INSTITUTIONAL INVESTOR COMMITTEE

Best Practice Guidance for Issuers when Raising Equity Capital

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In association with:

Association of British Insurers

Investment Management Association

NAPF Securing the future of pensions

Introduction

Issues of new equity capital by companies and the basis on which they do so have significant implications for the delivery of long-term shareholder value which can easily be lost if the equity issue is not undertaken on an efficient basis. This guidance has therefore been produced by the Institutional Investor Committee (IIC) drawing upon the findings in its Rights Issue Fees Inquiry report[i].

The Inquiry was initiated because of mounting shareholder concern about the leakage of value to intermediaries. The Inquiry found that in many cases Issuers were unfamiliar with the equity capital raising process and were unwilling to challenge their advisers and banks, especially as to the cost of underwriting fees. The OFT Market Study 'Equity underwriting and associated services'[ii] similarly observed that an optimal, efficient equity underwriting market requires companies, as purchasers, to drive competition. However, companies and institutional shareholders needed to do more in pursuit of cost-effective outcomes especially given the quantum of fees involved in most cases.

This document is intended to inform Issuers and their Boards about institutional shareholders' views on best practice when raising equity capital. It is designed to provide guidance to companies about issues which may arise and questions which they could usefully ask of their advisers so that the process is as transparent, efficient and cost effective as possible. Section 1 covers what companies could do as general preparation for the eventuality that they may have to raise equity in the future. Subsequent sections are written on a timeline from the beginning of an actual equity raising exercise through to the end of the process.

[i] IIC Rights Issue Fees Inquiry, in association with the ABI, NAPF and the IMA, December 2010

[ii] Equity underwriting and associated services – An OFT Market Study Office of Fair Trading, January 2011

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Background preparation

Familiarisation with equity capital raising process and engagement with advisers and shareholders

Most companies infrequently come to the capital markets to raise new equity. It is therefore possible that members of the Board, and in particular Executive Directors, have little or no experience of the process. The IIC recommends that this should therefore be covered both as part of the individual induction process for new directors and also, collectively as part of their regular evaluation, Board members should familiarise themselves with what is involved in a capital raising exercise.

The views of institutional shareholders, with their understanding of markets and the drivers of shareholder value, are an important external resource available to companies. Shareholders can assist companies in understanding more about the rights issue process and the roles played by advisers and other market participants in a capital raising exercise.

Appointments of corporate brokers or other advisers are significant events for any company and an appropriate governance structure around the decision-making process is needed. As part of the evaluation process discussions should take place regarding how a hypothetical equity raising exercise would be handled, how fee levels might be affected under different scenarios and advice provided on what structure the issue might take. Fee levels, possibly under different scenarios, should also be discussed. There may also be a role for independent financial advisers to play at this stage.

Shareholder engagement should include discussion about appropriate capital structure, how it is managed and its cost. Companies should also ask their shareholders whether and for how long they would be prepared to receive price sensitive information in the event of a capital raising exercise, and whether they would in principle have the ability and/or appetite to act as a sub-underwriter when the time came.

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When the need for a capital raising exercise is foreseen

The Board should be informed as soon as possible when it appears likely that the Company will need to raise additional capital. At this stage a number of options may exist regarding timing, and structure and it is important that the pros and cons are worked through by the executives and considered at Board level. Any conflicts of interest need to be identified. An appropriate governance structure is needed around all key decision-making; the audit committee and, where relevant, the risk committee, may need to be specifically involved.

Selection of advisers

The Board will need to decide whether the Company's existing advisers are well placed to act on its behalf or whether additional sources of advice are required. The appointment of an independent financial adviser, if one is not already retained, should be actively considered at this stage, especially where the Board does not have deep experience of accessing the equity capital market. An independent adviser is a regulated firm that provides advice to the Board of an Issuer. Such a firm would not underwrite a rights issue and therefore has reduced potential for conflicts of interest. In practice, such an adviser should be able to help negotiate appropriate terms, conditions and underwriting commitments with the Company's brokers or investment banks, and propose ways of introducing a competitive element to improve the final result if that proved necessary.

The Company will need to decide whether its existing adviser(s) should be engaged as lead underwriter(s) to the envisaged issue or whether a competitive tender for the underwriting should be undertaken. It should not be a foregone conclusion that a parent bank of the corporate broker is appointed as the lead underwriter to the issue. The incentive of the parent bank is usually to generate transactional revenue as a pay-back for low-margin corporate broking services rendered to date. While such quid pro quos are common in Company/broker relationships, it is important this does not prejudice appropriate decisions being taken given the specific risk and complexity of the transaction being undertaken.

Issue structure

Where material amounts of equity need to be raised a rights issue will generally be the way to proceed. However, choices will need to be made about whether and how a rights issue should be underwritten and, related to this, whether the issue is to be made at a shallow or deep discount. The size of the discount alone does not normally have material implications for shareholder value since the issuing of shares pre-emptively to existing shareholders at a discount is not a cost to the Company. The Company's historic per share financial track record is then adjusted for the bonus element in the rights issue in order to allow comparison of future performance with the past.

However, there is a trade-off to be made between the size of the discount and the fees that it will be appropriate to pay for the protection that underwriting the rights issue will provide. The level of the discount indicates the size of the 'buffer' between the rights issue price and the theoretical share price post offer. This 'buffer' offers protection to the underwriters against a downward movement in the share price so that the intrinsic value of each right is more likely to remain positive. Clearly the higher the discount or 'buffer' the lower the risk that the issue is not taken up and the lower the fees should be.

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Actual equity raising process

Issue and fee proposal

As the parameters of the capital raising exercise become clear it is important that the Company is well-prepared and in a position to take informed decisions. The advisers will be expected to firm up their proposal for the issue structure and the fees that will be payable. The Board should ask for a full breakdown of the advisers' proposed fees and should satisfy itself that it understands what is being paid and for what purpose; for example, how much is for advice and how much is an underwriting fee as well as the justification for the split between proposed lead and sub-underwriting fees. In the event that the issue is proposed to be structured with a deep discount to the theoretical ex-rights price (typically over 20%) the Board should further consider whether it is necessary for it to be underwritten in whole, in part, or not at all.

Those shareholders who have indicated a willingness to being made insiders should be consulted on the proposed issue, its proposed fee basis, their commitment to take up their rights and their potential appetite for sub-underwriting. This should inform the Board, and the corporate adviser, on final decisions as to whether and to what extent the issue needs to be underwritten.

When entering into a primary underwriting agreement the Issuer will need to understand both the intentions of the lead underwriter regarding sub-underwriting, the likely appetite of shareholders (and other potential investors) to support the issue, and their ability to sub-underwrite. The implications regarding allocation of sub-underwriting, especially where significant reliance is being made on those who would not be natural holders of shares at the rights issue price, need to be carefully considered. In the event that the issue is not fully taken up, it is usually advantageous for the Company to place unsubscribed shares with existing or new long-term institutional holders via a "rump" placement immediately after the end of the rights subscription period. This is preferable to calling on the sub-underwriters to take up their allocation which should be a last resort.

The possibilities regarding pre-commitment by existing shareholders to take up their entitlement should be considered. It would also be sensible to discuss with the independent adviser (if one has been appointed) and/or lead underwriter whether "offset" for sub-underwriters would be beneficial to the execution of the offering. "Off-set" is the entitlement for a sub-underwriting shareholder to reduce its sub-underwriting exposure by the number of shares for which it subscribes in exercising its rights in the offering. The advantage of granting such an entitlement is that it encourages shareholders both to sub-underwrite and to take up their rights and, in so doing, reduces the overall risk of the underwriting process. The disadvantage of granting such an entitlement is that it increases the residual underwriting risk for the primary underwriter(s), or the other sub-underwriters, and in turn could conceivably make the underwriting process more difficult or more costly.

Once the decision to undertake the issue has been made

The Issuer should at an early stage and prior to final decisions being made on allocation, be provided with the proposed sub-underwriting list drawn up by the corporate broker. The Issuer should ask how much of the issue is proposed to be retained by the lead underwriter and why. The retention by the lead underwriter of a significant amount may raise the question as to whether the underwriting risk has been mispriced.

The Issuer should seek assurance from the lead underwriter that if any sub-underwriters are prepared to take a lower fee than that proposed, the benefit should flow back to the Company and not be retained by the lead underwriter. This will likely reflect an over-cautious pricing of the underwriting risk and a commensurate reduction in the lead underwriting fee would therefore also be appropriate in such circumstances.

The Issuer should insist that the lead underwriter commits, as a term of the contract of appointment, to give to the Issuer copies of all sub-underwriting letters signed with sub-underwriting institutions. Such disclosure will achieve transparency for the Issuer over how shareholders and non-shareholders were treated, over how much risk was retained by the lead underwriter (and any other primary underwriters) and whether any variations were made or agreed by the lead underwriter in the terms of the sub-underwriting letters (especially in connection with anti-hedging clauses, if included in the primary underwriting agreement).

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Post issue

The Board should ensure that details of fees paid to whom and for what are publicly disclosed as soon as possible through the required channels for news announcements to the market, and are subsequently reported in detail to shareholders in the Annual Report and Accounts. A full breakdown of the difference between gross and net proceeds should inform shareholders on what services their money has been spent. Where the fee agreement includes a performance element this is likely only to be determined a period of time after the conclusion of the issue. In this case the potential range of the performance fee should be disclosed up-front and the fee actually paid in this regard disclosed once it has been determined.

The Board should be provided with the final sub-underwriting list itemising participation by sub-underwriters.

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