AUSTRALIAN CENTRE FOR FINANCIAL STUDIES

FINANCIAL REGULATION DISCUSSION PAPER SERIES

Small–Cap Equity Raisings: Are the ASX Proposals the best option?

FRDP 2012 – 2

May 20, 2012

The Australian Securities Exchange has recently released a consultation document S*trengthening Australia's equity capital markets*[1] outlining *inter alia* proposals aimed at improving access to additional equity capital for small and mid-sized listed firms.[2] In essence, such firms would be able to issue additional new shares:

- by way of a placement, of up to 10 per cent of market capitalization (in addition to the current 15 per cent limit not requiring shareholder approval) [3];
- subject to a maximum discount to market price of 25 per cent;

if they have obtained shareholder approval to do so at the latest Annual General Meeting.

This proposed regulatory change would be likely to fail a rigorous social cost-benefit analysis and appears to take no account of available research findings regarding seasoned (secondary) equity offerings. The proposal is flawed for four reasons (which apply to varying degrees in different circumstances):

1. It relaxes constraints on market discipline of corporate managers, making it easier for them to pursue private objectives of empire building rather than maximizing value for existing shareholders. It also exposes potential (albeit "sophisticated") investors to unnecessary risks due to imperfect information.
2. It creates the potential for significant wealth transfers from existing shareholders to new investors through the dilution effects of placements.
3. It creates the potential for placements to lead to significant shifts in voting power.
4. Other changes to equity raising arrangements, including those for rights issues, have potential to meet the objectives of the regulatory change at a more favorable benefit- cost ratio.

[1] http://www.asxgroup.com.au/media/strengthening_australias_equity_capital_markets_2Apr12.PDF
[2] The ASX uses a market capitalisation of $300 million as the cut-off point for defining small to mid cap stocks which includes around ¾ of listed stocks of which around half are resource stocks.
[3] It appears from the consultation document (Chapter 7) that the 10 per cent limit relates effectively to shares on issue at the time of the proposed placement rather than at the time of the AGM. The latter could be 115 (or a higher) per cent of shares on issue at the AGM date if a 15 per cent placement (or a rights issue) has been made in the interim.

Rationale for Regulatory Change

Underpinning the ASX proposals is the perspective that small to medium sized listed companies face difficulties in raising additional equity capital. Difficulties can include such factors as: high issuance and administration costs; time lags and risk of failure of an offering of securities; high required returns of potential investors. Placements are perceived by the ASX as offering a lower cost and quicker method of raising equity than alternatives such as rights issues. Whether investors who might participate in a placement have a lower required return on equity than current shareholders, such that raising funds in that way would be to the benefit of the latter is an empirical question (about which more will be said later).

While there may be greater difficulty or costs in using rights issues under current regulatory arrangements, they have been a popular form of secondary equity raisings. Regulatory changes allowing accelerated "non-traditional" rights issues have assisted in this regard.[4]

Some recent data is provided by Connal and Lawrence (2010)[5] who examine secondary equity raisings by ASX listed firms during 2008 and 2009, and Table 1 summarizes their findings.

TABLE 1: Secondary Equity Raisings by ASX listed firms, 2008-2009

Type	Number	Amount raised ($ bill.)	Average size (% of shares)	Average Discount (%)	Average time taken (days)
Placements	140	44.8	19	12.3	17
Rights – Non renounceable	57	31	47	25.2	34
Rights – Renounceable	21	15	70	37	43
Share Purchase Plans	61	8	7	11	45

Source: Connal and Lawrence (2010)

What is particularly noticeable from Table 1 is the fact that the average discount on placements is well below that on rights issues. And despite there being no maximum discount constraint on placements of up to 15 per cent of outstanding equity (which are currently allowed without need for shareholder approval) the average discount figure shown in Table 1 is around half the maximum of 25 per cent proposed by the ASX. Other studies examining earlier periods have also found that the typical discount on placements is well below that on rights issues, and generally quite a bit lower than the 2008-2009 figures.

The ASX appears to have given no substantive justification for allowing up to a 25 per cent discount, and the figure appears anomalous (and high) given both data from past placements

[4] An overview of alternative capital raising methods can be found in http://www.asx.com.au/documents/about/20100129_asx_information_paper_capital_raising_in_australia.pdf

[5] Connal, Simon J and Lawrence, Martin, Equity Capital Raising in Australia During 2008 and 2009 (August 16, 2010). Available at SSRN: http://ssrn.com/abstract=1664889 or http://dx.doi.org/10.2139/ssrn.1664889

and when compared to a 20 per cent maximum discount allowed for non-renounceable rights issues.

Issue 1: Corporate Governance, Market Discipline and Placements

Ideally, management acting in the best interests of shareholders will not pursue fund raising strategies to the detriment of shareholders. However, given the self-interest of managers and directors, that requires very strong corporate governance arrangements and standards, if the resulting agency problems are to be overcome. Where are these least likely to be found? Arguably in relatively small companies with entrenched boards, limited shareholder monitoring by institutional investors, and opaque activities. This is precisely the group at which the ASX proposals for relaxing rules regarding placements are aimed, and where management bias towards self-interested objectives such as expansion is likely to be significant.

It should be noted that international studies have generally found that the announcement of placements leads, on average, to short-term positive abnormal stock returns, to the advantage of existing shareholders – although there is generally subsequent long-run underperformance. This short run "bounce" has typically been interpreted as reflecting evidence of "certification" by new investors that the firm appears undervalued or that they intend to play an active role in monitoring management.

But, in a recent US study by Barclay et al (2007)[6], it is found that "when there is a large discount on a large- percentage block sold to someone who does not become active in firm affairs [around 80 per cent of their sample of placements], the associated stock returns tend to be large and negative." Thus while some placements might, despite involving some discount, temporarily add value for existing shareholders, large, high discount placements to passive investors look more likely to be value destroying. And while placements to potentially active investors may add value, there is the risk that information must be provided to such parties which, despite regulatory standards and disclosure requirements, may be more comprehensive than that available to existing shareholders.

A major problem with the proposed changes is that they reduce market discipline upon management, enabling it to raise capital to undertake projects which are value destroying. The reason is straightforward. While the funds provided by new investors may be used to fund a particular project, those investors obtain returns based on profitability of both existing and new projects. New investors may be aware that the new project is not value enhancing, but if their share of proceeds from pre-existing projects is sufficiently high, they will be willing to provide funds. This can occur when new shares are issued to outsiders at a discount to the current market price. The resulting dilution of interests of existing shareholders is a transfer of wealth to outsiders, meaning that their investment of funds does not depend solely upon whether the proposed use of those funds is value enhancing. Even if the placement is to some existing

[6] Michael J. Barclay, Clifford G. Holderness, Dennis P. Sheehan, Private placements and managerial entrenchment, Journal of Corporate Finance, Volume 13, Issue 4, September 2007, Pages 461-484

shareholders, there is still a wealth transfer between shareholders. Box 1 provides a simple arithmetic illustration.

In contrast, under a rights issue there is no such wealth transfer biasing shareholder decisions on whether to participate. (If the planned use of funds is not perceived to be value enhancing, or interpreted as a signal that the current share price is overvalued, shareholder responses to the proposed issue will be reflected in a lower share price and wealth loss – with this possibility acting as a constraint upon managerial decision making).

BOX 1: Funding Negative NPV Projects by Placement Discounts

Consider a company which has 100 shares on issue with market price of $10 each and earning the required return of investors of 10 per cent p.a. (ie $100 p.a. on the market capitalization of $1,000). It makes a placement of 25 shares at a 25 per cent discount to market price, ie $7.50 each and raising $187.50 in total, to new investors to fund a project generating only 8 per cent p.a. (ie $15 p.a.). The new investors own 20 per cent of the company giving them a return of one fifth of total earnings of $115 p.a., ie $23, which is a return of 12.27 per cent p.a. Even though the new funds raised have been applied to a negative NPV project, the providers of those funds receive a rate of return in excess of the required return. This is because the issue discount enables them to obtain a higher share of earnings from the firm's existing activities than would be implied by comparing the size of their subscription relative to initial market capitalization.

While placements are required to be made only to "sophisticated investors" the empirical evidence from international studies that firms making placements tend to subsequently under-perform raises the issue of investor protection. For Australia, Brown et al (2006)[7] and Brown et al (2009)[8] have also shown that firms making placements subsequently under-perform and do worse than firms issuing equity via rights issues. Brown et al (2006) attribute this to a preponderance of small loss making firms among those making placements, and managers taking advantage of temporary overvaluation of their equity to time equity raisings. Brown et al (2009) also note that speed of issue and other characteristics of placements mean that they can be more readily made to take advantage of temporary stock price overvaluation. They also find that issuing firms with better governance (based on the indicators they construct) are less likely to have longer run underperformance.

Evidence such as this (and that of Barclay et al) should raise warning flags about loosening the bounds on managers of small firms to make large placements at large discounts. Poor, value-

[7] Brown, Philip S. and Gallery, Gerry T. and Goei, Olivia (2006) Does market misvaluation help explain share market long-run underperformance following a seasoned equity issue?. Accounting and Finance 46(2):pp. 191-219.

[8] Brown, Philip R., Lee, Michael, Owen, Sian A. and Walter, Terry S., Corporate Governance and the Long-Run Performance of Firms Issuing Seasoned Equity: An Australian Study (April 13, 2009). 22nd Australasian Finance and Banking Conference 2009. Available at SSRN: http://ssrn.com/abstract=1378485 or http://dx.doi.org/10.2139/ssrn.1378485

destroying, decision making is facilitated. "Sophisticated investors" who participate in placements are assumed to be informed and capable of assessing management ability and equity values, but that does not appear to be necessarily the case. "Caveat emptor" may, quite reasonably, underpin the attitude towards protection of "sophisticated investors", but that is no reason to unnecessarily increase their exposure to bad options which they are not well placed to adequately evaluate.

Issue 2: Shareholder Wealth Dilution

Where a placement is made at a discount to investors who are not existing shareholders, the potential financial costs to existing shareholders can be high. This can occur regardless of whether the new funds are used for expansion or replacement of debt. Suppose a company with 100 shares on issue with a current market price of $10 per share makes a placement to third parties of 10 shares at a price of $8 per share (ie a discount of 20 per cent). The pure dilution effect of this can be found by noting that the market capitalization of the company (assuming no pure announcement effect on the stock price) would now be $1,080 (compared to $1,000 previously) and, with 110 shares now on issue, the share price would decline from $10 to $9.82 – a loss of around 2 per cent. The larger the discount and the larger the issue, the greater is the cost to existing shareholders. Under the ASX proposals, the loss could be up to 5 per cent if 25 per cent additional shares were issued at a 25 per cent discount. This is higher than the all-up (transactions, underwriting etc) costs to existing shareholders of a fully underwritten renounceable rights issue.

It is argued by the ASX that shareholder rights are protected by the requirement that shareholders have voted at the last AGM to give management the flexibility to make a placement of an additional 10 per cent of equity capital at a discount of no more than 25 per cent. This places significant, unsubstantiated, trust in the effectiveness of shareholder voting arrangements. It is not hard to imagine scenarios in which a small number of large shareholders with a combined majority could vote in favour of such a resolution in the expectation that they have a significant probability of being the favoured participants in any such placement, to the detriment of other shareholders. More generally, rarely do board initiated proposals get voted down by shareholders – which could be due to their being perceived as being in shareholder interests or because shareholders are unable to assess the merits of those proposals and assume (perhaps wrongly) that directors are acting in the best interests of all shareholders.

Issue 3: Control Rights

The third matter for consideration is the potential change in voting rights of shareholders. With a pro-rata rights issue, shareholders who do not participate are compensated for their dilution in voting rights through sale of their rights in the case of a renounceable issue. In the case of a non-renounceable issue, investors can sell existing shares to finance new purchases and avoid wealth dilution from the discount. However, the transactions costs of doing so may be relatively high for small shareholders, causing them not to pursue this strategy and hence suffer the costs of dilution. (It is difficult to see what social benefits arise from permitting non-renounceable rights issues, other than possibly the company avoiding the costs and time lags associated with listing and trading of rights on the exchange).

In the case of a placement, existing shareholder voting rights are automatically diluted, and potentially quite substantially. Placements have the potential to change the balance of voting power and/or to further entrench boards and management when made to "friendly" investors. While directors could face legal challenges if placements created marked shifts in the balance of control, their ability to make placements to "friendly" investors is not so constrained.

In that regard, the recent study by Barclay et al (2007) of a large sample of placements by US companies is instructive. Their study "suggests that private placements are often made to passive investors, thereby helping management solidify their control of the firm" and the evidence "favors managerial entrenchment as the explanation for many private placements".

Connal and Lawrence (2010) note the absence of any requirement in Australia for companies to disclose the identity of recipients of shares via a placement. While privacy arguments can be advanced as a rationale for this, it is not apparent that this is sufficient justification for not holding management and directors accountable to shareholders for their dilutionary decisions by requiring appropriate disclosure.

Issue 4: Alternative Issuance Mechanisms

The ASX notes that the proposed changes make issuance arrangements more in line with those in a number of other countries. Why that is a good objective is far from apparent.

But more importantly, the critical question to be answered is why would any manager, acting in the best interests of all existing shareholders, prefer to use a placement rather than a rights issue. Potential arguments which can be advanced include: speed of issue; regulatory and transaction costs and impediments; access to cheaper funding; risks of not successfully completing the required capital raising; legal risks faced by directors arising from the capital raising. Under current regulatory arrangements some of those arguments may have merit, but imply a review of regulations and rules affecting all types of equity raisings, particularly rights issues, to ascertain what changes are best, rather than simply accepting the change proposed by the ASX. This is particularly so given that advances in electronic communications and transactions have opened up a range of options which were not feasible when current rules and regulations were fashioned.

Consider first speed. Over the past decade or so, regulations have been changed which enable listed companies to undertake rights issues in a number of alternative "non-traditional" ways. These include accelerated institutional rights issues, followed by a retail rights or entitlement issue. The time delays involved here are not substantial, and there has been no evidence provided that they necessarily compare unfavourably to those associated with a placement.

Regulatory costs may be another factor which reduces the appeal or increases the costs of rights issues. Information provision requirements are one example, although since 2007 there has no longer been a requirement for a prospectus for rights issues. And while conveying information to multiple shareholders can be costly, electronic communications provide the potential to dramatically reduce such costs.

Transactions costs are also potentially greater when funds are raised from a large number of investors (as with a rights issue) rather than by placement with one or a few institutional investors.

But it is worth considering these issues in more detail. Electronic communications arguably can make it feasible for a company to inform and provide details to a large number of shareholders of a forthcoming rights issue at a cost no larger than for a placement. Currently, many shareholders do not receive company communications electronically, and the requirement that information be mailed out imposes costs.

Enabling companies to make rights issue announcements solely by electronic means would overcome that cost impediment. And with the capacity for subscriptions for new issues to be made by way of BPay or other electronic means, the transactions costs of receiving smaller amounts of funds from many subscribers should not be markedly greater than those associated with a placement.

While solely electronic communications would disadvantage shareholders not accessing such information and thus not participating, it should be possible to implement arrangements to protect such shareholders. (Even without such safeguards, the cost to them maybe no more than that associated with placements). Such arrangements could involve the automatic sale of rights of investors who do not subscribe to the issue at their theoretical value to underwriters. (Similar arrangements already apply in the case of investors outside Australia and New Zealand in the case of renounceable rights issues where rights which would have accrued to such investors are required to be sold and proceeds remitted to them). Requiring that prior shareholder approval be obtained at an AGM for electronic-only notification of rights issues would also be necessary

Conclusions

Based on the preceding analysis the following conclusions can be drawn.

1. Company management acting in the best interests of all shareholders should raise new equity capital by providing existing shareholders with the opportunity to participate in pro-rata issues (such as rights issues) unless there are discernible benefits to them from alternative issue methods such as private placements.

2. Placements made at a discount reduce market discipline upon management, can facilitate entrenchment and weaken governance, and enable management to more easily pursue private goals at the expense of shareholders. Management may also be better able to use placements to “time the market” by issuing equity when their private information indicates stock is overvalued to the detriment of new investors.

3. Placements may provide net benefits for existing shareholders if associated "certification" and "monitoring" service benefits from the new shareholders outweigh dilution effects. However, this is unlikely to be the case where large placements at large discounts are made to "passive" investors by poorly governed companies. Substantial evidence of longer run underperformance by companies which have made placements suggests that this latter case is pervasive.

4. Lower transaction and regulatory costs of raising funds by placements, relative to rights issues, may have provided some justification for use of placements in the best interests of existing shareholders the past. However, modern electronic technology opens new possibilities for lower cost pro-rata type issue techniques to existing shareholders which warrant consideration and potential regulatory changes to accommodate.

5. The ASX proposal to allow smaller companies to make substantial additional placements at large discounts lacks merit on these grounds, and should be rejected in favour of a broad ranging review of issuance arrangements and options. This should include a review of the merits of current arrangements allowing all companies to make placements of up to 15 per cent of shares, at any discount, without shareholder approval. The merit of not requiring companies to make public the identity of participants in private placements also warrants review.

This FRDP was prepared by Kevin Davis, Research Director of the Australian Centre for Financial Studies.

The ***ACFS Financial Regulation Discussion Paper Series*** provides independent analysis and commentary on current issues in Financial Regulation with the objective of promoting constructive dialogue among academics, industry practitioners, policymakers and regulators and contributing to excellence in Australian financial system regulation.

For more in this series, please visit our website at
http://www.australiancentre.com.au/category/financial-regulation-discussion-paper-series/