Raising Capital
The Process and the Players

The Finance

- **Finance** is the study of trade-off between the present and the future
  - Investor – giving up something today to gain something in the future
- **Capital market** is an area in which firms and other individuals or institutions that require funds to finance their operations come together with individuals and institutions that have money to invest.

Financing the Firm

- Households, firms, financial intermediaries, and government all play a role in the financial system of every developed economy.
- **Financial intermediaries** are institutions – banks, that collect money - the savings of individuals and corporations and funnel them to firms that use the money to finance their investments.

Financing the Firm

- Indirect financing
  - Through financial intermediaries
- Direct financing
  - Through individual buying and holding stocks of bonds

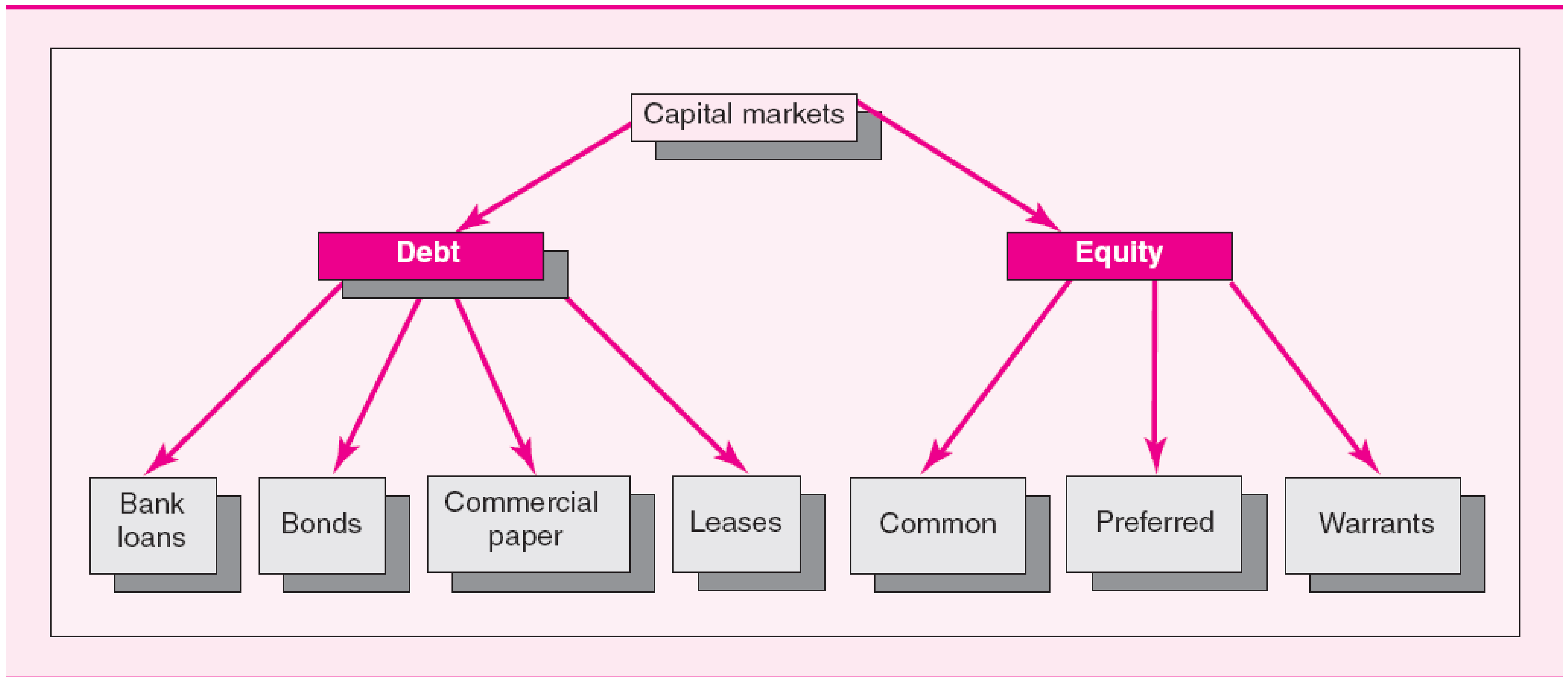
Description of Financial Intermediaries

Financial Intermediary	*Description*
Commercial bank	Takes deposits from individuals and corporations and lends these funds to borrowers.
Investment bank	Raises money for corporations by issuing securities.
Insurance company	Invests money set aside to pay future claims in securities, real estate, and other assets.
Pension fund	Invests money set aside to pay future pensions in securities, real estate, and other assets.
Charitable foundation	Invests the endowment of a nonprofit organization such as a university.
Mutual fund	Pools savings from individual investors to purchase securities.
Venture capital firm	Pools money from individual investors and other financial intermediaries to fund relatively small, new businesses, generally with private equity financing.

Decisions Facing the Firms

- Firms can raise investment capital from many sources with a variety of financial instruments.
  - The firm’s financial policy describes the mix of financial instruments used to finance the firms
- Internal Capital
  - Firms raise capital internally by **retaining the earnings** that generate
- External Capital: Debt vs. Equity
  - Firms must **gain an access to the capital** market and make a decision about a type of funds to raise.

Sources of Capital



External Capital: Debt vs. Equity

- The main difference between debt and equity is that the debt holders have a contract specifying that their claims **must be paid in full between the firm can make payments to its equity holders**.
  - In other words, debt claims are senior, it means have priority, over equity claims
- Second important difference between the debt and equity is that payments to debt holders are generally viewed as **a tax deductive expense** of the firm.
  - In contrast, dividends on an equity instrument are viewed as a payout of profits and are not tax-deductible expanses
- Major corporations frequently raise outside capital by accessing the debt markets
  - **Equity is less frequently used as a source for external financing**

Public and Private Source of Capital

- Firms raise debt and equity capital from both **public** and **private sources**
  - Capital raised from public sources must be in the form of registered securities
- Securities are publicly traded financial instruments
- **Public securities** differ from private instruments because they can be **traded in public secondary market** like NYSE, PSE, FSE etc.
- Private capital comes at most in the form of **bank loans** or in the form called as **private placements**
  - Financial claims takes of the registration requirements that apply to securities
  - To quality for this private placement exemption, the issue must be restricted to a small group of sophisticate investors – fewer than 35 in number – with minimum income or wealth requirements
    - These sophisticate investor are very often represented by insurance companies of pension funds

Public and Private Source of Capital

- Public markets tend to be anonymous, that is, buyers and sellers can complete they transactions without knowing each others identities
  - Uninformed investor run the risk of trading with other investors that are more informed because they have "inside" information about the particular company and can make a profit from it.
    - Although, insider trading is illegal and uninformed investors are at least partially protected by laws that prevent investors from buying and selling public securities based on insider information.
    - Insider information is an internal company information that has not been made public
      - In contrast, investors of privately placed debt and equity are allowed to base their decision of information that is not publicly known.
        - Because traders in private market are assumed to be sophisticate investors who are aware of each other's identities, inside information about privately placed securities in not as problematic
    - Because private market are not anonymous, they generally are less liquid
      - Transaction costs associated with buying and selling private debt and equity are generally much higher than the costs of buying and selling public securities

Result

- Corporation raise capital from both private and public sources. Some advantages associated with private sources are follows:
  - Terms of private bonds and stock can be customized for individual investors
  - No costly registration with some security commission – SEC, CNB, etc.
  - No need to reveal confidential information
  - Easier to renegotiate
- Privately placed financial instruments also can have some disadvantages
  - Limited investor base
  - Less liquid
- Depending on the state of the market, about 70 percent of debt offerings are made to the pubic and about 30 percentage are private placement.

The Environment for Raising Capital

- A bulk of regulations govern public debt and equity issue.
  - These regulations certainly increase the costs of issuing public securities, but also provide protection for investors which support the value of securities.
    - Markets that are highly regulated are e.g. markets in Western Europe or in the US
    - less regulated are e.g. emerging market
      - Major risk in emerging markets is that shareholder rights will not be respected and as a result and, many stocks traded in these markets sell for substantially less than the value of their asset

The Environment for Raising Capital

- For example:
  - In 1995 Lukoil, Russia’s biggest oil company with proven reserves of 16 billion barrels, was valued at 850 USD million, that implies that its oil was worth 5 cents a barrel
  - At the same time Royal Dutch/Shell with about 17 billion barrels of reserves, had a market value 94 billion USD, making its oil worth more than 5 USD per barrel
  - Lukoil is worth so substantially less because of uncertainty about shareholder’s rights in Russia.

Investment banks

- The most important subject in the process of issuing of securities
- Modern investment banks are made up of two parts
  - Corporate businesses
  - Trading businesses

Investment banks

- The Corporate Business
  - The corporate side of investment banking is a fee-for-service business
    - Investment bank sells its expertise
  - The main expertise banks have is in underwriting securities
  - But they are also sell other services
    - Merge and acquisition advice
      - Prospecting for takeover targets
      - Advising clients about the price to be offered for these targets
      - Finding financing for the take over
      - Planning takeover tactics or on the other side takeover defenses
  - Major investment banking houses are also actively engaged in the process of new financial instruments design
    - ETFs, investment certificates, etc.

Investment banks

- The Sale and Trading Business
  - Investment banks that underwrite securities sell them to the bank’s institutional investors
  - These investors include mutual funds, pension funds or insurance companies
  - Sales and trading of these institutions also consists of public market making, trading for clients, etc.
    - Market making requires that investment bank act as a dealer in securities. It means that is standing ready to buy and sell, respectively, announces its **bid** and **ask** prices. The bank makes money from the difference between the bid and ask price called bid-ask spread.

The Underwriting Process

- The underwriting of a security issue performs four functions
  - Origination
  - Distribution
  - Risk bearing
  - certification

Origination

- Origination involves giving advice to the issuing forms about
  - the type of security to issue
  - the timing of the issue
  - and the pricing of the issue
- Origination also means working with the firm to develop the registration statement and forming a syndicate of investment bankers to market the issue

Distribution

- It is the second function in underwriting process, distribution means selling of the issue
- Distribution is generally carried out by a syndicate of banks formed by the lead underwriter
- The banks in the syndicate are listed in the prospectus along with how much of the issue each has aggregate to sell

Risk Bearing

- The third function the underwriting process is risk bearing
- In most cases, the underwriter has agreed to buy the securities the firm is selling and to resell them to its clients
- The Rules of Fair Practices prevents the underwriter from selling securities at a price higher than that agreed on at the pricing meeting, so the underwriter's upside is limited
- If the issue does poorly, the underwriter may be stuck with securities that must be sold at bargain prices

Certification

- An addition role of an investment bank is to certify the quality of an issue, which requires that the bank maintain a sound reputation in capital markets
- An investment banker's reputation quickly decline if the certification task is not performed correctly
- If an underwriter substantially misprices an issue, in the future business is likely to be damaged
  - Studies suggested (Booth and Smith 1986) that underwrites require higher fees on issues that are harder to value

Underwriting Agreement

- The underwriting agreement between the firm and the investment bank is the document that specifies **what** is being sold, the **amount** that being sold and the **selling price**.
- The agreement also specifies the underwriting spread, which is the difference between the total proceeds of the offering and the net proceeds that is accrue to the issuing firm
- The underwriting agreement also shows the amount of fixed fees the firm must pay like listing fees, taxes, etc.

PROSPECTUS

2,500,000 Shares

Common Stock

All of the 2,500,000 shares of common stock, $0.01 par value (the "Common Stock"), offered hereby are being sold by QuadraMed Corporation, a Delaware corporation ("QuadraMed" or the "Company"). Prior to this offering, there has been no public market for the Common Stock. See "Underwriting" for a discussion of the factors considered in determining the initial public offering price. The Common Stock has been approved for quotation on the Nasdaq National Market under the symbol "QMDC."

The shares offered hereby involve a high degree of risk.

See "Risk Factors" beginning on page 6 herein for a discussion of certain matters that should be considered by potential investors.

THESE SECURITIES HAVE NOT BEEN APPROVED OR DISAPPROVED BY THE SECURITIES AND EXCHANGE COMMISSION OR ANY STATE SECURITIES COMMISSION NOR HAS THE SECURITIES AND EXCHANGE COMMISSION OR ANY STATE SECURITIES COMMISSION PASSED UPON THE ACCURACY OR ADEQUACY OF THIS PROSPECTUS. ANY REPRESENTATION TO THE CONTRARY IS A CRIMINAL OFFENSE.

	Price to Public	Underwriting Discount(1)	Proceeds to Company(2)
Per Share	$12.00	$.84	$11.16
Total(3)	$30,000,000	$2,100,000	$27,900,000

(1) The Company has agreed to indemnify the several underwriters identified elsewhere herein (the "Underwriters") against certain liabilities under the Securities Act of 1933, as amended (the "Securities Act"). See "Underwriting."

(2) Before deducting expenses payable by the Company estimated at $900,000.

(3) The Company has granted the Underwriters a 30-day option to purchase up to 375,000 additional shares of Common Stock on the same terms and conditions as set forth above, solely to cover over-allotments, if any. If the Underwriters exercise this option in full, the total Price to Public, Underwriting Discount and Proceeds to Company will be $34,500,000, $2,415,000 and $32,085,000, respectively. See "Underwriting."

The shares of Common Stock are offered by the Underwriters, subject to prior sale, when, as and if issued to and accepted by the Underwriters and subject to approval of certain legal matters by counsel for the Underwriters. It is expected that delivery of the Common Stock will be made against payment therefor on or about October 15, 1996, in New York, New York.

Jefferies & Company, Inc. **Pacific Growth Equities, Inc.**

October 10, 1996

UNDERWRITING

Subject to the terms and conditions of the Underwriting Agreement, the Company has agreed to sell an aggregate of 2,500,000 shares of Common Stock to the Underwriters named below (the "Underwriters"), for whom Jefferies & Company, Inc. and Pacific Growth Equities, Inc. are acting as representatives ("Representatives"), and the underwriters have severally agreed to purchase from the Company the number of shares of Common Stock set forth opposite their respective names in the table below at the price set forth on the cover page of this Prospectus.

Underwriter	Number of Shares
Jefferies & Company, Inc.	930,000
Pacific Growth Equities, Inc.	930,000
Bear, Stearns & Co. Inc.	40,000
Alex. Brown & Sons Incorporated	40,000
Donaldson, Lufkin & Jenrette Securities Corporation	40,000
Lehman Brothers Inc.	40,000
Montgomery Securities	40,000
Morgan Stanley & Co. Incorporated	40,000
Prudential Securities Incorporated	40,000
Smith Barney Inc.	40,000
Brean Murray, Foster Securities, Inc.	20,000
Cowen & Company	20,000
Fahnestock & Co. Inc.	20,000
First of Michigan Corporation	20,000
Hampshire Securities Corporation	20,000
M.H. Meyerson & Co. Inc.	20,000
Morgan Keegan & Company, Inc.	20,000
Needham & Company, Inc.	20,000
Piper Jaffray Inc.	20,000
Punk, Ziegel & Knoell	20,000
The Robinson-Humphrey Company, Inc.	20,000
Unterberg Harris	20,000
Vector Securities International, Inc.	20,000
Wessels, Arnold & Henderson, L.L.C.	20,000
Wheat First Butcher Singer	20,000
The Williams Capital Group, L.P.	20,000
Total	2,500,000

The Underwriting Agreement provides that the obligation of the Underwriters to purchase shares of Common Stock is subject to certain conditions. The Underwriters are committed to purchase all of the shares of Common Stock (other than those covered by the over-allotment option described below), if any are purchased.

The Underwriters propose to offer the Common Stock to the public initially at the public offering price set forth on the cover page of this Prospectus, and to certain dealers at such price less a concession not in excess of $0.52 per share. The Underwriters may allow, and such dealers may reallow, a discount not in excess of $0.10 per share to certain other dealers. After this offering, the public offering price, the concession to selected dealers and the reallowance to other dealers may be changed by the Representatives. The Representatives have informed the Company that the Underwriters do not intend to confirm sales to any accounts over which they exercise discretionary authority.

The Company has also granted to the Underwriters an option, exercisable for 30 days from the date of this Prospectus, to purchase up to 375,000 additional shares of Common Stock at the public offering price, less the underwriting discount. To the extent such option is exercised, each Underwriter will become obligated, subject to certain conditions, to purchase additional shares of Common Stock proportionate to such Underwriter's initial commitment as indicated above in the preceding table. The Underwriters may exercise such right of purchase only for the purpose of covering over-allotments, if any, made in connection with the sale of the shares of Common Stock.

Classifying Offering

- IPO
  - Initial Public Offering
    - Issuing equity to the public for the first time
- SEO
  - Seasoned Offering
    - If a firm has already publicly traded and is simply selling more common stock
- Both IPO and SEO can include primary and secondary issues
- In a primary issue
  - A firm rises capital for itself by selling stock to the public
- In a secondary issue
  - It is undertaken by existing shareholders who want to sell a number of shares they currently own

The Costs of Debt and Equity Issues

EXHIBIT 1.7 **Direct Costs as a Percentage of Gross Proceeds for Equity (IPOs and SEOs) and Straight and Convertible Bonds Offered by Domestic Operating Companies, 1990–1994**

	Equity						Bonds					
	IPOs			SEOs			Convertible Bonds			Straight Bonds		
Proceeds (millions of dollars	*GS*[a]	*E*[b]	*TDC*[c]	*GS*	*E*	*TDC*	*GS*	*E*	*TDC*	*GS*	*E*	*TDC*
$ 2–9.99	9.05%	7.91%	16.96%	7.72%	5.56%	13.28%	6.07%	2.68%	8.75%	2.07%	2.32%	4.39%
10–19.99	7.24	4.39	11.63	6.23	2.49	8.72	5.48	3.18	8.66	1.36	1.40	2.76
20–39.99	7.01	2.69	9.70	5.60	1.33	6.93	4.16	1.95	6.11	1.54	0.88	2.42
40–59.99	6.96	1.76	8.72	5.05	0.82	5.87	3.26	1.04	4.30	0.72	0.60	1.32
60–79.99	6.74	1.46	8.20	4.57	0.61	5.18	2.64	0.59	3.23	1.76	0.58	2.34
80–99.99	6.47	1.44	7.91	4.25	0.48	4.73	2.43	0.61	3.04	1.55	0.61	2.16
100–199.99	6.03	1.03	7.06	3.85	0.37	4.22	2.34	0.42	2.76	1.77	0.54	2.31
200–499.99	5.67	0.86	6.53	3.26	0.21	3.47	1.99	0.19	2.18	1.79	0.40	2.19
500 and up	5.21	0.51	5.72	3.03	0.12	3.15	2.00	0.09	2.09	1.39	0.25	1.64
Average	7.31%	3.69%	11.00%	5.44%	1.67%	7.11%	2.92%	0.87%	3.79%	1.62%	0.62%	2.24%

Note:

[a]GS—gross spreads as a percentage of total proceeds, including management fee, underwriting fee, and selling concession.

[b]E—other direct expenses as a percentage of total proceeds, including management fee, underwriting fee, and selling concession.

[c]TDC—total direct costs as a percentage of total proceeds (total direct costs are the sum of gross spreads and other direct expenses).

Source: Reprinted with permission from the *Journal of Financial Research*, Vol. 19, No. 1 (Spring 1996), pp. 59–74, "The Costs of Raising Capital," by Inmoo Lee, Scott Lochhead, Jay Ritter, and Quanshui Zhao.

The Costs of Debt and Equity Issues

- Debt fees are lower than equity fees
  - Equities are related with higher risk
  - Bonds are easier for pricing than stock
- There are economies of scale in issuing
  - Fixed fees decline as issue size rises
- IPO is much more expensive than SEO
  - IPOs are far riskier and much more difficult to price

Raising Capital in International Markets

- Euromarkets
- Direct Issuance

Euromarkets

- The term Euromarkets is a bid misnomer because Euromarkets have no true physical location
- Euromarkets are a collection of large international banks that helps firm issue bonds and make loans outside the country in which the firm is located
- E.g. firms domiciled in the U.S. could, for instance, issue dollar denominated bonds known as a Eurodollar bonds outside the U.S. or yen-denominated bonds known as a Euroyen bonds outside Japan
- On the other hand
  - German company could borrow through the Euromarkets in e.g. British pounds or Swiss francs

Direct Issuance

- The second way how to raise money internationally is to sell directly in the foreign markets, or what is called as direct issuance
- E.g. a U.S. corporation could issue a yen-denominated bond in the Japanese bond market
- Or a German firm might sell stock to U.S. investors and list its stock on one of the U.S. exchanges

Trend in Raising Capital

- Globalization
- Deregulation
- Innovative Instruments
- Technology
- Securitization

Globalization

- Capital market are now global
- Large multinational firms routinely issue debt and equity outside their domestic country
- By taking advantages of the differences in taxes and regulations across countries, corporation can sometimes lower their cost of funds
  - As firms are better able to shop globally for capital, we can expect regulation around the world to become similar and the taxes associated with raising capital to decline
    - As a result, the costs of raising capital in different part of worlds are likely to equalized

Deregulation

- Deregulation and globalization go hand in hand
- Capital will tend to go to countries where returns are large and restrictions on inflows and outflows are small

Innovative Instruments

- New instruments
  - Allow firms to avoid the constraints and costs imposed by government
  - Tailor securities to appeal to new sets of investors
  - Allow firms to diminish the effects of fluctuating interest and exchange rates
- The result of this process is a wide range of financial instruments available in the global amrket place

Technology

- Technology allows many of these recent trends to take place
  - Technology leads to continuous 24-hour trading around the world, thus producing a true world market in some securities

Securitization

- It is the process of bundling
  - that is, combining financial instruments that are not securities, registering the bundles as securities, and selling them directly to the public
    - E.g. CMOs – Collateralized Mortgage Obligations
      - Debt contracts based on the payoffs of bundles of publicly traded mortgages
    - Market of asset-backed securities

Thank you for you attention