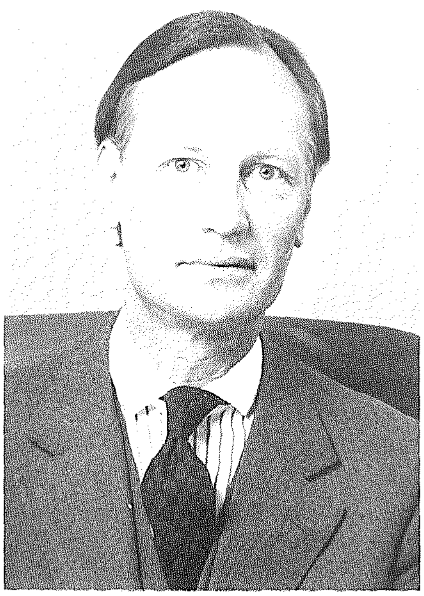
RIGHTS, WRONGS OF CASH ISSUES

SHOULD SHAREHOLDERS HAVE FIRST BITE?



by F. H. MULLENS

The tradition of allowing existing shareholders pre-emptive rights to new cash issues is being questioned — and the questions raise important issues for companies and investors.

Many practices and fashions which originate abroad eventually find their way to Australia, as did deregulation. In the United States, the system of capital raising does not give existing shareholders first priority to participate in cash issues. In the UK and Europe, where it does, the practice is beginning to be questioned. So, is there merit in the idea of a change in Australia?

Already, in one instance, it is about to happen. In February this year, International Income Property Inc (IIP) proposed a change to its Certificate of Incorporation (equivalent to the Australian Articles of Association) to permit the directors to offer new stock to other than existing shareholders.

True, IIP is an American company, but when Mr G. J. Dusseldorp founded it, its stock was offered to Australian investors and it was listed on Australian exchanges. It was subsequently quoted on American and the London exchanges. Nevertheless, it is regarded as a member of the Lend Lease group of companies, still with many Australian stockholders.

If Lend Lease itself should adopt a similar proposal, the merits or otherwise of shareholders not having pre-emptive rights might attract a lot more public discussion on the lines of that aired earlier this year in an issue of *The Economist* (see box).

In Australia for many generations the conventional thinking has been that a large part of the benefit of equity ownership has come from the shareholders' prior right to subscribe for cash issues. Frequently, cash issues were made at a deep discount to give the holder a large "bonus" element.

As the markets have become more competitive and mature, this tradition has been moderated by the awareness that the closer the issue price is to the market price, the more economic the cost of the finance to the issue company and the greater the ultimate benefit to all shareholders.

Indeed, if the issue price is sufficiently finely pitched in relation to the market price, the rights value can be so small that many holders neither sell nor take up their entitlements; they allow them to lapse. If the issue has been underwritten the stock then goes to the underwriter.

The question then becomes whether everyone may not have been better off by disregarding the pre-emptive right of shareholders and simply making a placement of the whole issue at the same, or less, discount on market price without incurring the cost of underwriting.

Notwithstanding this argument, many investors believe that by taking up issues where they are offered, even at little or no discount on market price, their overall return improves. Presumably this is because the very making of the issue depresses the share price during the issue; then, when the issue has been fully digested, the price recovers to its "natural" level. Thus, those who

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subscribe to issues ultimately do better than those who sell rights or forgo their entitlements.

Clearly, the question of whether to subscribe or not assumes that the holder regards the stock as a fundamentally attractive investment and is concerned only about the timing and price of the particular issue.

Perhaps the best illustration of this is listed property trusts, such as IIP. Many such trusts make their cash issues as close to market price as underwriters will tolerate, particularly if the market price is at a discount to assessed net asset value, as is often the case.

Listed property trusts, in many respects, are the purest form of finance and accounting: because they distribute virtually 100 per cent of their net revenue, they do not generate unitholders' reserves and so have to raise all their capital from unitholders on terms which must be enticing to the subscriber and at the same time economically viable in relation to the property investment to be made.

The price of many property trust issues is so close to market price that the rights value is minimal.

This fine balance between the two parties is a real test of the economic efficiency of the market. As a result, the price of many property trust issues is so close to market price that the rights value is minimal, and many holders allow their entitlements to lapse.

It seems that IIP has found this to be the case in its issues and has come to the conclusion that because it invests in America, it needs the benefits of the American capital-raising system to be a competitive investment as an international stock.

However, careful analysis of issues, and comparison of overall returns between investors who subscribe and those who sell their rights entitlements, show that the investor who subscribes has often been better-off. The table, which lists the returns of 13 trusts over five

PRE-EMPTORY CHALLENGE

This comment was published in* The Economist *in March of this year.

Britain's Treasury is threatening a campaign to loosen what it reckons is an iniquitous City moneypress: pre-emption rights. These insist that companies raising cash through equity issues must offer them first to existing shareholders.

These rights, argues the government, hamper British companies from tapping capital from cheaper sources – especially foreign investors. In America, where pre-emption rights do not exist, investment banks bid to underwrite a whole issue; the winner then distributes the paper to investors wherever it sees fit.

Sadly for the government, companies are currently unenthusiastic about dancing to the Treasury's tune, which is being conducted by the financial secretary, Mr Norman Lamont. True, the debate was a lively one two years ago. Then, two biggish companies, Fisons and C.H. Beazer, wanted to use new issues to tap overseas markets and establish a foreign share-ownership to match their foreign sales. Since existing shareholders would not get any of the issues, British institutions balked at this. Fisons had to scrap its issue, Beaser had to scale its one down.

Then came the stockmarket crash. New equity issues have slumped – from 16 billion pounds ($28 billion) in 1987 to 9.9 billion pounds last year. And firms remember that during the crash, foreigners were quicker to dump their overseas holdings than their domestic ones.

Institutions point out that companies may launch (without approval from shareholders) non-rights issues of shares up to 7.5 per cent of the total allocated share capital over a rolling three-year period, but no more than 5 per cent in any one year.

Companies usually issue new shares at a hefty discount to the prevailing share price to make them more appealing. If those discounted shares were to pass to outside investors, then the value of existing shareholders' stakes would be diluted. There is no net loss of value when existing shareholders take up their pro-rata portion of a rights issue, because, in effect, shareholders are paying themselves.

Opponents of pre-emption rights retort that with American "bought deals", new issues rarely have to be priced at a discount, since companies can tap a much wider pool of capital. But total fees for underwriting and distributing big new issues are much the same in America and Britain, at around 2 per cent.

Institutions argue that there is no real cost to shareholders when companies pay them to sub-underwrite new issues. More real for some; since it is the institutions who do the underwriting, there is a cost to the smaller shareholders left out. It is a transfer from small investors to big ones. Sub-underwriting is one of the few remaining City cartels.

Because of this cartel, the Treasury appears to think that pre-emption is hampering the growth of private share ownership. Despite past privatisations, the proportion of British shares owned directly by individuals has dropped, from nearly 30 per cent to 18 per cent since the Tories came to power in 1979. The fall is explained partly by the cost for small investors of dealing in London, and partly by the government's own tax regime, which gives favourable treatment to insurance-linked savings schemes.

Recently, London's International Stock Exchange said it was setting up a committee to look into new-issue procedures. The committee will consider whether the current procedures for new issues are damaging either London's attraction as a capital-raising centre, or the push towards wider share ownership.

It would be surprising if the committee can suggest anything constructive about the latter. Pre-emption is part of British and European Community company law. The committee could propose that companies set aside a part of each new issue for fresh shareholders, as often happens in France. But even with laxer rules on pre-emption, share ownership will not get much wider without the kind of retail share distributions that exist in America (through wire houses) and France (through the branch networks of big banks) to push new issues. □

years, shows that unitholders in nine did better, in three worse and in one the same by taking up rights.

This raises questions in the event of it becoming accepted that issuers are not bound by the pre-emptive right of existing holders:

- will market values fall because equities are less attractive, thereby making capital raising less economic? or
- will the improved economics of capital-raising be sufficient to result in a higher dividend return to holders, thereby making equities as attractive as when they had pre-emptive rights?

The arguments for and against will probably become topical only when an investor-favourite, such as Lend Lease or BHP, proposes to make placements instead of pro-rata cash issues to shareholders. In the past, even the non-renounceable pro-rata issue has not been popular with Australian investors, even though it is more economical in that it relieves the issuer of the cost of registration of rights transfers etc.

Therefore, would the abolition of pre-emptive rights be even less well-received in Australia and would holders "vote with their feet" and move to alternative investments?

Another aspect of this subject which must be considered is the length of time it takes for an Australian company to complete a pro-rata cash issue. From the decision to make an issue on particular terms to the final banking of the cash will take as long as 35 days on the "short" timetable and 45 days on the "normal" timetable of the Australian stock exchanges. These time-spans leave either the issuer or the underwriter exposed to market movements for a long period. The longer the period of exposure, the greater the cost of underwriting.

If companies were not bound by shareholders' pre-emptive rights, would the ability to make placement issues allow abuse?

For example, Boral made a non-underwritten issue at an attractive discount at the beginning of October 1987. Before the issue closed, October 20 had come and gone, leaving the stock selling well below the new-issue price. The company aborted the issue.

If pre-emptive rights are disregarded, the price of an issue need not be determined until the eleventh hour and the cash can be banked within a few days. Further, the subscribers to the issue can on-sell stock to adjust their portfolios in relation to the prevailing market. And the administrative cost of making and processing a placement issue is reduced to a negligible amount. With markets as sensitive and volatile as they have been in recent years, the opportunity costs incurred because of the timetable of pro-rata issues can be very real.

However, there are certain other "very real" considerations which the article in *The Economist* has not canvassed.

If companies were not bound by shareholders' pre-emptive rights, would the ability to make placement issues allow abuse? For example, might favoured shareholders or other investors be offered stock on unnecessarily generous terms? If AMP took all the issue, would other shareholder institutions be amused? Could the ability to make quick placement issues be used as a defence against what management regards as an unwanted takeover bid? Once again, would such pressure cause unwarranted generosity to some and not to others?

Even in less extreme circumstances, determining the best price of an issue may require procedures just as cumbersome as pro-rata. For example, putting an issue out to tender is time-consuming and may result in an embarrassing failure if the prices offered are considered ludicrously low — which in turn could cause the market price to drop. Certainly, going to tender would make it difficult to keep the proposal confidential.

In light of recent "insider trading" scandals and the poor track record in ethical matters of many Australian company directors, as well as their lack of financial prudence and judgment, the scope for malpractice with placement issues may do more harm than good to the confidence of investors, with very deleterious effects on the efficiency of the market for the economic raising of capital. □

Internal rates of return for five years (% p.a. up to 30/6/87)

	Rights taken up			Rights sold		
	1	2	3	1	2	3
General	31.97	26.14	18.85	26.33	21.50	15.42
Schroders	23.32	19.98	14.50	20.59	16.70	11.78
Stockland	42.18	35.10	25.52	42.64	35.49	26.01
Westfield	24.82	20.44	14.19	21.76	17.33	12.32
Austore	7.58	2.86	2.86	8.22	3.55	3.55
Canberra	10.73	6.27	5.56	10.73	6.27	5.56
Capital Pr	22.82	16.99	12.39	26.58	21.41	15.21
Capital	31.14	27.17	18.82	24.20	20.09	14.49
Equitable	18.21	12.29	9.67	15.39	9.31	7.97
IIP	29.35	28.12	20.61	25.47	24.25	17.96
McNamara	11.92	6.72	6.48	10.54	5.50	5.03
PA Trust	27.08	25.41	17.62	26.36	24.74	17.23
Stirling	11.93	9.06	7.84	9.95	6.53	6.17

Key: 1. Tax free. 2. Tax paid on distributions. 3. Tax paid on distributions and capital gain.