

Financial Markets + Institutions

fifth edition



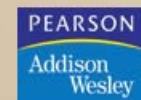
Frederic S. Mishkin

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Class 4

Primary markets

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How can the firm attract external financing?

- Debt vs. equity
- Private placement
 - For start-up, small, and financially troubled firms the public market is often not available
 - The biggest drawback: securities cannot be easily resold
- vs. public offering
 - **IPO** (initial public offering): the first public equity issue
 - The firm is assisted by the underwriter (an investment bank)



Public offering

- The rights offer
 - Each shareholder receives an offer to buy a proportional number of new stocks at a fixed price
 - This allows shareholders to maintain their % ownership
 - Shareholders can either exercise their rights or sell their rights
- vs. the general cash offer (90%)
 - Everybody can participate



The IPO procedure

- Management gets the approval of the board of directors
- The firm prepares and files a *registration statement* with SEC
 - Info about the firm, purpose of the funding, and assessment of the security's risks
 - Required for amounts over \$1.5 mln in a year and maturity over 270 days



The IPO procedure

- SEC studies the registration statement during the *waiting period*
 - If the SEC does not object during the 20 days, it is fine to continue
- The underwriter sets the IPO price and selling effort gets underway
- The underwriter supports the stock price at the secondary market



The IPO procedure

Steps in Public Offering	Time
1 Pre-underwriting conferences	Several months
2 Registration statements	20-day waiting period
3 Pricing the issue	Usually on the 20th day
4 Public offering and sale	After the 20th day
5 Market stabilization	30 days after offering

Main Reasons for Going Public

- (Access to) new finance
 - Improved prospects for growth (esp. by acquisition)
 - Strengthening the equity base and reducing leverage
 - Liquidity and diversification for the previous owners
 - Liquidity for new investors
 - Competition among suppliers of finance



Main Reasons for Going Public

- Enhanced company image and public exposure
- Motivating management and employees
- Cashing in
- Exploiting mispricing



Disadvantages of IPOs

- Direct costs:
 - Underwriter fees, legal/filing expenses
 - Negative market reaction upon announcement
 - Underpricing at the IPO
 - The next-day secondary market price is usually higher
 - *Green shoe* provision: option for the underwriters to buy additional shares at the offering price
- Greater transparency
 - For competitors / tax authorities / employee unions
- A danger of losing control

Why are IPOs underpriced?

- Asymmetry of information between investors
 - Some investors are better informed
 - They only go for the underpriced issues
 - The uninformed investors are subject to the winner's curse
 - When they buy more at the IPO, they discover they have overpaid
 - The price at *each* IPO should be lower to attract the uninformed investors

Why are IPOs underpriced?

- Reputational issues of the underwriters
 - The underwriters face a trade-off between underpricing too much (to please investors) and too little (to please the issuers) to sustain long-run reputation
 - Potential legal liabilities because of *due-diligence* obligations

Empirical evidence on IPOs

- Underpricing of IPOs
 - Offering price is on average about 15% below the last trading price
 - This can be partly explained by underwriter price stabilization in the aftermarket
 - Winner's curse: only about 60% of IPOs are underpriced (and oversubscribed)

Empirical evidence on IPOs

- High year-to-year variability in number and volume of IPOs
 - Firms issue equity when stocks are overvalued
 - E.g., in the end of 1990s: boom of dot-com IPOs
- Long-run (3 year) underperformance of new issues
 - IPO firms earn less than their peers
 - Do they window-dress their reports before the IPO?

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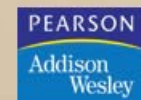
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Discussion topic

Why are Russian
companies
interested in IPOs
abroad?

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Specifics of Russian IPOs

- Are these really initial offerings?
 - Privatization created many non-traded public companies
 - Listing in a good exchange = ‘real’ IPO



Russian IPOs: Pros

- Money for expansion / cashing in
- Reputation and hedge against political risk
- Commitment to keep high corporate governance standards
- Liquidity and higher demand by foreign investors



Russian IPOs: Cons

- High costs, esp if abroad
 - Underwriting: 3% of the issue amount
 - Audit, legal, etc.: ~\$1 mln in Russia, ~\$2 mln abroad
- Higher transparency
 - Intl accounting and audit
 - Ownership structure



Where to do an IPO?

- LSE (AIM)
- Frankfurt
- Warsaw
- Moscow



Boom of IPOs in Russia

- 2004: 5 companies, \$620 mln
- 2005: 13 companies, \$4.5 bln
- 2006: 22 companies, \$17.7 bln
 - Rosneft: record \$10.blm
 - Cf: China \$59 bln

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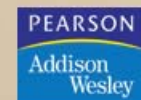
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Secondary markets

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Why do people trade?

- Is it a zero-sum game?
 - Winner's gain = loss
- Profit is not the only motive!



Why do people trade?

- Investing or borrowing
 - To solve the intertemporal cash flow timing problems
- Hedging and distributing risks
 - To mitigate individual risks
- Speculating and gambling
 - To make a bet on future market movements
 - For profit or entertainment



Trader types

- Profit-motivated traders
 - Speculators
 - Dealers / market-makers
- Utilitarian traders
 - Investors and borrowers
 - Hedgers
 - Gamblers



Trade intermediaries

- Brokers
 - Trading on behalf of a client
- Dealers
 - Trading for their own account
- Market-makers
 - Providing bid-ask quotes



Placing an order

- Market
 - Buying/selling at the prevailing market price
- Limit
 - Buying (selling) at a market price not higher (lower) than X
- Short sale: *'selling a cow, which you don't own'*
 - Sell a stock borrowed from (another client of) your broker
- Stop loss
 - Conditional market order: sell if the market fell below certain level



Margin trading

- Initial / maintenance margin
 - % of MV(assets) kept in the account as a collateral
 - The rest is borrowed from the broker
- Margin call
 - If the amount in the account drops below maintenance margin
- Leverage effect: $r = (\Delta P - \text{interest}) / (P_0 * \text{margin})$



What are good markets?

- **Efficient** markets: informative prices
 - Help to make production and allocation decisions
 - E.g., determine the required rate of return
 - E.g., evaluate the company managers
- **Liquid** markets: low transaction costs
 - Ability to open or close large positions without strong effect on prices
 - Allow the market participants to more efficiently share risks



Important factors

- Low transparency
 - Little information leads to high volatility
- Insider trading
 - Hurts average investors who leave the markets
- Gamblers
 - Create liquidity

Traditional division of secondary markets

<i>Stock exchange</i>	<i>OTC</i>
Auction	Dealer market
One center	Different locations
Access only for members	Much wider membership
Listing with strong requirements for companies	No or weaker requirements
Quoting: a single price	Bid/ask quotes

Typology of modern markets

- Degree of continuity
 - Periodic vs continuous systems
- Reliance on market makers
 - Dealer / quote-driven market: agents trade at the quotes provided by the market-makers
 - Dealers provide liquidity in exchange for the preferential position
 - Auction / order-driven market: many agents trade with each other

Typology of modern markets

- Degree of automation
 - Floor vs screen-based electronic systems
- Transparency: providing info before (quotes, depths) and after (actual prices, volumes) the trades
 - Extent of dissemination: brokers, customers, or public
 - Speed of dissemination: real time / with delay
 - Degree of anonymity: hidden orders, counterparty disclosure

Three basic trading systems

- Batch auction / call market: NYSE open
 - Agents submit demands to the auctioneer who sets common market clearing price
- Dealership market: NASDAQ, RTS
 - Market-makers provide bid and ask prices at which other agents may trade
- Continuous auction: NYSE intraday, Euronext, MICEX
 - Floor: brokers trade with each other on behalf of their clients
 - Electronic: the system displays the best limit orders and automatically executes incoming market orders

Dealership market

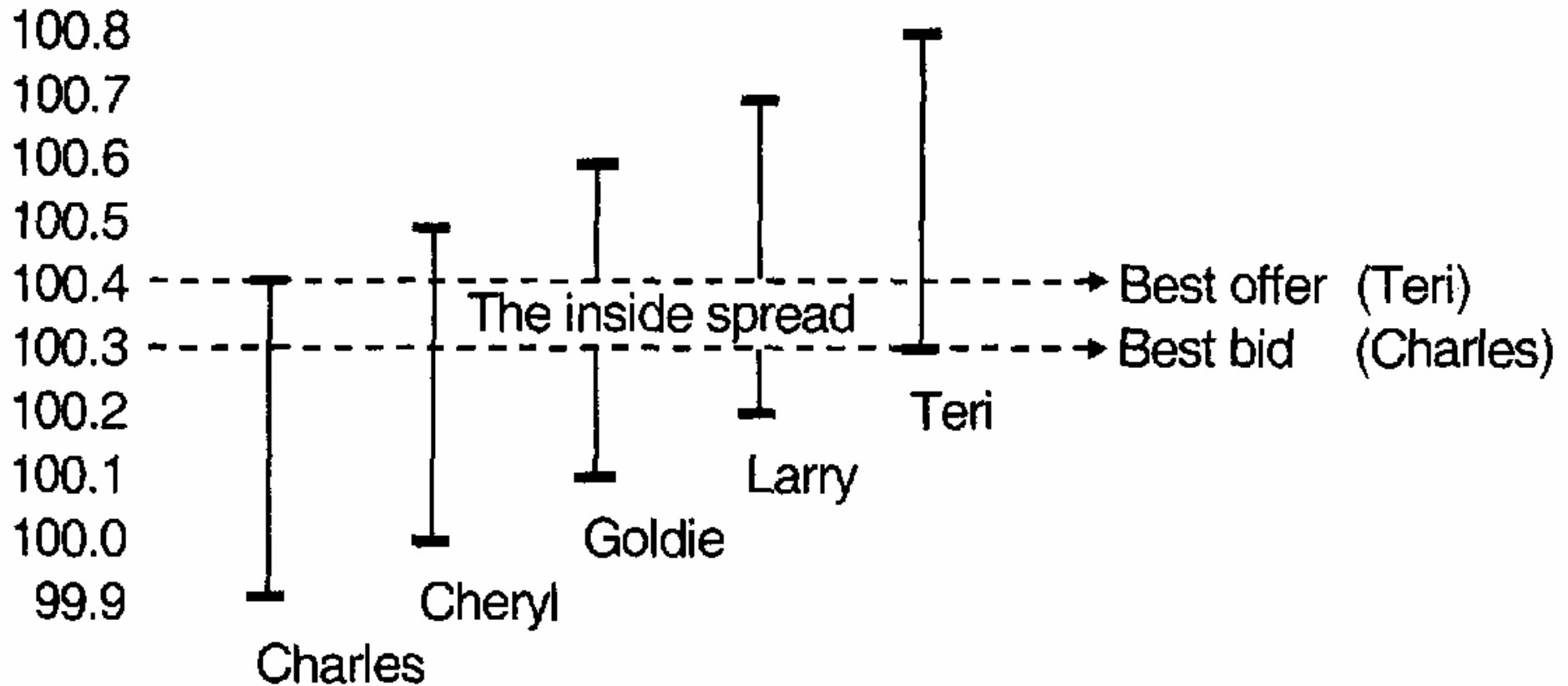


FIGURE 13-1.

The Inside Spread in RobertsonBooks.com

Order-driven market

TABLE 6-2.
Example Order Book

SELLERS			BUYERS		
TRADER	SIZE	ORDER PRICE	SIZE	TRADER	
Sol	1	19.8	7	Bud	
Sue	6	20.0			
		20.0	2	Ben	
		20.0	3	Bea	
Sam	2	20.1	2	Bob	
Stu	5	20.2			
		market buy	4	Bif	

NYSE vs. NASDAQ

	Nasdaq- NMS	NYSE Open	NYSE Intraday
Market Type			
Continuous	×		×
Floor-based		×	×
Dealer Presence	×	×	×
Multilateral		×	
Transparency			
Pre-trade Quotes	×		×
Post-trade Reports	×	×	×

Trading volumes

Биржа	Оборот в январе-августе 2006 г. (\$ млрд)	Число эмитентов
NYSE	11 712,6	2242
NASDAQ	7889,6	3139
LSE	4846,2	3205
Euronext	2274	1218
Deutsche Börse	1822,7	756
OMX Group	860	750
MMBB	322,6	192
SGX	116,4	693
WSE	34,4	270
PTC	24,2	283

ИСТОЧНИК: ММББ, PTC, OMX GROUP

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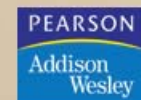
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Discussion topic

Why did the
MICEX overturn
RTS as the main
trading place for
Russian stocks?

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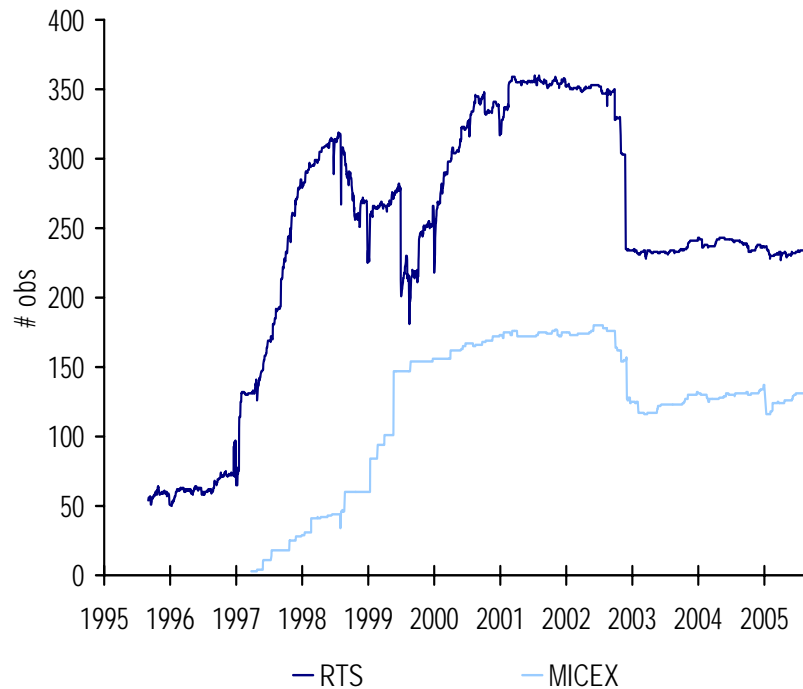


RTS vs. MICEX

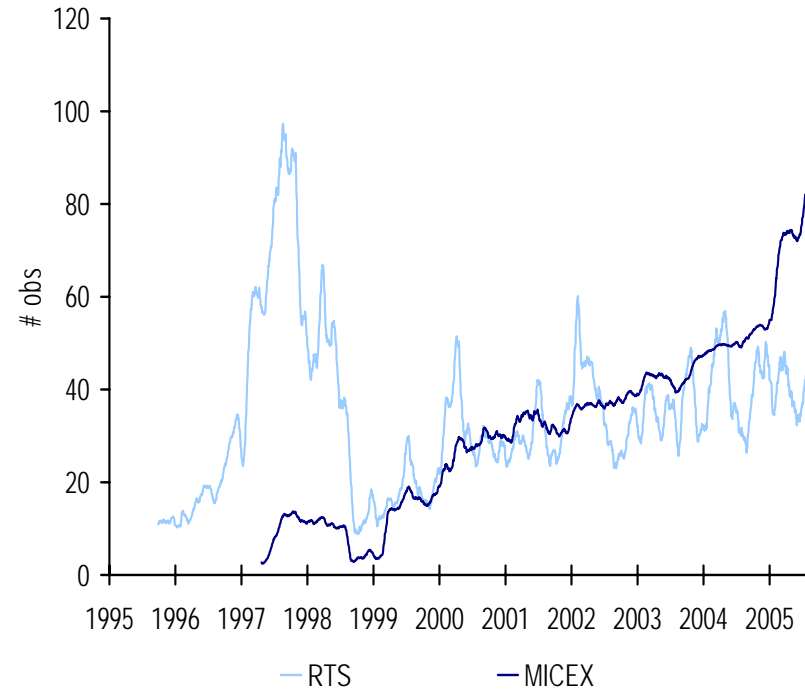
- Created in 1995 as a stock market
- **Dealership** system
- Quotes in dollars
- 230 listed stocks
 - 40 traded stocks
- 250 brokers/dealers
- Started in 1992 as FX market
 - Stocks since 1997
- **Order-driven** system
- Quotes in rubles
- 130 listed stocks
 - 80 traded stocks
- 530 brokers/dealers

Evolution of the market size and liquidity

stocks *listed*
on RTS & MICEX

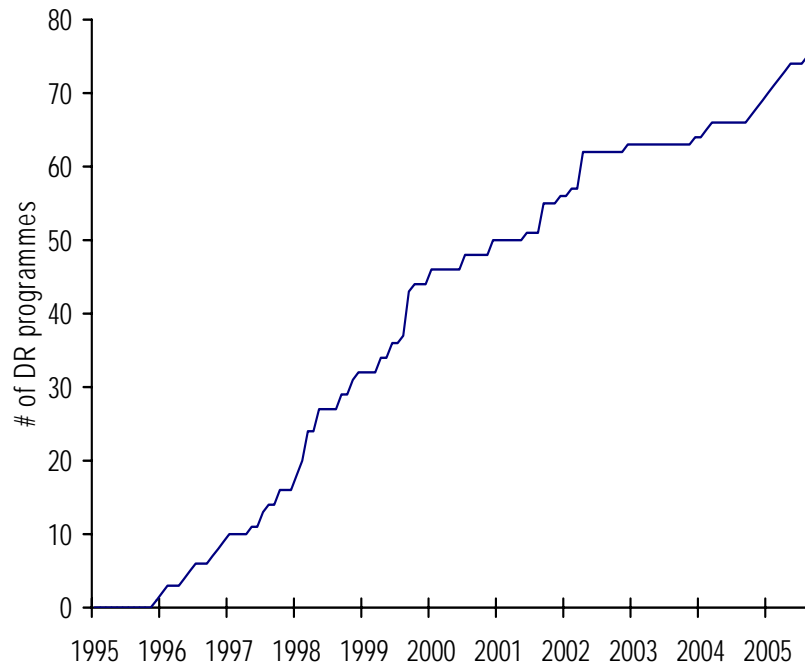


stocks *traded*
on RTS & MICEX



Evolution of the market size and liquidity

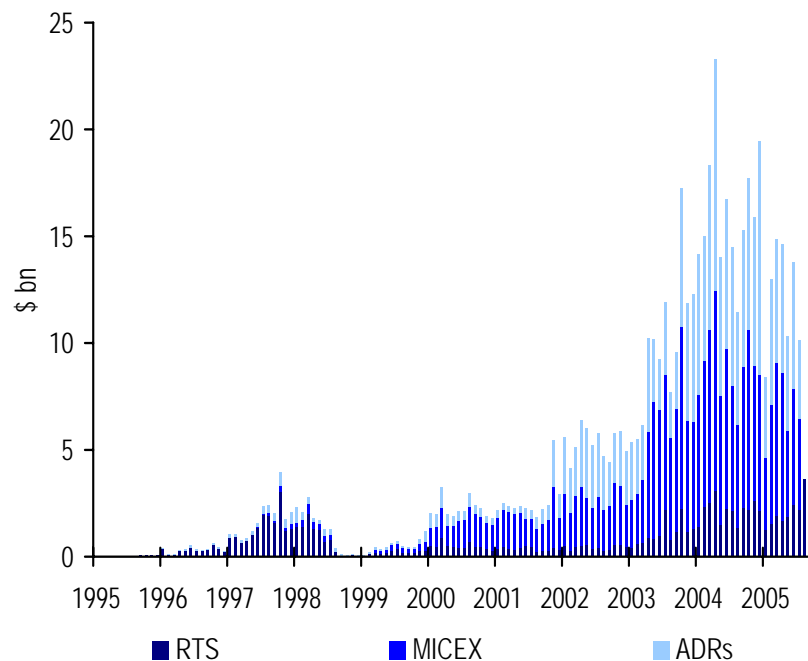
stocks with
depository receipts



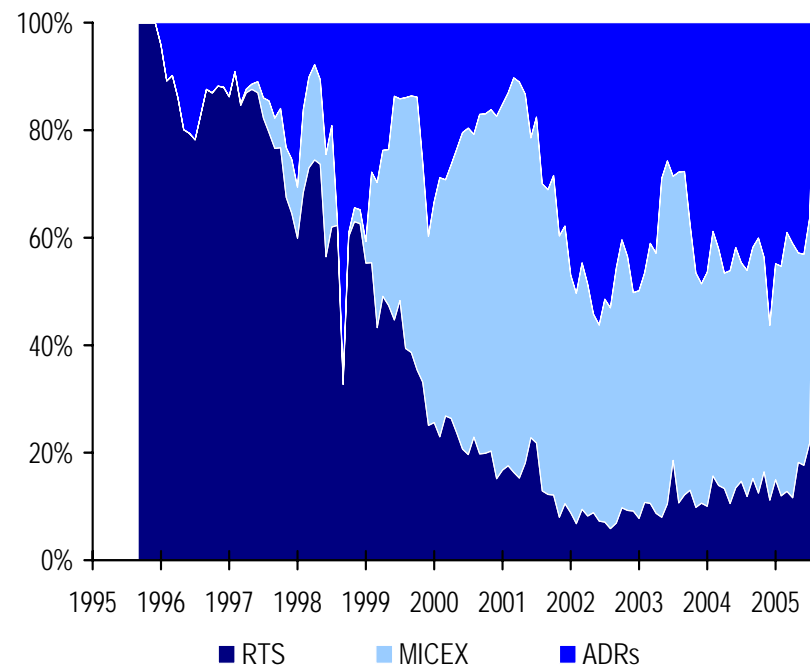
- Three main segments:
 - RTS
 - MICEX
 - ADRs
- Most stocks are still traded in RTS,...
- yet the trading volume has migrated from RTS to MICEX and foreign exchanges

Evolution of the market size and liquidity

Monthly trading volumes, \$ bln



Monthly trading volumes, %





MICEX vs. RTS

- MICEX is a more liquid market than RTS
 - Trading volume in December 2006: 20:1
- Though trading is concentrated in blue chips
 - 82%: Gazprom, Lukoil, Nornikel, RAO UES
- But the RTS index remains the main benchmark
- Common competitor: **OTC**
 - Comparable trading volumes
 - Soon must be reported for a fee