A brave face

WITH THE DANGER OF INVESTOR FATIGUE SETTING IN FOLLOWING A RUSH OF RIGHTS ISSUES AT THE START OF THIS YEAR, SHOULD COMPANIES SIMPLY HOLD OFF OR REVIEW HOW TO BEST STATE THEIR CASE? **GRAHAM BUCK** FINDS OUT.

As a sign of the tougher times we are in, a growing number of organisations are either announcing plans for rights issues or are actively considering tapping investors for additional funding. Between the start of 2009 and late March, companies had already managed to raise more than £22bn this way.

Among the FTSE 100 elite, HSBC, Wolseley and Xstrata are among those to have announced rights issues in recent months; all three of them were met with a distinctly unenthusiastic response. When HSBC announced a £12.5bn cash call at the beginning of March, its share price plummeted, taking the FTSE 100 to a new six-year low with it. And that left Wolseley with even more of an uphill struggle: although the company wants to raise a comparatively modest £1bn, its market capitalisation is little more than this figure.

A typical example of a recent rights issue – and the motives behind it – is provided by car dealer Inchcape. Its £232m call has been brought about by the downturn and the resulting slump in sales across the motor industry. The group says it will use the proceeds of the call to halve its debt load of £408m, giving it greater headroom on a covenant that requires it to maintain profits at three times interest payments, and to delay refinancing until 2012. Chief executive Andre Lacroix stresses that a rights issue is preferred to refinancing debt on more expensive terms, and will save the group more than £70m in interest over the next three years.

But, like many others, Inchcape has been forced to deeply discount the nine-for-one issue to get it off the ground. The new shares were offered at an issue price of 6p against a closing price of nearly 51p when the proposed issue was announced.

Executive summary

- Gone are the days of share buybacks. Instead, companies across all sectors are turning to rights issues to bolster their balance sheet during the downturn, paying down debt and ensuring they stay the right side of the covenant line. But in raising billions via rights issues, companies have to pay a price to convince shareholders that it is the right course of action and it is the treasurer's job to ensure that investors know the whole story.

“THE QUESTION IS WHETHER INVESTORS BELIEVE WE ARE HEADING FOR FINANCIAL ARMAGEDDON. IF THE ANSWER IS YES, THERE IS LITTLE POINT IN INVESTING.”

Not every rights issue this year has carried the mark of desperation. HMV enjoyed a generally friendly reception in January when it turned to its shareholders for nearly £20m. The money was for a specific purpose: to fund a deal that saw the group become joint owner of 11 live music venues.

HMV could have resorted to its £220m bank facility for funding, but chose to raise a relatively modest amount through a share placement undertaken at only a small discount of 4% to the prevailing market price.

BOLSTERING THE BALANCE SHEET But most companies are rushing to access the market as soon as possible to bolster their balance sheets, says Justin Urquhart-Stewart, director and co-founder of Seven Investment Management. But even though investors are being offered some “astonishing discounts” on shares as a result, in the midst of a bear market and generally depressed earnings they still need to be convinced that they will not simply be throwing good money after bad.

“There is, understandably, quite a high level of cynicism among investors,” says Urquhart-Stewart. “What should influence their decisions is good, old-fashioned pound cost averaging.”

Investors are well aware that a significant proportion of this year’s rights issues are designed simply to help companies to survive, rather than anything more ambitious such as funding acquisitions. Niall Paul, deputy chief executive of Aviva Investors, recently noted that the number of rights issues steadily rose between 1988 and 1992 when the UK last entered recession after a period of slowing growth. The number peaked in 1991, when the downturn was at its worst.

Paul forecast that as many as one in five of the FTSE 100 could resort to rights issues this year. “That is a lot for the market to digest,” he pointed out.

This time around, though, investment banks will merely be advisers, having lost their traditional role as underwriters and providers of capital over the past 12 months. To offset this more limited role, the level of fees they are charging is reportedly the highest for at least 30 years.

Rights issues were showing signs of falling out of fashion before the credit crunch hit. Companies found it relatively easy to leverage their balance sheets instead and merger and acquisition deals boomed thanks to cheap and easily available debt. The curtain came down on cheap loans in summer 2007, as the most highly geared companies quickly became the most vulnerable.

As the prospect of any early return to normal credit conditions recedes, companies are rediscovering the virtues of long-term equity investors as a valuable source of increasingly scarce finance.

The current volume of rights issues should therefore come as no surprise says Jane Fuller, co-director at the Centre for the Study of Financial Innovation. She points out that many companies have entered the recession carrying a significant debt load, which is growing as their profits decline and working capital increases. Despite government efforts to bring down interest rates, the premium being charged has often risen.

“The timing is interesting and reflects that we don’t really know how long the recession is going to last,” she adds. “Companies are moving before investor fatigue sets in, so they can also have a capital cushion to absorb potential future losses.

“Previous recessions have also shown that companies can go bust just as the general economy has started improving and working capital levels need to be raised for investing in stock. It may therefore be prudent to allow a degree of balance sheet inefficiency so that there is a bit of spare capacity.”

MAJOR DRAWBACKS But with equities back in bear market territory for the second time in a decade, there are several major drawbacks to rights issues. Depressed share prices restrict the amount of funds that can be raised and companies need to discount their offerings if they are to attract investors. Those investors will require further convincing that the company can either take advantage of tough economic times to consolidate and enhance its market position or at least ride them out, rather than simply seeking to hold off an inevitable demise.

A rights issue whose proceeds will be used to fund acquisitions is a significantly more attractive proposition for investors than one whose proceeds are intended just to help the company survive. So the growing demand for a limited amount of cash could mean that many investors become reluctant to support any company in which they are not already a shareholder. Planned rights issues could be abandoned or fail to get off the ground as competition intensifies. Some companies most in need of a capital injection through a rights issue are thwarted because their debt significantly exceeds their market capitalisation.

The struggle will be particularly hard for companies where a ratings downgrade results in tension between shareholders and bondholders. Shareholders will baulk at investing more money in the company unless bondholders agree to restructure debt, but the latter won’t do so unless and until the company can raise additional funds.

From the investors' viewpoint, there are two basic questions to be answered, says Urquhart-Stewart. "The first is whether they believe we are heading for financial Armageddon. And if the answer is yes, then there is little point in investing.

"The second is whether they believe the market will be in a better state in five years' time. If the answer is yes, there are good opportunities to be had in the current market."

The next step – selecting specific stock – will be governed by the investors' perception of whether a company is likely still to be in existence by 2014. While sectors such as retail, construction and property look set to incur further casualties, for many companies the bad news has already been factored into a low share price and prospects for recovery are good.

THE TREASURER'S ROLE What role should the treasurer play in the company's tapping of the investor market? "He or she should ensure that the story being promoted to the market is a true one," says Urquhart-Stewart. "If the company misleads or over-eggs its prospects, it will suffer a damaging loss of trust. Treasurers can also underline the company's strengths and support the corporate message that there is a basically sound business that needs a little help in getting through difficult times."

While companies seem to have decided to make an early approach to the market, there is a case for holding back if the company's planned rights issue risks getting lost in the stampede, adds Fuller.

The decision should be based on when it is sensible for the company to raise funds, and financial advisers should be able to offer intelligence on when the timing is right. Treasurers will ask what the sustainable level of debt is and assess the advantages of reducing it. There are clear advantages in avoiding a potential breach of covenant.

In some cases, the company might decide that while it might not need funds just at that time, there is a window of opportunity that it should take advantage of. At the same time, if a company taps investors for funds but has no apparent need for them, its motives may attract suspicion. This makes it important for the treasurer to work closely with the investor relations department, so that the message conveyed to investors is consistent.

Fuller agrees that while the company needs to be frank and upfront, its message needs to be positive. There are a lot of competing calls on investors' cash at present, including government bonds that have the backing of the Bank of England.

"The company might, for example, promote the message that funds are needed to ensure it doesn't have to operate under undue constraints or cut back on research and development," she says.

Other factors to be considered are whether accelerating the pricing of the rights issue will reduce the likelihood of the company's share price sliding, and how heavy the rights issue needs to be to reduce debt significantly. The company may also want to consider the option of book building, which will incur a higher level of fees but may also see the rights issue attract a better price than it would otherwise do.

Ultimately, however, all these considerations may be rendered academic if investor fatigue sets in after the busy first quarter of 2009. There is already doubt as to whether other companies that had been expected to come to market – such as Brixton, Debenhams, ITV and Liberty International – will now do so. Reports suggest that other companies have dipped a toe in the rights issue water, but have decided against plunging in.

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