FOUR WAYS TO USE UNDERWRITERS

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SUMMARY i

INTRODUCTION 1

THE FOUR WAYS 2

Offering Strategy 3
Expansion of the Universe 4
Service to Investors 5
Certification 6

"BOUGHT" OFFERINGS 8

SUMMARY. By allowing "shelf registration," the SEC has opened up new strategies for companies that want to issue securities. While it is hard to put dollar values on them, there are four ways in which an offering through a traditional underwriting syndicate may help a company's stockholders. A company that issues shares directly to an institution that has decided to buy on its own may miss out on the benefits of a traditional underwriting. If the company fails to issue shares to the institution, the institution will bid the price of the company's shares above what the price would otherwise have been. The traditional underwriting, when it comes, may then allow the sale of securities at a price higher than the price offered to the company by the institution.

INTRODUCTION

The Securities and Exchange Commission has been revising the rules for companies that want to issue securities. It has simplified registration requirements in several ways. One change, allowing "shelf registration," is designed to let a company register in advance the securities it expects to sell over a two-year period.

A company that has registered its securities in advance will be able to bypass the traditional underwriting syndicate in offering its securities. Brokers may offer to sell the company's shares gradually, without an intensive sales effort. Other brokers may approach the company as agents of institutions who have already decided to buy the company's securities. Such a "bought" offering at or near the current market price may seem attractive to a company that is worried about depressing its stock price when it announces a formal underwriting.

It's not easy to say what a company should do when faced with an alternative to the traditional underwriting process like a "bought" offering. The company's stockholders want the company to make the choice that will maximize the company's stock price. When an institution offers to buy shares directly from the company at the current market price, that's a sign that it feels it would drive up the stock price if it bought the shares on the open market.

But the company's stockholders may be quite happy to let the institution drive up the stock price. That may more than offset the cost of using an underwriting syndicate to issue the company's securities. In other words, there is a hidden cost in accepting a "bought deal" that may exceed the known cost of a traditional underwriting.

THE FOUR WAYS

What does an investment banker who works with a company on a traditional underwriting do for the company? Does the underwriting syndicate simply contact buyers for the securities, or does it do things that increase the company's stock price in the face of a new offering of securities?

It's hard to answer these questions by looking at stock prices before and after an underwriting. Since the underwriting will be known in advance, prices both before and after the underwriting will be affected. We would like to know what the prices would have been if there had been no underwriting, or if there had been an offering of some other kind. Unfortunately, we can't observe what the prices would have been.

We can, sometimes, get information from the reaction of a company's stock price to announcements of actions it plans to take. A rise in price means the market thinks the announcement was more favorable than it expected, while a fall in price means the market thinks the announcement was less favorable than it expected. The trick here is figuring out what the market expected. This kind of event is easiest to interpret when it is plausible that the market expected no announcement at all.

It's also possible that the market's reaction to an announcement is based on misinformation or misinterpretation. The market may not see the full implications of an action the managers plan to take as well as the managers do. Still, when the stock price falls significantly after an announcement, it makes sense for the managers to reassess their decision.

I am not aware of any systematic study of stock price reactions to announcements about stock offerings. Thus we can't rely heavily on data in making decisions about ways to offer stock. We must use theory.

A company's stock price is most heavily influenced, of course, by the fundamentals of the company and its business. The better the prospects for the industry the company is in, the higher its stock price will be. Within an industry, the better a company is at making and selling its products and

services, the higher its stock price will be.

The price is also influenced, though, by the approach the company takes to its investors and potential investors. Accounting policy matters, disclosure policy matters, public relations policy matters, and the handling of new issues of securities matters. While these factors are not as important as the fundamentals, I believe they can easily make a difference of 10% or 20% in the stock price. Sometimes they make an even bigger difference.

Let's look more closely at the handling of new issues of securities. It seems to me that a company can use its investment banker in at least four different ways. Each of these will have an impact on the stock price, including the price at which the company can sell its securities.

Offering Strategy

At any given time, some kinds of securities will be easier to sell than others. The choices are almost endless: stocks, bonds, convertibles, preferreds, royalty participations, leasebacks, and many others. And what's easy to sell now may not be easy to sell next week or next month.

The investment banker has special information about the market: how customers feel about new issues; how current offerings are going; and what offerings are coming up. The investment banker can give advice on what kind of security to issue, and on when to issue it.

The right security issued at the right time will cost the company less than the wrong security or the right security at the wrong time. Since it will be relatively easy to sell, the net proceeds to the company will be high.

The market pays attention to a company's financing plans. Choosing to issue a security gives information about a company's performance and prospects. The investment banker can advise the company on what message issuing a security will give the market. A company with a track record of appropriate messages should have a higher stock price than a company with a poor record.

Preregistration of securities can help the company prepare to issue the right security in the right market environment. That does not mean, however, that the company should issue securities whenever an institution decides to take a large position.

The arrival of a large institutional buyer may well allow the company to issue securities without depressing its stock price. But if the company does not issue securities, the institutional buyer may force the stock price up. What's relevant is the difference between the price if the company sells securities and the price if it does not. The investment banker can help the company estimate that difference. We will look at this question in more detail in the last section of this paper.

Expansion of the Universe

For a very few companies, the universe of investors who are potential stockholders is essentially all investors. Information on these companies is widely available in the press, and there is a large number of actual stockholders. People decide to hold stock or not based on their perceptions of price and value. They hold a stock when they think its price is below its value.

For most companies, the universe of actual and potential stockholders is not so large. Each stockholder will hold only so much stock. If a company wants to expand the amount of its stock outstanding, it must offer a lower price to its existing stockholders, or it must draw in new investors who are willing to hold stock at the current price.

Normally, both devices are used. A new offering is priced at a market price that is below what the stock would otherwise sell for, and the underwriting syndicate uses a marketing program to draw in new investors. There is some optimal mix of underpricing and selling. The degree of underpricing is hard to detect, because the market price is affected before the actual offering by the prospect of the offering.

Under this view, the selling is not aimed at putting a rosy image on the company. New investors who are drawn into the universe of potential stockholders may underestimate or overestimate the company's value. Those who correctly estimate the company's value will buy the stock if it is correctly priced or underpriced. Those who overestimate the company's value will buy the stock if it is correctly priced or even somewhat overpriced. Drawing new investors into the universe of potential stockholders means selling more stock without depressing the price.

It works a little differently in reverse. If an institution changes its mind on a stock, and decides to take a large position, it can do so normally only by inducing existing stockholders to sell. It must bid up the price. It does not have the option of telling existing stockholders to forget about the company.

But if the company supplies stock to the institution without a formal offering through a syndicate, it relieves the pressure on the price. The price will not go up as much as it would have gone up.

Moreover, the institution may later decide to sell its stock, and would not normally use underwriters in that sale. That later sale may push down the price more than a sale by underwriters will push it down, because the organized marketing element will be missing.

Thus a company should think carefully before selling stock using a method other than a traditional offering through an underwriting syndicate. The organized marketing provided by the syndicate may be important in expanding the universe of potential investors.

Service to Investors

While the underwriting team is formally working for the issuer, it has lots of contact with investors too. The sales people provide various services to these investors: they give information about the company and its industry,

they give advice on portfolio strategy, and they discuss economic trends.

Investors value these services. That's one reason they buy what the underwriting team is selling. They buy even if they think the securities are correctly priced. Sometimes they even buy securities they think are overpriced.

As a result, companies that use traditional underwriting methods induce extra demand for their securities from investors who value these services. Other things equal, the stock of a company that uses traditional methods will be priced higher than the stock of a company that doesn't, and its securities will be distributed more widely.

Of course the cost of the underwriting must be balanced against this and other benefits from the underwriting process. There will be times when the cost of the underwriting exceeds the benefits. Judging from the extent to which companies use traditional methods, those times are rare.

When considering a particular strategy, such as offering preregistered stock through a "bought deal," it's important to think carefully about the four kinds of potential benefits of a traditional underwriting. The costs are easier to estimate than the benefits, but the benefits may well exceed the costs in most cases.

Certification

Sometimes investors buy securities from companies with serious problems without knowing how serious the problems are. This happens with both underwritten issues and issues that are not underwritten, but it is less likely when an underwriter is involved, because an underwriter will try to uncover such problems. The underwriter will refuse to issue the securities or will make sure the problems are known to potential investors.

Underwriters have different strategies for rooting out problems, of course. Some underwriters will only handle issues where the probability of an unknown

major problem is very small. So there's a message in what kind of underwriter is handling an issue, as well as a message in the fact that the issue is underwritten at all.

Thus a company using preregistration will want to consider using a major investment banker as managing underwriter, if that option is available. It may also pay to go through the traditional underwriting process when the securities are sold so that the fact of the certification becomes widely known in the market.

"BOUGHT" OFFERINGS

We have noted that an offer by a broker to buy your preregistered stock for an institutional customer or for a group of customers or for its own account may have hidden costs. If you don't sell through this broker, the buyers are likely to force your stock price up trying to attract stock from existing holders. If you do sell through this broker, and the broker takes some of the stock or the customers intend to resell it, your stock price may be forced down by the fact that the sale is not organized in the way a formal underwriting is organized.

Let's illustrate this process with an example. Since I don't know how to estimate the indirect costs and benefits, the figures I will use are purely hypothetical. However, I believe that they are within the range of possibilities.

Your stock is trading around $20. Based on a new and correct analysis of the prospects for your business, a large institution decides that your stock is worth $25. Since you have preregistered a large block of stock, it approaches you with an offer to buy a block at a net price to you of $20. If you accept the offer, you will receive $20 a share. As others make the same analysis and arrive at the same conclusions, the market price will rise to about $25, assuming that economic conditions remain about the same. You will regret having sold your shares for $20.

If you decline the offer, the institution will buy in the open market. Its buying will force the price up toward $25. Since it will be paying higher prices than $20, it will buy fewer shares than it wanted to buy from you. Your market price will approach $25 sooner, assuming that economic conditons remain about the same, than it would have if you had accepted the offer.

With a traditional underwriting, your net price might be $24. The underwriting syndicate's selling activities will motivate investors to look at your company more closely. This may speed the spread of the new analysis of your prospects.

Moreover, if you accept the original offer, there is always the danger that the institution will change its mind and sell your stock, forcing the price down again from $25 to $23. With a traditional underwriting, this is less likely, because the stock is more widely dispersed, and because there has been an attempt to place the stock with investors who will hold on to it. Perhaps a limited amount of reselling might force the price down from $25 to $24.

In this example, you receive $20 if you accept the "bought deal," and $24 if you go for a traditional underwriting. After the offering, the price goes to $23 with the "bought deal," and $24 with the traditional underwriting. Eventually, the price will reflect the correct results of the new analysis of your prospects and the costs of the kind of offering you have chosen.

This example is a case where the traditional underwriting is the correct choice. In other cases, accepting the bought deal is the correct choice. I believe, though, that the traditional underwriting will be the correct choice in most cases.