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CORPORATE
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FORUM

Capital Raisings:
The Forum's Perspective

There has been considerable discussion in the media and among market participants regarding the merits and comparative fairness of different capital raising structures.

The NZ Corporate Governance Forum[1] (the **Forum**) has followed these discussions with interest and commends NZX for its ongoing review into capital raising practices.

Capital raising structures generate rights to subscribe for new shares at a fixed price. Either those rights are allocated to existing shareholders to exercise or sell, or the rights (or the value of the rights) are allocated by the issuer. As such, the choice of offer structure can result in value being transferred from shareholders who are not given the opportunity to participate, or cannot or do not participate, to other parties.

The rights of institutional investors such as Forum members are generally not prejudiced by the choice of offer structures. This is because they are well-positioned to participate and to ensure they receive and exercise at least their pro-rata allocations. However, that is not the case for all shareholders and important market integrity issues may arise depending on the choice of structure. The Forum is mindful that a key responsibility of institutional investors is to monitor the performance of Issuers and Boards in governance decisions, such as the choice of offer structure.

Choice of Offer

Board decisions on capital raising structures are complex and challenging. The choice of the 'optimal structure' depends on a myriad of nuanced factors including business prospects, time constraints, perception of risk, capital structure, the ownership composition (major supportive or non-supportive shareholders versus a more distributed register) and the availability of underwriting.

Moreover, many Boards will only encounter capital raising transactions infrequently, meaning it can be difficult to maintain deep experience on the various considerations that impact offer outcomes.

[1] The New Zealand Corporate Governance Forum is committed to promoting good corporate governance within NZ companies for the long-term health of the NZ capital market. The Forum's members are institutional investors with significant investment in NZ listed companies.

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As such, the Forum considers that Issuers should:

- support Boards by seeking expert independent advice on capital raising decisions; and,
- encourage director groups to provide focused training on capital raising structures.

Ideally, Issuers should always first consider whether shareholder approval can and should be sought in respect of a significant offer of equity securities. The Forum's guidelines maintain that *"listed companies should not be able to materially dilute shareholders without their approval"* and should significant dilution occur, the Forum considers that the Issuer should provide a full explanation of share issuance regardless of the size of the capital raising.

It is important for Boards to establish and refer to fundamental principles. In our view, the key principle is clear: shareholders are the owners of the Issuer and the rights to subscribe new capital in a capital raising should belong to them, either to be exercised or sold. The capital raising structure that is most consistent with this principle is a pro-rata offering, and ideally a "traditional" pro-rata, quoted, renounceable rights offer. Offer structures such as "placements" or "ANREOs[2]" may not give all existing shareholders the rights to participate proportionately, or the ability to sell their rights to participate. These structures may result in a direct value transfer to any new investors or, if underwritten, the offer underwriters.

The Forum's view is solidly supported by Recommendation 8.4 of the NZX Corporate Governance Code (the **Code**):

> *"If seeking additional equity capital, Issuers of quoted equity securities should offer further equity securities to existing equity security holders of the same class on a pro-rata basis, and on no less favourable terms, before further equity securities are offered to other investors."*[3]

The Forum recognises that under some conditions Issuers should raise capital using non-pro-rata methods: for example, when a traditional pro-rata capital raising is not possible, or a non-traditional raise is materially less expensive.

In the Forum's opinion, the current debate and tension have arisen from Issuer practice. Despite Recommendation 8.4 of the Code, prevailing market practice suggests Boards and Issuers prefer non-pro-rata offer structures, most commonly a placement combined with a share purchase plan (SPP). While Issuers are generally focused on selecting structures which closely replicate pro-rata allocations, there are inevitably groups of shareholders who cannot or do not participate (e.g. overseas holders, less sophisticated or disadvantaged shareholders)[4].

The Forum's view is that those shareholders who, through the choice of offer structure, do not receive the value of their rights to participate, should receive a full and timely justification that their cost is compensated by the benefit to the Issuer (i.e. all shareholders).

The Forum considers that Recommendation 8.4 of the Code was intended to provide this justification. Our view is that many explanations have not provided shareholders with enough information to fully assess the merits of the capital raising decision.

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[2] Accelerated Non-Renounceable Entitlement Offers

[3] NZX Listing Rules, *Appendix 1 - NZX Corporate Governance Code*, (10 December 2020), p 32 https://www.nzx.com/regulation/nzx-rules-guidance/corporate-governance-code

[4] See further information on this in the Forum's submission on the Code at https://www.nzcgf.org.nz/assets/Uploads/pdf/20220128-NZX-Corporate-Governance-Code-Review-2021-final.pdf

Transparency is key

The Forum would like to see greater disclosure concerning equity capital raising decisions, including when Issuers explain non-compliance with Recommendation 8.4. Boards should consider enhanced disclosure on the following:

- The reason for the decision to not follow Recommendation 8.4, including details of the benefits of the chosen offer structure as compared to a traditional pro-rata offer. For instance, if lower cost is the reason, the details should include a clear comparison of the cost of the non-pro-rata issue with the equivalent pro-rata issue[5];
- The process to set the placement/issue price and the objectives of the allocation process, details of the allocation framework and which firms or groups influenced decisions;
- The groups of shareholders which were disadvantaged by the choice of structure (e.g. who could not participate) and the measures taken to mitigate those disadvantages;
- If an SPP was used, was the SPP fully subscribed? If the SPP was scaled how was the scaling done and if done on shares cum issue, the effective dilution after the scaling for the investors that were scaled; and,
- The percentage of shares held by shareholders which were diluted and the change in the registry composition resulting from the capital raising, including the number of shares allocated to new shareholders, the underwriters and sub-underwriters.

Disclosure should be made as close as possible to the offer date (c.f. the information is often stale if disclosed in the ensuing annual report which is the current requirement). While many of the disclosures can be made upon launching the offer, others would need to be made once the offer outcomes are known.

In summary

Board decisions on capital raising structures are complex and challenging, and we encourage focused training on capital raising structures. Many Boards will only encounter capital raising transactions infrequently. Therefore, the Forum considers that Issuers should seek expert independent advice on capital raising decisions and encourage director groups to provide focused training on capital raising structures.

In our view, the key principle concerning equity capital raisings is that shareholders are the owners of the Issuer and the rights to subscribe to new capital should belong to them, either to be exercised or sold. The capital raising structure that is most consistent with this principle is a pro-rata offering, and ideally a "traditional" pro-rata, quoted, renounceable rights offer. However, in certain circumstances Issuers can, and sometimes should, legitimately raise capital using non-pro-rata methods.

The Forum's view is that those shareholders who do not receive the value of their rights to participate through the choice of offer, should receive a full and timely justification that their cost is compensated by the benefit to the Issuer, i.e. to all shareholders. Recommendation 8.4 of the Code was intended to provide this justification and the Forum is concerned that many explanations have not provided shareholders with enough information to fully assess the merits of the capital raising decision.

[5] The offer costs will include external adviser and lead manager costs which will differ depending on the terms of the offer. Issuers tend to focus on the relative discount to market price, which may be less for a non-pro-rata offer. However, this may be overly simplistic, in that for a pro-rata offer the discount will not impact existing shareholders in the same manner since they can sell rights, whereas in a non-pro-rata offer the discount results in direct dilution/cost to non-participating shareholders.

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