Chapter 5

RIGHTS ISSUES/ SECONDARY OFFERINGS

Corporate financiers also have a key role to play when companies need to raise equity capital in the years following flotation. Companies raise money in order to invest in new capital expenditures or projects, to make acquisitions of other companies, to repay debt or simply when the market is good and they can opportunistically raise funds. Such subsequent equity financing can also be called *secondary offerings*, making it sometimes confusing with the term 'secondary offering' referring to the sale of shares by existing owners. In America, subsequent equity issues are referred to as 'seasoned' equity offerings.

In the UK, almost all subsequent equity offerings are done by way of a rights offering. The financier will advise the company on the amount to raise, the pricing and market conditions. As in flotations, the corporate finance team is responsible for the documentation, discussions with the regulators and overall co-ordination of the transaction team (solicitors, PR, stockbrokers, accountants).

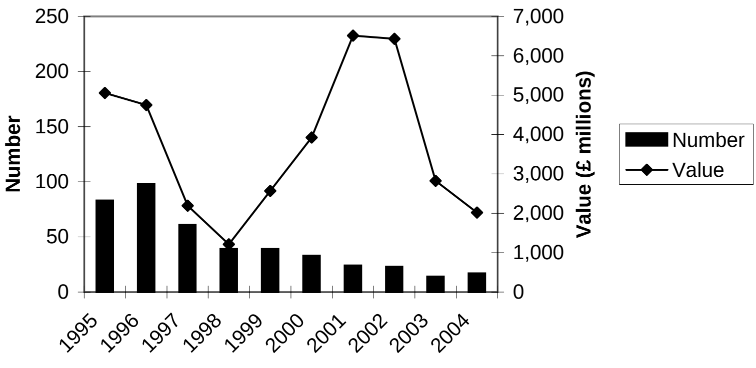

Figure 5.1 UK Rights Issues (1995–2004).

In a 'rights offering' (the term is used interchangeably with rights issue), all shareholders receive notification of the fundraising. If they wish to purchase the new shares, they do so (i.e., they exercise or take up their rights). If the shareholder does not wish to purchase the shares to which he is entitled, he can sell his rights on the Stock Exchange.

PRE-EMPTION RIGHTS

Investors in UK Stock Exchange-quoted companies are protected from the dilution of their ownership stake through pre-emption rights. This means that if a firm wishes to raise new equity capital, it must first offer the shares it is planning to sell to its existing shareholders. The protection from dilution is as a result of both laws and strong traditions in the City. Assuming a shareholder 'takes up' her rights to subscribe to the new issue, she will maintain her proportionate share of the equity in the company.

An exemption to pre-emption practices exists in the UK. Companies are permitted to make an issue of up to 5% of shareholder's capital without offering the new shares first to existing shareholders.

Continental European companies can seek, and regularly receive, permission from their shareholders to waive pre-emption rights. Such pre-emption rights are not part of the corporate finance landscape in Canada or the US.

During the mid- to late-1990s, corporate financiers were at the centre of a debate over whether UK companies should change their approach to fundraising. Many people believed that pre-emption rules prevent new investors from achieving meaningful stakes in companies, thus narrowing the shareholder base and increasing dependence on a few investors. Many others argued that the *status quo* should be maintained.

A survey of UK finance directors into the system of rights issues and raising equity capital was conducted by MORI in 1998. Its main conclusion was that nearly 80% of finance directors believed that they should have access to a greater variety of financing methods.

When it came to the system of pre-emption rights, most supported the system, but thought that the 5% exemption was too low. One-third believed 10% was more appropriate, while 23% supported an exemption of up to 25%. Large-company finance directors generally found the current system most restrictive and half the finance directors (61% of FTSE 100 finance directors) believed that companies in other countries had a competitive advantage because of the flexibility of their systems.

The other side of the issue is represented by the following excerpt from a *Financial Times* article by Carol Galley, then co-head of Merrill Lynch Mercury Asset Management:

... Pre-emptive rights are enshrined in law. They give existing shareholders first refusal on any new shares in a rights issue. Two things are central to this

Table 5.1 Large UK rights issues.

Company	**Year**	**Amount raised (£m)**
British Telecommunications	2001	5,927
Pearson	2000	1,705
BP	1987	1,500
Zeneca	1993	1,300
Eurotunnel	1994	858
ICI	2002	800
Allied-Lyons	1994	670
RMC Group	1995	493
Spirent	2000	528
Logica	2000	463
EMAP	1998	368
Scottish & Newcastle	1995	364
Misys	1997	334

principal: transfer of value and transfer of control. If shares are issued to new rather than existing shareholders there may be a transfer of value to the new shareholders from the existing ones. Whether this has actually happened can only be known with hindsight. In a pre-emptive issue no such transfer of value can take place. We therefore believe that pre-emptive issues are the correct way for companies to raise new equity and that proposals to permit more non-pre-emptive issues are misplaced.

SETTING THE PRICE

One of the most important aspects of a rights offering is setting the terms and the price of the new shares.

Typically, the new shares are offered at a discount to the prevailing trading price on the Stock Exchange. In most instances, the discount is set between 10 and 15%. For assurance, the issuing company will have the offer 'underwritten' – as in a flotation. This means that if the share price falls below the purchase price and the shareholders do not subscribe to the issue, the company is guaranteed to receive the funds.

The reason that offerings are underwritten is that they must remain open for 21 days. It is possible that the shares will fall below the issue price during this period. If so, no rational investor would purchase new shares when she could buy them in the market at a lower price.

Calculating the theoretical rights price

For example, Bridge plc has 125 million shares outstanding, currently trading at 240p per share. The company needs £50 million to complete several projects and its corporate finance advisors have recommended a rights issue.

The advisors suggest an offering of 25 million shares at 200p per share (a discount of approximately 17% to the current price). The ratio of new shares to old is 25 : 125, meaning that for every five existing shares an investor owns, he is entitled to purchase one new share at 200p. This is referred to as a one for five rights issue (the ratio of 25 : 125 simplified). Rights issues can be done on the basis of any ratio (e.g., 1 for 4, 2 for 7, 3 for 11, etc.).

On issue, the share price is likely to fall from its current 240p, reflecting the new money raised and the new shares issued. The price at which the shares are likely to settle is referred to as the theoretical ex-rights price and is calculated as follows:

Five existing shares at current price of 240p	1,200
One new share for cash at 200p	200
Value of six shares	1,400
Theoretical value of one share ex-rights (1,400/6)	233p

If a shareholder decides not to exercise his rights, he is able to sell the rights he has been sent on the Stock Exchange. The value of a right on one existing (old) share is:

$$\frac{TMV - SP}{n} = \frac{233 - 200}{5}$$
$$= 6.60\text{p}$$

where TMV = Theoretical market value of share ex-rights;
SP = Subscription price;
n = Number of old shares required to pur chase one new share.

Therefore, the value of a right on one new share is equal to:

$$TMV - SP = 233 - 200$$
$$= 33\text{p}$$

This is the approximate price at which the rights should trade on the Stock Exchange during the issue period, other things being equal.

RIGHTS ISSUE TIMETABLE

Rights issues follow a fairly standard timetable, leaving investors 21 days to decide whether to exercise their rights or to sell them in the stock market – rights become listed on the London Stock Exchange (*LSE*) or Alternative Investment Market (*AIM*) for their lifetime. Box 5.1 is a detailed timetable for the £5.9 billion rights offer launched by British Telecommunications plc (*BT*) in the spring of 2001.

Fees and commissions

Traditionally, UK rights offerings carried a 2% commission. The total commission paid by the company raising the funds was divided as follows:

Primary underwriter	0.50%
Broker to the issue	0.25%
Sub-underwriters	1.25%

The traditional fee structure mirrors that of the fee structure for UK flotations.

In 1996 the Office of Fair Trading began an investigation into the traditional split of fees – and particularly, the amount paid to sub-underwriters. This was as a response to a study conducted by academics at the London Business School which found that sub-underwriters were 'overpaid' for the risks taken in underwriting during the period 1986–1994.

Box 5.1 Rights issue timetable.

Record date for the Rights Issue	Close of business on 9 May
Nil Paid Rights and Fully Paid Rights enabled in CREST	By 8 a.m. on 21 May
Dealings in new BT Shares, nil paid, commence on the LSE	8 a.m. on 21 May
Recommended latest time for requesting withdrawal of Nil Paid Rights from CREST	4.30 p.m. on 7 June
Latest time for depositing renounced Provisional Allotment Letters, nil paid, into CREST or for dematerialising Nil Paid Rights into a CREST stock account	3 p.m. on 11 June
Latest time and date for splitting Provisional Allotment Letters	3 p.m. on 12 June
Dealings in new BT Shares, fully paid, commence on the LSE	8 a.m. on 14 June
Latest time and date for acceptance	9.30 a.m. on 15 June
Recommended latest time and date for requesting withdrawal of Fully Paid Rights from CREST	4.30 p.m. on 22 June
Latest time and date for splitting Provisional Allotment Letters, fully paid	3 p.m. on 27 June
Latest time for depositing renounced Provisional Allotment Letters, fully paid into CREST or for dematerialising Fully Paid Rights into a CREST stock account	3 p.m. on 27 June
Latest time and date for registration of renunciation of Provisional Allotment Letters, fully paid	3 p.m. on 29 June
New BT Shares credited to CREST stock accounts	2 July
Despatch of definitive share certificates for new BT Shares	By 16 July

In response, since 1996, sub-underwriters have been invited (by the primary underwriter or sponsor) to 'bid' or tender for the fee they require to take up any shares that remain as a result of unexercised rights. This has resulted in a general decrease in the sub-underwriting portion of the total commission.

The first issue which included a tender for sub-underwriting occurred in 1996 as part of a £222 million rights issue for Stakis, the hotels group. Corporate financiers at Schroders devised a method whereby institutions who were interested in sub-underwriting the issue tendered for the fee that they would receive for doing so. One-third of the sub-underwriting fees were put out to tender, which resulted in bids that saved the company approximately £400,000 in underwriting commissions.

In October 1997, Schroders put the sub-underwriting for all of a £125 million rights issue for Berkeley out to tender. In that offer, the shares were offered at a discount of 26% to the previous market price in order to reduce risk to the sub-underwriters – in most cases, the discount is set at 10–15%. This resulted in the sub-underwriting commission being cut from its 'standard' 1.25% to 0.3%, saving Berkeley nearly £1.2 million.

Finally, in April 1998, Monument Oil and Gas did away with underwriters altogether by getting its leading shareholders to underwrite the issue, rather than engaging an underwriter and sub-underwriter. In doing so, the company saved itself £1.3 million in commissions on its

£96 million rights issue. Monument was able to do so because it had relatively few, large shareholders who were long-term supporters of the company. Institutional investors representing 54% of share capital took up their rights, leaving only 46% of the issue to be underwritten. The commission on the remainder of the issue was 0.625%, less than half the 1.75% combined underwriting and sub-underwriting fees. The one for four rights issue was priced at a 10% discount to the share price prior to announcement.

Deep discounted rights issues

One way to avoid paying underwriting commissions is the use of a deep discounted rights issue. This type of issue sets the price of the new shares at much greater than the 10–15% discount noted above. Companies have tended to shy away from deep discounted rights issues for several reasons. In particular, many believed they would be under pressure to maintain the level of dividends on the enlarged equity, increasing their cost of capital.

Deep discounted issues are relatively uncommon in the UK, although as the following paragraphs describe, the second largest rights issue ever completed was done at a 50% discount.

On Monday, 31 July 2000 Pearson announced a takeover bid of $2.5 billion (£1.66 billion) for a US company called National Computer Systems (*NCS*) which is involved in education services. To finance the acquisition, one of many made by Pearson in 2000, the company announced a £1.7 billion rights issue on the basis of three new shares for every 11 owned at a price of £10 per new share – 170 million new shares were issued. The price of £10 was a discount of approximately 50% to the prevailing share price of £20.10.

One of the reasons Pearson decided to offer a deep discounted rights issue was that it was able to minimise the commissions paid. In deep discounted issues, it is unusual for an investor not to participate, and some dispense with underwriting completely. In Pearson's case, it decided to underwrite £1.5 billion of the total (organised by Goldman Sachs and Cazenove) which ensured that the bulk of the funds would be available on closing. The cost of the underwriting was 0.5% of the funds raised or £7.5 million in total. If the issue had been underwritten on standard terms, Pearson would have paid £35 million in commissions. At the time, institutions backed the move which they described as 'innovative' and 'cost-effective'.

SECONDARY OFFERINGS

In countries where pre-emption rights do not exist or are regularly waived by investors, companies requiring equity capital have two choices: a marketed offering or a 'bought deal'.

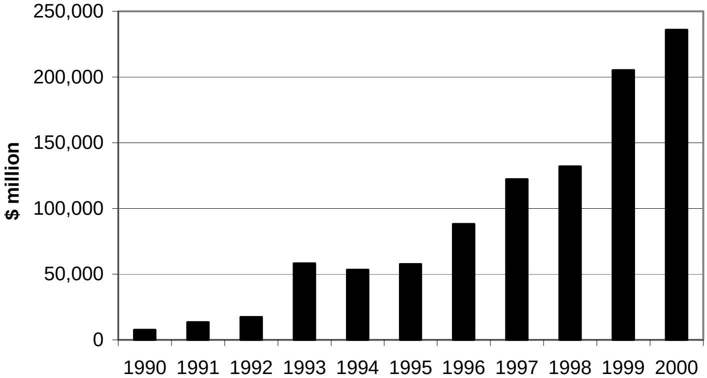

Figure 5.2 Global secondary offerings (1990–2000).

Marketed offerings

Marketed secondary offerings are structured in a manner very similar to an Initial Public Offering (*IPO*). The marketed offering is the most common method of raising funds in the US. The company appoints an investment bank and assembles a team of lawyers, accountants and PR experts. Corporate financiers co-ordinate the preparation of a prospectus and take soundings in the market regarding investor appetite for the new shares. Confidentiality is important in marketed offerings as information regarding a firm's impending sale of shares would cause a fall in the company's share price.

Once the preliminary prospectus is prepared and filed with the regulator a marketing campaign commences. Marketing for a secondary offering is less extensive than that for a company's IPO as investors are already familiar with the firm's business. Where an IPO often has a 4–6-week marketing period, a secondary offering typically uses 1–3 weeks.

Once the regulator approves the offering documents, and the lead manager has sufficient orders, the lead manager closes the book and prices the new issue. The price of the new shares is usually set at a very small discount to the closing price on the pricing day.

Bought deals

A bought deal, sometimes referred to as a 'block trade', involves a bank buying shares in a company, using its own capital, and then selling the shares as quickly as possible to institutional investors. The difference between the buying and selling price is the investment bank's profit.

A bought deal is more risky for an investment bank (compared with an offering using bookbuilding) because it can suffer losses if it is unable to sell the shares. Vendors like bought deals, because they are faster than formal offerings (rarely taking more than 24 hours for successful transactions). On the other hand, the vendor must accept that it will likely have to sell its shares at a discount to the prevailing market price. The discount is required because of the need for speed and secrecy as well as the fact that the investment bank is risking its own capital.

Bought deals typically work best when a small proportion of the total capital of the company's shares are being sold (i.e., less than 5%), the company is well known with a research following and there is a liquid market in the shares.

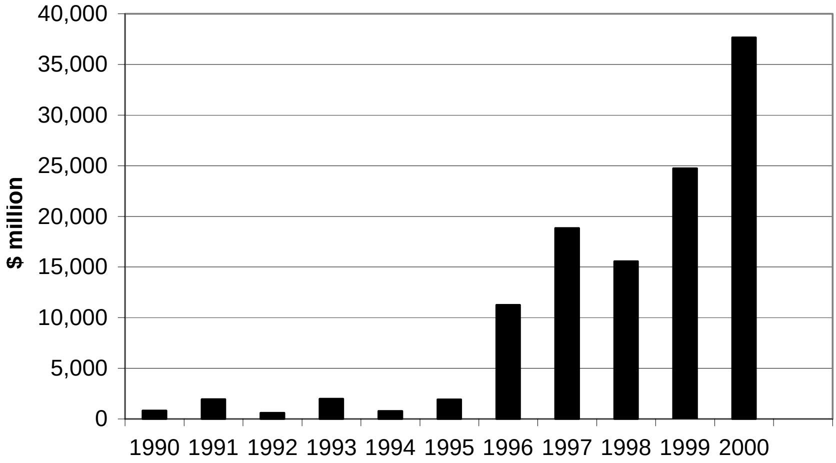

Figure 5.3 Global bought deals (1990–2000).

Bought deal example

In 1995, the UK Government hired NM Rothschild, the merchant bank, to advise it on the sale of the state's remaining holdings in a number of privatised companies. These were worth approximately £1.2 billion. The largest holding was a 1.8% stake in British Petroleum (*BP*), valued at over £500 million in December 1995.

Late in the year, Rothschild was ready to move. On Friday afternoon, 1 December, the firm received approval for its plan from the Treasury. Following a weekend of fine-tuning their strategy, corporate finance and equity capital markets professionals were sure of its success.

On Monday, a number of leading investment banks in London were invited to Rothschild's offices at 8 p.m. after the markets in London and New York had closed.

The firms were not told which of the stocks they were bidding for until after they had arrived. The only indication they had been given in advance was that they would be called upon to commit a large amount of capital.

Rothschild kept the bidders apart all evening. After being told that they were bidding for the government's entire stake in BP, each investment bank was given 2 hours to respond. The winner was SBC Warburg (now UBS Investment Bank) which bid 508p per share for 101 million shares – just over £513 million. This compared with the closing price of 531p, a 4.15% discount. Other bidders were said to be BZW (Barclays), Merrill Lynch and at least one other American house, each of whom had offered less than 508p per share.

When trading opened on Tuesday, 5 December, Warburg's salesmen called institutions throughout the UK and Europe and at lunch-time began to offer shares to US investors, as they arrived in their offices. The holding was placed with approximately 100 institutions, split evenly between the UK and Europe, and the US, at a price of 513p. BP shares closed at 517p, down 14p on the day, but still above the re-offer price.

For the day's work and the use of the firm's capital, Warburg earned approximately £5 million.

Accelerated bookbuilding

Accelerated bookbuilding is a variant on the bought deal. A company that is reasonably well known, with good liquidity in its shares, may opt for a shortened marketing period, rather than the typical 2–3 weeks as in a traditional marketed offering. In an accelerated bookbuilding, the investment bank(s) may organise only two or three roadshow presentations in order to build demand for the shares over 2 or 3 days. In some cases, if the company is well enough known, the bankers can do away with the requirement for investor presentations altogether.

In February 2000, National Grid, in an extremely well-timed move, reduced its holding in the telecommunications and Internet company, Energis from 46% to 36% via an offer using accelerated bookbuilding. The sale of 30 million shares raised £1,014 million (before costs, commissions and taxes) for the parent company.

During January and February shares in all European telecommunications companies had been rising. The week before the sale of Energis shares was announced, its share price had increased by an extraordinary 30% to £37.97 each. At the opening of the UK market on Wednesday, 9 February, National Grid announced that it had hired ABN Amro Rothschild leading a small syndicate of banks which included Cazenove, Dresdner Kleinwort Benson and HSBC to sell up to 30 million shares.

On announcement of the accelerated bookbuilding, the shares dropped to £33.63, below the price that the banks were offering the shares (£33.80). However, by the end of the day all 30 million shares had been placed at the offer price.

DEMERGERS

A demerger occurs when a parent company distributes shares in a subsidiary to its (the parent's) shareholders. On completion of a demerger, the two publicly traded companies will have identical shareholder lists. A demerger can be completed in conjunction with a capital raising for the subsidiary as in the case of the ICI–ZENECA demerger in 1993 in the UK. To illustrate, if an investor had owned 2% of ICI shares prior to the demerger, she would own 2% of ICI and 2% of ZENECA following the demerger.

Corporate finance teams are called upon to help companies determine the most appropriate structure for demerged entities. Their knowledge of how institutional investors are likely to react is extremely important to chief executives and finance directors. Once the structure is in place, corporate financiers co-ordinate the documentation and other aspects of the demerged firm's introduction to the Stock Exchange.

In 1997, British Gas demerged its pipeline network and international operations from its domestic gas distribution business. Then in 2000, management announced the demerger of the international operations (Lattice) from its pipeline network (BG).

In September 2000 Kingfisher, a UK retail group, announced that it was to split in two in early 2001. Its domestic general merchandise case chains (Woolworths and Superdrug) would form one company, while its pan-European DIY and electricals businesses (Comet, B&Q, Darty and Castorama) would form the second.