Risk of ineffective shares issue and methods of its reduction – Polish experience

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Abstract

Issue of shares is regarded as the most efficient source of corporate capital. However, there exists significant risk that the investors will not be interested in purchasing shares offered by the company and the issue become ineffective (unsuccessful).
This article defines the ineffectiveness of shares issue and briefly presents different methods of risk reduction that can be used by Polish companies such as: divesting of preemptive rights, spread issue, sponsor and underwriting arrangement, private subscription, issue of convertible bonds, bonds with priority warrants and subscription warrants, preceded shares issue.

Key words

Shares issue, risk of ineffective shares issue, risk reduction methods, underwriting

1 Issue of new shares as a method of raising additional equity capital

Issue of shares is the most important source of corporate capital. It is often regarded as the most efficient way of raising additional capital for the company's development. However, the decision to issue new shares requires accepting capital market conditions which may cause ineffectiveness of the entire procedure. Raising equity capital by issuing new shares on the market is a very complicated and time-consuming process. It requires observing the law regulations and fulfilling formal obligations. These factors increase the uncertainty of the shares issue.

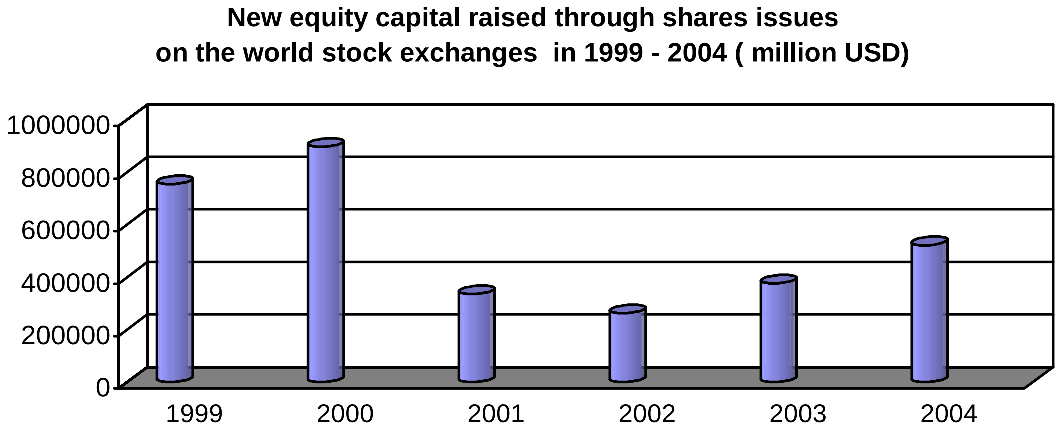

Fig. 1: Amount of corporate capital raised through shares issues on the stock exchanges associated in the World Federation of Exchanges in 1999 – 2004.
Source: Annual reports of the World Federation of Exchanges, www.world-exchanges.org

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The most important source of equity capital are shares issues on the organized stock exchanges. Fig. 1 presents the amount of corporate capital raised through shares issues on the stock exchanges- members of the World Federation of Exchanges. The biggest amount of equity capital, almost 900 000 million USD, was raised in 2000. However, within next two years, the amount of raised equity decreased significantly to the level of 334 000 million USD in 2001 and 267 000 million USD in 2002. Since 2003 an upward trend in the amount of equity capital can be noticed – in 2004 over 520 000 million USD was raised by the stock exchanges.

The issue of new shares enables the company to obtain cash inflow which increases the initial capital. The decision to issue new shares may be connected with:

- financing investment projects
- financial restructuring of the company
- obtaining strategic investor
- improving creditworthiness of the company
- increasing the company's future ability to use debt capital.

As a result of the successful process of increasing equity capital the company gains additional funds to finance its investment projects and simultaneously improves its borrowing capacity.

New shares in Polish companies can be offered:

- to the existing shareholders by exercising preemptive rights (closed subscription)
- to the designated investors (private subscription)
- to all investors who are interested in purchasing shares of the issuer while the General Meeting of the company should waive the preemptive right for a period (open subscription).

Also in Poland the most popular way of raising equity capital is to issue shares on the public market. Fig. 2 presents nominal value of shares issued on the public market within eleven-year period – from 1994 till 2004. These issues are divided into two parts: Initial Public Offerings and follow on equity offerings (seasoned offerings). In 2004 the record number of IPOs occurred (44) and raised over 9 000 million Zlotys while seasoned offerings raised over 3 000 million Zlotys.

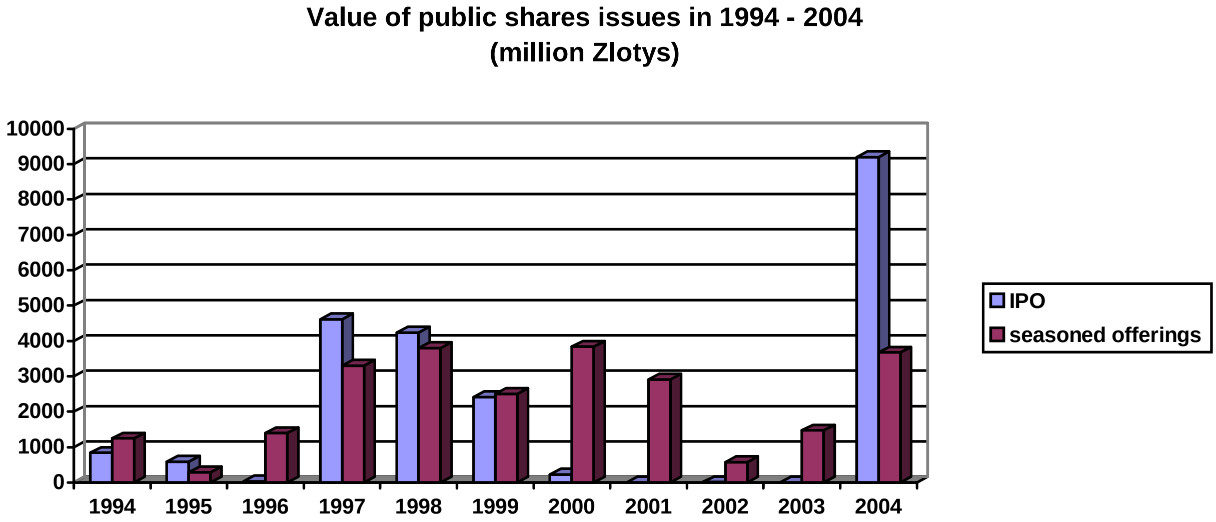

Fig. 2: Nominal value of shares issued on the public market in Poland in 1994-2004.
Source: Annual Report 2004 of the Polish Securities and Exchange Commission (Komisja Papierów Wartościowych i Giełd), www.kpwig.gov.pl

When the company decides to issue new shares, following aspects should be taken into consideration:

- volume and timing of the issue
- method of offering shares and its influence on the existing ownership structure of the company
- decision of choosing the sponsor (issuing house) and obtaining the underwriter
- pricing of new shares concerning the cost of issue (including sponsor's and underwriter's fee)
- fulfillment of organizational and legal requirements connected with the process of obtaining funds on the capital market
- guarantee investors the required level of return on investment.

All these aspects are very important and have crucial influence on the effectiveness of the issue.

2 Risk of ineffective shares issue

According to the Polish law regulations covered by The Code of Commercial Partnerships and Companies, the issue of new shares may be unsuccessful under certain circumstances. The General Meeting of the company has the obligation to state the amount of shares that must be purchased or subscribed to make the issue effective and then the registration of the amendment to company articles can be made.

The issue is regarded as successful, when this amount of shares by which the initial capital is to be increased, is subscribed by investors within the three-month period from the day on which the General Meeting adopted the resolution. However, when the company's investment plans require more funds than the capital obtained from investors who subscribed for the minimum amount of shares, the company may be under the necessity to look for additional capital sources or to reduce the investment expenditure. This situation may result in higher cost of capital and unfavorable changes in the capital structure – regarding these aspects the issue should be accepted as effective only when all shares offered to investors are subscribed.

Some authors define also "the market effectiveness of the shares issue" as the situation in which all shares offered to the public will be subscribed by investors without the participation of the underwriters.

The company may suffer number of negative consequences of ineffective issue such as:

- financial loss (caused by costs related with issue)
- damage to the company's reputation on the capital market and decrease in the market value of the company
- reduction in the investment plans
- higher cost of capital obtained from other sources.

3 Methods of risk reduction

The most important objective of the issuer is to guarantee the success of the issue. Many factors (inside the company and in its environment) have influence on the effectiveness of the shares offer. In order to reduce this risk of issue failure, Polish companies may use different methods such as:

- divesting preemptive rights
- spread issue
- private subscription
- hiring the sponsor of the issue (issuing house)
- underwriting arrangement

- issue of convertible bonds, bonds with priority warrants and subscription warrants, preceded shares issue.

3.1 Divesting preemptive rights

By divesting preemptive rights, new shares can be offered to wide range of investors, who are not connected with the company yet. This solution is the most popular method of risk reduction. It can be used as an individual instrument or as a part of more complex procedure.

All existing shareholders own the right to purchase additional shares in the company in priority to other investors. Shareholders can exercise their rights in proportion to their existing holding which gives them opportunity to retain their proportionate ownership in the firm. Rights issue enables the company to raise additional equity capital in a relatively cheap and quick way – while the ownership structure remains unchanged. Nevertheless, it can not be used for large amount of finance to be raised, because the potential funds of the existing shareholders can be limited. In addition – exercising rights can be unattractive to the existing shareholders, so they may decide to leave them to expire or to sell them to other investors who are interested in buying shares in the company.

Therefore divesting preemptive rights may be used as a method of risk reduction and it may increase chances for successful issue. However, the potential changes in the ownership structure and dilution of control must be taken into account.

Divesting rights enables the company to avoid time limits connected with their execution. The possibility of rights waiving may be embodied in the company's articles or it may be adopted by the General Meeting. Preemptive rights may be waived only in the interest of the entire company and the decision should be taken by a majority of four-fifth of votes. This procedure may be used in order to establish new ownership structure and new decision-making centers in the company.

The existing shareholders must be always divested of preemptive rights in part or in whole when the company decides to raise equity capital from new investors by Initial Public Offering (IPO).

3.2 Spread issue

The General Meeting in its resolution on shares issue must state the amount by which the Initial Capital is to be increased. This amount may be defined in different ways – there can be fixed amount of shares or the minimal and maximal number of shares may be stated with determined nominal value which will be offered to the investors. In this situation, the issue is regarded as successful when the minimum amount of capital is subscribed and duly paid. This method is a very flexible instrument of risk reduction.

The company may also settle only the maximum amount by which the Initial Capital is to be increased. In this case, the issue is effective even if only one share is subscribed by investors. However, in this situation the process of raising additional equity capital may become irrational regarding all costs of preparing issue of shares. In order to avoid such situation, the company should state the minimum amount of shares at which the issue provides funds that will meet company's capital needs. Flexible amount of shares (spread issue) enables also the company to lower the underwriting fee. By using this method of risk reduction, it is not necessary to divest the preemptive rights.

3.3 Private subscription

New shares in the company can be offered directly to the designated offeree accepted by the General Meeting or by the Management Board. This offeree is usually a strategic investor, but there may be also an existing shareholder of the company. However, in this situation he will be treated as an investor without any connection with the issuer.

Such an individual purchase agreement enables the company not only to reduce the risk of ineffective increase of equity capital and obtain additional funds but also gives the access to the assets, knowledge and skills of the strategic investor. Private subscription often results in changes in control and limited freedom of action of the company – it usually weakens the voting power of existing shareholders, so their opinion should be taken into consideration during negotiation between the Management Board and the potential investor. Private subscription can be used only if the General Meeting decides to divest the existing shareholders of their preemptive rights. The most important advantages of this method of risk reduction are:

- lower costs of obtaining capital than costs related to open subscription of shares
- stable legal status of the issuer
- lack of exposure to the insolvency risk (investor can not demand repayment of the capital given to the company).

However, there may be some problems with preservation of the issuer's position in case of investor's withdrawal and remaining the control power of existing shareholders.

3.4 Shares issue with help of the issuing house/ sponsor

The company may offer shares to investors by itself (direct placement) but it is better to hire the professional financial institution which handles all the matters connected with issue (indirect placement). The sponsor helps the issuer to decide the technalities – the optimal amount of shares to be issued that may be subscribed by investors and the optimal issuing price at which the issue shall be deemed effective. The process of issuing shares requires also thorough analysis of the existing and future financial standing of the company. It is also very important to build the proper investor base (book building) that would guarantee both the success of the issue and the ownership structure accepted by the existing shareholders.

Therefore, in order to reduce the risk of issue failure, the company should define the conditions of issue that can be accepted by the majority of potential investors. The investment bank (sponsor) gives the issuer access to its highly professional advisors and its technical and organizational base. In return, the bank receives fee, which decreases the total amount of capital collected by issuer from investors.

3.5 Underwriting arrangement

It is a very popular solution which can reduce or even eliminate the risk of unsuccessful issue of shares. In Polish legal regulations two types of underwriting arrangements are defined, while in other countries more different types of underwriting arrangements are used.

Distribution underwriting - is referred to as a firm commitment when the underwriter agrees to buy on his own account all of securities or part of the issue at a set price and then offers shares to the public on the primary market. The underwriter discount (gross spread) is the difference between the price paid to the issuer and the price at which the investment bank reoffers the security to the public. This kind of arrangement is defined as a unconditional sale agreement and can be signed only by: issuing house, investment bank, foreign financial institution seated in OECD countries or consortium of these institutions. For the issuer it is a very safe way of raising equity capital – the company receives all funds at the beginning of the issue procedure, while the underwriter bears the risk of unsuccessful issue and potential costs of issue failure.

In the investment underwriting the underwriter agrees to buy on his own account all of securities or part of the issue, that have not been subscribed for. This kind of arrangement is defined as a conditional sale agreement and is singed by the issuer not only to reduce the risk of inefficient issue but also to establish a proper ownership structure of the company. The underwriter fee consists of two parts: charge for accepting the potential risk (as a fixed percentage of value of the entire issue) and discount on the price of shares actually purchased. This type of underwriting arrangement can be made by: issuing house, trust or investment fund, investment bank or foreign financial institution seated in OECD countries or consortium of these institutions. When investors fail to subscribe the entire issue, the underwriter itself decides about further actions.

The underwriting arrangment is signed by the Management Board at least 2 days before the beginning of the subscription of shares and the investors must be immediately informed about the agreement. The underwriter can put together a group of firms to underwrite the issue and share the risk – this group is called the underwriting syndicate.

The underwriting arrangement is the most efficient way to reduce the risk of issue failure (by transferring it to the underwriter), but it is also a very expensive one – the underwriter fee can even reach 20% of the value of the issue.

Tab. 1 ranks the 5 top underwriters on US and Polish markets based on total IPO proceeds and new shares issue for which they were the lead or co-lead managing underwriters in 2002 and 2000.

Underwriter rankings based on 2002 US IPOs	Underwriter rankings based on 2000 new shares issue on Polish market
Citigroup	COK Bank Handlowy
Goldman Sachs	CAIB Securities
Merrill Lynch	CDM Pekao
Credit Suisse First Boston	BM PBK
Lehman Brothers	BRE Brokers

Tab. 1: Underwriter rankings on US and Polish markets.
Source: DRAHO J.: The IPO Decision. Why and How Companies Go Public. Edward Elgar Publishing Limited, Cheltenham, Northhampton 2004 and WALKIEWICZ R.: Underwriting. Gwarantowanie emisji akcji. Difin, Warszawa 2001

Both international and Polish underwriting market for shares issue are dominated by traditional investment banks, independent or bought by commercial banks. Every year more and more banks are interested in underwriting becasue it is a highly lucrative business.

3.6 Issue of other corporate securities

The issue of new shares can be preceded by issuing other types of company's securities such as: convertible bonds, bonds with the priority warrants or subscription warrants. Such actions increase the potential investor base and reduce the risk of ineffective issue of common stock of the company.

The holders of the convertible bonds have the right to convert the bonds into the shares of the issuer in a specified period in the future at the fixed price. The investor decides to convert bonds into shares only if it is profitable for him and the opportunity to become the issuer's shareholder is attractive. In this situation the initial capital increases as a result of conversion of debt into equity capital without any cash inflows to the company – the total amount of company's funds will not rise, there will be only changes in the capital structure. The issue of convertible bonds enables the company to improve its liquidity, increase the net value of assets, reduce the cost of debt capital and summarize procedure of obtaining capital. And in case of conversion the company's debt becomes self-liquidated. The most important disadvantage of convertible bonds is the potential dilution of control, unfavorable changes in the ownership structure of the company and unprofitable relation of conversion price to the market price of the shares. In order to reduce these disadvantages the company may introduce call provision to the construction of convertibles and thus force the bondholder to exchange securities.

The holder of corporate bonds with priority warrants attached to them has the right to take up new shares in the company at the set price before other investors. If the market price of share rises above the strike price fixed in the warrant, the bondholder will exercise the right to buy new securities. New shares purchased through exercising priority rights have to be fully-paid by the investors – so the issuer receives additional inflows of funds. The issuer's position is similar to the situation with convertible bonds – the main threat is connected with potential changes in the ownership structure and control power.

Issuance of bonds – convertibles or with attached warrants – does not eliminate the risk of unsuccessful issue of shares because the bondholder can decide either to exercise the right to convert debt into shares/ purchase shares or to receive money (capital repayment and interest) from the issuer. The decision to receive the repayment of debt or to exercise the right depends on many factors such as: market price of new shares, investors preferences and their ability to finance new investment. The procedure of raising additional capital by issuing corporate bonds is rather complicated and expensive. The articles of the company should state the possibility of issuance of corporate bonds granting special rights to the bondholder. The procedure of waiving the preemptive rights is also required in this situation.

Subscription warrants give the holder the right to subscribe for a particular amount of new shares at a fixed price. The warrant agreement should state following issues: the maturity date of warrant, the strike price which is equal to the subscription price of new shares, number of shares that can be subscribed for each warrant. Warrants can be sold as separate financial instruments by the issuer as a method of raising equity capital (target capital or conditional initial capital increase). The issue of warrants, similar to the bonds, increases the company's liquidity and reduces the risk of inefficient shares issue. The company receives additional capital and at the same time it has no obligation to make any payments to the holders of warrants – on the contrary to the bondholders (repayment of capital and interest) or shareholders (payment of dividend). Warrants can be attached to other securities such as common stock, in order to enhance the investors to purchase them – in this case warrants are called "equity kicker" or "equity sweetener". Warrants can be also used as an additional payment for the managers and employees who become joint owners of the company which results in reduction of the agency costs and in obtaining proper ownership structure.

It seems that in the above presented group of methods, the most efficient way to reduce or even eliminate the risk of issue failure is the underwriting arrangement with financial institution, which transfers risk from issuer to the underwriter. It is also the most popular solution used on the global financial markets, more and more Polish companies also use this method to protect against the risk of ineffective issue.

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Summary

Risk of ineffective shares issue and methods of its reduction – Polish experience

The issue of shares is the most important source of corporate capital. However, the procedure of issue is rather complicated and expensive and unfortunately it may prove to be ineffective. The issuer should consider potential threats and take actions in order to protect against the risk of unsuccessful issue of shares. There are different methods of risk reduction, such as: waiving of preemptive rights, spread issue, underwriting arrangement, sponsor agreement, private subscription or preceded issuance of other securities: convertible bonds, bonds with priority warrants and subscription warrants. All these methods can be characterized with different advantages and disadvantages (especially considering the level of costs). Underwriting arrangement is the most popular method which enables the issuer to transfer risk to the underwriter.