Rights issues – are they right for you?

The emergence of a spate of rights issues at pitifully low prices to re-capitalise the banking industry has suddenly projected this very British method of raising capital into the spotlight.

A rights issue provides a quoted company with a way to raise capital by giving existing shareholders the right to subscribe to new, discounted shares in proportion to their current share holding within a specified time period. It owes its existence to the concept of pre-emption rights: the idea that the existing owners of a business should get first crack at putting up any new capital before the new shares get offered to all and sundry.

Shareholders can individually choose to take up all, some or none of the rights offered to them. The rights can also be sold by the shareholder to a third party.

After a rights issue, distributable profits have to be shared over a greater number of shares than previously, resulting in lower earnings per share and a reduced dividend. Shareholders are therefore offered the subscription at a discount as an incentive to take up their rights and maintain their proportionate stake in the company. If they do not take up their rights their stake will be diluted and the value of their holding will be reduced. See the example opposite.

Whatever your initial decision on the take-up of a rights issue, keep an eye on the market price throughout the rights period as this will determine your return. In some recent banking rights issues the market share price has fallen below the subscription price — exacerbated by the practice of selling short on the presumption of further falls in the price — negating the incentive of discounted shares.

“Whatever your initial decision on the take-up of a rights issue, keep an eye on the market price throughout the rights period as this will determine your return.”

In fact, rights issues don’t do any favours for personal investors. Institutional shareowners have the money to take up their rights; personal investors frequently cannot afford to take up their rights, so their ‘nil-paid’ rights are sold or ‘lapse’, leaving institutional investors to take them up and further increase their holdings. So every time a company has a rights issue, the proportion of shares held by personal investors falls. If the company’s share price is high (for example, when it is raising finance for an acquisition from a position of strength), that may not be so much of a concern: at least personal investors are getting a decent price for their shares. But if the share price is seriously depressed, as with the current round of banking rights issues, this dilution is a serious financial blow to personal investors and is a result of the lack of foresight by some companies’ boards.

Let's look at an example.

Banking Rights Plc shares have a current market price of 400p per share. They offer a two-for-five rights issue, offering the extra shares at a subscription price of 225p per share. You own 100 shares and as a shareholder have the right to purchase an extra two shares for every five shares that you hold, i.e. an additional 40 shares. Note that this example uses a theoretical ex-rights share price; it is the actual ex-rights share price that determines the financial outcome of your decision and this will be influenced by both business and market factors.

Taking up the rights

If you choose to take up the rights to purchase the extra shares you will receive the same proportion of distributable profits as previously so your stake will remain undiluted.

Existing shares value:	**100 x 400p = £400**
New shares value:	**40 x 225p = £90**
Average value per share:	**£490 ÷ 140 = 350p**

Your original 100 shares will have a market value of £400; your 40 new shares will cost you an additional £90 giving a total value of £490 for 140 shares; an average value of 350p per share. This average value is the theoretical ex-rights share price (the price on completion of the rights issue) and reflects the diluted value of the shares.

Letting the rights lapse

If you choose not to take up the rights to purchase any extra shares your holding will be diluted as you will receive a smaller proportion of distributable profits than previously. Depending on the ex-rights share price, the value of your holding may also be diminished.

Ex-rights value of existing shares:	**100 x 350p = £350**

In this example, your share holding has lost £50 in value. However, once the rights issue process has concluded any lapsed rights will be sold on the market and the proceeds (the difference between the ex-rights share price and the subscription price less fees) will be distributed amongst those shareholders who let their rights lapse.

Lapsed rights value:	**40 x (350p-225p) = £50**

Disregarding fees, you could receive a payout of £50. But remember that as you will not take ownership of the new shares you will still receive a smaller proportion of distributed profits than previously. Should the ex-rights price fall to the subscription price or lower there will be no proceeds to distribute.

Selling the rights

Rights are usually tradable securities (which can be bought and sold through The Share Centre) so another option is to sell all or part of the rights before they expire. In this example, each right has a market value of the difference between the theoretical ex-rights price and the subscription price.

Rights price per share:	**350p – 225p = 125p**
Potential sale value:	**40 x 125p = £50**

Therefore if you sell all 40 rights at 125p you will recoup £50 before dealing commision. Disregarding fees, this will cover the loss in value of your existing holding, but as you will not take ownership of the new shares you will still receive a smaller proportion of distributed profits than previously.

An alternative is to sell some of the rights to fund the exercise of the remainder ('tail-swallowing' or 'cashless take-up'). For example:

Sale of 26 rights:	**26 x 125p = £32.50**
Exercise of 14 rights:	**14 x 225p = £31.50**

In this case you will gain 14 shares bringing your total share holding in Banking Rights Plc to 114 without spending any of your own money to fund the share purchase. However, you will still have a partially diluted stake in the company.

At a glance

Rights issues raise capital from existing shareholders.

Earnings per share are reduced.

Shareholders can take up some, all or none of the rights.

'Nil paid' rights can be bought or sold on the market.

Personal investors are disadvantaged.

So how can we get a better deal for personal investors? What we really need are swift, efficient ways to bring new issues of shares to personal investors generally. The internet and emails have made this possible, so that it is now possible to publicise an offer and get a response and payment back within days rather than weeks. Whether a current share holder or not, personal investors would have a better chance to bid for new shares alongside institutions. Issues would either be priced at close to the market price or on an open tender basis, to ensure that there was no proportion of the company 'given away' to new shareowners.

That said, not all rights issues are undertaken to prop up an ailing company; they may also be initiated for more positive purposes such as corporate expansion and may offer the potential of future growth and increased profits for both personal and institutional investors. It is worth remembering that personal investors can buy 'nil-paid' rights in the market themselves. As with all investment decisions, you need to consider your own personal circumstances and take financial advice as appropriate. If you require advice on any rights issues pertaining to shares you hold through The Share Centre, please contact our Advice Team on 01296 41 43 45.