Briefing notes: Risks that explain the rewards of rights issues

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Not all methods of raising equity cost the same: some carry higher fees, and there are hidden costs associated with others.

Concern about the cost of raising equity has come to prominence with the spate of capital injections for US financial institutions and deeply discounted rights issues among European banks.

Some of the investment banks handling the US fundraisings have earned fees of up to 3 per cent of the sum raised, according to people familiar with the transactions.

Tony Lomas, a partner at PwC, the consultancy, says there is a broad lesson for all companies here. “The more desperate you are, the more you will end up paying – whether you are raising debt or equity,” he says.

But the greatest controversy has been associated with the pricing of rights issues – and the complicated risk-reward dynamics that these fundraisings entail for those handling them.

In a rights issue, the company raising fresh equity sells newly created shares at a discount to its share price just before the issue is announced. The “rights” refer to rights of first refusal that the company’s existing shareholders have over these new shares. These rights are distributed on a pro-rata basis.

Rights issues have a beautiful simplicity to them. If the shareholders take up all of their rights and buy the new stock, then they will end up owning the same percentage of the company’s share capital when the rights issue is complete as they did beforehand.

The controversy surrounding rights issues centres on the high fees charged by the investment banks for underwriting the fundraising – that is, guaranteeing to buy the newly issued stock if other investors decide not to take up the shares.

Getting a rights issue underwritten means that the company is assured its cash. Without underwriting, the company is exposed to the risk that its shares fall below the issue price set for the new stock, in which case investors would have no incentive to participate in the issue because they could buy the company’s shares for less on the stock market.

In underwriting the issue, the investment banks are taking a risk: this is, the company’s share price may collapse to below the rights issue price, leaving them to buy the newly issued stock at the issue price, and thereby generating an immediate loss. Naturally, the banks expect to be compensated for this risk.

TOP 5 LARGEST RIGHTS ISSUANCES WITH UNDERWRITING FEES MORE THAN $100M
GLOBAL, 2001-MAY 20 2008

Date	Issuer	Issuer country	Proceeds ($bn)	Lead underwriters
Mar 20 2003	Allianz	Germany	**4.7**	Citi, Deutsche Bank, Goldman Sachs, UBS
Oct 11 2007	Fortis Group	Belgium	**18.7**	Fortis, Fox-Pitt, ING, Merrill Lynch
Oct 17 2003	Munich Re	Germany	**4.6**	Deutsche Bank, DKW
Nov 26 2003	Koninklijke Ahold	Netherlands	**3.4**	ABN, Goldman Sachs, ING, JPMorgan, Rabo Bank
Mar 11 2008	Société Générale	France	**8.5**	Credit Suisse, JPMorgan, Merrill Lynch, Morgan Stanley, SocGen

Source: Freeman & Co

Investment banks try to minimise their chances of losing money by insisting that the rights issue is priced at a wide discount to the company's share price before the fundraising is announced – and that is what generates controversy.

Companies and their investors question why investment banks charge such large fees for rights issues when the discount minimises their risk, and when the fees comfortably cover their costs.

The most visible instance of this in recent years was Royal & Sun Alliance's rescue rights issue of 2003. The insurer paid a 3.5 per cent underwriting fee in spite of the rights issue being priced at a near 50 per cent discount to its share price before the cash call was announced.

Europe's biggest ever rights issue, the £12bn ($24bn) cash call by Royal Bank of Scotland announced last month, saw gross fees of only 1.5 per cent, with a 0.25 per cent discretionary payment for excellent execution of the fundraising.

Even so, shareholders – who ultimately pay these fees – were incensed when the investment banks tried to lay off the underwriting risk and offered a fee of only 0.8 per cent to the so-called "sub-underwriters".

This would have enabled the banks to pocket a net fee of at least 0.7 per cent for taking no risk whatsoever on a portion of the transaction. The banks subsequently agreed to raise this so-called sub-underwriting fee to 1 per cent after investors complained to RBS.

There are other hidden costs to rights issues for the company's shareholders. These affect investors who choose not to take up their rights, perhaps because they cannot afford to do so.

Shareholders in this group typically sell their rights to other investors, who may find them a more efficient way of getting into the stock than buying the company's existing shares traded on the stock market.

The problem is that non-participating shareholders often fail to get a fair price for the rights they sell. This is, in part, a function of supply and demand. But certain hedge fund strategies designed to exploit rights issues also play a role by putting downward pressure on the company's share price and, therefore, the price of the traded rights.

Investment bankers like to defend the large discounts they demand in rights issues by arguing that such discounts are irrelevant to investors.

While a larger discount involves greater potential dilution because more stock is being issued, shareholders have correspondingly more rights that they can either take up or sell.

But shareholders' failure to get a full and fair price for their rights is exacerbated the greater the discount of the issue. It is estimated that the all-in costs of a rights issue, factoring in banking fees, legal fees and these hidden costs, could be as much as 5 per cent.

Companies concerned about these costs have other options for raising capital.

A sale of a non-core subsidiary will involve investment banking fees typically of between 0.5 per cent and 1 per cent of the value of the transaction. Likewise, companies may choose to sell off investments in listed companies.

A placing in the market of a large block of stock would typically cost about 1 per cent if the vendor was willing to accept the market price, but much more if it wanted the investment bank to guarantee a price – perhaps as much as 7 per cent of the market value of the stake prior to the sale taking place.