Ask the experts:

Are underwriting fees excessive?

THREE EXPERTS – ONE FROM THE ACT, ALONG WITH A CONSULTANT AND A BANKER – DEBATE THE RIGHTS AND WRONGS OF FEES, WHILE A TREASURER RECOUNTS HIS RECENT EXPERIENCE OF A RIGHTS ISSUE.

Martin O'Donovan, assistant director for technical and policy, ACT

Right issues have been attracting steadily increasing fees from the banks – both for underwriting and for the whole package, including advice – over the past decade. Ten years ago a figure of 1.5% or 2% of proceeds was typical; today 3% and even 4% is common.

Another development has been for the rights issue to be priced well below current market value. This gives shareholders more of an incentive to take up the issue and prevent dilution, and there is less risk of the share price sliding towards the rights issue level. There have also been cases of rights issue being launched into a weak market, with the share price falling below the rights issue level as a result.

Although underwriting fees have risen, the level of risk taken on by underwriters has fallen. Another development has been the increase in pre-marketing, also known as pre-sounding. Traditionally, a company would keep its plans for a rights issue confidential ahead of the launch, to prevent rumours from spreading – although it would attempt to gauge likely demand.

The increasing use of pre-sounding has seen underwriters approach investors much earlier, to get a more accurate indication of what take-up of the issue is likely to be. This means they can be fairly confident in advance that the rights issue will be successful, which in turn further reduces the degree of risk they are assuming. The greater degree of confidence would seem to merit lower fees; the fact this hasn't happened suggests that companies are being overcharged.

These trends have been noticed, though – hence the Institutional Shareholders' Committee report on right issues in December, which urged companies to be more alert and to demand a greater degree of competition.

It was followed by an Office of Fair Trading report in January. Since the OFT stopped short of describing the banks' fees as anti-competitive, the inference is that buyers are failing to challenge underwriters on whether their work merits such high charges.

As issuers don't usually engage in rights issues very often, they rely on the expertise of their advisers as to whether a rights issue is actually needed, when the best timing is, etc. Yet they often use the same bank for both the advisory work and the underwriting – surely there is a conflict here even if it's different units of the bank divided by Chinese walls.

The size of the rights issue and the size of the discount rest to some extent on the adviser's recommendations. The underwriter wants an easy life, so will tend to set both at a cautionary level. This might have been prudent when markets were very volatile, but despite a few jitters during 2010 the underlying trend has been a return to more normal conditions. Also, although advisers would probably caution against going ahead with a rights issue if they felt the timing to be completely disastrous, they might be minded to recommend going ahead when conditions are "iffy" to avoid missing out on their fee.

Yet a rights issue is a big deal for a company. If it doesn't work out, the outcome can be very serious, so companies must proceed cautiously.

Treasurers would be well advised to hold a competitive tender for the underwriting contract instead of simply using their house bank. They should also ask for an itemised breakdown when the advisory and underwriting fees are bundled together. Bear in mind that any bundling of charges usually works to the benefit of the provider.

So the message is:

- treat the rights issue as a serious transaction, which means putting it out to competitive tender;
- question whether the rights issue actually needs to be fully underwritten; and
- be aware that networking is still prevalent – the prospect of a rights issue often sees investment banks buttering up the CEO and bypassing both the treasurer and CFO.

It's good to see that shareholders have begun questioning the levels of fees charged. However, while they can put pressure on management and raise the public debate they can't actually take action themselves.

A concluding thought: given that underwriting a rights issue is a major strategic activity, companies and their treasury teams might consider working through the various issues well in advance of commencing any rights issue – on a "how would we organise it if we went ahead with one?" basis. This process would involve the legal team and consider at what point to put it out to competition. Now that two recent reports have publicised the issue of fees, companies have more ammunition to question pricing and even whether underwriting is needed.

The ACT has worked with other bodies on guidance to rights issues – suggesting, for example, that they didn't always need to be underwritten. However, we have found it impossible to agree a wording acceptable to everyone; the projected guidance was continually redrafted or our radical proposals were watered down.

The ACT is now considering reviving the project to issue guidance, perhaps in conjunction with investors. ACT's technical and policy director John Grout has just issued a blog on this topic and posted it on the ACT website at **www.treasurers.org/node/6750**

Stephanie Maguire, professional support consultant, Herbert Smith

During the banking crisis, many rights issues took place in the UK under challenging market conditions, and the level of fees charged by underwriters was seen to reflect the increased risks at that time. However, as market conditions have improved there has been no corresponding reduction in underwriting fees.

Given this, in July 2010 the Institutional Investor Council (IIC) announced that it was conducting an inquiry into underwriting practices on rights issues in the UK. In the course of its review, it looked at the role and selection of advisers and underwriters, the pricing and structure of capital raising, the level of underwriting fees relative to changing risk exposure, the transparency of underwriting fees, and sub-underwriting practices.

Following its review, the IIC inquiry issued a detailed report and made a number of recommendations to improve the equity underwriting process for issuers. While some of the proposals would require regulatory changes (for example, the recommendation that the Listing Rules require issuers to disclose in detail all fees paid on a rights issue, to whom they are paid and for what services), there are some more straightforward suggestions in the report that issuers considering an equity capital raising could follow now. These include seeking independent advice, not automatically assuming that the rights issue must be fully underwritten, and always putting the primary underwriting contract out to tender. Issuers concerned about the expectations of their investors should look at the draft generic guidance relating to the expectations of institutional shareholders in an issuer conducting an equity capital raising.

The rights issue fees inquiry is not, however, the end of the story. Not long after the IIC launched its inquiry into underwriting, the Office of Fair Trading also launched a market study in this area. It has recently published its findings, which broadly indicate there is little competitive tension between investment banks during the equity raising process and that issuers raising equity capital are not focused principally on reducing underwriting fees. It also found that there had been a significant increase in fees since the start of the financial crisis and those fees have not since fallen in line with the reduction in risk.

However, the OFT has provisionally concluded that it is not appropriate to refer the equity underwriting market to the Competition Commission for investigation as the market has just been through an exceptional period following the credit crisis. Instead, it believes the issues can be addressed most effectively by issuers and institutional shareholders negotiating harder over fees and taking other steps to help reduce fees.

At a practical level, the OFT report, like the IIC inquiry, suggests that issuers should, among other things, seek more advice about the process from their institutional shareholders, non-executive directors and legal advisers, and put greater pressure on fees by asking for a costs breakdown. It also recommends that issuers improve the competitive tension for the underwriting business by, for example, inviting banks with which they have existing relationships to compete for different aspects of the underwriting, and by increasing the number of banks they have relationships with.

The OFT believes that institutional shareholders should put greater pressure on issuers to reduce fees. It suggests that they should discuss the principles for any future equity raisings with the issuer and, where possible, commit to sub-underwriting before the announcement of the rights issue, thereby reducing the underwriting risk and, potentially, the fees.

Looking forward it will be interesting to see how market practice on these points develops. At the very least, issuers are likely to have further pressure placed on them by institutional investors to negotiate underwriting fees and banks should expect to be having more heated debates on fees.

The British Bankers' Association

The argument persists across public debate that for there to be effective competition in banking there needs to be a significant number of players in the market. Yet evidence abounds that the banks remain in aggressive competition with each other for customers, in international commerce as in the high street. They only ever come together, with some reluctance, in times of pressing need.

Lately we have seen several examples of that kind of pressing need emerging, as the entire banking industry has taken the reputational hit for the high-profile failures of a few. Project Merlin was an attempt to provide reassurance that the banks were committed to supporting the economic recovery. The Business Finance Taskforce is the banks' joint initiative to provide firm, deliverable commitments to businesses seeking financial support for the recovery.

Competition is a good thing – indeed, it is vital to functioning markets – and the British Bankers' Association always welcomes the emergence of new entrants in the market (and not simply because they swell our membership). But the market does not necessarily need an abundance of different companies in order to work. Nevertheless, we have seen new entrants to the investment banking market in recent years and there is increasing competition among the big global investment banks in the world's biggest financial markets, including our own.

The Office of Fair Trading's recent investigation into investment banking fees charged by UK banks – which it ultimately decided not to refer to the Competition Commission – did level criticism at the industry, which is currently being discussed across the City with a view to improving banking services to customers. But it also pressed customers to be more alert to the deals available. Specifically, it urged companies and institutional shareholders to push hard for the best deals in equity underwriting fees – and correctly so. Competition works best when customers hold out for the optimum deal.

But decisions on matters that can be vital to a company's future are rarely made solely on price. And that price must reflect the inherent risk in the transaction. It is a regulatory obligation that all banks must now seek to manage their exposure to risk more carefully, and, as with all regulations, this has an impact on the wider economy as well. Too often in public debate we hear banking regulation referred to as if it has no impact on the economy beyond the way that banks conduct their business. In fact, capital and risk controls in particular have a fundamental impact on the availability of banks to support businesses.

The banks carry special responsibilities here, both in the wake of the economic crisis and as engines of the economy. We have all been through very turbulent times and banks must take their share of the responsibility for what happened. We now need to work together to ensure Britain's businesses can be assured of the support and the services they need in order to restore lasting stability to our economy.

Case study: National Grid

MALCOLM COOPER, GROUP TAX AND TREASURY DIRECTOR OF NATIONAL GRID, RECOUNTS HIS RECENT EXPERIENCE OF A £3.3BN RIGHTS ISSUE TO **GRAHAM BUCK**.

One of the more unexpected stock market announcements of 2010 came in May, when National Grid used the release of its full-year results to launch a rights issue involving the sale of 990 million shares in a two-for-five placing at 335p a share.

The plan by the UK's largest utility group caught many investors off-guard, but appears less surprising in retrospect. National Grid needs to upgrade the UK's power infrastructure over the next five years and estimates that the total cost will come in at £22bn. The news was also sweetened by the group announcing a 12% rise in pretax profits, and an 8% increase in the dividend, which it pledged to maintain over two further years.

National Grid's rights issue also differed from most others in being specifically allocated for organic growth, rather than to fund an acquisition or provide an injection of capital to a business in trouble. Many of those announced during 2009 and the early months of 2010 fell into the latter category, says its group tax and treasury director Malcolm Cooper.

The group's treasury team was informed early in the year of plans to step up its investment programme and worked on the issue over several months, with progress periodically reviewed at board level, he says. "It was evident the sum involved meant that it wasn't fundable internally and we would need to seek equity from the outside."

Cooper admits that choosing the right timing was difficult, particularly when a general election was confirmed for early May. It was eventually decided that the rights issue announcement would coincide with the release of the results for the year to 31 March 2010, which were scheduled for release on 20 May.

"There was some concern that the news might leak ahead of this date, but fortunately it remained confidential and we avoided any uncertainty caused by speculation and also any share overhang," says Cooper.

National Grid announced that the issue would raise gross proceeds of £3.3bn and a net figure of £3.2bn, with the difference consisting of the fees for underwriters Morgan Stanley, Bank of America-Merrill Lynch and Deutsche Bank.

"Yes, it's debatable whether such a level of fees was justified," Cooper says. "With National Grid behind the offering, you can argue that the degree of risk taken on by the underwriters was minimal.

"But at the same time, it provided an insurance policy against unexpected events; had the issue failed, then the fees would have been worth every penny. And it was a tough market last May, with Greece's sovereign debt crisis creating uncertainty and much volatility in the equity markets."

Fortunately, although the market's initial response was unenthusiastic – the share price fell 43p to 577p on the day of the announcement – the issue was highly subscribed, with a take-up rate of around 95%.

"We knew beforehand it was inevitable that a rump of shareholders, mainly our smaller shareholders, wouldn't be able to take up the rights," says Cooper. "So all in all we were very pleased with the outcome."

> "IT PROVIDED AN INSURANCE POLICY AGAINST UNEXPECTED EVENTS. HAD THE ISSUE FAILED, THEN THE FEES WOULD HAVE BEEN WORTH EVERY PENNY."

The share price also traded much in line with the treasury team's expectations, despite the fact that on 3 June – 12 days before trading in the new shares commenced – the shares went ex-dividend. By 17 June, the share price was at 514p and in line with the theoretical ex-rights price (TERP), which carried a discount of 35.7%. The other key metric, the bonus element from the dilution, was 1.1426.

"So in retrospect, the timing proved very satisfactory," Cooper says. "The transaction went very smoothly and we successfully got funding in place towards our five-year plan. I also believe that it represented the largest rights issue to date designated for organic growth."

Power points: some of National Grid's electricity transmission infrastructure in the UK