Comparing Public and Private Financing

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WHAT'S COVERED

In this lesson, you will learn about the advantages of being a publicly traded company or a private company. Specifically, this tutorial will cover:

1. Public Financing

A publicly traded company is a company that offers securities 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. Because of that, they can attract a higher quality of employees and a higher level of management talent.

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

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2. Private Financing

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 and 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 a company's stock at a higher price than if it was trading on the market because they are willing to pay more in order to privately control the firm.

There is also the possible reduction of administrative costs, like reporting and registration, along with regulation costs and 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 a large anonymous group that are often uninformed and do not typically know the business, much less the daily operations, and therefore not in a good position to manage it. Private investors can offer expert knowledge and direct oversight in a way that can benefit performance.

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3. Leveraged Buyouts

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 high levels of debt – perhaps a combination of 10% equity and 90% debt.

The cash flows of the business being acquired finance the debt. Because the debt usually has a lower cost of capital than the equity, the returns on the equity increase with the increasing debt. The debt effectively serves as a lever, hence the term leveraged buyout.

BIG IDEA

Leveraged buyouts are usually financed by private equity firms.

Targets for a leveraged buyout would be companies

- With strong cash flows that are stable and non-cyclical
- With Low debt levels
- With good existing management teams
- In distress in otherwise good industries

In the 1980s, leveraged buyouts became prominent as a way to generate higher returns while only risking a small amount of capital. Since then, investors and property equity teams have become more risk-averse and they require as much as 50% down through debt and 50% equity to fund the business.

TERM TO KNOW

Leveraged Buyout

An acquisition where the purchase price is financed through a combination of equity and debt, and in which the cash flows or assets of the target are used to secure and repay the debt.

SUMMARY

In this lesson, you learned that a **public financing** involves a business 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, or IPO, have the advantage of diversifying their investor base, have cheaper access to capital, and have an improved public image, which can lead to attracting better managers and employees.

Private financing can raise increased capital because investors are willing to pay a higher price than in a 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, are in a good position to offer expert knowledge.

Private companies are created through **leveraged buyouts**, which are financed by private equity firms. Buyouts are executed through high debt levels, increasing equity value as the debt is repaid, hence "the leverage." They are less popular than they were in the 1980s because private investors have become more risk-averse.

Best of luck in your learning!

TERMS TO KNOW

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