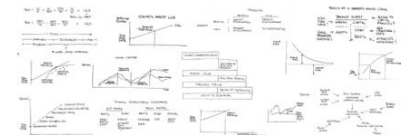


PRIVATE CAPITAL MARKETS

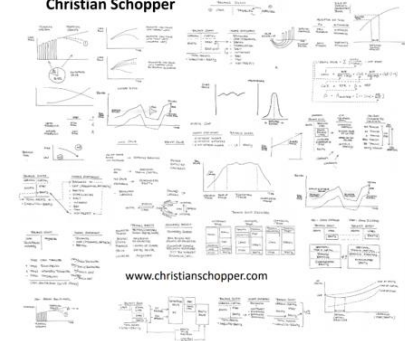
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Corporate Finance Concepts

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Funding of Growth Companies

Continuing High Business Risk

- **Marketing is key focus** rather than the R & D or technology focus
 - Growth stage requires a change in business processes
 - As scale of operations grows, and the number of employees and divisions increases, there is a need for more structure
- Continuing high business risk still requires **low-risk financing**
- **New investors are taking on a lower risk** (vis-à-vis start-up phase)
 - Hence it is possible to look to **raise this new equity funding from a broader potential base of investors**, possibly including the general public

Business risk	Very high
Financial risk	Very low
Source of funding	Venture capital
Dividend policy	Nil payout ratio
Future growth prospects	Very high
Price/earnings multiple	Very high
Current profitability, that is, eps	Nominal or negative
Share price	Rapidly growing but highly volatile

IPO vs Private Placement

- In most countries there are **tight rules** applying to the control of companies which wish to **raise funds from the general public**
 - Try to safeguard less sophisticated investors and maintain confidence
- **Tighter controls** automatically translate into **higher cost**
 - Registration fees; legal and professional costs of raising funding and of maintaining a stock exchange listing; shareholder communication; compliance with the rules of the various bodies of which the company becomes a member.
- **Costs** can be **substantially reduced** by **private placements**
 - Public not invited to invest
 - Private equity institutions have portfolios including for pre-IPO companies
- However, also private funding sources will eventually seek an **exit** ...

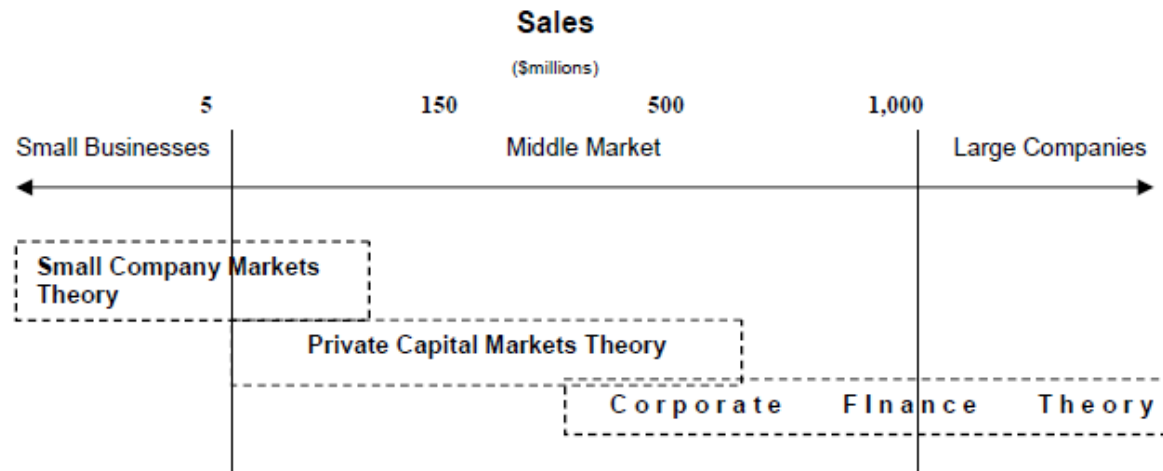
Private Capital Markets

What makes Private and Public Capital Markets Different?

- **Risk and return** unique to each market
- **Liquidity**
- **Motives** of private owners different from professional managers'
- Underlying **capital market theories** that explain the behavior of players in each market are different
- Private companies are **priced at a point in time** while public companies are continuously priced
- Public markets allow ready access to capital, while private capital is **difficult to arrange**
- Public shareholders can diversify, whereas **private shareholders can not**
- **Private markets are inefficient**, whereas public markets are fairly efficient
- Market mechanisms have differing effects on each market
- Capital market lines (**costs of capital**) are substantially different for each market
- The **expected holding period** for investors is different for each market

Capital Markets Theories

- **Corporate finance theories** explain and organize the public capital markets ...
- ... but **have never been intended to explain nonpublic capital markets**
- **Private capital markets theory** is the integrated capital market theory unique to private companies, especially those with annual sales of US\$5m to 500m
 - This theory describes the valuation, capitalization and transfer of private business interests

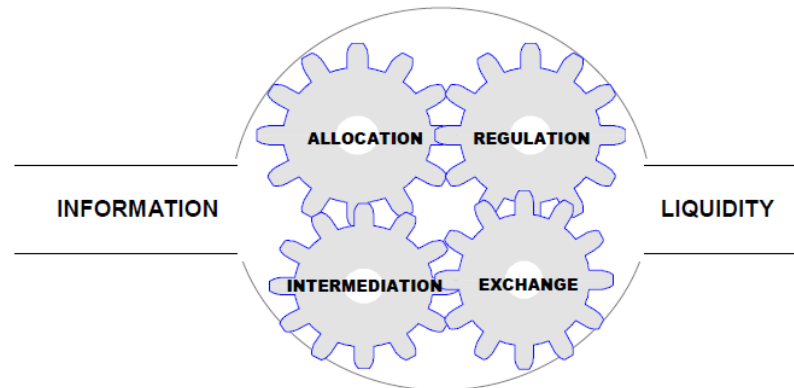


Capital Markets Theories (cont'd)

Corporate Finance Theory	Private Capital Markets Theory
Use of a C corporation *	Can be any type entity (S, LLC, etc)
Value is established by a market	Value is established at a point in time
Ready access to public capital markets	No access to public capital markets
Owners have limited liability	Owners have unlimited liability
Owners are well diversified	Owners have one primary asset
Professional management	Owner management
Company has infinite life	Typical company life of one generation
Liquid securities efficiently traded	Illiquid securities inefficiently traded
Profit maximization as goal	Personal wealth creation as goal

* A corporation taxed separately from its owners

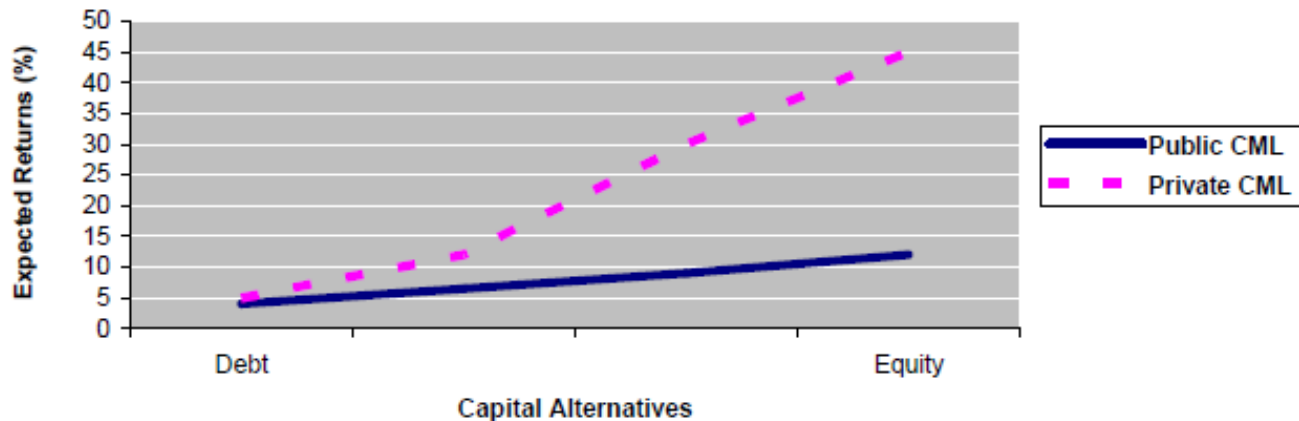
Structures of Capital Markets



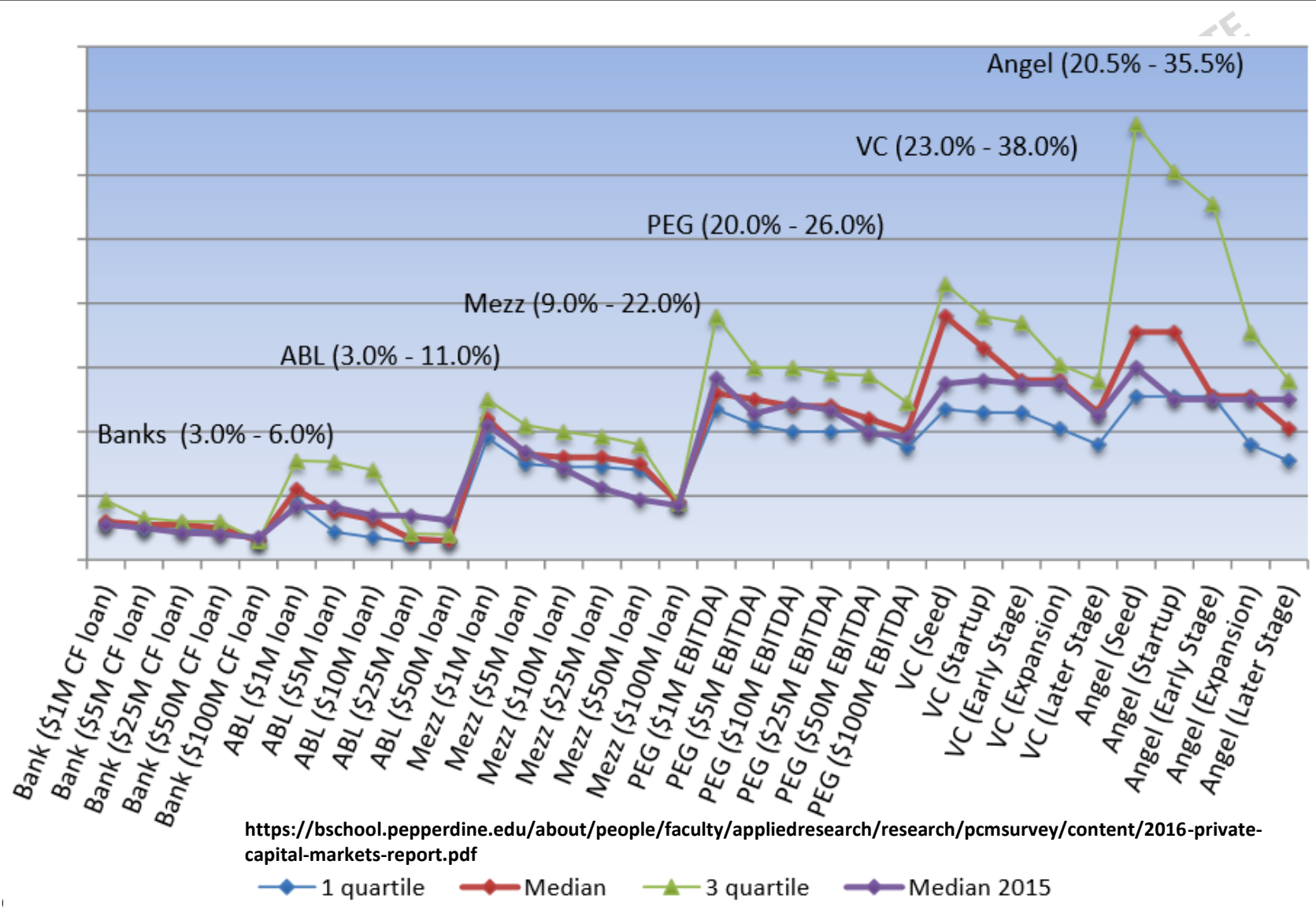
Market Mechanism	The Public Markets Enjoy:	The Private Markets Exhibit:
Information	Symmetrical information Transparent information on the subject	Asymmetrical information Opaque information on the subject
Liquidity	Transfers of mainly minority interests Instant trading	Transfers of mainly enterprise interests Long-term planned exits
Allocation	Efficient allocation	Fairly inefficient allocation
Regulation	A regulated market	A mainly non-regulated market
Intermediation	An industry of agents and market makers	A segmented industry of agents
Exchange	Continuous pricing	Point in time pricing

Investor Return Expectations

- Capital markets are segmented by a number of factors, including **how participants in the segment view risk and return**
 - Differentiating via risk and return is important because this measure is the basis for asset valuation
 - Hence, participants in each segment would value the same asset differently
 - Therefore, each segment's capital market line is unique
- A **capital market line** (CML) represents expected returns vs risk (standard deviation) to the capital providers



Private Capital – Yield Expectations



<https://bschool.pepperdine.edu/about/people/faculty/appliedresearch/research/pcmsurvey/content/2016-private-capital-markets-report.pdf>

1 quartile Median 3 quartile Median 2015

When You Substitute Market Theories and Ideas ...

PASTE

Public Market Given	Ramification in the Private Markets
Public market stocks trade as minority interests	There is no market for private minority stock interests. Private investors must have control to determine an exit.
Public market offers instantaneous trading of minority interests	Holding period for private stocks is 5-7 years, on an enterprise basis. Private investors must take a very long view toward the investment.
Public managers can finance projects at the company's marginal cost of capital	Most private companies can not access needed capital at any cost. This severely limits a private manager's ability to plan the growth of the business.
Public market offers instant pricing of securities. Thus, the perspectives of all investors is reflected in a market price	Private stocks must be valued at a point in time. This causes a private company to have dozens of correct values at any time, because "value to whom" must be answered for each appraisal purpose.
Public risk is ascertainable via predictive models such as the CAPM	No predictive models currently exist to accurately derive the risk of private ownership. Risk, therefore, is empirically observed via acquisition multiples and expected returns of private capital providers. Private cost of equity is often an unknown.

CO

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