

U K SHAREHOLDERS' ASSOCIATION

RIGHTS ISSUES: THE THREAT TO SHAREHOLDERS' PRE-EMPTIVE RIGHTS

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0. INTRODUCTION & SUMMARY

The right of shareholders to participate in Rights Issues is currently being questioned in various quarters.

UKSA is trying to ensure that the concerns of private investors are made known at an early stage, before a more formal threat to shareholders' rights emerges.

This briefing has been prepared by the Policy Group of the UK Shareholders' Association, and represents current UKSA policy.

1. THE CURRENT POSITION

At present, a company wishing to raise capital by a share issue is obliged to make a **rights issue**, in which all existing shareholders may participate. The issue is generally at a modest discount to the current market price of the existing shares. Shareholders who do not wish to increase their investment in the company may sell their rights in the market.

Underwriters agree to buy (at the issue price) any rights that are not exercised. This ensures that the company will raise the planned amount regardless of market conditions.

The cost of a rights issue is largely made up of the underwriters' fees, which are almost invariably 2%.

Very rarely, a **deeply discounted rights issue** is made. With these, the discount to the market price is so great that the rights are almost certain to be exercised, so that underwriting is unnecessary, reducing the issue cost by 2%.

A common alternative is the **Placing and Open Offer**, where existing shareholders are entitled to buy the new issue of shares, but **may not sell their rights in the open market**. The shares are also provisionally pre-placed by the company with institutional investors; any shares that are not bought by the existing shareholders then go to the placees.

Companies are also allowed to make a **Placing** of shares without offering them to existing shareholders, but only if the number of shares being issued is less than 5% of the number of existing shares.

There are two recognised shortcomings to the traditional Rights Issue.

First, the 2% underwriting fee is excessive, in relation to the average risk incurred, and is to all intents and purposes fixed. This is an unnecessarily high cost, which is effectively paid for by the shareholders.

Secondly, the issue does not immediately increase the shareholder base, as it is made available only to existing shareholders. This may depress the share price in the medium term, as well as losing an opportunity for an increase in the shareholder base.

2. THE CURRENT PROPOSALS, AND THEIR SPONSORS

The **Office of Fair Trading** investigated underwriting fees in 1995, and concluded that they were too high, implying the existence of an informal cartel. However, it deferred taking immediate action, in the hope that the situation would improve. There was no improvement, so the OFT's current director general, John Bridgeman, launched a further review of the fees, with the support of the Treasury. This review is now concluding and the OFT is expected to refer the matter to the Monopolies and Mergers Commission.

Individuals within the **Confederation of British Industry** have questioned the principle of pre-emption rights, arguing that making new shares available only to existing investors, at a discount, and charging the 2% underwriting fee, 'raises the cost of capital'. It is also argued that companies retaining their dividends at the same level after a rights issue incur greater costs, because the dividend has to be paid on a larger number of shares, some of which have been issued at a discount.

The CBI is therefore being urged to ask institutional investors to consider increasing the percentage of new shares that may be placed without being offered to existing investors, from 5% to 25%.

The **Treasury** is believed to support a loosening of pre-emption rights (FT, 10/5/96).

The **deregulation working party**, an unofficial group chaired by former Treasury minister Francis Maude, is also reported to be supporting this argument (Evening Standard, 3/6/96).

NAPF and the ABI (**National Association of Pension Funds and Association of British Insurers**) have responded that pre-emption rights must be protected, and that the 5% ceiling must not be raised. However, they have also agreed that underwriting fees can be brought down, and have stated that they have no problem with dividends being reduced after a rights issue.

Mercury Asset Management has argued that 'Pre-emption rights are a fundamental protection for shareholders as owners of a company, providing protection against involuntary dilution' (FT, 13/5/96).

3. OBJECTIONS TO THE CURRENT PROPOSALS

A. Pre-emption Rights as a Basic Protection of Ownership Rights.

Pre-emptive rights are a fundamental protection for existing shareholders, as NAPF and the ABI have indicated. There are numerous instances in American corporate history of directors using new issues of shares to themselves or their allies, issued at a substantial discount to market value, to dilute or expropriate ownership of a company from its existing shareholders. This was one of the main mechanisms used by the American 'robber barons' to establish their huge fortunes in the last century.

Pre-emption rights have protected British investors from this sort of abuse for over a century, and it is a well-proven and relatively efficient mechanism.

Proposals to increase the ceiling for non-pre-emptive share issues from 5% of a company's share capital to 25% would mean that the size of a company's share base could be increased by a quarter, reducing a private investor's share in the company's total value by a fifth, without the investor having any opportunity to participate.

In the United States, new shares are frequently issued through investment bankers to themselves and their clients. This clearly creates a conflict of interest between the existing shareholders and the company's financial advisers, since the more an issue is underpriced the more the financial advisers and their clients stand to benefit at the expense of existing shareholders.

B. Direct Cost of Capital

Some industrialists apparently believe that a rights issue issued to existing shareholders at a substantial discount to the market price directly increases the 'cost of capital' of the new shares.

This argument has been explored in depth by Paul Marsh, of the London Business School, who has written a definitive article on the subject, published in The Financial Times of 24 May 1996, and who also wrote a paper for the Office of Fair Trading (Underwriting of Rights Issues) in 1994. Paul Marsh concludes that this argument is financially illiterate.

If, as a private investor, you own 3% of a company which is raising a million pounds, and you are offered 3% of the new share issue for 30,000 pounds, it doesn't matter to you whether you are offered 30,000 shares at 100p or 60,000 shares at 50p. The net effect is that the company is 1 million pounds richer, and you still own 3% of the company. If the shares are issued at a large discount to market value, you can either exercise your rights to buy all of the shares, in which case the discount is irrelevant, or you can sell your rights in the market in which case you pocket the difference between the market value and the issue price. This directly compensates you for the reduction in value of your existing shares.

So the 'cost' of a rights issue discount flows straight back to existing shareholders, whether they exercise their rights or sell those rights in the market.

However, if shares are issued at a discount to market value and are not made available to existing shareholders, the value of each existing share is reduced as a result, at the expense of existing shareholders.

So in reality the only factors that directly affect the 'cost of capital' are:

- (i) the administrative costs associated with the issue, which are paid out to external advisers and therefore genuinely reduce the value of the company at the expense of all shareholders;
- (ii) the difference between the market value of existing shares and the price at which the new shares are issued, if they are not made available to existing shareholders - since the shareholders receive no compensation for the loss in value of their existing shares.

C. The Costs of a Rights Issue

A major part of the cost of a Rights Issue is the 2% underwriting fee, of which
0.5% goes to the investment bank organiser;
0.25% goes to the brokers;
1.25% goes to the sub-underwriters.

The last of these is where excessive profits are being made. The fee being charged is out of all proportion to the risk being taken on, according to the OFT. The Bank of England Quarterly Report of May 1996 comes to the same conclusion.

The fact that this fee is almost always the same, at 2%, is clear evidence of the existence of an informal cartel-like operation in the City.

A substantial reduction in the cost of underwriting would be of some benefit to shareholders, and UKSA has welcomed the OFT's investigation.

Leading institutional shareholders have already indicated that they are likely to accept lower underwriting fees. This may not be relied on, but should be encouraged by the OFT investigation.

However, the excessive 2% underwriting fees must be kept in perspective. All methods of fund-raising involve significant expense: even including these fees, the costs generally associated with a Rights Issue are very low compared to other methods.

D. The Costs of Alternative Methods

In the United States, where companies are not obliged to use Rights Issues, the commonest method used is to sell the new shares directly to the underwriters, who are chosen by (and may even be) the financial advisers. This is the most expensive method of all: once fees and the discount to market value are taken into account, the total cost is around three times the administrative cost of a Rights Issue.

So the US evidence is that, given the choice, companies are generally persuaded to choose far more expensive methods of fund-raising, by advisers who have a vested interest in maximising the benefit to themselves of shares issued at substantial discount, at the expense of existing shareholders.

E. Expanding the Shareholder Base

It is argued that making a new issue of shares available through a placing results in new shareholders, increasing the shareholder base and improving liquidity.

This is far from certain.

With a rights issue, any existing shareholders who do not wish to increase their holdings can sell their rights, in which case any new investors buying those rights will increase the shareholder base. Alternatively, existing shareholders may exercise their rights and then sell their new shares. Both activities increase the flow of shares onto the market. Meanwhile, the publicity surrounding the Rights Issue should increase demand for the shares from new investors. Taken together, the result should be an increase in the number of shareholders.

With a placing, the new shares may be placed with a single new investor. Alternatively, many of the new shares may be placed with favoured clients who are already shareholders in the company, so there is no guarantee that the shareholder base will be increased significantly.

In this respect, Placings do not offer any demonstrable advantage over Rights Issues.

F. Depressing the Value of Shares

There is certainly a concern that Rights Issues may tend to depress the value of a company's shares temporarily, precisely because all the existing shareholders not wishing to invest further in the company sell their rights, or their new shares, over a short period.

If the issue is unpopular, the market can easily be flooded with shares and rights, and the share price will be depressed unless there is a similar increase in demand for the shares by new investors. The result will be that existing shareholders who sell their rights may not get the full value of the rights or shares that they sell.

On the other hand, a well-publicised and popular Rights Issue often increases the value of existing shares because it is seen as a positive move for the company. Indeed, a rights issue should be surrounded by sufficient publicity to increase the demand for the shares, thus compensating for the increase in supply.

UKSA is not aware of any research into this issue. However, any analysis would have to take into account that a Rights Issue made at a discount to market value will proportionally reduce the value of existing shares - but at no real cost to the existing shareholders.

The argument that Rights Issues tend to depress share prices at the expense of existing investors should therefore be rejected on principle unless strong evidence of it can be provided.

G. Maintaining Dividends After a Discounted Rights Issue

It is also argued that a discounted rights issue increases the number of shares in issue, making it more difficult for companies to maintain the dividend per share, but that companies have great difficulty in persuading institutional investors to accept a lower dividend per share. This would certainly increase the dividend burden on the company.

However, the Association of British Insurers has said that its members would be willing to see dividends reduced following a discounted rights issue, and that they simply haven't been asked to do so until now.

4. CONCLUSIONS

The proposals for weakening pre-emption rights have received a frosty response so far from investing institutions, which fully recognise the inherent risks to existing investors.

Private investors are at the greatest risk from these proposals, which represent a major threat to our rights as owners.

The arguments against pre-emptive rights are not backed up by any statistical evidence - indeed Paul Marsh points to considerable evidence from the US that alternative issue methods incur far greater real costs.

Both rights issues and placings are almost invariably made at a discount to the prevailing market price. The major difference is that the discount on a placing allows new investors to come into the company cheaply, at the direct expense of existing shareholders, whereas the discount on a rights issue carries no real cost to existing shareholders. Furthermore, the US experience is that placings are issued at greater discounts than rights issues.

Company directors who are genuinely concerned with creating shareholder value should be made aware that substantial placings of new shares are more likely to destroy shareholder value.

Efforts to reduce excessive underwriting fees are to be welcomed. However, rights issues have served and protected shareholders well over many years, and should not be abandoned.

On behalf of private investors, the UK Shareholders' Association vigorously opposes any weakening of pre-emptive rights.

UK Shareholders Association

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