The rights and wrongs of a rights issue. The case of the African Bank Limited rights issue

Brian Kantor

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African Bank Limited (ABL) announced an intention to proceed with a rights issue on the 5th August 2013 of up to R4b. The terms of this rights issue were decided in early November . The company now plans to raise R5.482b from its shareholders by issuing 685.28 shares at R8.00 in the ratio of 21 shares for every 25 shares held.

We will offer a method to measure the success of this rights issue for current ABL shareholders who may follow their rights or alternatively dispose of their shares that will carry these rights to their new owners.

Some detail

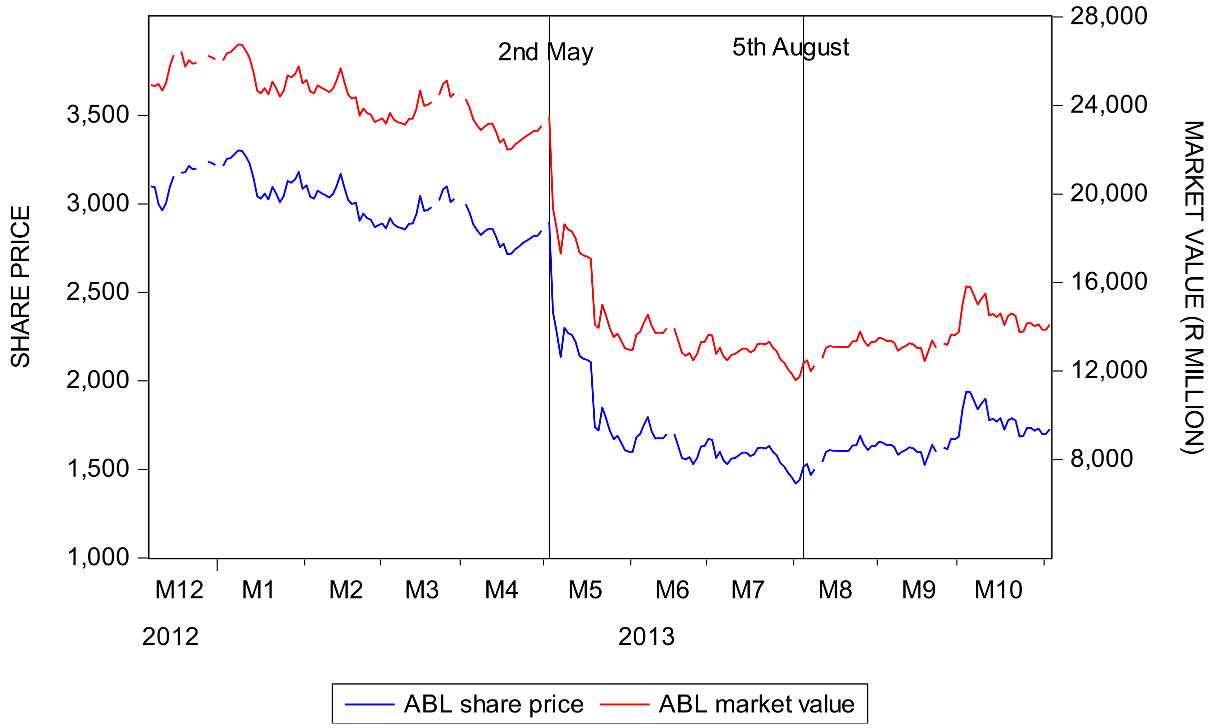
Shareholders or potential shareholders have until close of business on the JSE on Friday 8th November to qualify for these rights as registered shareholders. The rights will trade between the 11th November and the 29th November 2013. The last day to follow these rights, that is to pay R8 for the additional shares to be allotted is the 6th December

The rights issue is fully underwritten and so it is certain the capital will be raised and the extra number of shares issued as intended. That is whatever happens to the share price of ABL between now and the 6th December when all the shares can trade.

Some uncomfortable recent ABL history

The recent history of the ABL share price and its market value (share price multiplied by the number of shares in issue) is shown below. As may be seen the bad news that took the market by surprise happened on May 2nd 2013. It took the form of a trading statement that indicated that earnings per share were expected to decline by between 25 and 29 per cent. The share price then immediately declined by 19.3% on the news. By the end of May the share price had declined still further to R16 reducing the market value of ABL by more than half of its pre-trading statement value, that is by nearly R13b over the month,from on May 2nd to a market value of R12.963b on May 31st. Thereafter the share price varied from the R16 of May 31st 2013 to a high of R19 on the 10th October. Clearly the company had grossly underestimated its bad debts making a call on its shareholders to recapitalise the Bank inevitable given the decline in its market value.

The ABL share price and its market value December 2012-November 2013. Daily Data



Why the price at which a rights issue is pitched hardly matters at all - what matters is the amount of capital to be raised and what is to be done with the extra capital

If the rights to subscribe new equity capital are taken up by established shareholders in the same proportion they currently hold shares, their share of the company is unaltered. They will be entitled to exactly the same share of dividends or the company if liquidated as before. In the case of a rights issue established shareholders may however elect to sell all or part of their rights to subscribe to additional shares should these rights prove valuable, in which case they are giving up a share of the company but are fully compensated for doing so.

The key question for shareholders in the first instance and subsequently the market place that will prove the decision to go ahead with a rights issue should shareholders approve, is the following:

How well will the extra capital raised be employed by the managers of the company raising additional capital? Will the capital raised from old or new shareholders earn a return in excess of its opportunity costs? That is to be more precise, will it earn a return in excess of the returns shareholders or potential shareholders might expect from the same amount of capital they could invest in businesses with a similar risk character?

Doing the numbers for the ABL rights issue

In the case of the ABL rights issue approved by its shareholders, the essential judgment to be made by the market place is whether or not the Bank after the 6th December 2013 will be worth more than the extra R5.482b rand shareholders will have subscribed in additional share capital. ABL had a market value of R12.33b on August 5th when the rights issue was first announced. It would need to enjoy a market value of more than R17.88b on December 6th (R12.34b + R5.482b) = R17.88b

Given that 15.01m share will have been issued by then, (the sum of the 685.28m new shares plus the 815.811m shares previously issued) the break even share price for the established shareholders would have to be approximately R11.88. A share price of more than this would confirm the success of the rights issue when the process has been finally concluded. (We provide a formula below with which to calculate this break even share price, after a rights issue) Some simple algebra may help make the point. Readers without a mathematical bent may choose to skip this footnote and proceed. [1]

[1] The break even condition is that the market value of the company after the conclusion of the capital raising exercise (defined as *MC2*) will be

It is possible to infer the value of the rights implicit in the current R17.29 share price. R17.29 multipled by the 815m shares in issue gives a value of R14.09b. If we add the additional capital of R5.5b to this we get an implicit post rights issue value for the company of R19.59b. Dividing the R19.59 by the 1501m shares gives an implicit post rights issue share price of 13.05 cents. This is R1.17 ahead of the break even of 11.88. Hence the ABL capital raising exercise value has been value adding for shareholders.

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greater or at least equal to the market value of the company pre the rights issue, defined as *MC1* plus the additional capital raised defined as *k*. That is *MC2>MC1+k* if the capital raising exercise is to be judged a success.

This equation may also be used to establish a share price that would represent a break even for shareholders after the conclusion of the rights issue. That is, the share price after the event that would satisfy the value add (or rather the no value loss) condition. *MC2,* the value of the company after the rights issue is concluded, may be derived conventionally by multiplying the share price (post rights issue) by the number of shares in issue (*S2*), that is the market value of the company after the capital raising exercise *MC2 = P2 * S2* and *MC1*, the value of the company before the announcement, calculated in the same way as *P1*S1* where *S1* was the number of shares in issue before the rights issue. *P2* is the breakeven price after the announcement. Substituting *P1*S1* for *MC1* and *P2*S2* for *MC2* and solving this equation for *P2*, the break even post rights issue price, gives the following formula for the break even share price after a rights issue as: *P2 = (S1*P1+k)/S2*. In the case of the ABL rights issue the break even share price – solving for P2 gives a value of approximately R11.8. the market value was R12.33b on August 5^{th}. 815m shares were then in issue valued at R15.13 per share giving ABL its market value then of R12.33. Adding new capital of R5.4822b to 12.33 gives a break even value of R17.824b or 11.88 per share of which approximately 15m shares will be in issue (17824/15=11.88)

Another way of measuring the value add is to compare the post rights value of ABL at 13.05 cents per share of which there will be 1.501m in issue of R19.58b with the pre-rights issue value of 12.33b to which the 5.5b capital injection must be added. This amounts to 17.83b and so the value add is 19.59-17.83 =R1.76b.

The dilution factor - best to be ignored

The common notion that issuing additional shares will "dilute" the stake of established shareholders, because more shares in issue reduces earnings per share, assumes implicitly that the additional capital raised will not be used productively enough to cover the costs of the capital raised or earn more than the required risk adjusted return. But this is not necessarily so. Additional capital can be productively employed and can add, rather than reduce, value for shareholders. That is be worth more than the value of the extra capital they have invested in a company plus a carry cost.

In the case where balance sheets have been impaired the ability to raise additional capital from shareholders in a rights issue adds value to the company by reducing its default risk. This would appear to be the main factor adding value to ABL. It is up to established shareholders in the first instance to approve any rights issue- on the presumption that it will add value to the stake they have in the company. If they approve and are willing to invest more it will be over to the market place to decide whether or not the issue. That is to determine whether the gain in market value exceeds or falls short of the value of the additional capital subscribed.

In the case of a secondary issue of additional shares (rather than a rights issue) the answer is easily found by observing the share price after the capital raising. A gain in the share price would be evidence of a value adding capital raising exercise for both established shareholders who did not subscribe additional capital and also for all those who did.

However to be a truly value adding exercise, these share price gains made after a secondary issue would have to be compared to market or sector wide gains or losses. If the share price gains were above market average, the success of the capital raising exercise would be unambiguous.

Estimating the impact of a rights issue is complicated- a lower share price may be compensated for by more shares owned.

Estimating the value add in the case of a rights issue is more complicated. This is because the rights are typically priced at a large discount to the prevailing share price before the announcement. The share price after a rights issue is likely to go down but this will be compensated for by the fact that the shareholders, subject to a lower share price, will have received more shares at a discounted price, in exchange for additional capital subscribed.

The reason for pricing the rights at a discount to the prevailing share price is to attract attention to the offer and by so doing to make sure that the rights to subscribe additional capital will have market value and so will be followed and the additional capital secured.

Making the comparison with a sole owner of a business investing more capital in it.

For any sole owner of a business enterprise injecting more capital into his or her business the nominal price attached to the shares in issue would very clearly be irrelevant. He or she still owns all the shares, whether there be only one or one thousand shares in issue. The lower the nominal price attached, for book keeping purposes, to the extra shares issued in exchange for the capital infusion, the larger the number of additional shares will appear on the books, for the same amount of capital invested.

When a sole owner decides to add capital to the private unlisted business the test over time will be whether or not the business comes to be worth more than the extra capital invested- to which an opportunity cost should be added. That is what the same capital might have realised in an equivalently risky alternative investment.

The same is true of a rights issue in a listed company except, that if the shares are actively traded, the judgment of the market place on the wisdom in raising additional capital is immediate and continuous. Shares in a rights issue are being issued to shareholders in the same proportion to which they own them. As with a 100 per cent owner they would be issuing shares to themselves and their share of the company, after the rights issue, will remain the same- should they follow their rights.

The rights issue price therefore is largely irrelevant to the established shareholders. What matters is the amount of capital the shareholders are called upon to subscribe to and what this capital they have subscribed will come to be worth, when the rights issue and the capital raising exercise is concluded.

Why a large discount to the prevailing share price can be helpful to the success of the rights issue

This capital intended to be raised can be divided into a larger or smaller number of shares by adjusting the price at which the rights are offered without any important consequence for current shareholders – other than those who are financially constrained and therefore unwilling to come up with additional capital. They therefore would prefer not to take up their rights and to sell part or all of their rights to subscribe additional capital presuming these rights had a positive value.

The same would be true for any underwriter that presumably would prefer not to have to take up their rights. For the underwriter the larger the discount the better- the larger the discount the less likely they will be called upon. One wonders if the underwriting commission properly reflects this trade off- as it should. For the underwriter, as for any shareholders so less willing to follow rights, the larger the discount and so the more additional shares issued the better. A large discount to the prevailing share price will ensure an active market for the rights they wish to give up.

Conclusion

It is so far so good for shareholders in African Bank Limited following their rights issue. By agreeing to support the rights issue they have added value to the shares they owned in ABL. The market, as well have the shareholders have so far voted in favour of the rights issue. Had the shareholders decided not to support the rights issue and proved unwilling to risk additional capital the future of the bank might well have been regarded as much less certain and the share price damaged even more than it was. The market would have regarded any failure to support a rights issue as very negative indeed for the future of the Bank. The decision by shareholders to re-capitalise the bank was their vote of confidence in the management to realise good returns on capital in the future- even though they may have blotted their copy book. As they say forgiveness can be divine and also value adding.