



Andreas Krause

Adverse selection and financing choices

Information asymmetry

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Company types

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- ▶ $\hat{\Pi}_C^i = (1 - \lambda) (V_i)$

Companies raising equity funds

- ▶ Existing company owners retain their fraction of the company, whose value they know, in addition to the value generated by the new investment
- ▶ $\hat{\Pi}_C^i = (1 - \lambda) (V_i + \hat{V})$

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- ▶ The company **raising equity** will be of **low value**

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- ▶ The company raising equity will be of low value, while the company raising **no equity** will be of **high value**

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Distinguishing company types

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- ▶ If adverse selection is **medium** **high-value companies** will choose **loans**

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- ▶ If adverse selection is medium high-value companies will choose loans and low-value companies will choose equity

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- ▶ For medium adverse selection, the choice of debt or equity (capital structure), **reveals information** about the type of company

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- ▶ This information would then be reflected in the **value of the equity** as seen by **outside investors**

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