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This is Dr. Bob Nolley. And as we wrap up our unit on long-term capital financing, let's take a look at the advantages of public and private financing.

First, remember that a publicly traded company is one whose securities are for sale to the general public. They usually do this with a stock exchange or through market makers if they are operating in the over-the-counter markets. The main advantage of public financing is that the shares are owned by a great number of shareholders. Because of this, it is easier to raise large amounts of capital.

In addition to increasing the number of shareholders, a company can gain access to less expensive sources of capital. They achieve an enhanced public image, and therefore exposure and prestige. And because of that, they can attract a higher quality of employees and a higher level of management talent.

They are also in a better position to facilitate acquisitions, which they would do through shares of stock. So they create additional multiple financing opportunities, including debt and equity, and perhaps cheaper loans for financial institutions.

A privately held business is generally one whose shares are not available to be traded by the public. They are usually owned by the founders of the company, their families or estates, or by a very small group of investors.

Private financing also holds several advantages. There could be increased capital because investors are willing to buy company stock at a higher price than if it was trading in the market. Why? Because they are willing to pay more in order to privately control the firm.

There is also the possible reduction of administration costs, like reporting and registration and regulation costs in communicating with shareholders. The private firm saves all of these costs.

Often, it is management that takes over and privately controls a company. When this is the case, they have an immediate incentive to improve company performance because they are key investors as well. This also brings a higher level of investor involvement.

Publicly traded companies' shareholders are large, anonymous groups that sometimes can be uninformed and do not typically know the business, much less the daily operations, and therefore are not in a good position to manage it. Private investors can offer expert knowledge and direct oversight

in a way that can benefit performance.

While a company can become public through an IPO, a company can also go private through a leveraged buyout. A leveraged buyout is an acquisition of a company where the purchase is financed through a combination of perhaps 10% equity and 90% debt.

The cash flows of the business being acquired finance the debt. And because the debt usually has a lower cost of capital than the equity, as the returns on the equity increase as the debt is serviced, so the debt effectively serves as a lever, hence the term leverage, to increase returns.

They are financed by private equity firms. Targets for a leveraged buyout would be companies with strong cash flows that are stable and non-cyclical. They have low debt levels. And they have good management teams.

Companies that are in distress in otherwise good industries are also often favorable targets. In the '80s, these became prominent as a way to generate higher returns while only making a small amount of capital investment. Since then, though, investors and private equity teams have become more risk averse. And they require as much as 50% down through debt and 50% equity to fund the business.

Let's review the key concepts of public and private financing. A public company is the one whose shares are available to the general public and has the advantage of being available to many investors. They go public through an initial public offering, an IPO, and have the advantage of diversifying their investor base, having cheaper access to capital, an improved public image, which can lead to attracting better managers and employees.

A private firm can raise increased capital because investors are willing to pay a higher price than in the public market because they will have control. Since managers are also the owners, there is a great incentive to improve performance. Finally, the shareholders know the business and the daily operations and therefore in a good position to offer expert knowledge.

Private companies are created through leveraged buyouts. These are financed by private equity firms. And buyouts are executed through high debt levels, increasing equity value as the debt is repaid. This is the leverage. They are less popular than they were in the '80s because private investors have become more risk averse.

This is Dr. Bob Nolley. And I'll see you in the next lesson.

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