declining credit rating), the firm's WACC will increase. If the FCFF increases or the WACC decreases, the valuation will increase. Conversely, if the FCFF decreases or the WACC increases, the valuation will decrease.

To determine the free cash flow to the equity owners of the company, the market value of the outstanding debt is deducted; therefore, the value of equity is equal to:

$$\text{Equity Value} = \text{Firm value} - \text{Market Value of Debt}$$

From the example, equity value is $5,724,454 ($7,524,454 – $1,800,000). To find the value per share of equity, the $5,724,454 is divided by the 2,000,000 shares outstanding to arrive at a value per share of equity of $2.86.

As previously mentioned, an alternative approach that should provide a similar number for the value of the equity may be derived by using the following formula:

$$\text{Equity Value} = \frac{\text{FCFE}}{(1 + \text{Cost of Equity})}$$

Terminal Value In a discounted cash flow analysis, the cash flows are projected each year into the future for a certain number of years. At some point, rather than projecting future cash flows, a single value representing the discounted value of all future cash flows is used. This is referred to as the terminal value and may represent a significant component of an asset's valuation.

The value may be calculated based on the liquidation value of an asset or based on a company continuing its business as an ongoing concern. In the case of valuing common stock of an ongoing concern, an investment banking representative will use either a multiple of comparable firms (terminal multiple) or the perpetual growth method (DCF method).

The terminal multiple is the easier method and is based on a relative valuation—usually determined by enterprise value-to-EBITDA for similar companies or similar transactions in a merger analysis. Using this method, the terminal multiple (EV/EBITDA) is multiplied by the last projected cash flows

The perpetual growth method assumes the final year's cash flow (e.g., EBITDA) will grow at a fixed rate forever. The formula to calculate the perpetual growth method is:

$$\text{Terminal Value} = \frac{\text{Expected Cash Flow}_n \times (1 + \text{Terminal Growth Rate})}{(\text{Discount Rate} - \text{Terminal Growth Rate})}$$

In the formula above, the expected cash flow is typically a projection of the EBITDA in the final year of an analyst's DCF model. The terminal growth rate is the estimated growth the company can maintain in perpetuity (i.e., forever). The discount rate is the company's WACC that's used in the DCF model. An increase in this growth rate, or a reduction in the discount rate, will result in higher terminal value and, therefore, a higher valuation.

Calculating the Firm or Enterprise Value By combining the present values of the cash flows for a certain period and adding this amount to the present value of the terminal value, the firm or enterprise value is able to be determined.

The following formula is used to calculate firm value:

$$\text{Firm Value} = \frac{\text{Cash Flows for Each Period}}{(1 + \text{WACC})} + \frac{\text{Terminal Value}}{(1 + \text{WACC})}$$

Let's use the following information to calculate the equity value per share:

Projected Free Cash Flow to the Firm	
Year 1	$ 32,500
Year 2	$ 34,700
Year 3	$ 39,600
Year 4	$ 43,500
Terminal Value	$380,000

- The WACC is 11%.
- The company has cash of $50,000 and debt of $100,000.
- The company has 25,000 shares of common stock outstanding.

The discounted cash flow (DCF) method is used to calculate the present value of the firm's enterprise value (EV) and is determined by using the free cash flow to the firm (FCFF) divided by (1.00 + WACC). To determine the total present value of the company, it's necessary to discount each period's cash flow and to add the present value of the terminal value. The discount rate is applied (1 + WACC) and must be adjusted for each subsequent period. To determine the equity value of the company, cash is added to the total present value of the company and debt is subtracted. The implied equity value of the company is divided by the number of common shares outstanding to determine the implied equity value per share.

	FCFF	Divided By	Present Value
Year 1	32,500	$(1 + .11) = 32,500 \div 1.110 =$	$ 29,279
Year 2	34,700	$(1 + .11)^2 = 34,700 \div 1.232 =$	$ 28,165
Year 3	39,600	$(1 + .11)^3 = 39,600 \div 1.367 =$	$ 28,968
Year 4	43,500	$(1 + .11)^4 = 43,500 \div 1.518 =$	$ 28,656
Terminal Value	380,000	$(1 + .11)^4 = 380,000 \div 1.518 =$	$ 250,329
Total Present Value			$ 365,397
Plus Cash			$ 50,000
Minus Debt			($100,000)
Total Implied Equity Value			$ 315,397

Therefore, the total implied equity value per share is $12.61 ($315,397 ÷ 25,000).

Since discounting several years of cash flows with a simple calculator is tedious, two simplified version that are based on the perpetual growth method may be tested on the exam. In these questions, based on the variables given, the terminal value is used as an estimate of the enterprise or company value.

Shown below are the formulas to be used:

$$\text{Enterprise Value (EV Perpetuity Method)} = \frac{\text{Cash Flow x (1 + g)}}{\text{Discount rate – Growth rate}}$$

For example, a corporation has an expected long-term growth rate of 3% and cost of capital of 8%. If the company's cash flow is expected to be $20 million, the EV can be calculated as follows:

$$\text{EV Perpetuity Method} = \frac{\$20 \text{ million x } (1 + 3\%)}{(8\% - 3\%)} = \frac{\$20 \text{ million x } 1.03}{5\%} = \$412 \text{ million}$$

The other formula is referred to as the Net Present Value and is calculated as follows:

$$\text{Net Present Value} = \frac{\text{Annual Cash Flow in Perpetuity}}{\text{WACC}}$$

For example, a corporation with $50 million of annual cash flows in perpetuity and a WACC of 10% will have a net present value of $500 million ($59 million ÷ 10%).

Multistage Dividend Discount Model

When investors buy stock in a corporation, they become equity owners of a portion of that company. The expectation for these investors is that they will earn a return on their investment based on the risk being assumed. As the company engages in its normal business operations, it will generate cash flows in various forms, and as owners of the company, the investors have a reasonable expectation that they will receive some of the cash flows in the form of dividends. Since this is the case, it's logical then to examine the valuation of common stock in the form of its expected dividends. However, the expected dividends must be discounted to their present value. To examine the value of future cash flows, this section will concentrate on the dividend discount model.

Discounted Dividends According to one stock valuation technique, the value of a stock is equal to the present value of the expected future dividends. This valuation model assumes that investors buy stock solely for dividends and desire a current return. If an investor holds a stock for 10 years, the dividends over those 10 years and the terminal value that's received at the liquidation of the shares are discounted.

The general formula for this dividend model is:

$$P_0 = \frac{d_1}{(1 + k)} + \frac{d_2}{(1 + k)^2} + \ldots + \frac{d_n}{(1 + k)^n}$$

In the formula:
- P_0 = the value of the stock today (also considered the stock's intrinsic value)
- $d_1, d_2, \ldots d_n$ = the expected annual dividend stream
- k = the discount rate consistent with the uncertainty of the dividend estimates

Zero Growth Model The dividend rate reflects the risk-free rate plus a risk premium to account for uncertainty. In theory, this rate should rise over time. The model may be altered to account for dividend streams that remain constant (zero growth case), that grow at a constant rate, or that grow at a variable rate.

The zero-growth case is relevant for preferred stocks or very mature companies, such as electric and gas utilities. For these issues, the market prices cannot be separated from their dividends, and the stocks are frequently purchased for their current yield.

Therefore, the formula reduces to:

$$P_0 = \frac{d}{k}$$

In the constant growth case, where g is the rate of growth, the formula for the stock's expected total return reduces to:

$$k = \frac{d_1}{P_0} + g$$

If a stock's expected dividend is $2, its current market price is $40, and its expected growth rate is 5% per year, the expected return is:

$$k = \frac{\$2}{\$40} + .05$$

$$k = .10$$

In the constant growth case, the formula for the stock's expected total return may be simplified to:

$$P_0 = \frac{d_1}{(k - g)}$$

If a stock's projected dividend is $3, k is 10%, and g is 7%, at what price should the stock currently be trading? By applying the above formula, $3 divided by 3% = $100. The projected dividend one year forward is used.

For practical purposes, consider the following application:

XYZ Company	
	Current:
Dividends:	$1.10
EPS	$2.20
Return on Equity:	8.0%
Equity Cost of Capital:	7.5%

The requirement to define the variables in the denominator presents a challenge; therefore, to determine the intrinsic value of the company, it's first necessary to calculate the company's growth rate using the formula:

$$g = b \times ROE$$

In the formula:
- g = the dividend growth rate
- b = the earnings retention rate (the complement of the dividend payout ratio)
- ROE = the return on equity

The amount by which a company grows is based on reinvested earnings or the ROE multiplied by its retention ratio. The dividend payout ratio is 50% ($1.10 ÷ $2.20); therefore, the retention rate is 50%.

Let's determine growth rate: $g = 50\% \times 8.0\% = 4\%$

Constant Growth Model (Gordon Growth Model) Using the calculated growth rate, the next dividend (d_1) may be determined:

$d_1 = D_0 \times (1 + g)$
$d_1 = \$1.10 \times (1.0 + 4\%)$
$d_1 = \$1.14$

Next, the price may be determined by using the Gordon Growth Model.

$$P_0 = \frac{d_1}{(k - g)}$$

In the formula:
P_0 = the value of the company
d_1 = the dividend in the next period
k = the equity cost of capital
g = the growth rate

$$P_0 = \frac{\$1.14}{(7.5\% - 4\%)} = \frac{\$1.14}{3.5\%} = \$32.57$$

Since a current price has been projected, the P/E ratio may be estimated as 14.80 ($32.57 ÷ $2.20).

As evidenced, correctly utilizing the dividend discount model presents various challenges to an analyst. The primary questions that are raised include:

1. What dividend discount model should be used for a given company, the multi-stage dividend discount model, the zero-growth model or the Gordon Growth Model?
2. What method will be used to forecast dividends?
3. What rate of return should be used to discount cash flows to the present?

In addition, if the analytical approach considers earnings distributions in the form of dividends to be the primary reason for investment, what about earnings that are not distributed? Corporate earnings that are not distributed (retained earnings) are the basis for future expansion of the company and provide for ongoing payments of dividends. Therefore, the dividend discount model must consider all future dividend payments including those that are based on reinvested earnings.

Due to this consideration, the dividend discount model may be less sensitive to short-term fluctuations of value than other discounted cash flow models. Consequently, the dividend discount model is considered to reflect longer-term values.

Additional DCF Applications

Free cash flow analysis may also be used to calculate the amount of additional leverage or borrowing that a company is able to incur. This valuation technique is especially useful for financial buyers, such as leveraged buyout (LBO) firms.

Since free cash flow to the firm equals the cash that a company has available after paying its operating expenses and capital expenditures, the present value for the company's cash flows for the payback period may be used as a proxy to estimate the additional amount of debt that the company can incur. The after-tax cost of debt is used as the discount rate. A company with high free cash flow has the capacity to issue additional debt.

Economic Value Added (EVA) or Economic Profit

When making decisions on whether to commit capital to produce revenue (e.g., adding a new product offering), an important tool in the decision-making process is economic profit. Economic profit differs from accounting profit in that it not only takes into consideration the cost of capital (i.e., the profit from adding a new product), but also profit above the expected returns on the capital expenditure. Therefore, economic profit is a measure of adding value to the corporation.

Economic value added can be summarized as:

EVA = Accounting Profit – Opportunity Costs

The accounting profit is a simplified version of the income statement and typically takes the gross revenues from a project and deducts the explicit operating costs of a project. The opportunity costs are implicit costs of making alternative decisions. For example, rather than creating a new product, a company could just invest their cash in U.S. Treasury bonds. If capital commitments produce positive accounting profits, but negative economic profits, it means the money could be better invested elsewhere.

For example, if Treasury bills are currently yielding 5%, any allocation of capital will require a return exceeding 5% since T-bills are considered riskless investments. A return of 6% or 7% may be appropriate; however, it still must be compared to other investments. If a capital investment is made in a start-up company versus a well-established company, the expected return for the start-up company will logically be higher than for the established company. If the return on both investments is 11%, the decision should be made in favor of the established company, because it has reduced risk for the same return.

On the exam, the WACC is often used to estimate the opportunity costs of making an investment of capital. The after-tax EBIT [EBIT x (1 – Tax Rate%)] can be used to represent accounting profits. Therefore, the economic profit formula can be restated as:

Economic Profit (EVA) = [EBIT x (1 – Tax Rate%)] – [WACC x Investment Capital]

Remember, return on invested capital (ROIC) is {EBIT x (1 – Tax Rate%)]/Investment Capital. If the ROIC is greater than the WACC, the investment will have a positive economic value added. In other words, the return on the capital investment exceeds the costs. If the ROIC is less than the WACC, the economic profit is negative and the capital investment should not be made.

Let's consider an example of a small boutique brewery that produces and sells approximately 20,000 barrels of beer annually. It sells to the custom market and its wholesale price is $80.00 per barrel. Costs of production and distribution are $56.00 per barrel, the brewery has fixed costs of $150,000 per year, and shareholder investment in the company is $3,000,000. If the firm's marginal tax rate is 25% and the WACC is estimated to be 8%, what's the economic value added?

Current Production

Revenue		
Sales: 20,000 barrels x $80.00		$1,600,000
Cost of Goods		
Sunk Costs *		$ 150,000
Variable Costs: 20,000 x $56.00		$1,120,000
	Total Costs:	$1,270,000
Operating (Accounting) Profit		$ 330,000

Economic Value Added (EVA) = EBIT x (1 – Tax Rate%) – [WACC x Investment Capital]
EVA = $330,00 x (1 – 25%) – {8% x $3,000,000]
EVA = $247,500 - $240,000 = $7,500

Since the EVA is positive, the brewery is providing an economic value to its shareholders. The same conclusion could also be reached by calculating the ROIC ($247,500/$3,000,000 = 8.25%) and comparing it with the brewery's WACC (8%). Since the ROIC is greater than the WACC, there's economic value added.

Due to the increased popularity of its product, the company has the opportunity to expand its business and double production to 40,000 barrels. However, in order to facilitate the increased production, a capital expenditure of $500,000 in the next year must be made in additional plant facilities and equipment. If the marginal tax rate is 25% and the WACC is 8%, will the expansion add economic value?

Expanded Production

Revenue		
Sales: 40,000 barrels x $80.00		$3,200,000
Cost of Goods		
Sunk Costs *		$ 150,000
Variable Costs: 40,000 x $56.00		$2,240,000
	Total Costs:	$2,390,000
Additional Capital Contribution		$ 500,000
Accounting (Operating) Profit		$ 310,000

Let's consider the change in economic value to the producers of capital:

Economic Value Added (EVA) = EBIT x (1 – Tax Rate%) – [WACC x Investment Capital]
EVA = $310,00 x (1 – 25%) – [8% x $3,000,000]
EVA = $232,500 – $240,000 = ($7,500)

Since the EVA is negative, the brewery is not providing economic value for its shareholders. This same conclusion could also have been reached by calculating the ROIC ($232,500/$3,000,000 = 7.75%) and comparing it with the brewery's WACC (8%). Since the ROIC is less than the WACC, the firm is losing economic value. In other words, the added revenue is not enough to cover the opportunity costs and the capital investment should not be taken.

Sum-of-the-Parts Analysis

As valuation techniques are examined from the viewpoint of the providers of capital, the most important question to be answered is—what's the return on the investment? Whether using discounted cash flow, price ratios, free cash flow, or enterprise value, investors are always seeking an appropriate return for the risk being assumed. Additional concerns arise in regard to opportunity cost (e.g., whether the assets that are being allocated to a particular project may be better used elsewhere). An alternative source of return on investments may be in private equity, rather than in the public domain. For a well-diversified corporation, certain levels of asset allocation may be committed to investment in non-public related activities. Private equity activities may take the form of venture capital or managed buyouts.

When reviewing different companies for asset allocation decision-making purposes, an investment banking representative must be aware of the various business segments within the corporate structure. Each of the segments must be valued separately and then combined into a sum-of-the-parts analysis. In this type of analysis, the focus is that the separate segments of the company may be worth more alone than the combination of all segments that create the company. In other words, if the company is being sold today, the individual business segments may be sold for more value than the total corporate value. Unprofitable lines of business are able to be identified and divested, while the more profitable lines may be enhanced through additional capital commitment.

For example, let's consider a hypothetical company to illustrate the sum-of-the-parts concept. The company is a small, privately owned publisher and distributor of textbooks as well as audio/video training materials. The company has also entered into an agreement with a large production company that produces rock concerts and sports events in order to distribute its products on a national scale.

The small publishing company has recently expanded its business into the potentially lucrative general readership market for novels and periodicals. Also, as an extension of its audio/video line of business, it has created a consumer electronics division selling AV products through Internet-based outlets. An investment banking representative who is reviewing the company's business plan and financials for possible investment by her firm is faced with several questions before making a recommendation.

Among these questions are:

1. What method of valuation should be used for this company?
2. What's the value of each business segment of the firm?
3. What valuation metric should be used for each segment?
4. What's the per-share value of the firm?

Since the company is a private company and has various business lines (both new and established) that are each growing at a different projection rate, the representative decides that the best approach to valuation is the sum-of-the-parts analysis.

A review of the financials provides the following information:

Total net income:	$3,000,000
Common shares outstanding:	2,000,000

Business Line	% of Net Income	Projected Growth
Textbook sales	70%	15%
Audio/video sales	15%	20%
Media production	8%	10%
General market sales	5%	35%
Consumer electronic sales	2%	30%

When investing in non-public ventures, the required rate of return on equity for capital projects of the representative's firm is 18%. The small publisher is offering to sell its stock at $25.00 per share.

To calculate a value for the company, an investment banking representative must first project the growth of each of the business segments and then discount the amounts of projected income back to their present values. A constant growth rate over the next five years will be assumed for each segment at the percentages previously indicated.

Business Line	Current Income		Projected Income	% of Total
Textbook sales	$2,100,000 $(1.15)^5$	=	$4,223,850	64%
Audio/video sales	$ 450,000 $(1.20)^5$	=	$1,119,744	17%
Media production	$ 240,000 $(1.10)^5$	=	$ 386,522	6%
General market sales	$ 150,000 $(1.35)^5$	=	$ 672,605	10%
Consumer electronic sales	$ 60,000 $(1.30)^5$	=	$ 222,776	3%
Totals:	**$3,000,000**		**$6,625,497**	**100%**

When considering other businesses in the market sector of this company, research indicates that they typically sell for approximately 15 times their net income. If this company's projected income of $6,625,497 is multiplied by 15, the projected value for the company after five years is $99,382,455. However, this figure must be discounted back to its present value at the required rate of return.

The formula for calculating this discount is:

$$V_0 = \frac{T_5}{(1 + k^*)^5}$$

In the formula: V_0 = value as of the date of calculation
T = total income
k^* = required rate of return

$$V_0 = \frac{\$99,382,455}{(1.18)^5} = \$43,440,989$$

Therefore, the per-share value of the sum of the parts equals:

$$\frac{\$43,440,989}{2,000,000} = \$21.72$$

The results of the sum-of-the-parts analysis by business line indicates that some segments of the company produce positive values, while others produce negative values. Audio/visual sales and general market sales produced positive results and could be worth more than their projected values. Although consumer electronics produced a positive result, the amount was not significant in light of its growth projections. This may be due to low profit margins and a highly competitive marketplace. Further investigation is needed in order to determine whether this product line is worth the cost of capital.

Since textbook sales and the media production segments produced negative results, a closer look may be warranted. The media production segment is of special concern since the company doesn't control production of the product being distributed. If this line doesn't produce the required rate of return, the company should either renegotiate a higher fee with the producer or eliminate the product line. Although it's the mainstay of the business, textbook sales seem to be flattening out. If the market is becoming saturated at this point, perhaps closer scrutiny should be given to this segment.

In addition, opportunity costs should be closely examined. Since the company intends to sell its stock at $25.00 per share when the value per share is only $21.72, the offering price is too high for the cost of capital at this point. Before committing capital to this project, a potential purchasing company should consider investing elsewhere or even look into expanding internally before making the decision to invest in this private equity venture.

Different Valuations When using a sum-of-the-parts analysis, it may be necessary to use different valuation metrics for each business unit. For example, an investment banking representative may use 6.0 times EBITDA for one unit, 1.5 times revenue for another unit, and 13.0 times earnings for a third unit. By adding the value of all three units, subtracting the net debt, and then allowing for any non-operating adjustments, an investment banking representative could calculate the equity value of a firm. In some instances, the representative may use a DCF analysis with some businesses and a relative valuation with others.

Categorizing Valuation Multiples

Multiples of Earnings
▪ Equity earnings multiples: Price/earnings ratios and variants ▪ Operating earnings multiples: Enterprise value-to-EBITDA or EBIT ▪ Cash earnings multiples
Multiples of Book Value
▪ Equity book multiples: Price-to-book equity or tangible book value ▪ Capital book multiples: Enterprise value-to-book value of capital
Multiples of Revenue
▪ Price-to-Sales ▪ Enterprise Value-to-Sales

Intuitive Approach

Sector	Multiple Used	Rationale
Cyclical	Relative P/E	Use with normalized earnings
High Tech, High Growth	PEG	When significant differences exist across firms
High Tech / No earnings	Price/Sales or EV/Sales	Assuming future margins will be good
Heavy Infrastructure	EV/EBITDA	Firms in sector have losses in early years and reported earnings can vary depending on depreciation method
REIT	DCF, DDM, dividend yield, or funds from operations	Generally, no CAPEX investments come from equity earnings
Financial Services (banks, brokerage firms, and insurance companies)	Price/BV, EV/Book Value Price/Net Tangible Book Value	Book value is often marked-to-market
Retailing	Price/Sales	If leverage is similar across firms
Retailing	EV/Sales	If leverage is different across firms

What to Consider

1.	Multiple	Determining variables
2.	Price/Earnings	Growth, payout, risk
3.	Price/Book Value	Growth, payout, risk, ROE
4.	Price/Sales	Growth, payout, risk, net margin
5.	EV/EBIT	Growth, some reinvestment needs, leverage, risk
6.	EV/EBITDA	Growth, greater reinvestment needs, leverage, risk
7.	EV/Sales	Growth, net capital expenditure needs, leverage, risk, operating margin
8.	EV/Book Value	Growth, leverage, risk and return on capital
9.	EV/EBITDAR	Companies that depend on leases (e.g., restaurants and retail)

What Works Best in Certain Circumstances

Discounted Cash Flow (DCF)
▪ When cash flows are currently positive
▪ When cash flow is able to be estimated with some reliability for future periods
▪ When the risk benchmark (e.g., 5-, 10-, and 30-year Treasuries) is considered positively correlated to stock price
Dividend Discount Model (DDM)
▪ Dividends are currently positive
▪ Dividends are able to be estimated with some reliability for future periods

Chapter 9 Summary

Now that you've completed this chapter, for the following commonly tested concepts, you should be able to:

- Understand the two different methods of valuation—relative valuation and discounted cash flow
- Calculate the various versions of the P/E ratio and understand the underlying concept
- Calculate earnings yield and dividend yield and understand the concepts
- Understand the use of the PEG ratio and be able to calculate growth rate, PEG ratio, and target price
- Calculate the implied equity value range
- Understand the concept of CAGR and the simplified method to estimate CAGR
- Understand the concept of free cash flow and the difference between FCFF and FCFE
  - Calculate price-to-free cash flow and free cash flow yield
- Recognize the price-to-sales formula and understand its uses
- Recognize the price-to-book value formula and understand its uses
- Understand the concept of enterprise value and how it's calculated
  - Calculate equity price per share when given enterprise value and net debt
- Understand the concept of EV-to-EBITDA as it relates to valuation and be able to calculate the ratio
- Recognize the EV-to-net sales formula and understand its uses
- Define the terms *NPV* and *IRR* and understand how they're used to evaluate potential investment projects
- Understand the concept, uses, and limits of valuation based on discounted cash flow
  - Recognize the steps used to determine equity value based on using a DCF analysis
- Understand the concept of WACC and be able to calculate it
  - Cost of debt
  - Cost of equity based on CAPM versus Dividend Growth Model
    - Levered versus unlevered beta
  - Calculate weight of debt versus equity based on debt-to-equity ratio
- Calculate FCFF and FCFE and understand what changes the free cash flow
- Understand the concept of present value of free cash and what would change the valuation
- Understand the purpose of terminal value and the two methods to calculate it
- Calculate the terminal value using the DCF method and recognize what changes the value
- Understand how enterprise value is determined based on the DCF model
- Calculate EV using the simplified perpetuity method
- Calculate net present value (NPV) of a corporation
- Understand the Dividend Discount Model and be able to calculate:
  - The zero growth and constant growth (Gordon Growth) versions
  - Growth rate based on ROE
- Understand how DCF is used in LBO analysis
- Define *Economic Value Added (EVA)* and understand the concept and how it's calculated
- Understand the concept and use of the sum of the parts analysis
- Recognize which valuation methods are associated with the different types of businesses (*see tables in chapter*)

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Chapter 10

M&A Valuation

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Exchange Ratios

When one company agrees to purchase another, the acquiring company may use cash, its common stock, or a combination of the two. If the acquisition is made in stock, an investment banking representative needs to understand the concept of the exchange ratio.

	ABC	XYZ
EPS	$3.00	$1.25
P/E Ratio	16	20

Based on the earnings per share and the price/earnings ratio, the representative is able to determine the market price of the shares—ABC is trading at $48 ($3.00 x 16) and XYZ is trading at $25 ($1.25 x 20). If ABC is considering the possibility of making an acquisition of XYZ using its common stock and offers a premium of 20%, what's the exchange ratio? The formula for calculating the exchange ratio is the target's offer price (not the market price) divided by the acquirer's market price. In this example, the exchange ratio is .625 and is calculated as follows:

Step 1: $25.00 x 1.20 = $30.00

Step 2: $\frac{\$30.00}{\$48.00} = .625$

Accretion/Dilution Analysis – Is the Acquisition Accretive or Dilutive

Accretion/dilution analysis is used by a buyer that's a public company, but not by a buyer that's a private company. For the buyer that's a public company, the analysis is used to assess the impact on its earnings after the completion of the transaction based on a set of underlying assumptions.

Accretive or Dilutive To calculate whether the acquisition is accretive or dilutive, an investment banking representative adds the combined net incomes of the two companies and divides by the total number of shares of the acquiring company, including the additional shares issued to fund the transaction.

	ABC	XYZ
Outstanding shares	2,000,000	900,000
Net income	$6,000,000	$1,125,000

The total acquisition cost is $27,000,000 ($30 x 900,000 shares outstanding). This will require 562,500 additional shares of ABC stock to be issued, which brings the total number of shares outstanding to 2,562,500.

There are two methods by which the additional shares may be determined:

1. 900,000 x .625 = 562,500 or
2. $27,000,000 ÷ $48 per share = 562,500

The new level of earnings available to common for ABC is $7,125,000 (ABC $6,000,000 + XYZ $1,125,000). $7,125,000 ÷ 2,562,500 = $2.78 EPS, while the EPS of ABC was $3.00 before the acquisition. Since the acquisition has resulted in an earnings reduction of $.22 per share, the activity is considered dilutive to the shareholders of ABC.

Percentage Ownership To determine XYZ's percentage ownership after the merger, it's necessary to determine the exchange ratio and calculate the new number of shares being issued. The new number of shares being issued is then added to XYZ's outstanding shares to find the total number of shares of the combined company. Ultimately, the newly issued shares are divided by the combined company total. The original exchange ratio of .625 is multiplied by the percentage of stock being offered (100%); therefore, the exchange ratio remains .625. The newly issued shares equal 562,500 and the total number of shares of the combined company is 2,562,500. The result is that XYZ will own 22% of the combined company (562,500 ÷ 2,562,500).

Remember, many transactions are a combination of cash and stock. For an investment banking representative to find the percentage ownership in these situations, the exchange ratio must be multiplied by the percentage of the offer in stock. The previous example doesn't take into account a cash acquisition. If the cash being used for the acquisition was from borrowed funds (bank borrowing and/or a debt issue), the additional interest expense must be deducted from EBIT in order to calculate the revised net income. An investment banking representative may present various financing alternatives to the acquirer in order to create an accretive result for earnings.

Comparing a Stock versus Cash Transaction

	Company G	Company H
Revenue	$ 1,000	$ 900
Operating Income	$ 98	$ 92
– Interest Expense	$ 10	$ 7
– Taxes	$ 18.5	$17.85
Net Income	$ 69.5	$67.15
Shares Outstanding	60	30

(All numbers in millions)

Stock Transaction Company H has agreed to be acquired by Company G. The terms of the acquisition require the issuance of 1.5 shares of Company G common stock for each share of Company H. What's the effect on the EPS of Company G following the acquisition?

Based on the terms of the acquisition, an additional 45 million shares of Company G common stock will be issued (1.5 x 30 million). Following the acquisition, the total number of shares outstanding will be 105 million (60 million + 45 million) and Company G's net income is $136.65 million (Company G's net income of $69.5 million + Company H's net income of $67.15 million). Prior to the acquisition, Company G had $1.16 EPS ($69.5 million ÷ 60 million); however, following the acquisition, its EPS is $1.30 ($136.5 million ÷ 105 million), a $.14 accretive effect.

On the other hand, what if the terms of the transaction were in cash in lieu of stock?

Cash Transaction If Company G agrees to acquire Company H for $250 million in cash which was raised by issuing 7% debentures, what's the accretive effect on Company G's EPS (assuming there's no change in the tax rate for the company)? If Company G issues $250 million of debt to fund the acquisition, the interest expense will increase by $17.5 million ($250 million x .07).

	Company G	Company H	Combined Co.	(All numbers in millions)
Revenue	$ 1,000	$ 900	$ 1,900	
Operating Income	$ 98	$ 92	$ 190	
– Interest Expense	$ 10	$ 7	$ 34.5	
Income Before Taxes			$ 155.5	
- Taxes	$ 18.5	$ 17.85	$ 32.66	
Net Income	$ 69.5	$ 67.15	$ 122.84	
Shares Outstanding	60	30		

Since no additional shares are being issued, the EPS will be $2.05 ($122.84 million ÷ 60 million). The acquisition will have a $.89 accretive effect. Since the numbers being used are purely hypothetical, these results are not meant to favor cash versus stock transactions.

It's important to understand that these results may only provide a short-term analysis of the effect of the merger. The acquisition is made to create value and be accretive to shareholders. An acquisition is considered to be accretive to shareholder value if the return on invested capital (ROIC) exceeds the weighted average cost of capital (WACC).

Enterprise Value

As previously described, when a company completes an M&A transaction, its enterprise value will be affected. Below are some additional examples to review this concept:

Before the Transaction

	MST	RMM
Common Shares Outstanding:	2,400,000	2,000,000
Market Value:	$ 20.00	$ 11.00
Debt Outstanding:	$52,000,000	$10,000,000
Cash and Equivalents:	$16,500,000	$5,000,000

The terms and conditions of the acquisition include the following:

- MST agrees to purchase RMM for $20,000,000.
- The $20,000,000 is based on $6,000,000 of MST common stock (market value of $20 per share), $4,000,000 of newly issued MST 6.0% debentures, and $10,000,000 of cash paid to RMM shareholders and obtained from MST's revolving credit line.
- Additionally, MST will assume $10,000,000 of RMM's debt.

If MST stock is trading at $23.00 after the acquisition is complete, what's the new enterprise value?

Step 1: Determine the number of common shares outstanding (existing and newly issued) and multiply the total by the current market price. MST's 2,400,000 shares plus the 300,000 additional shares ($6 million ÷ $20) issued for the transaction equals 2,700,000 total shares.

Step 2: Add all of the debt of MST and RMM (both existing and newly issued). The total debt equals $76,000,000 ($52,000,000 existing for MST, plus $10,000,000 existing for RMM, plus $4,000,000 of newly issued MST debt, plus $10,000,000 for the use of the line of credit).

Step 3: Subtract the $21,500,000 in total cash and equivalents of MST and RMM ($16,500,000 and $5,000,000 respectively).

The following table illustrates the effects of the transaction:

After the Transaction

	MST	
Common Shares Outstanding:	2,700,000	
Market Value:	$ 23.00	
Debt Outstanding:	$ 76,000,000	
Cash and Equivalents:	$ 21,500,000	
To Calculate Enterprise Value:		
Market Capitalization:	$ 62,100,000	(2,700,000 x $23.00)
+ Total Debt:	$ 76,000,000	
– Cash	$ 21,500,000	
EV	$116,600,000	

Comparable Company and Precedent Transaction Analysis

When reviewing a potential M&A transaction, a common valuation metric is arrived at by comparing companies and any recent M&A transactions in a sector. *Comparable company analysis* (also referred to as trading comps) seeks to provide a company's implied value in the public equities markets through analysis of the trading and operating statistics of comparable companies. The reliability of comparable analysis depends on the level of comparability of other publicly traded companies such as industry, business mix, revenue base (size), geographical presence, profitability, and growth.

On the other hand, *precedent transaction analysis* (also referred to as transaction comps) provides a private market benchmark in change of control scenarios and applies multiples that are derived from similar or comparable precedent M&A transactions to the company's operating data. The reliability of precedent transaction analysis depends on the number of recent precedent transactions and their degree of comparability.

Effects of Employee Stock Options

When working on a potential M&A transaction, an investment banking representative may be asked by a managing director to adjust enterprise value or to recalculate the number of outstanding shares based on the expected exercise of employee stock options.

Most companies will use the proceeds from the exercised options to repurchase their shares in the market at the current price. Any differential in the number of shares will be made up through the treasury stock account. Assume the current stock price is $26 and offer price is $30.00

Consider the following example:

Current outstanding shares	6,000,000
Number of options:	300,000 at a strike price of $25 200,000 at a strike price of $50
Offered price:	$30

The expected exercise of employee stock options is limited to the options that have intrinsic value (i.e., the market value exceeds the strike price). The options that have a strike price of $25.00 will be exercised; however, the options that have a strike price of $50.00 will not be exercised. Therefore, the exercised options will generate proceeds to the company of $7,500,000 (300,000 x $25.00) and this will permit the company to repurchase 250,000 shares from the market ($7,500,000 ÷ $30.00). The difference between the number of shares repurchased and the number of shares granted through the exercise of the options, equals 50,000 shares (300,000 – 250,000). The additional shares are issued from the company's treasury stock account, bringing the number of shares outstanding to 6,050,000 (6,000,000 previously outstanding + 50,000 shares from treasury stock).

Offer Value

Calculating the offer price for a target company in an acquisition is a very important process. It's assumed that any employee with an in-the-money option will exercise his option. To take this example one step further, if this company was offered $45.00 per share, the offer value would be $272,250,000 (6,050,000 x $45.00).

Transaction Value In order to calculate the transaction value (enterprise value), the target company's net debt must be added to the offer value. Net debt is considered a company's total debt minus cash (also considered the difference between the offer value and the transaction value). If the net debt is assumed to be $50,000,000, then the transaction value is $322,250,000.

Implied Transaction Multiple In order to calculate the implied transaction multiple, the enterprise value (based on the offer price) is divided by the appropriate financial statement figure (e.g., revenue, EBIT, EBITDA). If the appropriate valuation metric is EV-to-EBITDA, and the EBITDA is $21,000,000, the multiple is 15.3 ($322,250,000 ÷ $21,000,000).

Analysis

Based on the current stock price of $30, the company's existing enterprise value is $231,500,000 ($30 x 6,050,000 + $50,000,000), and the current EV/EBITDA is 11 ($231,500,000 ÷ $21,000,000). The premium offer of $45.00 per share makes the implied transaction multiple 15.3. There are many variables involved in determining whether this is a fair price (e.g., the company's dynamics, the economy, the business sector, and financial ratio comparisons with similar companies). If only the numbers are examined, a review of recent transactions within this sector will provide the best analysis. Ultimately, an analyst will look for transaction multiples within a range of comparable transactions.

Depending on the type of company being analyzed, an investment banking representative calculates various valuation metrics. The target company is compared to other companies within its sector as well as recent similar merger transactions.

Assuming the target company had the following valuation, the table below summarizes how the analysis may be presented:

Remember, mean is the average value of a set of numbers. The median is the middle value of a set of numbers. If there are an even number of entries in a set of numbers (i.e., there's no middle value), the two middle values are averaged to determine the median.

Comparable Companies Analysis

		Selected Public Company Valuation Multiples			
	Implied Multiple at Offer Price	Minimum	Maximum	Median	Mean
Enterprise Value/LTM Revenue	.51x	0.33x	0.57x	0.48x	0.46x
Enterprise Value/LTM EBITDA	15.3x	12.3x	17.4x	14.1x	14.8x
Enterprise Value/LTM EBIT	22.9x	19.1x	25.8x	21.7x	22.1x

(LTM refers to the last twelve months' financials for the company.)

Based on the proposed offer price, the implied valuation is within the range of the selected companies.

Precedent Transaction Multiples Analysis

		Selected Transaction Valuation Multiples			
	Implied Multiple at Offer Price	Minimum	Maximum	Median	Mean
Enterprise Value/LTM Revenue	.51x	0.25x	2.51x	0.45x	1.06x
Enterprise Value/LTM EBITDA	15.3x	3.7x	23.4x	11.4x	10.9x
Enterprise Value/LTM EBIT	22.9x	9.9x	36.1x	18.3x	19.7x

Based on the proposed offer price, the implied valuation is within the range of the selected transaction valuation multiples.

Determining the Price to Offer the Target

An investment banking representative may be asked to assist in the valuation process concerning the price that a potential acquirer needs to offer to the target. If the approximate transaction multiple is 11 times EBITDA, at approximately what percentage of premium must the acquirer offer to equal the implied offer price?

DEF Manufacturing (Potential Target)

EBITDA:	$780 million
Cash:	$350 million
Debt:	$950 million
Outstanding Shares:	240 million
Current Stock Price:	$27.40

Based on the transaction multiple, the enterprise value is $8.58 billion ($780 million x 11). To determine the equity value, the company's net debt is subtracted from the enterprise value of the transaction. The net debt is $600 million ($950 million of debt – $350 million of cash). The equity value is $7.98 billion ($8.58 billion - $600 million) and, when divided by 240 million shares outstanding, results in an implied offer price of $33.25. Since the current stock price is below this value, an acquirer will need to offer approximately a 21% premium to equal the implied offer price ($33.25 - $27.40 = $5.85 and $5.85 ÷ $27.40 = 21.3%).

Calculating the Adjusted EBITDA Multiple

Since a buyer may be able to realize synergies due to an M&A transaction, adjusted EBITDA may be used as a valuation metric in a potential acquisition. To determine the adjusted EBITDA multiple, the current EBITDA must first be multiplied by the transactional multiple (EV-to-EBITDA), which equals the transactional value. The synergies are added to the original EBITDA and then this number is divided into the transactional value.

> *For example, if the initial EBITDA is $255 million and the client is willing to pay 9 times EBITDA, multiply $255 by 9, which equals a transactional value of $2.295 billion. Next, the synergies are added (assume $40 million) to arrive at an adjusted EBITDA of $295 million. The transactional value is divided by the adjusted EBITDA, which equals 7.8 ($2.295 billion ÷ $295 million).*

Purchasing a Privately Held Company

If a publicly traded company wants to purchase a private company, it may offer stock, cash, or a combination of the two. First, the valuation of the privately held company must be determined, which means the purchaser must decide both the valuation metric and the multiple it's willing to pay to acquire the target. For example, if a client is willing to pay 3.5 times book value, then the offer value is determined by multiplying the current book value by 3.5. If the book value is $45 million, the offer value is $157.5 million ($45 million x 3.5). If stock is being offered to the target, the number of shares required is found by dividing the offer value by the market price of the stock. If the market price of the acquirer's stock is $18, the number of shares needed to fund the acquisition is 8.75 million ($157.5 million ÷ $18).

Leveraged Buyout Analysis

A leveraged buyout (LBO) is a type of transaction in which an investor (usually a private equity fund) purchases a company or a division of a company using a high percentage of borrowed funds. The objective of the transaction is to use financial leverage to purchase the target. Private equity investors often finance their acquisitions using a small percentage of equity, with the remainder of the acquisition as debt.

This debt is usually considered senior debt which is obtained through lenders such as banks, insurance companies, and other financial services companies. Another possibility is to acquire the target through mezzanine financing. As implied by the name, mezzanine financing is debt that's considered junior to senior debt. In other words, it's in between senior debt and equity in priority of payment at liquidation.

LBO Steps The goal is to purchase a business using debt and some equity, improve the profitability of the company, and to pay down the debt in order to increase the equity value (time horizon is typically 3 to 7 years). The EBITDA may be used as a measure of cash flow. If the private equity firm acquires a company with a higher offer value, it would result in a lower return on investment. In addition, a company with high level of free cash flow would have the capacity to issue additional debt. Analyzing the effectiveness of an LBO involves the following:

- Purchasing the company based on a certain multiple and the cost of borrowing
- Making projections based on adjusted EBITDA and other financial metrics due to cost reductions and improvements in the business
- Estimating the multiple at which the financial sponsor (PE firm) expects to exit the business
- Calculating equity returns, such as IRR

In summary, the objective of the LBO is to improve the business, pay down debt, and increase equity value. An additional objective is to exit the business at a higher multiple than the one that was used to purchase the business (e.g., from 7x EDITDA to 8x EBITDA).

For example:

- EBITDA is $50 million, purchase at 7x or EV of $350 million
- Use 80% debt and borrow $280 million
- Contribute 20% equity of $70 million
  - Improve EBITDA (assume by 20%) to $60 million, and pay down a portion of the debt from $280 to $220 million
  - Exit after five years, at 7x new EBITDA of $60 million or $420 million, repay debt of $220 million, equity now $200 million
  - Increase equity by $130 million (from $70 million to $200 million) over a five-year period

If multiple increases to 8X EBITDA or $480 million, equity increases to $260 million.

Since many of these transactions are based on a multiple to EBITDA, an investment banking representative may be asked to perform certain calculations for a proposed transaction. One of these calculations will be to determine the debt-to-EBITDA ratio after the transaction is completed.

For example:

HLSL Corporation	
EBITDA:	$590 million
Transaction Purchase Price:	9.5 times EBITDA
Equity Contribution:	20%

The transaction value is $5.605 billion ($590 million x 9.5) and is being financed with 80% debt or $4.484 billion ($5.605 billion x .80). The debt-to-EBITDA ratio is 7.60 times ($4.484 billion ÷ $590 million). Since there's no existing debt mentioned in the example, it's assumed that the existing company is debt-free.

Calculating Goodwill After the Acquisition is Complete

To calculate the amount of goodwill created after the acquisition, the company's net tangible assets are subtracted from the offer value. The net tangible assets are determined by subtracting the company's liabilities, existing goodwill, and intangibles from its total assets. An investment banking representative is able to find this information on the target company's balance sheet.

TCB Corporation		
Total Assets:	$ 1,800	
Total Liabilities:	$ 700	
Existing Goodwill:	$ 250	(with the exception of stock prices, all numbers in millions)
Intangibles:	$ 180	
Shares Outstanding:	25	
Current Stock Price:	$ 74	
Offer Price:	$ 85	

- Net tangible assets are $670 million [$1.8 billion – ($700 million + $250 million + $180 million)].
- The offer value is $2.125 billion (25 million x $85).
- The amount of goodwill created is equal to $1.455 billion ($2.125 billion – $670 million).

This amount of goodwill is added to any existing goodwill of the acquirer in order to calculate the new total goodwill. (Note: intangibles may be recorded as intangibles on the acquirer's balance sheet, rather than being listed as goodwill.)

Fair Value The book value of the assets is adjusted to its fair market value on the date of the acquisition. Since the fair value is used, the net tangible asset total is usually higher, resulting in a lower amount of goodwill or at least less than expected. The difference between the fair value and book value of the company's assets is referred to as a write-up. For example, a company's balance sheet shows net tangible assets that are valued at $15 million (BV) and the company is acquired for a total purchase price of $45 million; however, the fair value (FV) of these assets is $25 million. The $10 million difference between the FV and BV is considered the write-up. The goodwill is determined by starting with the purchase or acquisition price and then subtracting the book value and the write-up ($45 million – $15 million – $10 million = goodwill of $20 million).

Negative goodwill is realized if the purchase or acquisition price is less than the fair value of the assets, which results in a bargain for the purchaser. If the assets are undervalued, it may cause the purchase price to increase, not decrease.

Exchange-Rate Risk

Strong U.S. Dollar A strong U.S. dollar (correlated with weakening foreign currencies) makes foreign companies more attractive takeover targets for U.S.-based buyers. If this is the case, U.S investors will be able to exchange their higher-priced currency for a greater amount of a foreign currency and will have more purchasing power as the dollar rises. In a strong U.S. dollar environment, U.S. companies are less attractive takeover candidates since foreign buyers will have less buying power.

Weak U.S. Dollar A weak U.S. dollar (correlated with strengthening foreign currencies) makes U.S. companies more attractive takeover targets for foreign buyers since they're able to convert their higher-priced currency into a greater amount of U.S. dollars. This weak-dollar environment gives foreign buyers greater purchasing power when acquiring U.S.-based assets. However, foreign companies will be less attractive takeover candidates for U.S. buyers due to the fact that these potential acquirers will have less buying power.

Hedging Exchange-Rate Risk If the acquirer or the target is concerned about exchange or currency risk, an investment banking representation may suggest the use of derivatives (e.g., foreign currency option contracts). In the U.S., options contracts of a foreign currency may be purchased or sold, but options on the U.S. dollar don't exist. Call options can be purchased if the concern is the increase or strengthening of a foreign currency (weakening USD). On the other hand, put options can be purchased if the concern is the decrease or weakening of a foreign currency (strengthening USD). These types of transactions are referred to as *exchange-rate risk hedges.*

Risk After the Deal is Announced If a company announces that it's acquiring a foreign company, but the target company's currency has declined in value by the time of the closing of the acquisition, the cost of the acquisition will have declined. For example, if the euro is currently trading at 1.24 and a German company announces the purchase of a U.S. company for $21,000,000, this purchase will equal €16,935,483 ($21,000,000 ÷ 1.24). However, if the euro is trading at 1.35 at the time of the closing, the U.S. dollar will have weakened and the German company's cost of acquisition is now €15,555,555 ($21,000,000 ÷ 1.35). The decline in the cost to purchase the U.S. company is €1,379,928. The reverse is true if the U.S. dollar strengthens against the euro. In this case, there's exchange-rate risk for the acquirer (not for the target company) since the offer is being made in U.S. dollars.

If an offer consists of stock or a portion in stock, there's also exchange-rate risk. For example, if a U.S. company offers .50 shares of stock (trading at $60) to a British company and the exchange rate is currently 1.65 dollars, the stock portion of the acquisition is £18.18 ($60 x .50 = $30 ÷ 1.65). If British pounds strengthen to an exchange rate of 1.75, the stock portion of the acquisition will now be valued at £17.14 ($60 x .50 = $30 ÷ 1.75). In this example, the target company will receive a lower value if the offer is based on the dollar value of the U.S. company and the dollar declines against British pound.

This is in addition to the risk that's associated with the acquirer's stock price fluctuations in a fixed exchange ratio transaction. In the previous example, if the market price of the U.S. company declines to $56.00 per share, the offer will decline in value even if the exchange rate remains unchanged. For example, if a U.S. company offers .50 shares of stock (now trading at $56) to a British company and the exchange rate is currently 1.65 dollars, the stock portion of the acquisition is now £16.97 ($56 x .50 = $28 ÷ 1.65).

If the U.S. dollar declines and the share price of the U.S. company declines, it will have a negative impact on the value of the transaction to the British company For example, if the stock price declined to $56 and the dollar declined, causing the exchange ratio to rise to $1.85, the value of the transaction to the target company will decline to £15.14 (($56 x .50) ÷ $1.85).

Chapter 10 Summary

Now that you've completed this chapter, for the following commonly tested concepts, you should be able to:

- Calculate the exchange ratio in an M&A transaction
- Calculate whether a transaction is accretive or dilutive to earnings after a stock/cash/use of debt transaction
- Calculate enterprise value after a merger
- Compare and contrast comparable company versus precedent transaction analysis
- Recognize how to account for the effect of employee stock options on shares outstanding
- Define the terms *offer value, transaction value,* and *implied transaction multiple*
- Understand how to use comparison tables to determine fair valuation
- Calculate an offer price based on the transaction multiple
- Calculate adjusted transaction multiple based on synergies
- Understand the steps involved in LBO analysis
- Calculate goodwill and understand how it may be adjusted to fair value
- Understand exchange-rate risk
  - Weakening versus strengthening dollar
  - Hedging risk with options

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